Financial Institutions and Services

DMGT512

Edited by:
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LOVELY PROFESSIONAL UNIVERSITY

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SYLLABUS

Financial Institutions and Services

Objectives: Management of Financial Institutions and Services course is intended not only for those interested in careers in Financial Service Firms, but also for those who wish to extend their institutional, industry specific knowledge. The teaching objective is to provide students with conceptual and pragmatic frameworks of issues confronting Managers of Financial Institutions. This course will emphasize management issues such as risk management and regulatory compliance, but will also touch upon some public policy concerns.

S. No.	Description
1.	***Financial system:*** Introduction, functions of financial system and its components
2.	***Financial markets:*** Introduction, Types-Capital market: Primary and secondary (introduction), money market: introduction, types of money market instruments-money at call, treasury bill, certificates of deposits, commercial papers.
3.	***Financial institutions:*** Definition, types, role in economic development, Commercial banks: emergence of private sector bank after liberalization, financial innovation in commercial banks
4.	***Financial Regulation:*** Reserve bank of India, its role and functions, SEBI-introductions and guidelines, Types of exchanges – National, Regional & Local
5.	***NABARD:*** Role and functions
6.	***NBFCs:*** Concept, guidelines, growth and prospects, IFCI, SFCs, IRBI, SIDC ,SIDBI– Introduction and operational policies
7.	***Mutual Funds:*** Introduction of UTI, types of mutual funds, significance, growth & performance of MFs in India, Basic operation of Private and public sector insurance (life and general)
8.	***Leasing:*** Meaning, types, financial, legal and tax aspects, Hire purchasing: Concept, legal framework and taxation, Factoring and forfaiting-meaning and mechanics, Bills rediscounting.
9.	***Management of Non Performing Assets by Banks:*** Introduction, Tools available to manage NPAs
10.	***Credit Rating:*** Introduction, Growth of credit rating agencies in India, Credit Rating Agencies in India

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Unit 1: Financial System

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Objectives

After studying this unit, you will be able to:

- Explain the functions of financial system
- Describe the components of financial system

Introduction

The questions and challenges that the world faces in the current times are fundamentally different from those that it has wrestled with for decades after decades. Liberalization and globalization have breathed new life into the foreign exchange markets while simultaneously besetting them with new challenges. Commodity trading, particularly trade in commodity futures, have practically started from scratch to attain scale and attention. The banking industry has moved from an era of rigid controls and government interference to a more market-governed system. New private banks have made their presence felt in a very strong way and several foreign banks have ventured into territories other than their own. Financial market provides channels for allocation of savings of assets to savers as well as various forms in which the investors can raise funds.

1.1 Functions of Financial System

The functions of a good financial system are manifold. They are as follows:

1. ***Regulation of currency:*** As a part of the financial system, central banks generally control the supply of a currency and interest rates, while currency traders control exchange rates.
2. ***Banking functions***
   (a) to assemble capital and make it effective;
   (b) to receive deposits and make collections;
   (c) to check out and transfer funds;

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(d) to discount or lend;

(e) to exercise fiduciary or trust powers;

(f) to issue circulating notes.

3. ***Performance of agency services and custody of cash reserves:*** Different constituents of the financial system act as the agents for their clients. They buy and sell shares and bonds, receive and pay utility bills, premiums, dividends, rents and interest for their clients.

4. ***Management of national reserves of international currency:*** Various parts of financial system help the economy in particular and polity in general to manage international reserve.

5. ***Credit control:*** Financial system controls credit by serving the dual purpose of:

   (a) increasing sales revenue by extending credit to customers who are deemed a good credit risk, and

   (b) minimizing risk of loss from bad debts by restricting or denying credit to customers who are not a good credit risk.

6. ***Ensure stability of the economy:*** Financial system performs the function of administering national, fiscal, and monetary policy to ensure the stability of the economy.

7. ***Supply and deployment of funds for productive use:*** Financial markets permit the transfer of funds (purchasing power) from one agent to another for either investment or consumption purposes.

8. ***Maintaining liquidity:*** Financial markets provide the holders of financial assets with a chance to resell or liquidate these assets.

9. ***Price determination:*** Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets.

10. ***Information aggregation and coordination:*** Financial markets act as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.

11. ***Risk sharing:*** Financial markets allow a transfer of risk from those who undertake investments to those who provide funds for those investments.

12. ***Improve efficiency:*** Financial markets reduce transaction costs and information costs.

13. ***Ensure long term growth to itself:*** Long-term growth of financial markets is ensured through:

    (a) Giving autonomy to Financial Institutions to become efficient under competition

    (b) Education of investors

    (c) Consolidation through mergers

    (d) Facilitating entry of new institutions to add depth the market

    (e) Minimizing regulatory measures and market segmentation.

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Caselet

Outlook for Indian Financial Markets: Stocks up, Rates Down?

Indian markets, with their increasing levels of integration with the international markets, have not been an exception to the corrections taking place in global markets now. But, as a consequence of the fact that our level of integration with the global markets is still only "increasing" and there is yet some policy restriction with respect to seamless flow of capital between the local and international markets, there have been differing reactions in various segments of the financial markets in India.

Equities have fallen quite sharply as the international exposure of the domestic stock markets is relatively much higher than that of the other key financial market segment, namely, debt.

The debt markets, dominated by government debt and with very limited international participation, have been influenced only by prevailing liquidity conditions (and perceptions about the same) in the domestic banking system.

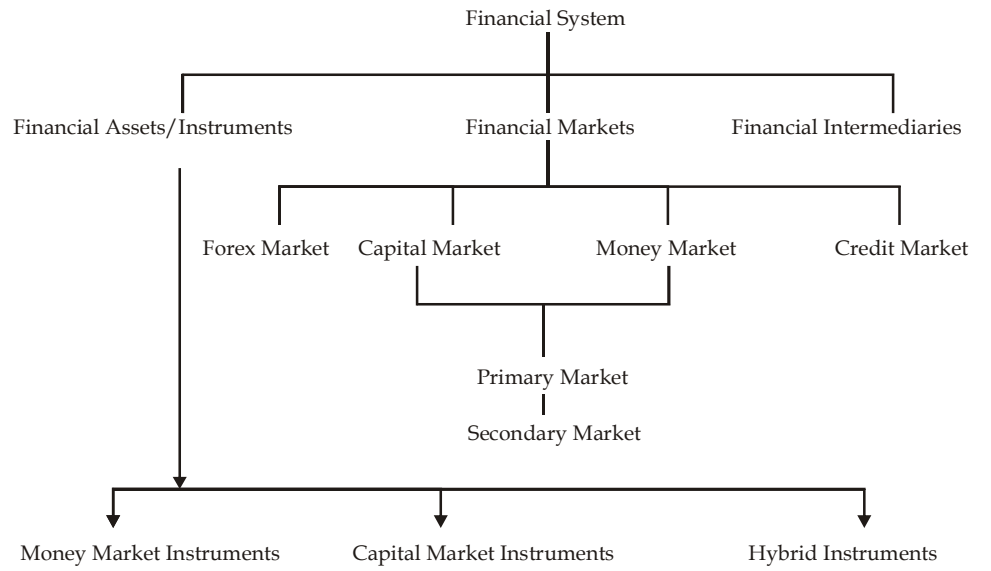
Sovereign bond yields have moved up in the past couple of weeks, particularly in the last couple of days, as the Reserve Bank of India put in place some measures for broadly stabilising/restricting the liquidity level in the financial system.

Therefore, while equity markets have moved in sympathy with stocks globally, the Indian bond market has seen yields rising while globally sovereign bond yields have fallen substantially.

Source: www.thehindubusinessline.com

1.2 Components of Financial System

Figure 1.1: Components of a Financial System



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The financial system consists of the Central Bank, as the apex financial institution, other regulatory authorities, financial institutions, markets, instruments, a payment and settlement system, a legal framework and regulations. The financial system carries out the vital financial intermediation function of borrowing from surplus units and lending to deficit units. The legal framework and regulators are needed to monitor and regulate the financial system. The payment and settlement system is the mechanism through which transactions in the financial system are cleared and settled.

1. Regulatory Authorities
2. Financial Institutions
3. Financial Markets
4. Financial Instruments
5. Payment and Settlement Infrastructure.

Let us get introduced to them one by one.

Regulatory Authorities

The main component of any financial system is the regulatory system it has. In any economy, the financial system is regulated by the central banking authority of that country. In India, the central banking bank is named as the Reserve Bank of India.

Reserve Bank of India (RBI)

The regulation and supervision of banking institutions is mainly governed by the Companies Act, 1956, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, Bankers' Books Evidence Act, Banking Secrecy Act and Negotiable Instruments Act, 1881.

The regulation and supervision of finance companies is done by the Banking Regulation Act, 1949 which governs the financial sector.

Individual Institutions are regulated by Acts like:

1. State Bank of India Act, 1954
2. The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
3. The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
4. National Bank for Agriculture and Rural Development Act
5. National Housing Bank Act
6. Deposit Insurance and Credit Guarantee Corporation Act.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India was made a statutory body on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

Insurance Regulatory and Development Authority (IRDA)

Insurance Regulatory and Development Authority regulates and supervises the insurance industry-insurance companies and their agents and insurance brokers to protect the interests of

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the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.

Financial Institutions

The financial system consists of many financial institutions. While most of them are regulated by the Reserve Bank, there are some which it manages just indirectly.

Institutions regulated by the Reserve Bank of India

The institutions regulated by the RBI are:

1. Nationalised Commercial Banks
2. Specialised Banks
3. Registered Finance Companies
4. Registered Finance Leasing Establishments
5. Micro-finance Institutions.

Institutions not regulated by the Reserve Bank of India

Certain financial institutions are not regulated by the Reserve Bank of India. These include securities firms, investment banks and mutual funds which come under the purview of the SEBI, Insurance Companies and Insurance Brokers which are regulated by the IRDA, etc.

Financial Markets

The Financial Market, which is the market for credit and capital, can be divided into the Money Market and the Capital Market. The Money Market is the market for short-term interest-bearing assets.

Examples:

1. Treasury bills
2. Commercial paper
3. Certificates of deposits

The major task of the Money Market is to facilitate the liquidity management in the economy.

The Capital Market is the market for trading in medium-long-term assets.

Examples:

1. Treasury bonds
2. Private debt securities (bonds and debentures)
3. Equities (shares)

The main purpose of the Capital Market is to facilitate the raising of long-term funds.

Did u know? The main issuers in the

1. ***Money Market*** are the Government, banks and private companies, while the main investors are banks, insurance companies and pension and provident funds.
2. ***Capital Market*** are the Government, banks and private companies, while the main investors are pension and provident funds and insurance companies.

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The Financial Market can also be classified according to instruments, such as the debt market and the equity market. The debt market is also known as the Fixed Income Securities Market and its segments are the Government Securities Market (Treasury bills and bonds) and the Private Debt Securities Market (commercial paper, private bonds and debentures). Another distinction can also be drawn between primary and secondary markets. The Primary Market is the market for new issues of shares and debt securities, while the Secondary Market is the market in which existing securities are traded.

The Reserve Bank of India through its conduct of monetary policy influences the different segments of the Financial Market in varying degrees. The Reserve Bank's policy interest rates have the greatest impact on a segment of the Money Market called the inter-bank call money market and a segment of the Fixed Income Securities Market, i.e. the Government Securities Market.

Financial Instruments

The main financial instruments can be categorized as under:

Deposits

Deposits are sums of money placed with a financial institution, for credit to a customer's account. There are three types of deposits — demand deposits, savings deposits and fixed or time deposits.

Demand deposits are mainly used for transaction purposes and for the safekeeping of funds. Funds can be withdrawn on demand. Demand deposits do not earn interest, but banks provide a number of services to demand deposit- holders like cheque facilities, standing orders, Automated Teller Machine (ATM) cards and debit cards to facilitate withdrawals and payments.

Savings deposits earn interest, which may be calculated on a daily, weekly, monthly or annual basis. Funds may be withdrawn from savings accounts at any time. However, if the number of withdrawals exceeds four in any month, interest will not be paid for that particular month. Financial institutions issue passbooks or statements detailing transactions to savings deposit holders and also provide services such as ATM and debit cards.

Fixed or time deposits are funds placed at financial institutions for a specified period or term. Fixed/time deposits earn a higher rate of interest than savings deposits. Fixed/time deposits can be for short, medium or long term. Funds can only be withdrawn before the maturity date with prior notice and a penalty may be imposed. A fixed/time deposit holder has a facility to borrow funds from the financial institution using the deposit as collateral.

Loans

A loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in installments or all at once, on agreed dates and at an agreed rate of interest. In most cases, financial institutions require some form of security for loans.

Treasury Bills and Bonds

Treasury bills are government securities that have a maturity period of up to one year. Treasury bills are issued by the central monetary authority (the RBI), on behalf of the Government of India. Treasury bills are issued in maturities of 91 days, 182 days and 364 days. Treasury bills are zero coupon securities and are sold at a discount to face value, which is paid at maturity. The difference between the purchase price and the face value is the interest income to the owner.

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Treasury bills are considered liquid assets as they can be easily sold in the secondary market and converted to cash. Treasury bonds are medium and long-term government securities and are issued in maturities ranging from 2 years to 20 years. Treasury bills and bonds are guaranteed by the Government and are the safest of all investments, as they are default risk free. Treasury bills and bonds are tradable securities which are sold by auction to Primary Dealers, who in turn market the securities to the public.

Notes The yields on Treasury bills and bonds are market determined and the market is both active and liquid.

Repurchase Agreements

Repurchase agreements (Repo) are arrangements involving transaction between two parties that agree to sell and repurchase the same security. Under repurchase agreement, the seller sells the specified securities to the buyer with an agreement to repurchase the same at a mutually decided future date and price. Such kind of transaction between parties approved by RBI and in securities (Treasury Bills, Central/State Govt. securities) as approved by RBI.

Task Find out the differences between the sale price and the repurchase price from the financial system of India.

Commercial Paper

Commercial Papers (CPs) are short-term, non-collateralised (unsecured) debt securities issued by private sector companies to raise funds for their own use, by banks and other financial intermediaries. CPs are generally issued by creditworthy (high-rated) institutions in large denominations and have additional bank guarantees of payment. CPs are usually sold at a discount, although some are interest bearing.

Corporate Bonds and Debentures

Corporate bonds are medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity. Corporate bonds that are not backed by a specific asset are called debentures.

Debentures are medium or long term, interest-bearing bonds issued by private sector companies, banks and other financial institutions that are backed only by the general credit of the issuer. Debentures are usually issued by large, well-established institutions. The holders of debentures are considered creditors and are entitled to payment before shareholders in the event of the liquidation of the issuing company.

1. ***Convertible Debentures*** are debentures issued with an option to debenture holders to convert them into shares after a fixed period. A convertible debenture is a type of debenture or commercial loan that gives the choice to the lender to take stock or shares in the company, as an alternative to taking the repayment of a loan. It is any form of debenture which can be converted into some other kind of security like shares or Common Stocks.

   Convertible debentures are either partially or fully convertible. In case of partially convertible debentures, part of the instrument is redeemed and part of it is converted into

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shares and in case of fully convertible debentures, the full value of the debenture is converted into equity. Convertible debentures are generally issued to prevent sudden outflow of the capital at the time of maturity of the instrument, which may cause liquidity problems. The conversion ratio, which is the number of equity shares exchanged per unit of the convertible debenture is clearly stated when the instrument is issued. Usually, Convertible Debentures offer more safety to the investor compared to Common Shares or Preference Shares. They are suitable for investors who look for potential increases in asset value (appreciation) compared to that yielded by Bonds, and more earnings than Common Stocks provide.

2. ***Non-convertible Debentures*** are debentures issued without conversion option. The total amount of the debenture will be redeemed by the issuing company at the end of the specific period.

Asset-backed Securities (Secured Debentures)

Asset-backed Securities (ABS) are bonds collateralised (secured) by mortgages, loans, or other receivables. Typically, the issuing institution sells mortgages, loans, instalment credit, credit card or other receivables to a trust or a Special Purpose Vehicle (SPV) that in turn sells ABSs to the public. ABSs are interest- bearing instruments and are often enhanced through the use of guarantees or insurance.

Warrants

Warrants can be described as a derivative security that gives the holder the right to purchase securities (usually equity) from the issuer at a specific price within a certain time frame.

Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. They can be used to enhance the yield of the bond, and make them more attractive to potential buyers. Warrants can also be used in private equity deals.

Warrants are often confused with call options. But the main difference between the two is that warrants are issued and guaranteed by the company, whereas options are exchange instruments and are not issued by the company. Also, the lifetime of a warrant is often measured in years, while the lifetime of a typical option is measured in months.

Shares

Shares are securities representing a portion of the ownership of a company that are a claim on the company's earnings and assets. Shareholders are paid dividends which are a percentage of the profits of the company.

Shares in the company may be similar i.e. they may carry the same rights and liabilities and confer on their holders the same rights, liabilities and duties. There are two types of shares under Indian Company Law:

1. ***Equity shares:*** Equity shares are shares which do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. The equity shareholder gets dividend only after the payment of dividends to the preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case of winding up of a company, the equity share capital is refunded only after refunding the preference share capital. Equity shareholders have the right to take part in the management of the company. However, equity shares also carry more risk.

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2. ***Preference shares:*** Preference shares are the shares which carry preferential rights over the equity shares. These rights are:

   1. receiving dividends at a fixed rate,
   2. getting back the capital in case the company is wound-up.

   Investment in these shares are safe, and a preference shareholder also gets dividend regularly. Preference Shares may be of following types:

   (a) *Cumulative or non-cumulative:* A non-cumulative or simple preference share gives right to fixed percentage dividend of profit of each year. In case no dividend thereon is declared in any year because of absence of profit, the holders of preference shares get nothing nor can they claim unpaid dividend in the subsequent year or years in respect of that year. Cumulative preference shares however give the right to the preference shareholders to demand the unpaid dividend in any year during the subsequent year or years when the profits are available for distribution. In this case dividends which are not paid in any year are accumulated and are paid out when the profits are available.

   (b) *Redeemable and non-redeemable:* Redeemable Preference shares are preference shares which have to be repaid by the company after the term for which the preference shares have been issued. Irredeemable Preference shares are those preference shares that need not be repaid by the company except on winding up of the organisation. However, under the Indian Companies Act, a company cannot issue irredeemable preference shares. In fact, a company limited by shares cannot issue preference shares which are redeemable after more than 10 years from the date of issue. In other words the maximum tenure of preference shares is 10 years. If a company is unable to redeem any preference shares within the specified period, it may, with consent of the Company Law Board, issue further redeemable preference shares equal to redeem the old preference shares including dividend thereon. A company can issue the preference shares which from the very beginning are redeemable on a fixed date or after certain period of time not exceeding 10 years provided it comprises of following conditions:

      i. It must be authorised by the articles of association to make such an issue.

      ii. The shares will be only redeemable if they are fully paid up.

      iii. The shares may be redeemed out of profits of the company which otherwise would be available for dividends or out of proceeds of new issue of shares made for the purpose of redeem shares.

      iv. If there is premium payable on redemption it must have provided out of profits or out of shares premium account before the shares are redeemed.

      v. When shares are redeemed out of profits a sum equal to nominal amount of shares redeemed is to be transferred out of profits to the capital redemption reserve account. This amount should then be utilised for the purpose of redemption of redeemable preference shares. This reserve can be used to issue of fully paid bonus shares to the members of the company.

   (c) *Participating preference share or non-participating preference shares:* Participating preference shares are entitled to a preferential dividend at a fixed rate with the right to participate further in the profits either along with or after payment of certain rate of dividend on equity shares. A non-participating share is one which does not have any such right to participate in the profits of the company after the dividend and the capital have been paid to the preference shareholder.

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Financial Derivatives

A financial derivative is a financial instrument that is linked to another specific financial instrument, indicator or commodity and through which specific financial risks (such as interest rate risk, foreign exchange risk, equity and commodity price risk) can in their own right, be traded in financial markets. The value of a financial derivative comes from the price of an underlying item such as an asset or index. Financial derivatives can be used for risk management, hedging (protecting) against financial losses on commercial transactions and financial instruments and arbitrage between markets and speculation. There are two distinct classes of financial derivatives — forwards and related instruments, and options. The most common forward instruments are forward contracts, futures contracts, Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRS). Financial derivatives are traded over-the-counter, in which case they are customised and can be purchased from financial institutions or are standardised products which are traded on organized exchanges.

Payment and Settlement Infrastructure

One of the most important functions of the financial system is to ensure safety and efficiency in payments and securities transactions. Financial infrastructure refers to the different systems that provide for the execution of both large-value and small-value payments. Payment and settlement systems enable the transfer of money in the accounts of financial institutions to settle financial obligations between individuals and institutions.

Case Study

Should Financial Systems be Rule-based?

After evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based.

The recent global meltdown has proved one thing: Neither a rules-based regulatory system nor a principles-based regulatory system is a guarantee against bank failure. However, after evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based; this is especially true in the UK.

In contrast, two committees set up in India - the Percy Mistry Committee (2007) and the Raghuram Rajan Committee (2008) - to look into financial sector reforms have recommended that India's regulatory regime should move from rules-based to a principles-based one.

Principles-based regulation (PBR) implies moving away, wherever possible, from dictating, through detailed prescriptive rules and supervisory actions, how firms should operate their businesses. Rules-based regulation, it is pointed out, is too rigid and prescriptive, and often the regulator and the regulated adopt adversarial and antagonistic postures. Some of the countries that follow principles-based regulatory systems are the UK, Australia, Canada and Ireland. Some of the leading countries whose regulatory regime is based on rules are the US, Spain and India.

However, as noted in the Turner Review, banks in countries following either of the systems have failed. For example, banks have failed in the US and the UK. So in a way, neither of the regulatory systems has proven to be robust. One way to draw lessons from the crisis would be to examine what countries such as India, Spain and Canada did right to insulate their financial systems from succumbing to the global crisis.

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Spanish Method

It would be worthwhile to examine the approaches of the various regulators to housing or mortgage finance. Spain, which follows a rules-based system, has a clearly spelt out mortgage risk policy for its credit institutions. Banco De Espana (BE) lays down that lending policy of credit institutions for mortgage should take into account the repaying capacity of the borrowers and should not just be based on the collateral. BE also emphasises on the importance of the loan to value (LTV) ratio. It cautions its credit institutions against being too permissive about LTV as this typically increases the expected losses in a mortgage loan portfolio.

The conservatism that insulated Spanish banks from crisis also played its role in keeping the banking system healthy in Canada, which follows a principles-based system of regulation. For example, mortgages with less than a 20 per cent down-payment have to be insured, and most of the securitised mortgage market consists of Canada Mortgage Bonds, which carry a government guarantee. The Canadian central bank also did not allow creation of complex, synthetic securitised instruments involving Canadian mortgage assets.

In India, the Reserve Bank of India (RBI) has strict rules regarding housing finance, specifying the risk weights to be attached to loans extended to borrowers. These risk weights vary according to the LTV ratios. The RBI also specifies the maximum sanctioned amount for LTV ratios as less than or equal to 75 per cent.

UK's System

In the UK, the Financial Services Authority (FSA) follows a principles-based regulation. However, in its proposed reforms for mortgage lending, it has categorically banned certain practices such as self-certified mortgages replacing it with those requiring verification of the income of the borrowers. It also now requires mortgage advisers to be personally accountable to the FSA.

Having realised that non-interventionist principles-based system need not always lead to the desired regulatory outcome, there appears to be a distinct shift in the UK from a non-interventionist stance to a more intrusive one.

The Federal Reserve has also notified a revision in its Regulation Z (which implements the Truth in Lending Act and Home Ownership and Equity Protection Act), prohibiting creditors from making higher-priced mortgage loans based on the "value of the consumer's collateral without regard to the consumer's repayment ability".

Thus, in the case of the US and the UK, at least with respect to mortgage lending, the bias is in favour of a rules-based system. But is this desirable?

One of the biggest criticisms levelled against the rules-based system is that it stifles innovation by being too interfering. In contrast, a principles-based regulation is more accommodative to innovation because it is pliant and flexible. But, as the recent meltdown has shown, while gains from financial innovation benefit a few, the losses affect a greater number through systemic instability. When it comes to a trade-off between profitability and financial stability, the choice is very clear. Financial stability creates conducive atmosphere for profitability and for carrying out banking. Therefore, a rules-based system clearly scores over a principles-based system.

A developing country like India has its own compulsions which make a rules-based system better suited when it comes to meeting our development objectives. For example, with respect to financial inclusion, unless it is specifically laid down that banks must offer

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no-frills accounts to their customers with zero or minimum balance and also relax criteria for identification and account opening, the goal of financial inclusion may not be achieved.

Also, there is nothing in the rules-based system that disallows innovation. If that were the case, Indian banks wouldn't have been allowed to offer several products that they now offer. The pace of innovation would be slow but if it ensures financial stability for the system, the trade-off would be well worth it.

Question

Discuss the importance of rules and regulation in financial system.

Source: http://www.thehindubusinessline.in

1.3 Summary

- The financial system is the system that allows the transfer of money between savers and borrowers.
- It is a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions.
- India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors.
- In a number of sectors Government plays the role of regulator.
- RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms.
- The commercial banking sector comprises of public sector banks, private banks and foreign banks.
- The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector.
- India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level.
- All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance.
- State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate.
- Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI.
- RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).
- SEBI established under the Securities and Exchange Board of India Act, 1992 is the regulatory authority for capital markets in India.
- Insurance sector in India has been traditionally dominated by state owned Life Insurance Corporation and General Insurance Corporation and its four subsidiaries.
- Insurance Development and Regulatory Authority (IRDA) is the regulatory authority in the insurance sector under the Insurance Development and Regulatory Authority Act, 1999.

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1.4 Keywords

Capital Market: The capital market is the market for securities, where companies and governments can raise long-term funds.

Deposit: An account at a banking institution that allows money to be deposited and withdrawn by the account holder.

Loan: A type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.

Money Market: That segment of the financial market in which financial instruments with high liquidity and very short maturities are traded.

1.5 Self Assessment

Fill in the blanks:

1. RBI regulates foreign exchange under the .....
2. A loan is a specified sum of money provided by a lender to a borrower on condition that it is .....
3. The main purpose of the capital market is to facilitate the raising of ..... funds.
4. A ..... is a financial instrument that is linked to another specific financial instrument.
5. ..... are securities representing a portion of the ownership of a company.
6. Corporate bonds that are not backed by a specific asset are called .....
7. ..... are funds placed at financial institutions for a specified period or term.
8. Financial system performs the function of administering national, fiscal, and monetary policy to ensure the ..... of the economy.
9. Financial markets provide the holders of ..... with a chance to resell or liquidate these assets.
10. Long-term growth of financial markets is ensured through giving ..... to financial institutions to become efficient under competition.
11. The ..... system is the mechanism through which transactions in the financial system are cleared and settled.
12. The debt market is also known as the ..... Market.
13. ..... are mainly used for transaction purposes and for the safekeeping of funds.
14. Treasury bills are government securities that have a maturity period of up to .....
15. Corporate bonds are medium or long-term securities of ..... sector companies.

1.6 Review Questions

1. What do you mean by financial system?
2. Is financial system synonymous to financial markets? If yes, elucidate upon the similarities. If no, discuss the difference.
3. Examine the various components of the Indian financial system.

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4. Comparing it with others, what is the main difference that you see in the components of the financial system of developed countries and that of India?
5. What in your opinion is the main reason for having various regulatory authorities in a financial system? Is the central monetary authority (the representative of the government itself) unable to control the entire system?
6. Why does business need long-term finance? Explain in brief.
7. Give the advantages of equity shares to:
   (a) The Management and
   (b) The Shareholders
8. Differentiate between:
   (a) Equity shares and preference shares
   (b) Shares and debentures
9. Comment on the state of Indian financial system vis a vis its international counterparts.
10. Why might a company choose debt over equity financing?
11. What do you consider as the biggest advantage of financial derivatives?
12. Are asset based securities of any use to general public? If yes, elucidate upon the benefit/s. If no, to whom and how are they beneficial?

Answers: Self Assessment

1. Foreign Exchange Management Act,
2. repaid
3. long-term
4. financial derivative
5. Shares
6. debentures
7. Time deposits
8. stability
9. financial assets
10. autonomy
11. payment and settlement
12. Fixed Income Securities
13. Demand deposits
14. one year
15. private

1.7 Further Readings

Books

Cooper Kersey and Donald R. Fraser, *The Financial Market Place,* Addison Wesley Publishing Company (Latest Edition).

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

Mandura Jeff, *Financial Markets and Institutions,* West Publishing Company, New York.

Meir Kohn, *Financial Institutions and Markets,* McGraw Hill Publishing Company, New York.

Notes

Online links

www.helplinelaw.com

www.sebi.gov.in

Notes

Unit 2: Financial Markets

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the types of financial market
- Define capital market
- Explain primary capital market and secondary capital market
- Define money market
- State the types of money market
- Define call money, treasury bills, certificates of deposits and commercial papers

Introduction

Financial Market is the interface between a large number of buyers and sellers of the financial products. The prices of the products are fixed by the market forces of demand and supply within the market itself.

The financial market promotes the savings of the economy, providing an effective channel for transmitting the financial policies. Technically speaking, a financial market facilitates:

1. Raising of capital (in the capital markets);
2. Transfer of risk (in the derivatives markets);
3. International trade (in the currency markets).

Notes

2.1 Types of Financial Market

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represent a claim to the payment of a sum of money sometime in the future and/or periodic payment in the form of interest or dividend.

1. ***Money Market:*** The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.
2. ***Capital Market:*** The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.
3. ***Forex Market:*** The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.
4. ***Credit Market:*** Credit market is a place where banks, FIs and NBFCs Purvey short, medium and long-term loans to corporate and individuals.

Caselet

Financial Literacy

Financial literacy should make us aware of the rewards and risks in the financial markets and help us make informed choices. It is a tool to improve the skill and confidence with which a common man improves and secures his financial condition. It is only a primary step and not a driving force behind financial inclusion.

India is among the world's most efficient financial markets in terms of technology and regulation. It has one of the highest savings rate in the world yet only four per cent of it is invested in the financial markets.

Unless the common man becomes a wiser investor, wealth creation will remain a distant dream. The Government can declare the next year as financial literacy year and focus on educating the average Indian family. Money sense, like civic sense, should me inculcated in people as early as possible.

2.2 Capital Market

The capital market is the market for securities, where companies and governments can raise long-term funds. It is a market in which money is lent for periods longer than a year.

The different types of financial instruments that are traded in the capital markets are equity instruments, credit market instruments, insurance instruments, foreign exchange instruments, hybrid instruments and derivative instruments.

Capital Market consists of primary market and secondary market. In primary market newly issued bonds and stocks are exchanged and in secondary market buying and selling of already existing bonds and stocks take place.

Notes

Notes Many people divide the Capital Market into Bond Market and Stock Market.

1. ***Bond Market*** provides financing by bond issuance and bond trading.
2. ***Stock Market*** provides financing by shares or stock issuance and by share trading.

As a whole, Capital Market facilitates raising of capital through the trading of long-term financial assets.

2.2.1 Primary Capital Market

The primary capital markets is also called the New Issue Market or NIM. The securities which are introduced in the market are sold for first time to the general public in this market. This market is also known as the long-term debt market as the fund raised from this market provides long-term capital.

The act of selling new issues in the primary capital market follows a particular process. This process requires the involvement of a syndicate of the securities dealers. The dealers who are running the process get a certain amount for as commission. The price of the security offered in the primary capital market includes the dealer, commission also.

Again, if the issue is a primary issue, the investors get the issue directly from the company and no intermediary is needed in the process. For the purpose, the investor needs to send the exact amount of money to the respective company and after receiving the money, the particular company provides the security certificates to the investors.

The primary issues which are offered in the primary capital market provide the essential funds to the companies. These primary issues are used by the companies for the purpose of setting new businesses or to expanding the existing business. At the same time, the funds collected through the primary capital market, are also used for the modernization of the business. At the same time, the primary capital market is also involved in the process of creating capital for the respective economy.

There are three ways of offering new issues in the primary capital market. These are:

1. ***Initial Public Offering (IPO):*** An IPO is the first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded.

   In an IPO, the issuer obtains the assistance of an underwriting firm, which helps it determine what type of security to issue (common or preferred), the best offering price and the time to bring it to market.

2. ***Preferential Issue:*** A preferential issue can be defined as an issue of stock available only to designated buyers. These buyers are a select set of people, whether promoters, their relatives, or institutional investors.

   One could call it a wholesale equity market since the retail investors or shareholders are not invited to participate.

3. ***Rights Issue:*** The rights issue is a special form of shelf offering or shelf registration for existing Companies. With the issued rights, existing shareholders have the privilege to buy a specified number of new shares from the firm at a specified price within a specified time.

Notes

Caution A rights issue is in contrast to an initial public offering, where shares are issued to the general public through market exchanges.

Case Study

TOUAX Success of Rights Issue

TOUAX is a French company and is currently Europe's no.1 in shipping containers and river barges, and no.2 in modular buildings and freight railcars. The Group provides operating leases to customers around the world, both on its own account and for third-party investors.

On June 24, 2009, TOUAX announced that its capital increased by waiving preferential subscription rights but with priority for existing shareholders, launched on 18th June 2009 for a total of E17,851,519.76 (gross) through the issue of 936,596 new shares which were subscribed in the entirety. Following partial application of the extension clause, 952,747 shares were placed or 101.72% of the issue; total proceeds were E18,159,357.82.

This rights issue has enabled the Group to strengthen its financial structure, to position itself with advantage for possible acquisitions of tangible stock, and to grasp opportunities thrown up by the crisis (purchase of shipping containers, modular buildings, river barges and railcars, for hiring out on mainly long-term leases). 370,062 new shares allotted under absolute entitlement were subscribed or 39.51% of the total number of new shares on issue. Another 555,685 shares were applied for subject to cutting back in the event of over-subscription, and orders for these were all filled. Another 27,000 shares had been applied for by the general public, and following partial application of the extension clause it proved possible to fill orders for all of these.

As the result of the rights issue, TOUAX is well placed to respond to the boom in corporate outsourcing of non-core assets, and every day provides over 5,000 customers with quick and flexible leasing solutions. TOUAX is now listed on Euronext in Paris - NYSE Euronext Compartment C (ISIN Code FR0000033003), and features in the SBF 250 Index.

Questions

1. After analyzing the case, do you think all the companies that can afford, should opt for rights issue to improve their financial status?
2. What do analyse as the 2 main advantages of the rights issue?
3. What do think can be the risks posed by rights issue?

2.2.2 Secondary Capital Market

The secondary capital market deals with those securities that are already issued in an initial public offering in the primary market. Typically, the secondary markets are those where previously issued securities are purchased and sold.

In the secondary capital market, the securities are generally sold by and transferred from one investor to another. Hence, the secondary capital market needs to be highly liquid in nature. A high transparency for the secondary market trading is also required. With the advancement of the technology, the trading concept in secondary market has changed substantially. In the earlier days, the investors needed to meet at fixed place in order to carry out the transactions. But now trading in secondary capital market has become much easier for the investors.

Notes

The secondary bond markets play a market place for the bonds that are already issued in the primary market while the secondary stock market trades those stocks that are already issued by the issuers. The treasury bills secondary market handles the trading of treasury bills.

The secondary market trading is vital for the capital market. A study in the secondary market trend can give some information on the investor's preference for liquidity. It means whether the investors want to invest their money for a short period of time or a longer period. It has been seen that the investors in the capital market do not prefer to put their money for the long term investments. But the secondary market investors, however, can compensate their investments with proper strategy.

The secondary market value of a stock or a bond is different from their face value. This happens due to the fluctuating interest rates. The resale value of the bonds in the secondary market is based on the interest rates at that very time when the sale goes through. In a typical secondary market, when the interest rate falls, the bond value goes up while when the rate rises, the bond value goes down.

2.3 Money Market

A money market can be defined as a market for short-term debt securities with a maturity of one year or less and often 30 days or less. Money market securities are generally very safe investments which return a relatively low interest rate that is most appropriate for temporary cash storage or short-term time horizons.

The money market is better known as a place for large institutions and government to manage their short-term cash needs. However, individual investors have access to the market through a variety of different securities.

2.3.1 Types of Money Market

Money market can be of two types namely organized money market and unorganized money market.

Organised money market: It comprises of commercial banks, financial institutions and all short term asset trading institutions.

Unorganised money market: Along with the organized money market, there exists a very strong unorganised money market, especially in countries that are developing but are still to be developed. In such countries, people and small companies prefer taking loans from relatives, usurers, sahukars, etc, instead of going and applying to organised institutions registered under the monetary authorities.

2.3.2 Money Market Instruments

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below:

1. Call/Notice Money
2. Treasury Bills
3. Term Money

Notes

4. Certificate of Deposit
5. Commercial Papers

Let us understand the main instruments of money market by the discussion hereunder:

1. ***Call/Notice Money:*** Call money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "Call Money". When money is borrowed or lent for more than a day and up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.

2. ***Treasury Bills:*** Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

3. ***Certificates of Deposits (CDs):*** Certificates of Deposit is a negotiable money market instrument and issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by:

   (a) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and

   (b) select All India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

   Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

4. ***Commercial Papers (CPs):*** CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. Guidelines for issue of CP were for long governed by various directives issued by the Reserve Bank of India, as amended from time to time. On July 2, 2007, a master circular (Ref.No. FMD.MSRG.No.14/02.02.009/2007-08) incorporating all the existing guidelines/instructions/directives on the subject was issued by the office of Chief General Manager of RBI, which states the following:

   (a) *Who can Issue Commercial Paper:* Corporates, Primary Dealers (PDs) and the All India Financial Institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by the Reserve Bank of India are eligible to issue CP.

   A corporate would be eligible to issue CP provided: (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹4 crores; (b) company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s/institution/s.

Notes

(b) *Rating Requirement:* All eligible participants shall obtain the credit rating for issuance of Commercial Paper from either the Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agencies as may be specified by the Reserve Bank of India from time to time, for the purpose. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

(c) *Maturity:* CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

(d) *Denominations:* CP can be issued in denominations of ₹5 lakhs or multiples thereof. Amount invested by a single investor should not be less than ₹5 lakhs (face value).

(e) *Limits and the Amount of Issue of CP:* CP can be issued as a "stand alone" product. The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' financing including CPs.

An FI can issue CP within the overall umbrella limit fixed by the RBI, i.e., issue of CP together with other instruments, viz., term money borrowings, term deposits, certificates of deposit and inter-corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. CP may be issued on a single date or in parts on different dates provided that in the lattercase, each CP shall have the same maturity date.

Every issue of CP, including renewal, should be treated as a fresh issue.

(f) *Who can Act as Issuing and Paying Agent (IPA):* Only a scheduled bank can act as an IPA for issuance of CP.

(g) *Investment in CP:* CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). However, investment by FIIs would be within the limits set for their investments by Securities and Exchange Board of India (SEBI).

(h) *Mode of Issuance:* CP can be issued either in the form of a promissory note (Schedule I) or in a dematerialised form through any of the depositories approved by and registered with SEBI.

CP will be issued at a discount to face value as may be determined by the issuer.

No issuer shall have the issue of CP underwritten or co-accepted.

(i) *Procedure for Issuance:* Every issuer must appoint an IPA for issuance of CP. The issuer should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, issuing company shall issue physical certificates to the investor or arrange for crediting the CP to the investor's account with a depository.

Notes

Investors shall be given a copy of IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

Task Do a research and list all the instruments of money market and capital market in India.

2.4 Summary

- Financial market can be explained as a mechanism that allows people to easily buy and sell (trade) financial securities, commodities (such as precious metals or agricultural goods) and other fungible items of value at low transaction costs.
- Financial market is used to match those who want capital to those who have it.
- Financial markets are essential for fund raising.
- Financial market is of two types, viz. Capital Market and Money Market.
- The market where investment funds like bonds, equities and mortgages are traded is known as the capital market.
- The primal role of the capital market is to channelise investments from investors who have surplus funds to the ones who are running a deficit.
- Money market is that segment of the financial market in which financial instruments with high liquidity and very short maturities are traded.
- The money market is used by participants as a means for borrowing and lending in the short-term, from several days to just under a year.
- Money market instruments consist of Treasury Bills, Certificate of Deposits, Commercial Papers, etc.

2.5 Keywords

Call Money Market: Market in which brokers and dealers borrow money to satisfy their credit needs, either to finance their own inventory of securities or to cover their customers' margin accounts.

Financial Market: It is a mechanism that allows people to easily buy and sell (trade) financial securities, commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient-market hypothesis.

Initial Public Offer: Introduction of new stocks in the market.

Underwriting: The process of offering new issues of existing stocks to the purchasers.

2.6 Self Assessment

Fill in the blanks:

1. ..... is the money borrowed or lent on demand for a very short period.
2. Money market can be of two types namely ..... money market and ..... money market.
3. The ..... and the corresponding ..... are determined at each auction of the treasury bills.

Notes

4. The secondary market value of a stock or a bond is different from their .....
5. With the rights issue, ... have the privilege to buy a specified number of new shares.
6. The ..... markets play a market place for the bonds that are already issued in the primary market.
7. A financial market can be defined as the market in which financial ..... are created or transferred.
8. The financial market promotes the savings of the economy, providing an effective channel for transmitting the .....
9. Financial Instruments represent a claim to the payment of a sum of money sometime in the .....
10. The capital market is the market for securities, where companies and governments can raise ..... funds.
11. The issue is a ....., the investors get the issue directly from the company.
12. The rights issue is a special form of shelf registration for ..... companies.
13. The resale value of the bonds in the secondary market is based on the ..... at that very time when the sale goes through.
14. Banks have the freedom to issue ..... depending on their requirements.
15. CP is a note in evidence of the debt obligation of the .....
16. The market where investment funds like bonds, equities and mortgages are traded is known as the ..... market.

2.7 Review Questions

1. What do you mean by financial markets?
2. Analyse the discussion in the unit carefully and tell the difference between the capital and money market else than the former being a market for long-term assets and the latter being for short-term.
3. What are the instruments of money market that a middle class bread earner would generally prefer and why?
4. Do the capital markets exist only for big corporate houses? To which market will the transaction belong in which an individual goes to a commercial bank for a 20 year housing loan?
5. Discuss the advantages/disadvantageous that you/your acquaintance faced due to availing a loan from unorganized money market.
6. Find how can a company admit its Commercial Paper in NSDL and discuss the process.
7. Credit risk depends on both internal and external factors. Identify some such external as well as internal factors.
8. Which is the instrument that is issued for automatic monetization of debt? Analyse its importance.
9. Why would it be desirable to avoid an excessively conservative regulation of the risk sensitivity in a regulatory capital regime?

Notes

10. Discuss the role of any two parties involved in floating an issue.
11. Make a comparative study of the investment objective of any five investment alternatives.
12. What care should an investor take while investing in securities?

Answers: Self Assessment

1.	Call money	2.	organized, unorganized
3.	rate of discount, issue price	4.	face value
5.	existing shareholders	6.	secondary bond
7.	assets	8.	financial policies
9.	future	10.	long-term
11.	primary issue	12.	existing
13.	interest rates	14.	certificates of deposits
15.	issuer	16.	capital

2.8 Further Readings


Books

Auerbach Robert D., *Finance Markets and Institutions,* Macmillan Publishing Co. Inc., New York.

Bhole M.K., *Financial Markets and Institutions,* Macmillan Publishing Co. Inc., New York.

Cooper Kersey and Donald R. Fraser, *The Financial Market Place,* Addison Wesley Publishing Company (Latest Edition).

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Mandura Jeff, *Financial Markets and Institutions,* West Publishing Company, New York.

Meir Kohn, *Financial Institutions and Markets,* McGraw Hill Publishing Company, New York.


Online links

bulletin.rbi.org.in

www.rbi.org.in

Notes

Unit 3: Financial Institutions

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define financial institutions
- Explain types of financial institutions
- Discuss the role of financial institutions in economic development
- List the commercial banks
- Discuss emergence of private sector bank after liberalization
- Know the financial innovation in commercial banks
- Describe the assets and liabilities management by commercial banks

Introduction

Financial sector plays an indispensable role in the overall development of a country. The most important constituent of this sector is the financial institutions, which act as a conduit for the transfer of resources from net savers to net borrowers, that is, from those who spend less than their earnings to those who spend more than their earnings. The financial institutions have traditionally been the major source of long-term funds for the economy. These institutions provide a variety of financial products and services to fulfill the varied needs of the commercial sector. Besides, they provide assistance to new enterprises, small and medium firms as well as to the industries established in backward areas.

Notes

3.1 Definition of Financial Institutions

A financial institution is an institution that provides financial services for its clients or members. Any institution that collects money and puts it into assets such as stocks, bonds, bank deposits, or loans is considered a financial institution.

There are two types of financial institutions primarily, viz.,

1. Depository institutions and
2. Non-depository institutions.

Depository institutions pay you interest on your deposits and use the deposits to make loans.

Examples:
1. Banks
2. Credit unions
3. Trust companies
4. Mortgage loan companies.

Non-depository institutions, on the other hand undertake the function of selling financial products. In other words, those government or private that serve as an intermediary between savers and borrowers, but do not accept time deposits, are known as non-depository institutions. Such institutions fund their lending activities either by selling securities or insurance policies to the public. Their liabilities (depending on the liquidity of the liability) may fall under one or more money supply definitions, or may be classified as near money.

Examples:
1. Insurance companies
2. Pension funds
3. Brokerage firms
4. Underwriting firms
5. Mutual fund companies
6. Investment trust

Many financial institutions provide both depository and non-depository services.

Probably the most important financial service provided by financial institutions is acting as financial intermediaries. Most financial institutions are highly regulated by government bodies.

Finance companies typically enjoy high credit ratings and are hence able to borrow at the lowest market rates, enabling them to make loans at rates not much higher than banks. Even though their customers usually do not qualify for bank credit, these companies have experienced a low rate of default. Finance companies in general tend to be interest rate-sensitive-increases and decreases in market interest rates affect their profits directly.

3.2 Types of Financial Institutions

Financial institutions can be of different types in accordance with the difference in the financial systems of different economies. In India, the financial system includes the following types of institutions, viz.

1. Financial Authorities

Notes

2. Commercial Banks
3. Regional Rural Banks
4. Non-banking Financial Companies
5. Co-operative Societies, etc.

Let us take them in details now:

1. ***Financial Authorities:*** Also known as financial regulators, they include:
   (a) Central Board of Direct Taxes (CBDT)
   (b) Central Board of Excise & Customs (CBE&C)
   (c) Reserve Bank of India (RBI)
   (d) Securities and Exchanges Board of India (SEBI)
   (e) Insurance Regulatory and Development Authority (IRDA).
2. ***Commercial Banks:*** The main commercial banks in India include:
   (a) Abu Dhabi Commercial Bank
   (b) Allahabad Bank
   (c) Bank Internasional Indonesia
   (d) Bank of Bahrain and Kuwait BSC
   (e) Bank of India
   (f) Corporation Bank
   (g) Federal Bank
   (h) ICICI Bank
   (i) IDBI Bank
   (j) IndusInd Bank Limited
   (k) SBI Commercial and International Bank Ltd.
   (l) State Bank of India
   (m) State Bank of Hyderabad
   (n) State Bank of Travancore
   (o) Union Bank of India
   (p) The Karur Vysya Bank Limited.
3. ***Regional Rural Banks (RRBs):*** The Government of India set up RRBs on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs.

   Initially, five RRBs were set up which were sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank of India. Presently the number of the RRBs stands at 95 (source www.rbi.org.in).

Notes

There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio, lower statutory liquidity ratio, lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training. The RRBs are under the control of NABARD which has the responsibility of laying down the policies for the RRBs, to oversee their operations, provide refinance facilities, to monitor their performance and to attend their problems.

4. ***Non-banking Financial Companies:*** Non-banking Financial Companies (NBFCs) are fast emerging as an important segment of Indian financial system. It is an heterogeneous group of institutions (other than commercial and co-operative banks) performing financial intermediation in a variety of ways, like accepting deposits, making loans and advances, leasing, hire purchase, etc. They raise funds from the public, directly or indirectly, and lend them to ultimate spenders. They advance loans to the various wholesale and retail traders, small-scale industries and self-employed persons. Thus, they have broadened and diversified the range of products and services offered by a financial sector.

   The types of NBFCs registered with the RBI are:

   (a) Equipment leasing company

   (b) Hire-purchase company

   (c) Loan company

   (d) Investment company.

   Now, these NBFCs have been reclassified into three categories:

   (a) Asset Finance Company (AFC)

   (b) Investment Company (IC) and

   (c) Loan Company (LC).

Task Find how many companies are registered under RBI as equipment leasing, hire-purchase, loan and investment companies respectively. Enlist the major players in each.

5. ***Co-operative Societies:*** The general policy on rural/agricultural credit is to provide timely and adequate credit to farmers for increasing agricultural production and productivity. It aims at providing better access to institutional credit for the small and marginal farmers and other weaker sections to enable them to adopt modern technology and improved agricultural practices has been a major concern of the policy.

   The Cooperative Movement has a long history in our country and today, India's Cooperative Movement is the largest in the world with currently a total of 447 cooperative credit societies. It comprises of the following:

   (a) The Primary Agricultural Co-operative Societies

   (b) District Central Co-operative Banks

   (c) State Co-operative Banks

   (d) National Co-operative Development Corporation (NCDC)

Notes

(e) National Co-operative Union of India (NCUI)

(f) National Agricultural Co-operative Marketing Federation of India (NAFED)

(g) Tribal Co-operative Marketing Development Federation of India Ltd.

(h) Indian Farmers Fertiliser Cooperative Limited (IFFCO)

(i) Krishak Bharati Co-operative Limited (KRIBHCO)

(j) National Bank for Agriculture and Rural Development (NABARD)

(k) National Federation of State Co-operative Banks Limited (NAFSCOB)

(l) Gujarat Cooperatives Milk Marketing Federation Ltd. (AMUL)

(m) National Dairy Development Board (NDDB).

6. ***Credit Reporting and Debt Collection Companies:*** Though the Credit Reporting and Debt Collection is more in scattered form, it includes companies like that of:

   (a) Trustman Credit Management Services

   (b) Pankaj Saraf

7. ***Insurance Companies:*** There is an existence of many insurance companies in Indian market. The main of them are:

   (a) General Insurance Corporation of India Ltd.

   (b) Life Insurance Corporation

   (c) New India Assurance Company

   (d) United India Insurance Company.

8. ***Merchant Banks:*** Merchant banks are institutions like:

Examples:

1. Citibank
2. Bajaj Capital Limited
3. Standard Chartered Bank
4. SPA Merchant Bankers Limited

9. ***Mutual Funds:*** According to Chapter 1, Securities and Exchange Board of India (Mutual Funds) Regulations, December 9, 1996, a "mutual fund" means a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.

Examples:

1. AIG World Gold Fund
2. Franklin Infotech Fund
3. Birla Sun Life Commodity Equities Fund
4. ICICI Prudential Technology Fund.

Notes

10. ***Specialised Financial Institutions:*** They are government undertakings established with a view to offer financial as well as technical assistance to the Indian industries. The list of specialized financial institutions in India mainly includes:

    (a) Export-Import Bank of India

    (b) Board for Industrial & Financial Reconstruction

    (c) Small Industries Development Bank of India

    (d) National Housing Bank.

11. ***Venture Capitalists:*** Venture capitalists are the institutions that deal in venture capital. Venture capital (also known as VC or Venture) is a type of private equity capital typically provided to early-stage, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company.

Examples:

1. 2i Capital (India) Private Limited
2. Avon Capital Services Ltd
3. Baring Private Equity Partners (India) Limited
4. Canbank Venture Capital Fund Limited.

3.3 Role in Economic Development

Financial institutions have been there in the world markets for a long time now. They have also made significant contributions. The two main reasons for the existence of financial institutions are:

1. Economic development
2. Financial stability.

If we penetrate a little, we will find that the second reason for the existence of financial institutions leads to the first again. In the first place, banks offer deposits that claim to be capital certain. If this promise is to be honoured, then there must be limits to the range and nature of assets that a bank can reasonably take on to its balance sheets. More generally, financial institutions perform a plethora of activities through their provision of liquidity, divisibility, informational efficiencies and risk pooling services which broaden the spectrum of risks available to investors. In this way, they encourage and improve the efficiency of investment and savings in the economy. Through the provision of a broader range of financial instruments, they are able to foster a risk management culture by attracting customers who are not as much able to bear risks.

Also, from the view of financial stability, in an economy in which the institutions are comparatively less developed, banks will inevitably be required to assume risks that otherwise might be borne by the stock market, collective investment schemes or insurance companies. One way of minimizing financial fragility in the developing economies is to encourage a diversity of financial institutions, where investors are able to assume a variety of risks outside the banking system itself. Without this diversity, there is a tendency for all risks to be bundled within the balance sheet of the banking system, which more likely may lead to severe financial crises.

The financial institutions play an important role in complementing the facilities offered by the banks in an economy. In fact, the existence of Banking Financial Institutions (BFIs) and Non-banking Financial Institutions (NBFIs) supported by efficient money and capital markets, keep the financial sector complete and enhance the overall growth of the economy.

Notes

Financial institutions are the key players in the development of the capital market in any economy. But even after their great performance, there generally remain some sectors comparatively more challenging. For them there developed a special need for special financial institutions. In fact, the need for establishing such financial institutions arose mainly because of the following causes:

1. It has been difficult for industry in general to procure sufficient long- term funds in the capital markets. There has been a lack of financial institutions to supply long-term finance to industry. AS we know, traditionally, and more popularly, commercial banks provided only short term finance. Thus some Special Financial Institutions (SFIs) were established to ensure that industry got sufficient long-term funds in the desired sectors. And that too in accordance with the priorities determined.
2. Certain specific sections of the industry faced greater difficulties as compared with the others in procuring long-term finance. Some such sections were:
   (a) Small and medium sized organisations
   (b) Specific industries requiring funds for modernisation
   (c) New concerns set up by new entrepreneurial groups
   (d) Concerns involved in innovation and new technological developments
   (e) Concerns requiring extra-ordinarily large amounts of finance for a long gestation period
   (f) Concerns in backward areas. One of the very important needs for SFIs was to meet the long-term financial requirement of such organisations on economic and social grounds.

In general it can be said that the gap between the demand for and supply of finance in general and industrial finance more specifically, is sought to be filled through term loans being offered by various financial institutions. And this makes itself as the most important need for financial institutions.

3.4 Commercial Banks

Commercial bank is the term used for a normal bank to distinguish it from an investment bank. This is what people normally call a "bank". The term "commercial" was used to distinguish it from an investment bank. Since the two types of banks no longer have to be separate companies, some have used the term "commercial bank" to refer to banks which focus mainly on companies. In some English-speaking countries outside North America, the term "trading bank" was and is used to denote a commercial bank. During the great depression and after the stock market crash of 1929, the U.S. Congress passed the Glass-Steagal Act 1930 (Khambata 1996) requiring that commercial banks only engage in banking activities (accepting deposits and making loans, as well as other fee based services), whereas investment banks were limited to capital markets activities. This separation is no longer mandatory.

It raises funds by collecting deposits from businesses and consumers via checkable deposits, savings deposits, and time (or term) deposits. It makes loans to businesses and consumers. It also buys corporate bonds and government bonds. Its primary liabilities are deposits and primary assets are loans and bonds.

Commercial banking can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to normal individual members of the public (retail banking).

Notes

3.5 Emergence of Private Sector Bank after Liberalization

Without a sound and effective banking system in India it cannot have a healthy economy. The banking system of India should not only be hassle free but it should be able to meet new challenges posed by the technology and any other external and internal factors.

For the past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main reasons of India's growth process.

Not long ago, an account holder had to wait for hours at the bank counters for getting a draft or for withdrawing his own money. Today, he has a choice. Gone are days when the most efficient bank transferred money from one branch to other in two days.

The commercial banks in India are categorized into foreign banks, private banks and the public sector banks. They indulge in varied activities such as acceptance of deposits, acting as trustees, offering loans for the different purposes and are even allowed to collect taxes on behalf of the institutions and central government.

India embarked on a strategy of economic reforms in the wake of a balance-of-payments crisis in 1991; a central plank of the reforms was reforms in the financial sector, and with banks being the mainstay of financial intermediation, the banking sector. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. The thrust of these reforms was to promote a diversified, efficient and competitive financial system, with the ultimate objective of improving the allocative efficiency of resources, through operational flexibility, improved financial viability and institutional strengthening.

The first Private Bank in India to receive an in principle approval from the Reserve Bank of India was Housing Development Finance Corporation Limited, to set up a bank in the private sector banks in India as part of the RBI's liberalisation of the Indian Banking Industry. It was incorporated in August 1994 as HDFC Bank Limited with registered office in Mumbai and commenced operations as Scheduled Commercial Bank in January 1995.

Today there are more than 20 private banks operating in India. The most popular of them are as under, viz.

1. Bank of Punjab
2. Bank of Rajasthan
3. Catholic Syrian Bank
4. Centurion Bank
5. City Union Bank
6. Dhanalakshmi Bank
7. Development Credit Bank
8. Federal Bank
9. HDFC Bank
10. ICICI Bank
11. IDBI Bank
12. INDUSIND Bank

Notes

13. Jammu & Kashmir Bank
14. Karur Vysya Bank
15. Laxmi Vilas Bank
16. Nedungadi Bank
17. Ratnakar Bank
18. SBCI
19. South Indian Bank
20. United Western Bank
21. UTI Bank
22. Vijaya Bank.

Note: For latest detail on Private Sector Banks in India please visit www.rbi.org.in.

Private banks deliver sophisticated solutions to complex financial problems, with an attention towards the clients' affairs in totality and offer individual advice and tailored solutions.

The emergence and development of private banks has helped the general public to achieve their financial goals in the most effective way possible. To do so, these banks:

1. manage wealth of their clients
2. nurture it by providing their clients with investment strategies
3. assist in estate planning and banking requirements
4. identify future sources and opportunities to develop their wealth throughout
5. develop their customers' business interests through the investment, corporate, commercial banking facilities they provide.

Some private banks even indulge in functions like those of introducing their customers to third party service providers who can help them plan their estate to manage inheritance issues or helping maximize the impact of their customers' philanthropic efforts.

Caselet

Banks, FIs Cut Holdings of US Custodial Assets

Indian banks and financial institutions reduced their holdings of US custodial assets by over $10 billions in February this year.

According to the US Treasury Department data, American banks' custodial liabilities to Indian financial institutions amounted to $16.277 billions in February, as against $27.133 billions in January and $36.977 billions in February 2009.

Custodial assets of Indian banks and financial institutions include short-term US treasury bills and holdings of agency debts. Institutions that invest in dollar securities besides the Reserve Bank of India include General Insurance Corporation of India, foreign branches/ subsidiaries of domestic banks and domestic mutual funds that are permitted to invest in foreign securities.

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The reduction in holdings was most significant in short-term negotiable instruments that included dollar-denominated treasury bills. Holdings of short-term negotiable securities in February this year were $1.8 billions. In January, the holdings amounted to $11.794 billions.

But the liquidation of custodial assets by Indian institutions coincided with the phased withdrawal of the US Federal Reserve Board's collateralised liquidity support to the financial markets. The withdrawal signified exit from quantitative expansion with the potential to gradually harden the dollar yield, implying losses if held further. Traders said that part of the reduction in February was also on account of the year-end inter country adjustments.

The reduction in the holdings could also be partly attributed to the RBI's note purchase agreement with the International Monetary Fund (IMF) in July 2009.

India finally subscribed to the IMF notes in March this year. The shift to multilateral agency debt instruments, traders said, was partly on account of better yields. Short term dollar treasury bills offer low yields of barely 0.5 per cent. Interest rates on SDR (special drawing rates of the IMF) are currently about 1.3 per cent. In February, however, India's holdings of the dollar treasury securities dropped only $1.1 billions. Traders said that there was also some shift to the longer end of the yield curve. This was evident from the sharp reduction in short term securities to only a slight reduction in long term securities.

The shift notwithstanding, India's long term investments were entirely in the dollar treasury notes. The dollar treasury notes have a maximum maturity of ten years. The shift to the longer end was partly driven by better yields. The yield on ten-year dollar treasury notes in February was as high as 3.75 per cent. The shift was also partly on account of the longer term nature of the accretion to the India's foreign exchange reserves. Long-term accretions included foreign direct investments and accretions to non resident non-repatriable deposits in the banking system.

Source: www.thehindubusinessline.com

3.6 Financial Innovation in Commercial Banks

The term "financial innovations" refers to the various innovative activities in respect of strategic decision making, system arranging, institutional setting, personnel preparing, mode of management, business flow and financial products and so on, which are carried out by commercial banks through bringing in new technologies, applying new methods, expanding new markets and establishing new organizations in order to adapt to the development of economics, and which are finally embodied into continuous improvement of the risk management capacities of banks, and the creations and updating of service products and service methods offered to customers.

Notes Modern day commercial banking, was itself a significant financial innovation some three centuries ago in Europe, as it originated from the practice of goldsmiths issuing receipts against the gold deposited with them by customers.

These 'goldsmith receipts' were an accepted means of payment. Goldsmiths soon found that as long as they maintained gold to satisfy occasional redemptions, they could issue receipts for more than the value of the gold deposited with them. Such receipts were effectively loans made to customers and being an accepted means of exchange, it promoted economic activity and trade and incidentally earned a good profit also for the goldsmiths.

Notes

Financial innovation places the interests of the consumers at the core, and follows basic market principles in approach. Through financial innovation, commercial banks raise their competitive strengths, improve their risk management skills, and better satisfy the needs of their customers and market requirements. Financial innovation is one of the most important elements of the commercial banks' sustainable growth strategy.

A pre-condition of financial innovation is proper risk management. Commercial banks identify, measure, monitor and control new risks on a timely basis.

Did u know? **What is fractional-reserve banking?**

Fractional-reserve banking, is a system where banks hold only a certain percentage of their deposits as ready cash.

Over the years, the banking sector in India has seen a number of changes. Most of the banks have begun to take an innovative approach towards banking with the objective of creating more value for customers, and consequently, the banks. Some of the significant changes in the Indian banking sector are discussed below:

1. ***Technology for Value Creation:*** The use of information technology in the Indian banking sector was a corollary of the liberalization process initiated in the country in the early 1990s.

2. ***Rural India Catching Up:*** With a majority of the Indian population living in rural areas, rural banking forms a vital component of the Indian banking system. Besides, rural banking operations in India are rather different from urban operations, due to the strong disparity that exists between urban and rural life, and the needs of these two sections of people are also different.

   The commercial banks in India have seen the huge possibility available to avail profits through operating in the rural sectors. This has led the rural India to catch up with the fast pace of banking in the economy.

3. ***Banking Beyond Banking:*** While traditionally, banking meant 'borrowing and lending', in the latter part of the 20th century, the word took on a different meaning altogether. Banks no longer restricted themselves to traditional banking activities, but explored newer avenues to increase business and capture new markets.

   Indian banks could not be left behind. They innovated their operations into fields unexplored as yet and started venturing into varied activities already discussed in the above section.

4. ***Credit/Debit Cards:*** In India, there has been an exponential increase in credit/debit cards utilization in the last 10 years.

   It is now difficult to imagine life without these electronic cards. They are a fast, convenient and safe method for making payments. In the case of credit cards, they are also a key channel for making short-term, unsecured loans which can enable households to smoothen their consumption over time. The risk and instability this innovation can cause, of course, is that some people borrow more than they can afford. But, overall, credit/debit cards are a key payment/credit innovation which has lowered transaction costs, improved resource allocation and supported economic growth.

5. ***Money Market Mutual Funds:*** Money market mutual funds were an interesting innovation arising or rather necessitated by the ceilings which governments placed on bank deposit

Notes

interest rates. These funds offered (savers) investors the benefits of both liquidity and a rate of interest higher than they could earn on bank deposits. Commercial banks, very early on, saw money market funds as a key competitor and over the course of many years have developed many deposit products which seek to provide depositors the same flexibility which money market funds provide. This therefore was an innovation which triggered greater efficiency in the intermediation of savings and investments in the financial system, though its initial impact was to modify the characteristics of the deposit base of the banking system.

Case Study

Yes Bank Subscribes to Non-convertible Debentures of SKS Microfinance

Yes Bank, one of India's leading private sector banks, announced in March 2009 that it has subscribed to ₹ 250 millions of rated Non-convertible Debentures (NCD) issued by SKS Microfinance, India's largest and the world's fastest growing Micro-finance Institution (MFI). The bond has a tenor of one year from the date of allotment with a coupon rate of 10.50% per annum. Yes Bank thus became the lead manager to the issue a first of its kind issuance of rated paper by an Indian micro-finance institution.

Microfinance has been recognized as an efficient poverty alleviation tool, its expansion in India is significantly impeded by its relatively limited access to capital markets resulting in MFIs continuing to face challenges of high cost of funds. On successful completion of the transaction, Suresh Gurumani, MD and CEO of SKS Microfinance said, "SKS is the only MFI in the country to raise funds through non-convertible debenture. The funds will be utilised to provide financial services to a larger section of the poor." Somak Ghosh, group president, corporate finance and development banking, YES Bank, on fully subscribing to the issue said, "Yes Bank's microfinance initiatives/approach/focus is centred on using structured capital market products to provide MFIs access to a broader base of investors and lenders thus reducing cost of funds and lowering transaction costs for the sector. The successful closure of SKS's rated bond issue is the fruition of such efforts at Yes Bank and SKS Microfinance and will help the MFI tap sophisticated capital market investors opening up additional, cost-effective sources of funds." Announcing this landmark transaction, S. Dilli Raj, CFO of SKS Microfinance said, "SKS becomes the first Indian MFI to issue a rated bond. This showcases SKS's structuring and financial innovation skills. The fact that the Bond is a stand alone issuance with no credit enhancement in the form of any 3rd party guarantee or collateral speaks volumes of SKS's Balance Sheet strength".

Questions

1. How do you think has the move helped Yes bank?
2. What other innovative tools do you think Yes Bank could have employed to yield similar results?

Source: Myiris.com

3.7 Assets and Liabilities Management by Commercial Banks

Banks face several risks such as the liquidity risk, interest rate risk, credit risk and operational risk. A bank with mismatched assets and liabilities can be badly hurt by unexpected interest rate changes.

Notes

Example: In the 80's, many Savings & Loan associations in Europe went bankrupt owing to rates increases: since they had borrowed short and lent long, both their income and their net worth had become negative.

Asset Liability Management (ALM) is a strategic management tool to manage interest rate risk and liquidity risk faced by banks, other financial services companies and corporations.

Banks manage the risks of asset liability mismatch by matching the assets and liabilities according to the maturity pattern or the matching the duration, by hedging and by securitization. They use the gap and the duration analyses to respectively evaluate (not necessarily to eliminate) their exposure to income and to capital risks.

Gap Analysis

Gap analysis estimates the net effect on income of interest rate changes (parallel shifts). Income risk is two forged: there is a reinvestment risk when assets mature before liabilities.

Example: When a bank has financed a 6 months T-bill by issuing a 1 year fixed rate CD: when, after 6 months, it cashes the T-bill, it may be unable to reinvest the proceeds at a profitable rate.

There is also a refinancing risk when liabilities mature before assets.

Example: When a bank has financed a 1 year fixed rate asset by issuing a 6 months CD: when the liability will mature, the bank has to refinance its position by issuing another 6 months CD. But, if interest rates have increased, the bank will have to pay a higher rate.

For the Gap analysis all items, on both sides of the balance sheet, are classified into two categories: rate-sensitive and fixed-rate (non-sensitive).

Example:

Assets		Liabilities	
Rate-sensitive: RSA *(variable-rate loans and bonds; bills and short-term securities)*	**40**	**Rate-sensitive: RSL** *(variable-rate deposits; short-term or variable-rate securities)*	**30**
Fixed-rate: NSA *(fixed-rate loans; fixed-rate long-term bonds; reserves)*	**60**	**Fixed-rate: NSL** *(fixed-rate loans; fixed-rate long-term bonds; net worth)*	**70**

Gap = RSA – RSL = 40 – 30 = 10 millions

The (annual) income will change by the size of the gap multiplied by the size of the interest rates change: if the rates increase by 2% (200 basis points), the annual income will increase by: 2% of 10 millions = ₹ 200,000.

GAP>0 = The bank is asset sensitive: it benefits from interest rate increases and suffers from decreases.

GAP<0 = The bank is liability sensitive: it gains when rates decrease and loses when they increase.

Notes

A positive gap (asset sensitive bank) is an implicit bet that interest rates will increase; a negative one (liability sensitive bank) that they will fall. When the gap is zero, the bank has no exposure to income risk: a change in interest rates will not change the bank's income. The relation for the expected change in interest margin is given by:

$$E(\Delta IM) = GapE\ (\Delta i)$$

Gap ratio: defined as RSA/RSL is frequently utilised to evaluate the time-path of a bank Gap or to make comparisons with the Gap of other banks.

To reduce the gap to zero, the bank of the example can sell 10 mln of short-term assets and buy 10 mln of long-term assets. Alternatively, it can operate in derivatives, both symmetric and asymmetric. In the first case, it can buy futures or it can sell interest rate swaps or FRAs in order to transform 10 mln of its floating rate assets into fixed rate assets, as we shall show later on.

3.8 Summary

- Financial institutions can be defined as private or public organizations that, broadly speaking, act as a channel between savers and borrowers of funds.
- Two main types of financial institutions with increasingly blurred dividing line are depository banks and credit unions and non-depository insurance companies and mutual funds.
- The two main reasons for the existence of financial institutions are economic development and financial stability.
- Financial stability as a reason for the existence of financial institutions leads to its role in economic development again.
- A commercial bank is a type of financial intermediary that provides checking accounts, savings accounts, and money market accounts and that accepts time deposits Commercial banks.
- Private sector banks emerged in India after liberalization.
- Commercial banks had to keep up with the progressive offers made by their private and foreign counterparts.
- Thus Indian commercial banks started making financial innovations.
- Some innovations are driven by broader technological advances.
- Some are purely a reaction to a profit or business opportunity.
- There are also innovations which are the result of regulation or other government policy actions.
- For smooth functioning, commercial banks have to manage their assets and liabilities.

3.9 Keywords

Credit Cards: A card that may be used repeatedly to borrow money or buy products and services on credit.

Debit Cards: A card which allows customers to access their funds immediately, electronically.

Gap Analysis: Gap analysis estimates the net effect on income of interest rate changes.

Notes

Venture Capital: Venture capital is a type of private equity capital typically provided to early-stage, high-potential, and growth companies in the interest of generating a return through an eventual realization event.

3.10 Self Assessment

Fill in the blanks:

1. If a bank is ....., it benefits from interest rate increases and suffers from decreases.
2. Banks face several risks such as the ..... risk, ... risk, ... risk and ..... risk.
3. ..... funds offered (savers) investors the benefits of both liquidity and a rate of interest higher than they could earn on bank deposits.
4. ..... banking, is a system where banks hold only a certain percentage of their deposits as ready cash.
5. The first Private Bank in India to receive an in principle approval from the Reserve Bank of India was .....
6. The two main reasons for the existence of financial institutions are ..... and .....
7. ..... is any financial institution whose principal business is that of leasing equipments or financing of such an activity.
8. ..... is any financial intermediary whose principal business is that of buying and selling of securities.
9. ..... offer financial as well as technical assistance to the industries.
10. Venture capital is a type of ..... capital.
11. The duration is the average period of .....
12. ..... is established in the form of a trust to raise money through the sale of units to the public or a section of the public.
13. The general policy on rural credit is to provide timely and adequate credit to farmers for increasing agricultural ..... and .....
14. ..... have broadened and diversified the range of products and services offered by a financial sector.
15. The government of India set up ..... on October 2, 1975.

3.11 Review Questions

1. What financial innovations do you see around you to have been done by financial market in India?
2. Critically analyse the working of commercial banks in India.
3. "Financial market in India has come off age". Comment.
4. What are the most significant changes you see in the commercial banks of India in past decade?

Notes

5. What do you think are the benefits of asset liability management by the banks for
   (a) themselves
   (b) their customers?
6. What do you mean by financial institutions? Discuss various types of financial institutions.
7. Discuss various strategies which have been used by the commercial banks to control rapidly increasing NPAs in the last few years.
8. Every fourth co-operative in India is a primary credit society. Why so?
9. How is GAP analysis useful in asset liability management of banks?
10. Is "Financial Innovation" Good for Bank Profitability? Why/ why not?
11. Find out if Deutsche Bank AG, India has a comprehensive 'Financial Planning' module. What are its benefits?
12. Why would an ALM department need to deal with instruments generating credit spread risk?
13. What do you analyse as the impact of 1991 policy reforms on India's private banks?
14. "The financial institutions play an important role in complementing the facilities offered by the banks in an economy." Comment.

Answers: Self Assessment

1.	asset sensitive	2.	liquidity, interest rate, credit, operational
3.	Money market mutual	4.	Fractional-reserve
5.	HDFC	6.	economic development, financial stability
7.	Equipment leasing company	8.	Investment company
9.	Specialised Financial Institutions	10.	private equity
11.	capital commitment	12.	Mutual fund
13.	production, productivity	14.	NBFCs
15.	Regional Rural Banks		

3.12 Further Readings

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Unit 4: Reserve Bank of India

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the role of Reserve Bank of India
- Explain the functions of Reserve Bank of India

Introduction

The central bank of India is called the Reserve Bank of India (RBI). It was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934 with a view to organize the financial frame work and facilitate fiscal stability in India.

The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. Though originally privately owned, since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India and acts the central regulatory authority with regard to the functioning of the various commercial bank and the other financial institutions in India. It regulates the issue of Bank Notes and keeps the reserves with a view to securing monetary stability in India. It also operates the currency and credit system of the country to its advantage.

4.1 Role of Reserve Bank of India

The Preamble prescribes the objective of the Reserve Bank of India in the following lines:

"*…to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.*"

Thus RBI plays the most important role in:

1. Securing monetary stability in India and
2. Operate the currency and credit system of the country.

Notes

Apart from these two role plays, RBI being the central monetary authority plays a very significant role in the Indian Economy.

Guarantor of Price Stability

Being the monetary authority of the economy, RBI is responsible for implementing, formulating and monitoring the monetary policy of India. Keeping this authority in mind the RBI is required to maintain price stability and ensure adequate flow of credit to productive sectors.

Regulator and Supervisor of the Financial System

The Supreme financial body sets down broad parameters of banking operations within which the country's banking and financial system operates. This reasonably helps in maintaining public confidence in the system. It in turn protects depositors' interest and provides lucrative banking services to the public.

Manager of Exchange Control

The RBI is responsible for managing the Foreign Exchange Management Act, 1999. It is the nodal agency which facilitates external trade and payment and promotes orderly development and maintenance of foreign exchange market in India.

Issuer of Currency

It is the only supreme body which issues and exchanges or destroys currency and coins not fit for circulation. This facilitates in giving the public adequate quantity of currency notes and coins and in good quality.

Developmental Role

The RBI since its inception performs a wide range of promotional functions to support national objectives and generate goodwill among the citizens of the country.

Caselet

CRR Hike Slightly Aggressive: Economists

Economists were "slightly surprised" by the extent of the cash reserve ratio (CRR) hike (of 0.75 per cent) but felt that the Reserve Bank's move was strongly influenced by rising inflationary pressures and the compelling need to rein them in.

"The market was expecting a 0.50 per cent hike in CRR and I feel the 0.75 per cent is slightly aggressive. It is more a pre emptive move to control inflationary expectations," Bank of Baroda's Chief Economist, Rupa Rege Nitsure, told PTI here.

The Reserve Bank today upped the cash reserve ratio from 5 per cent to 5.75 per cent, a move expected to flush out ₹ 36,000 crores from the system. It also pegged expected inflation by March end at 8.5 per cent, sharply up from its earlier projection of 6.5 per cent. "The move is targeted at combating the liquidity over hang in the system," Nitsure said.

Crisil's Director and Principal Economist, D K Joshi, said, "today's move is a clear enunciation that inflation has emerged as a major concern for the RBI. This is clear from

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the fact that the apex bank hiked CRR by 0.75 per cent instead of by the widely expected 0.50 per cent."

While interest rate pressures are seen, there may not be an immediate increase in rates, the economists said.

Source: www.thehindubusinessline.com

Task

Find out what are the developmental activities RBI is involved in and evaluate them one by one.

4.2 Functions of Reserve Bank of India

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank the Reserve Bank of India.

Monetary Authority

The Reserve Bank of India formulates, implements and monitors the monetary policy with an objective of maintaining price stability and ensuring adequate flow of credit to productive sectors. Monetary Policy can be broadly defined as "the deliberate effort by the Central Bank to influence economic activity by variations in the money supply, in availability of credit or in the interest rates consistent with specific national objectives." The Reserve Bank adopts expansionary or contractionary methods of investment and consumption expenditure to regulate the money supply in Indian economy. For this RBI resorts to quantitative as well as qualitative methods.

Quantitative Measures

1. ***Open market operations:*** Open market operations make quite an important instrument of credit control. The Reserve Bank of India purchases and sells securities in open market operations. In times of inflation, RBI sells securities to mop up the excess money in the market. Similarly, to increase the supply of money, RBI purchases securities.
2. ***Bank rate policy:*** Bank rate, also referred to as the discount rate, is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries. Changes in the bank rate are often used by central banks to control the money supply. During inflation, the bank rate is increased and during deflation, bank rate is decreased.
3. ***Repo/ reverse Repo:*** Repo comes from the repurchasing agreement. Whenever the banks have any shortage of funds they can borrow it either from Reserve Bank of India |RBI] or from other banks. The repo rate is the rate at which the banks borrow these excess funds. The borrowing bank mortgages its government securities to carry out this loan transaction. A reduction in the repo rate will help banks to get money at a cheaper rate. When the repo rate increases borrowing from RBI becomes more expensive.

   Reverse repo rate is the rate that RBI offers the banks for parking their funds with it. Reverse repo operations suck out liquidity from the system.

Notes

Did u know? **What is the differences between Bank Rate and Repo Rate?**

While repo rate is a short-term measure, i.e. applicable to short-term loans and used for controlling the amount of money in the market, bank rate is a long-term measure and is governed by the long-term monetary policy of the Reserve Bank.

4. ***Cash Reserve Ratio (CRR):*** All commercial banks are required to keep a certain amount of their total deposits with RBI in form of cash. This percentage is called the cash reserve ratio. This instrument can change the money supply very soon. Higher the CRR, lower will be the loanable funds available with the commercial banks and so will be the amount of credit created by them. Higher the CRR, lower is the money supply in the economy and vice versa.

5. ***Statutory Liquidity Ratio (SLR):*** Statutory Liquidity Ratio is the percentage of demand and time deposits that banks need to keep with themselves in any or combination of the following forms:

   (a) Cash,

   (b) Gold valued at a price not exceeding the current market price,

   (c) Unencumbered approved securities valued at a price as specified by the RBI from time to time.

This is the proportion of deposits which Banks have to keep liquid in addition to CRR. This also has the same bearing on money supply in the economy as CRR.

Qualitative Measures

1. ***Fixation of Margin Requirement:*** Banker lends money against price of securities. The amount of loan depends upon the margin requirements of the banker. The word margin here means the difference between the loan value and market value of securities. The central bank has the power to change the margins, which limits the amount of loan to be sanctioned by the commercial banks. As obvious, during inflation higher margin would be fixed while during deflation, lower margin would be fixed.

2. ***Regulation of consumer credit:*** Customer gets this type of foreign exchange reserves and exchange value of the rupee in relation to other country's currencies. Currencies should be exchanged only with RBI or its authorized banks.

3. ***Credit rationing:*** It is a method of regulating and controlling purpose for which credit is guaranteed by the commercial bank. It may be of two types:

   (a) *Variable portfolio ceilings:* In this method, the central bank fixes a maximum amount of loans and advances for every commercial bank.

   (b) *Variable capital assets ratio:* In this method, the central bank fixes a ratio, which the capital of the commercial bank must bear to the total assets of the bank. By changing these ratio the credit can be regulated.

4. ***Moral suasion:*** This is a gracious method followed by RBI. In this method the RBI gives advices and suggestions to the bankers to follow the instructions given by it, by sending letters and conducting meeting of the Board of Directors.

5. ***Direct action:*** To regulate the volume of bank loans the central bank may issue directives to the commercial banks from time to time. The directives may be in the form of oral or written statements or appeals or warnings. By means of these directives the RBI may decrease or increase the volume of credit.

Notes

Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations.

The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than ₹ 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-war period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of ₹ 200 crores, of which at least ₹ 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business

Notes

within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

1. It holds the cash reserves of all the scheduled banks.
2. It controls the credit operations of banks through quantitative and qualitative controls.
3. It controls the banking system through the system of licensing, inspection and calling for information.
4. It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than ₹ 10,000. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. Further, the RBI has the responsibility of administering the exchange controls of the country.

Supervisory Functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation.

The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

Notes The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives.

Publication of Data

The Reserve Bank of India collects data related to all economic matters such as finance, production, balance of payments, prices etc. and are published in the form of reports, bulletins etc.

Notes

Bank of Central Clearance

The Reserve Bank of India acts as a bank of central clearance in settling the mutual accounts of commercial banks. If there is no RBI branch to do this service, the State Bank of India discharges these functions.

Promotional Functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies.

Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

Central Banking Functions

The monetary functions also known as the central banking functions of the RBI are related to control and regulation of money and credit, i.e., issue of currency, control of bank credit, control of foreign exchange operations, banker to the Government and to the money market. Monetary functions of the RBI are significant as they control and regulate the volume of money and credit in the country.

Equally important, however, are the non-monetary functions of the RBI in the context of India's economic backwardness. The supervisory function of the RBI may be regarded as a non-monetary function (though many consider this a monetary function). The promotion of sound banking in India is an important goal of the RBI, the RBI has been given wide and drastic powers, under the Banking Regulation Act of 1949 - these powers relate to licencing of banks, branch expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation. Under the RBI's supervision and inspection, the working of banks has greatly improved. Commercial banks have developed into financially and operationally sound and viable units.

Did u know? The RBI's powers of supervision have now been extended to non-banking financial intermediaries. Since independence, particularly after its nationalisation 1949, the RBI has followed the promotional functions vigorously and has been responsible for strong financial support to industrial and agricultural development in the country.

Notes

Case Study

RBI asks Banks to Fund Self-help Groups Directly

–Alarmed at micro-finance institutions' exposure to SHGs.

Both public and private sector banks were too "lethargic" in financing and re-financing SHGs, which has "led to MFIs taking advantage and becoming aggressive lenders at high rate of interest".

Alarmed at micro-finance institutions' exposure to self-help groups (SHGs), the Reserve Bank of India has asked public and private-sector banks to step up lending to SHGs. This directive also comes at a time when micro-finance institutions (MFIs) have been asked to reduced their high rate of interest being offered to their customers.

Speaking at a Dharwad District Consultative Committee meet recently, an RBI official said that both public and private sector banks were too "lethargic" in financing and re-financing SHGs, which has "led to MFIs taking advantage and becoming aggressive lenders at high rate of interest".

He also pointed out that MFIs were "funding too much to SHGs".

According to a report released by Sa-Dhan, which has 264 members, the total loan outstanding for all 264 MFIs that reported to Sa-Dhan is ₹ 18,343.9 crores reaching out to 2.67 crores active borrowers, and an additional ₹ 4,200 crores of outstanding portfolio is being managed by MFIs on behalf of banks and other financial institutions, taking the total outstanding portfolio managed by MFIs to about ₹ 22,544 crores.

In contrast, a NABARD report on the 'status of microfinance in India 2010', says that during 2009-10, banks in India financed 15.87 lakh SHGs, including repeat loan to the existing SHGs, with loans of ₹ 14,453.30 crores, registering a growth of 17.9 per cent over the previous year in loans disbursed. As on March 31, 2010, 48.51 lakh SHGs had outstanding bank loans of ₹ 28,038.28 crores, a growth of 23.6 per cent in bank loans outstanding against SHGs.

The RBI official said that with active help from NABARD, Central and State agencies, public and private sector banks should "aggressively fund SHG projects directly instead of present practice of using MFIs as middlemen".

As banks have access to cheap credit, they should take advantage and fund SHGs at village level, he suggested. "Through this, banks can win over the trust and lay a strong foundation for financial inclusion and creating joint liability groups at village or taluk level," he added.

With banks now on a wait-and-watch mode as far as lending to MFIs goes, the present crisis in Andhra Pradesh could well present them good avenues to reach out to SHGs better, said an official with a public sector bank. "Banks can offer direct linkage to SHGs at within 12 per cent, and even after including the SHG margin of 3 per cent, credit is available at around 15 per cent, which is much lower than the high rates of interest that MFIs charge," he explained. This is one way of tackling the MFI issue.

Some banks like Canara Bank, which were not aggressive lenders to MFIs, want to continue having direct credit-linkage to SHGs. "We have always thought of lending directly, and there is no need for a change in that philosophy now. And we have never been aggressive lenders to the MFI sector," Mr S. Raman, Chairman and Managing Director, Canara Bank, told Business Line recently.

Contd...

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This fiscal, the bank has disbursed credit of ₹ 1,000 crores to SHGs directly, and expects to close the year with a 25 per cent growth in this portfolio.

As banks are now looking at direct credit-linkage to SHGs aggressively, MFIs are now forced to operate on a low-margin high-volume model. With MFIs being forced to reduce their rate of interest, "margins will be significantly impacted for several of them," pointed out Mr Suresh K. Krishna, Managing Director, Grameen Koota.

The drop in margins could be as high as 30-40 per cent for those who offer higher rates now. "But others, who currently offer loans at less than 30 per cent interest rate, there wouldn't be much of a difference," he added.

Question

Discuss the role of RBI in helping the Self-help Groups.

Source: http://www.thehindubusinessline.in

4.3 Summary

- The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 provides the statutory basis of the functioning of the bank.
- The bank was constituted for the need to regulate the issue of banknotes, maintain reserves with a view to securing monetary stability and operate the credit and currency system of the country to its advantage.
- Reserve Bank plays very important role in Indian economy by maintaining economic stability, price stability and ensuring overall development of the economy.
- The main functions of the RBI include being the bank of note issue.
- RBI is also the banker to the Indian government.
- It also performs the function of being a bankers' bank and the lender of the last resort.
- Apart from these, the RBI works as the controller of credit and custodian of foreign reserves also.

4.4 Keywords

Custodian: One that has charge of something; a caretaker.

Demand loan: Loan with no specific maturity date, but payable at any time. Only interest is paid until the principal is paid off, or until the lender demands repayment of principal.

Liability: A required transfer of assets or services that must occur on or by a specified date as a result of some other event that has already occurred.

4.5 Self Assessment

Fill in the blanks:

1. The monetary functions are also known as the ..... functions of the RBI.
2. Being the monetary authority of the economy, RBI is responsible for ....., ... and ..... the monetary policy of India.

Notes

3. Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of .....
4. The ..... function of the RBI may be regarded as a non-monetary function.
5. The RBI acts as the lender of the last resort by providing ..... facilities to scheduled banks.
6. The power of the RBI to call for information is also intended to give it effective control of the .....
7. The Reserve Bank of India has the responsibility to ..... the official rate of exchange.
8. The Reserve Bank of India acts as a bank of ..... in settling the mutual accounts of commercial banks
9. Under the method of ....., the RBI gives advices and suggestions to the bankers to follow the instructions given by it
10. In India, the currencies should be exchanged only with ..... or ..... banks.
11. ..... means the difference between the loan value and market value of securities.
12. ..... is the nodal agency which facilitates external trade and payment in India.
13. RBI destroys currency and coins ..... for circulation.
14. If there is no RBI branch in a certain region, some of its services can be discharged by the .....
15. The Reserve Bank of India helps the Government - both the Union and the States to float new ..... and to manage public .....

4.6 Review Questions

1. What are the main supervisory functions that the Reserve Bank of India has?
2. What role is played by the RBI in order to keep the economy stable?
3. "RBI has started doing commercial banking functions also." Discuss.
4. Do you think RBI has been able to successfully shield Indian economy from the global recession? Support your argument with reasons.
5. "RBI has emerged as one of the strongest central banking authorities of the world." Comment.
6. Discuss about the relationship between the commercial bank and RBI. How does RBI regulate the working of commercial banks?
7. If the US hikes the Fed rate, and India stays still, what will be the impact on Indian currency? If the RBI wants to prevent the situation, what will it do and how?
8. What are the current challenges to Indian monetary policy?
9. One key driving factor for economic recovery is low interest rates. Comment with regard to the monetary policy directives of India during recent times.
10. On April 22, 2009, the Reserve Bank of India (RBI) warned that banks, which engaged in sponsoring and managing private pools of capital, were prone to high risk. Why so?
11. Examine the process of working of various tools of monetary policy of India.
12. According to you which works better: Repo or CRR? Why?

Notes

Answers: Self Assessment

1. central banking
2. implementing, formulating, monitoring
3. international currencies
4. supervisory
5. rediscount
6. credit system
7. maintain
8. central clearance
9. moral suasion
10. RBI, its authorised
11. Margin
12. RBI
13. unfit
14. State Bank of India
15. loans, debt

4.7 Further Readings

Online links

bulletin.rbi.org.in

fiilist.rbi.org.in

rbidocs.rbi.org.in

www.24framesdigital.com

www.rbi.org.in

Notes

Unit 5: Securities and Exchange Board of India

CONTENTS

Objectives

After studying this unit, you will be able to:

- Know the guidelines
- State the types of exchanges
- Identify national exchange
- List the regional exchange or local stock exchange

Introduction

SEBI is the Regulator for the Securities Market in India. The Securities and Exchange Board of India was established in 1988 and was given the statutory status on April, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as:

"*…..to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto*".

Notes

5.1 SEBI Functions and Responsibilities

Chapter IV of the SEBI Act, 1992 deals with the powers and functions of the board. SEBI has to be responsive to the needs of three groups, which constitute the market:

1. Issuers of securities
2. Investors
3. Market intermediaries.

SEBI has three functions rolled into one body quasi-legislative, quasi-judicial and quasi-executive. It drafts regulations in its legislative capacity, it conducts investigation and enforcement action in its executive function and it passes rulings and orders in its judicial capacity. Though this makes it very powerful, there is an appeals process to create accountability. There is a Securities Appellate Tribunal which is a three member tribunal. A second appeal lies directly with the Supreme Court.

5.2 Guidelines

SEBI has enjoyed success as a regulator by pushing systemic reforms aggressively and successively.

Example: On April 1, 2003, SEBI made it compulsory for all transactions in all groups of securities in the equity segment and fixed income securities listed on BSE, to be settled within 2 days after the trade day. (T+2 rolling settlement). This made a quick movement of the market to get electronic and paperless.

SEBI has been active in setting up the regulations as required under law.

Section 11 of the Act lays down that it shall be the duty of the board to protect the interests of the investors in securities and to promote the development of and to regulate the securities markets by such measures as it thinks fit. These measures would include:

1. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner.
2. Registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the board may, by notification, specify in the behalf.
3. Registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds.
4. Promoting and regulating self-regulatory organizations.
5. Prohibiting fraudulent and unfair trade practices relating to securities markets.
6. Promoting investors education and training of intermediaries of securities markets.
7. Prohibiting insider trading in securities.
8. Regulating substantial acquisition of shares and takeover of companies.
9. Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organizations in the securities market.

Notes

10. Performing such functions and exercising such powers under the provisions of the Securities Contracts Act, 1956, as may be delegated to it by the Central Government.
11. Levying fees or other charges for carrying out the purposes of this section.
12. Conduction research for the above purposes.
13. Calling from or furnishing to any such agencies, as may be specified by the board, such information as may be considered necessary by it for the efficient discharge of its functions.
14. Performing such other functions as may be prescribed.

For carrying out the duties assigned to it under the act, SEBI has been vested with the same powers as are available to a Civil Court under the Code of Civil Procedure, 1908 for trying a suit in respect of the following matters:

The discovery and production of books of account and other documents at the place and time indicated by SEBI. Summoning and enforcing the attendance of persons and examining them on the place and time indicated by SEBI. Inspection of any books, registers and other documents of any person listed in section 12 of the Act, namely stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustee of trust deed, registrar to an issue, merchant bankers, underwriters, portfolio managers, registrar to an issue, investment advisors and other such intermediaries associated with securities markets.

Caselet

SEBI eases Lending Disclosure Norms for FIIs

SEBI on Tuesday said that FIIs will now have to disclose information on Indian securities lent by them to overseas entities (for the purpose of short selling) on a weekly rather than a daily basis.

The information will be submitted every Friday and SEBI will make it public the following Tuesdays This circular will be implemented from July 2.

The first such report will be submitted to SEBI on July 9 and it will be made public on July 13, said the SEBI circular.

According to the current guidelines, FIIs have to submit reports to the markets regulator on a daily basis and the details are made public by SEBI on Tuesdays and Fridays.

Participatory Notes issuing FIIs are required to submit details regarding "any fresh short positions" to SEBI immediately, the circular said.

Brokers are of the view this will not make much difference to the Securities Lending and Borrowing segment as there is hardly in activity happening in it.

Source: http://www.thehindubusinessline.in

Notes

5.3 Types of Exchanges

The exchanges of India can be divided into national, regional or local exchanges. A detailed explanation of each is as follows:

5.3.1 National Exchange

The National Stock Exchange of India Limited (NSE), is a Mumbai-based stock exchange. It is the second largest stock exchange in India in terms of daily turnover and number of trades, for both equities and derivative trading. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions. The NSE's key index is the S&P CNX Nifty, known as the Nifty, an index of fifty major stocks weighted by market capitalisation.

NSE is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India but its ownership and management operate as separate entities.

NSE is the third largest Stock Exchange in the world in terms of the number of trades in equities. It is the second fastest growing stock exchange in the world with a recorded growth of 16.6%.

NSE has remained in the forefront of modernization of India's capital and financial markets, and its pioneering efforts include:

1. Being the first national, anonymous, electronic Limit Order Book (LOB) exchange to trade securities in India. Since the success of the NSE, existent market and new market structures have followed the "NSE" model.
2. Setting up the first clearing corporation "National Securities Clearing Corporation Ltd." in India. NSCCL was a landmark in providing innovation on all spot equity market (and later derivatives market) in India.
3. Co-promoting and setting up of National Securities Depository Limited, first depository in India.
4. Setting up of S&P CNX Nifty.
5. NSE pioneered commencement of Internet Trading in February 2000, which led to the wide popularization of the NSE in the broker community.
6. Being the first exchange that, in 1996, proposed exchange traded derivatives, particularly on an equity index, in India. After four years of policy and regulatory debate and formulation, the NSE was permitted to start trading equity derivatives.
7. Being the first and the only exchange to trade GOLD ETFs (exchange traded funds) in India.
8. NSE has also launched the NSE-CNBC-TV18 media centre in association with CNBC-TV18.

Currently, NSE has the following major segments of the capital market:

1. Equity
2. Futures and Options
3. Retail Debt Market
4. Wholesale Debt Market
5. Currency futures.

It is the one of the most important stock exchanges in the world.

Notes

5.3.2 Regional or Local Stock Exchange

There are 23 stock exchanges in India. Among them two are national level stock exchanges namely Bombay Stock Exchange (BSE) and National Stock Exchange of India (NSE). The rest 21 are Regional or Local Stock Exchanges (RSE).

List of Regional Stock Exchanges in India

1. Ahmedabad Stock Exchange
2. Bangalore Stock Exchange
3. Bhubaneshwar Stock Exchange
4. Calcutta Stock Exchange
5. Cochin Stock Exchange
6. Coimbatore Stock Exchange
7. Delhi Stock Exchange
8. Guwahati Stock Exchange
9. Hyderabad Stock Exchange
10. Jaipur Stock Exchange
11. Ludhiana Stock Exchange
12. Madhya Pradesh Stock Exchange
13. Madras Stock Exchange
14. Magadh Stock Exchange
15. Mangalore Stock Exchange
16. Meerut Stock Exchange
17. OTC Exchange of India
18. Pune Stock Exchange
19. Saurashtra Kutch Stock Exchange
20. Uttar Pradesh Stock Exchange
21. Vadodara Stock Exchange.

The Regional Stock Exchanges started clustering from the year 1894, when the first RSE, the Ahmedabad Stock Exchange (ASE) was established. In the year 1908, the second in the series, Calcutta Stock Exchange (CSE) came into existence.

During the early sixties, there were only few recognized RSEs in India namely Calcutta, Madras, Ahmedabad, Delhi, Hyderabad and Indore. The number remained unchanged for the next two decades. 1980s was the turning point and many RSEs was incorporated. The latest is Coimbatore Stock Exchange and Meerut Stock Exchange.

A new share trading platform called the BSEIndonext, inaugurated recently, might at best provide a lifeline to regional stock exchanges. These have been fast losing business to the two principal stock exchanges, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE). A more optimistic inference seems premature if recent stock exchange history is anything to go by. Until the mid-1990s the regional stock exchanges were significant players in the Indian

Notes

capital market. Company law as well as capital market rules and regulations gave them a sizable captive business from companies located in their areas. A company going public had to have its shares listed in the regional stock exchange nearest to its place of incorporation and only optionally with the BSE. In case of oversubscription, it was the regional exchange that approved the allotment pattern. Companies having a large market capitalisation as well as a wide branch network chose to have their shares listed in many regional stock exchanges as well as in the BSE. A major reason for the survival of regional stock exchanges was seen in the slow pace of technological progress. Well into the 1990s, Indian stock exchanges in general were laggards in adopting communication technology that was transforming bourses in the U.S. and Europe. Regional exchanges could still conduct trade in isolation from one another and from the BSE. This had several undesirable consequences: illiquidity of stocks, possibilities of manipulation, and arbitrage were some of them.

A vastly expanded reach was one of the major benefits the new technology conferred on the stock exchanges. Significantly improved trading and settlement practices resulted. These advantages were dramatically demonstrated by the advent of the NSE; it came into being in November 1994 with a specific mandate to develop a better model than the existing exchanges. Adopting the state of the art in technology and stock exchange management skills — the NSE is the only exchange run wholly by professionals — the new exchange soon acquired pre-eminence. Investors in many centres, outside the metros and even in semi urban areas, could trade on the all-India exchange. Very soon the BSE followed suit with its own "BOLT" system. The marginalisation of the regional stock exchanges became complete. Many large corporates, not perceiving any benefit in sticking to a regional exchange, opted out. This process was facilitated by the changed rules. Simultaneously, as part of stock market reform in India, exchanges were required to professionalise their management and change their organisational structure from a "mutual" basis — essentially a club type format with stock brokers as the only members — to a "demutual" basis, a corporate form. That move has gathered momentum with the Government amending the relevant legislation.

Will the regional exchanges adapt to the requirements of technology and organisational restructuring and remain viable entities? Until recently many experts felt the regional exchanges would go the way of many smaller exchanges in the developed world. However, the advent of Indonext opens up many possibilities for survival by coming together and trading through a new platform specially designed for the stocks of small and medium companies. As a rule such stocks do not have liquidity. The hope is that the new platform will pool the resources of its 18 members and overcome the deficiencies of trading in illiquid stocks and small exchanges. There have been some tall claims of Indonext paving the way for a strong all-India exchange that would eventually be up in competition with the BSE and the NSE. A more realistic view is that the new platform will give regional exchanges a lease of life.

Task Find out what is BSEIndonext and discuss its utility for RSEs.

5.4 BSE Derivative Trading

The path for derivatives trading was cleared in India with the introduction of Securities Laws (Amendment) Bill in Parliament in 1998. Yet the introduction of derivatives was delayed for as the infrastructure for it had to be set up. Derivatives trading required a computer-based trading system, a depository and a clearing house facility. In addition, problems such as low market capitalization of the Indian stock markets, the small number of institutional players and the absence of a regulatory framework caused further delays.

Notes

On June 9, 2000, the Bombay Stock Exchange (BSE) introduced India's first derivative instrument - the BSE-30(Sensex) index futures. It was introduced with three month trading cycle - the near month (one), the next month (two) and the far month (three). BSE Derivatives trading came as essentially a form of forward trading in derivative products like stock indices. An investor could buy or sell index at a future date. His gain/loss would be determined on the basis of the real level of the index on that date.

On NSE soon following BSE steps, and capturing the activity, SEBI put in place stringent entry norms for derivatives trading. Clearing members with or without trading rights should have a net worth of ₹ 3 crores while security deposit would be ₹ 50 lakh broken into cash, cash equivalent and securities. Trading members were required a minimum net worth of ₹ 50 lakh and a security deposit of ₹ 10 lakh.

Presently, BSE has determined the following roadmap for aspirants to become a member of its derivatives segment. The derivatives membership application forms can be downloaded from the BSE website and the applications forms duly filled along with the required documents should be submitted to the Membership Services & Development. The application is then placed before the BSE Committee of Executives. Applications approved by BSE Committee of Executives are sent to SEBI for approval and registration. After the BSE Committee of Executives approval, the MSD issues election and admission letter. After receipt of SEBI registration, applicants account is debited by ₹ 50,000.00 in case of Clearing Membership. For commencement of business in the derivatives segment, the person then has to contact Relationship Managers (BDM Department) and finally, start the trading.

Types of Membership in the BSE Derivatives Segment

There are following types of memberships in the BSE derivatives segment-

1. ***Trading Member:***
   - (a) A Trading Member should be an existing Member of BSE cash segment.
   - (b) A Trading Member has only trading rights but no clearing rights. He has to associate with a Clearing Member to clear his trades.
2.. ***Trading-cum-Clearing Member:***
   - (a) A Trading-cum-Clearing Member should be an existing Member of BSE cash segment.
   - (b) A TCM can trade and clear his trades. In addition, he can also clear the trades of his associate Trading Members.
3. ***Professional Clearing Member/Custodial Clearing Member:***
   - (a) A Professional Clearing Member need not be a Member of BSE cash segment.
   - (b) A PCM has no trading rights and has only clearing rights i.e. he just clears the trades of his associate Trading Members & institutional clients.
4. ***Limited Trading Member:***
   - (a) A Limited Trading Member need not be a Member of BSE cash segment.
   - (b) A LTM has only trading rights and no clearing rights. He has to associate with a Clearing Member to clear his trades.
5.. ***Self-clearing Member:***
   - (a) A Self Clearing Member should be an existing member of the BSE cash segment.

Notes

(b) An SCM can clear and settle trades on his own account or on account of his client only and not for any other Trading Member.

Clearing Members of the Derivatives Segment (including Trading cum Clearing Members), are required to maintain the net-worth criteria of ₹ 3.00 crores, as per the following formula prescribed by SEBI.

Capital + Free Reserves – Non-allowable assets

Notes Non allowable assets include:

1. Fixed assets
2. Pledged Securities (Pledged securities are required to be deducted at book value).
3. Member's card
4. Non-allowable securities (unlisted securities)
5. Bad deliveries
6. Doubtful debts and advances (debts/advances overdue for more than three months or given to associates)
7. Prepaid expenses, losses
8. Intangible assets
9. 30% of marketable securities (30% of Book value or Market Value, whichever is lower, of marketable securities).

Caution

1. Pledged securities are not to be considered at point no. (i)
2. Securities held as stock-in-trade, are not to be considered at point no. (i)

In the meantime, derivatives trading on the NSE (National Stock Exchange) picked up significantly since it was launched. Daily trading volumes in Nifty futures and options, and options on individual stocks, averaged ₹ 300 crores for some time. In contrast, trading in the BSE's (Bombay Stock Exchange) derivatives (Sensex options and futures and options on stocks) remained lacklustre, with an average daily volume of about ₹ 4 crores.

In a bid to stimulate derivatives trading, the BSE invited prospective market-makers with a range of sops. For broker-members willing to commit to market-making, the exchange would waive the charges for the use of up to two VSATs or leased line links to the trading system. It would also waive its transaction fees (except for contribution to trade guarantee fund and investor protection fund). In return, market-makers would have to commit to offering quotes for purchase or sale of their chosen derivative products for a stipulated minimum order quantity. They also had to specify a spread (the difference between 'buy' and 'sell') prices below a stipulated figure. The market-maker's quote did not, however, enjoy any precedence over other quotes, once trading started. These were pretty stringent requirements. The 'incentives', on the other hand, were niggardly-the transaction charges that the BSE offered to waive were as low as 0.002 per cent of the traded value. As such, the sops were unlikely to catalyse any significant increase in trading volumes.

Till June 2009, derivatives' trading on BSE was done only through Derivatives Trading and Settlement System (DTSS), which used to generate trades by matching orders.

Notes

Till then, only cash market trades were done through Bolt. The efforts of the Bombay Stock Exchange (BSE) to infuse life into its moribund derivatives segment by shifting the trading platform to BSE Online Trading (Bolt) terminals are not yielding any results, at least till now.

BSE, which began trading in futures on its Sensex index and 100-odd individual stocks on Bolt terminals from June 29, is yet to attract trades from brokers.

As per the data available on the BSE website, the trading turnover in the derivatives segment was an insignificant ₹ 4.34 lakh on July 1, compared with its rival National Stock Exchange's ₹ 65,000-plus crores average daily turnover. BSE claims it would take some time before brokers get used to trading on Bolt, which is designed to make derivatives trading 'easier and cost-effective'.

At present, only futures trading have been shifted to Bolt and soon trading in options will also be transferred to Bolt, they said.

Did u know? **What is short selling?**

Simply put, short selling is the sale of shares that the seller does not own. That sounds funny, right? It isn't. Short selling is the sale of stocks that seller doesn't own, but there is a promise of delivery. It may sound a bit complicated, but it is actually a very simple concept. When you are short selling a stock, your broker lends the stock to you. The stock may be part of the broker's portfolio holdings, a customer's or from another broking house. You have the obligation to close the "short" by buying the same number of shares (covering in technical parlance) and return them to your broker.

In India, SEBI had banned short selling after heavy shorting by operators resulted in a crash in the stock market in 2001. After plugging a few loopholes, it thought short selling could be re-introduced, as it would add depth to the market. Consequently, short selling was re-introduced on Dec 20, 2007 in Indian market again.

5.5 BSE Indices

For the premier stock exchange that pioneered the securities transaction business in India, over a century of experience is a proud achievement. A lot has changed since 1875 when 318 persons by paying a then princely amount of ₹ 1, became members of what today is called Bombay Stock Exchange Limited (BSE).

Over the decades, the stock market in the country has passed through good and bad periods. The journey in the 20th century has not been an easy one. Till the decade of eighties, there was no measure or scale that could precisely measure the various ups and downs in the Indian stock market. BSE, in 1986, came out with a Stock Index-SENSEX- that subsequently became the barometer of the Indian stock market.

Sensex

SENSEX, first compiled in 1986, was calculated on a "Market Capitalization-Weighted" methodology of 30 component stocks representing large, well-established and financially sound companies across key sectors. The base year of SENSEX was taken as 1978-79. SENSEX today is widely reported in both domestic and international markets through print as well as electronic media. It is scientifically designed and is based on globally accepted construction and review methodology. Since September 1, 2003, SENSEX is being calculated on a free-float market capitalization methodology. The "free-float market capitalization-weighted" methodology is a widely followed index construction methodology on which majority of global equity indices

Notes

are based; all major index providers like MSCI, FTSE, STOXX, S&P and Dow Jones use the free-float methodology.

The growth of the equity market in India has been phenomenal in the present decade. Right from early nineties, the stock market witnessed heightened activity in terms of various bull and bear runs. In the late nineties, the Indian market witnessed a huge frenzy in the 'TMT' sectors. More recently, real estate caught the fancy of the investors. SENSEX has captured all these happenings in the most judicious manner. One can identify the booms and busts of the Indian equity market through SENSEX. As the oldest index in the country, it provides the time series data over a fairly long period of time (from 1979 onwards). Small wonder, the SENSEX has become one of the most prominent brands in the country.

Specifications

Base Year	1978-79
Base Index Value	100
Date of Launch	01-01-1986
Method of calculation	Launched on full market capitalization method and effective September 01, 2003, calculation method shifted to free-float market capitalization.
Number of scrips	30

BSE-100 Index

A broad-based index, the BSE-100 was formerly known as the BSE National index. This Index has 1983-84 as the base year and was launched in 1989. In line with the shift of the BSE Indices to the globally accepted Free-Float methodology, BSE-100 was shifted to Free-Float methodology effective from April 5, 2004. The method of computation of Free-Float index and determination of free-float factors is similar to the methodology for SENSEX.

Index Specification

Base Year	1983-84
Base Index Value	100
Date of Launch	January 03, 1989
Method of calculation	Launched on full market capitalization method and effective April 05, 2004, calculation method shifted to free-float market capitalization.
Number of scrips	100

BSE-200 Index

Over the years, the number of companies listed on BSE continued to register a phenomenal increase; from 992 in to over 3,200 companies by March 1994, with combined market capitalization rising from ₹ 5,421 crores to ₹ 3,98,432 crores as on 31st March, 1994.

Though SENSEX (1978-79=100) was serving the purpose of quantifying the price movements as also reflecting the sensitivity of the market in an effective manner, the rapid growth of the market necessitated compilation of a new broad-based index series reflecting the market trends in a more effective manner and providing a better representation of the increased equity stocks, market capitalization as also to the new industry groups. As such, BSE launched on 27th May 1994, two new index series-BSE-200 and Dollex-200.

Notes

The equity shares of 200 selected companies from the specified and non-specified lists of BSE were considered for inclusion in the sample for 'BSE-200'. The selection of companies was primarily been done on the basis of current market capitalization of the listed scrips. Moreover, the market activity of the companies as reflected by the volumes of turnover and certain fundamental factors were considered for the final selection of the 200 companies.

Specification

Base Year	1989-90
Base Index Value	100
Date of Launch	May 27, 1994
Method of calculation	Launched on full market capitalization method and effective August 16, 2005, calculation method shifted to free-float market capitalization.
Number of scrips	200

Dollex Series of BSE Indices

All BSE indices reflect the growth in market value of constituent stocks over the base period in Rupee terms. A need was felt to design a yardstick by which these growth values are also measured in Dollar terms. Such an index would reflect, in one value, the changes in both the stock prices and the foreign exchange variation.

This was facilitated by the introduction of a dollar-linked index in which the formula for calculation of index is suitably modified to express the current and base market values in dollar terms. The scope for dollar-linked index emerged from the background of Indian equity markets increasingly getting integrated with global capital markets and the need to assess the market movements in terms of international benchmarks. The dollar-linked indices are useful to overseas investors, as it helps them measure their 'real returns' after providing for exchange rate fluctuations.

Dollex-30, a dollar-linked version of SENSEX, was launched on July 25, 2001 whereas Dollex-200, a dollar-linked version of BSE-200 was launched on May 27, 1994. These indices were initially calculated at the end of the trading session by taking into consideration day's rupee/ US$ reference rate as announced by India 's Central Bank i.e. Reserve Bank of India.

BSE introduced Dollex-100, a dollar linked version of BSE-100, on May 22, 2006.

Dollex-30, Dollex-100 and Dollex-200 are calculated and displayed through BSE On-line trading terminals (BOLT) by taking into account real-time Re./US$ Exchange rate. The formula for calculating the index is:

$$\text{Dollex} = \frac{\text{Index Value } (\text{In local currency}) * \text{Base rupee-US\$ rate}}{\text{Current rupee-US\$ rate}}$$

BSE-500

Bombay Stock Exchange Limited constructed a new index, christened BSE-500, consisting of 500 scrips w.e.f. August 9, 1999. The changing pattern of the economy and that of the market were kept in mind while constructing this index.

BSE-500 index represents nearly 93% of the total market capitalization on BSE. BSE-500 covers all 20 major industries of the economy. In line with other BSE indices, effective August 16, 2005 calculation methodology was shifted to the free-float methodology.

Notes

Specification

Base Year	February, 1999
Base Index Value	1000
Date of Launch	August, 1999
Method of calculation	Launched on full market capitalization method and effective August 16, 2005, calculation method shifted to free-float market capitalization.
Number of scrips	500

Over the years, BSE shifted all its indices to the free-float methodology (except BSE-PSU index).

Sectoral Indices

BSE also constructs various sectoral indices "Sector Series (90/FF)" as detailed below. All these indices are calculated and disseminated on BOLT, BSE's trading terminal on a real time basis. "90/FF" implies that the index covers 90% of the sectoral market capitalization and is based on the Free-Float methodology.

BSE Sector Series (90/FF) Indices

1. BSE Auto Index
2. BSE BANKEX
3. BSE Capital Goods Index
4. BSE Consumer Durables Index
5. BSE FMCG Index
6. BSE Healthcare Index
7. BSE IT Index
8. BSE Metal Index
9. BSE Oil & Gas Index
10. BSE Power Index
11. BSE Realty Index

Index Specification

Index	Base Period	Base Index Value	Date of Launch	Method of Calculation
BSE Auto	01 February, 1999	1000	23 August, 2004	Free-float market capitalization
BSE BANKEX	01 January, 2002	1000	23 June, 2003	Free-float market capitalization
BSE Capital Goods	01 February, 1999	1000	09 August, 1999	Launched on full market capitalization method and effective August 23, 2004, calculation method shifted to free-float market capitalization

Contd...

Notes

BSE Consumer Durables	01 February, 1999	1000	09 August, 1999	Launched on full market capitalization method and effective August 23, 2004, calculation method shifted to free-float market capitalization
BSE FMCG	01 February, 1999	1000	09 August, 1999	Launched on full market capitalization method and effective August 23, 2004, calculation method shifted to free-float market capitalization
BSE Healthcare	01 February, 1999	1000	09 August, 1999	Launched on full market capitalization method and effective August 23, 2004, calculation method shifted to free-float market capitalization
BSE IT	01 February, 1999	1000	09 August, 1999	Launched on full market capitalization method and effective August 23, 2004, calculation method shifted to free-float market capitalization
BSE Metal	01 February, 1999	1000	23 August, 2004	Free-float market capitalization
BSE Oil & Gas	01 February, 1999	1000	23 August, 2004	Free-float market capitalization
BSE Power Index	03 January, 2005	1000	09 November, 2007	Free-float market capitalization
BSE Realty	2005	1000	09 July, 2007	Free-float market capitalization

BSE TECk Index

The decade of 1990s saw the emergence of the TMT sector as a major force in the Indian economy. The remarkable growth of this sector was reflected in the financial markets.

Going by the trading pattern, around 19% of the turnover on the stock exchanges is taking place in TMT sector stocks. These stocks collectively account for 15% of the total market capitalization. The investment interest in technology stocks continues unabated.

Recognizing the growing importance of the TMT sector, BSE TECk index was launched in 2001.

Specification

Base Year	April 02, 2001
Base Index Value	1000
Date of Launch	July 11, 2001
Method of calculation	Free-float market capitalization method
Number of scrips	Variable as it aims to represent minimum 90% market capitalization from the universe of BSE-500 index

BSE PSU Index

Bombay Stock Exchange Limited launched "BSE PSU Index" on 4th June 2001. This index consists of major Public Sector Undertakings listed on BSE. The BSE PSU Index is displayed on-line on the BOLT trading terminals nationwide.

Notes

Objective

1. An Index to track the performance of listed equity of PSU companies.
2. A suitable benchmark for the Central Government to monitor its wealth on the bourses.

Index Specification

Base Year	February 01, 1999
Base Index Value	1000
Date of Launch	June 04, 2001
Method of calculation	Full market capitalization method
Number of scrips	All PSU stocks in BSE-500 index

BSE Mid-Cap and BSE Small-Cap Index

BSE introduced the new index series called 'BSE MID-Cap' index and 'BSE Small-Cap' index to track the performance of companies with relatively smaller market capitalization.

BSE-500 Index - represents more than 93% of the listed universe. Companies with large market capitalization bias the movement of BSE-500 index. This necessitated construction of a separate indicator to capture the trend in companies with lower market capitalization. Over the years, BSE Mid-Cap and BSE Small-Cap indices have proven to be a great utility to the investing community.

Specification

Base Year	2002-03
Base Index Value	1000
Date of Launch	April 11, 2005
Method of calculation	Free-float market capitalization method
Number of scrips	Variable

BSE IPO Index

On August 24, 2009, Bombay Stock Exchange today announced the launch of BSE IPO index that will track the value of companies for two years after listing subsequent to successful completion of their Initial Public Offering (IPO).

IPO index has been introduced with expectations of robust growth of the Indian economy to boost the primary market and to introduce an indicator that will track primary market conditions in the Indian capital market.

According to guidelines issued by BSE, a company seeking listing on the exchange after completion of IPO shall be considered eligible for inclusion in the index, but follow-on public issues shall not be considered for inclusion.

A scrip must have the minimum free-float market capitalisation of ₹ 100 crores on its first day of listing and will be included in the index on the third day of its listing. A scrip will be excluded from the index on the second Monday of the month after completion of two years of listing. At all time a minimum of 10 scrips shall be maintained in the index. In case, there are less than 10 companies on account of possible exclusion after two years, the exclusion of such company shall be delayed till such time new inclusion is made in the index.

Notes

The maximum weight of any scrip shall be capped at 20 per cent and the constituent weightage shall be reviewed at the time of inclusion/ or exclusion of a scrip and on monthly rebalancing. Index value on August 21, 2009 is 1901.67 and the index would be calculated and disseminated on a real-time basis through BOLT effective August 24, 2009. However, follow-on public issues shall not be considered for inclusion in the index and a minimum of 10 scrips shall be maintained on the index at any given point in time, the statement added.

Specifications

Base Date	May 3, 2004
Base Index Value	1000
Calculation Methodology	Free float Methodology
No. of Scrips on launch date	48

BSE disseminates information on the Price-Earnings Ratio, the Price to Book Value Ratio and the Dividend Yield Percentage on day-to-day basis of all its major indices.

The values of all BSE indices are updated on real time basis during market hours and displayed through the BOLT system, BSE website and news wire agencies.

All BSE Indices are reviewed periodically by the BSE Index Committee. This Committee which comprises eminent independent finance professionals frames the broad policy guidelines for the development and maintenance of all BSE indices. The BSE Index Cell carries out the day-to-day maintenance of all indices and conducts research on development of new indices.

Case Study

SEBI seeks more details on FIIs' Structure

ROUND-TRIPPING FEARS.

New Norms

The FII has to "declare that it is not a Protected Cell Company or Segregated Portfolio Company and doesn't have an equivalent structure," said the SEBI circular issued.

The Securities and Exchange Board of India has issued a circular on Thursday directing FIIs to provide additional information pertaining to their structure by September 30.

This is an obvious indicator that SEBI is suspicious that the very structure of the Foreign Institutional Investors could be misused for round-tripping, whereas earlier the regulator's concentration was on misuse of P-note issuances by FIIs, said an expert on regulatory matters.

The FII has to "declare that it is not a Protected Cell Company (PCC) or Segregated Portfolio Company (SPC) and doesn't have an equivalent structure," said the SEBI circular.

FIIs have also been directed to declare that they are not a multi-class share vehicle (MCV) by constitution and do not have an equivalent structure. (MCV by definition means the entity has issued different classes of shares to investors which differentiate the ownership pattern of shareholders.)

The FIIs have to declare that "it (FII investment) contains only single class share," (instead of MCV), said SEBI.

Contd...

Notes

In case an FII happens to be an MCV or has an equivalent structure, it must give an undertaking that common portfolios shall be allocated across various share classes and it shall be broad-based.

Alternatively, it must give an undertaking that if it has segregated portfolios, then each share class shall satisfy the broad-based criteria; that in case of change in structure of classes of shares, prior SEBI approval shall be sought.

The declarations and undertakings shall be made by all FIIs that are registered with SEBI as on April 7, as well as all fresh applicants.

Barclays and Societe General Cases

SEBI had come across violations of FII regulations by Barclays and Societe General while issuing offshore derivative instruments to their clients, which may have prompted the regulator to issue these directives, experts familiar with the matter said.

From the reports submitted by Barclays (FII) between January 2006 and January 2008 in SEBI cases against them, SEBI observed that Barclays had issued Offshore Derivative Instruments in 2006 to UBS AG with Reliance Communications Ltd shares as underlying. When the regulator sought documents in support of these ODIs, the FII had reverted that it had identified some discrepancies and it was reviewing them.

Later Barclays told SEBI that the counterparty for the ODI transactions was not UBS AG but Hythe Securities Ltd, an entity that was not part of any periodical submissions made by Barclays or in the specific information submitted to SEBI's query with reference to underlying shares of Reliance Communications.

SEBI said the ODIs under reference were issued to Hythe and that they were onward issued to 'Pluri Emerging Companies PCC Cell E Emerging Markets Growth Fund', which the FII said was regulated by the Financial Services Authority in the UK. SEBI's case against Societe General was along similar lines; in fact the Hythe Securities was one of the entities involved in this case too.

Question

Discuss the role of SEBI in regulating the functioning of FII.

Source: http://www.thehindubusinessline.in

5.6 Commodity Exchange

A commodity exchange is a place where various commodities and derivatives are bought and sold. Commodities exchanges usually trade on commodity futures.

Reasons for Trading in Commodity Exchanges

1. ***Hedging:*** Commodities are subject to constant and extreme price fluctuations. Traders are the worst sufferers of the price risk. Forward contracts have come to their rescue.

   A forward contract requires a buyer and a seller to take and make a delivery of a definite quantity of a particular commodity at a future specified date. Such contracts are traded on an exchange, which provides guarantee for all futures dealings, and parties can "hedge" at suitable levels. Hedging lessens risk since it involves the purchase or sale of a commodity with the intention of counterbalancing the profit or loss of another investment. Therefore, any loss on the previous investment will be hedged, or compensated, by a matching profit from the hedging instrument.

Notes

2. ***Speculating:*** Speculators are people who are prepared to bear risks in anticipation of earning profits. Markets are granted liquidity by speculators and it is hard to conceive of a futures market devoid of speculators.

3. ***Arbitrage:*** Arbitrage involves buying a commodity at a low price and instantly selling it for a higher price in another market. Thus, traders can profit from arbitrage opportunities occurring due to price differences between two exchanges.

4. ***Shifting of Risk:*** The minute a trader finalizes a deal and secures a price, he is no longer concerned by unfavorable price shifts. For example, if a seller trades a specific contract for $ 450 and soon after the price comes down to $440, there has been an unfavourable price shift but the seller has made a profit of $10. At this point, the risk has been transferred to the buyer of the contract. Speculators trade on commodities and derivatives by undertaking risks in order to maximize profits.

5. ***Information:*** Exchanges produce huge volumes of data that are intensely scrutinized and monitored by a wide cross-section of people as the data provides gainful insights about the prevailing economic conditions.

List of Exchanges in India

1. Bhatinda Om & Oil Exchange Ltd., Batinda.
2. The Bombay Commodity Exchange Ltd., Mumbai
3. The Rajkot Seeds Oil & Bullion Merchants' Association Ltd.
4. The Kanpur Commodity Exchange Ltd., Kanpur
5. The Meerut Agro Commodities Exchange Co. Ltd., Meerut
6. The Spices and Oilseeds Exchange Ltd.
7. Ahmedabad Commodity Exchange Ltd.
8. Vijay Beopar Chamber Ltd., Muzaffarnagar
9. India Pepper & Spice Trade Association, Kochi
10. Rajdhani Oils and Oilseeds Exchange Ltd., Delhi
11. National Board of Trade, Indore
12. The Chamber of Commerce, Hapur
13. The East India Cotton Association, Mumbai
14. The Central India Commercial Exchange Ltd., Gwalior
15. The East India Jute & Hessian Exchange Ltd.
16. First Commodity Exchange of India Ltd, Kochi
17. Bikaner Commodity Exchange Ltd., Bikaner
18. The Coffee Futures Exchange India Ltd, Bangalore
19. Esugarindia Limited
20. National Multi Commodity Exchange of India Limited
21. Surendranagar Cotton Oil & Oilseeds Association Ltd.
22. Multi Commodity Exchange of India Ltd.

Notes

23. National Commodity & Derivatives Exchange Ltd.
24. Haryana Commodities Ltd., Hissar
25. e-Commodities Ltd.

Of these 25 commodities exchanges the MCX, NCDEX and NMCEIL are the major Commodity Exchanges.

Multi commodity exchange of India Ltd - MCX is an independent and de-mutualised exchange based in Mumbai. Established on 10th November, 2003, it is the third largest bullion exchange and fourth largest energy exchange in the world. Recognized by the Government of India it deals in numerous commodities and carries out online trading, clearing and settlement processes for commodity future market countrywide.

MCX COMDEX is India's foremost and sole composite commodity futures price index.

National Commodity & Derivatives Exchange of India Ltd (NCDEX) located in Mumbai, is a public limited company incorporated on 23rd April 2003. Promoted by national level establishments it is run by professional management. Regulated by the Forward Market Commission with reference to futures trading in commodities, it trades in various commodities online. The NCDEX is covered by:

1. Companies Act
2. Stamp Act
3. Contracts Act
4. Forward Commission (Regulation) Act.

National Multi-commodity Exchange of India Limited (NMCEIL) is considered the first de-mutualised, online exchange dealing in numerous commodities. Incorporated on 20th December 2001, it is promoted and run by:

1. Central Warehousing Corporation
2. National Agricultural Cooperative Marketing Federation of India Limited
3. Gujarat Agro Industries Corporation Limited
4. National Institute of Agricultural Marketing
5. Gujarat State Agricultural Marketing Board
6. Neptune Overseas Limited.

The Commodity Exchanges with their extensive reach embrace new participants, resulting in a powerful price discovery process.

5.7 Summary

- SEBI, established in 1988 and became a statutory body by the year 1992 with defined responsibilities to cover both development & regulation of the market.
- A Board by the name of the Securities and Exchange Board of India (SEBI) was constituted under the SEBI Act to administer its provisions in 1992 with one chairman and five members.
- SEBI has to be responsive to the needs of three groups, which constitute the market, viz., the issuers of securities, the investors and the market intermediaries.

Notes

- SEBI has three functions rolled into one body quasi-legislative, quasi-judicial and quasi-executive.
- It drafts regulations in its legislative capacity, it conducts investigation and enforcement action in its executive function and it passes rulings and orders in its judicial capacity.
- Though this makes it very powerful, there is an appeals process to create accountability.
- There is a Securities Appellate Tribunal which is a three member tribunal.
- A second appeal lies directly to the Supreme Court.
- SEBI has enjoyed success as a regulator by pushing systemic reforms aggressively and successively.
- SEBI has been active in setting up the regulations as required under law.

5.8 Keywords

Initial Public Offering (IPO): The first sale of stock by a company to the public.

Sensex: Sensitivity Index

Stock Exchange: An exchange on which shares of stock and common stock equivalents are bought and sold.

5.9 Self Assessment

Fill in the blanks:

1. A new share trading platform called the ....., inaugurated recently, might at best provide a lifeline to regional stock exchanges.
2. The two national level stock exchanges in India are ..... and ..... of India.
3. ..... is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India.
4. SEBI has three functions rolled into one body ....., ... and .....
5. SEBI is the ..... for the Securities Market in India.
6. ..... is considered the first de-mutualised, online exchange dealing in numerous commodities.
7. ..... is regulated by the Forward Market Commission with reference to futures trading in commodities.
8. ..... is the third largest bullion exchange and fourth largest energy exchange in the world.
9. ..... are people who are prepared to bear risks in anticipation of earning profits.
10. ..... lessens risk since it involves the purchase or sale of a commodity with the intention of counterbalancing the profit or loss of another investment.
11. A ..... contract requires a buyer and a seller to take and make a delivery of a definite quantity of a particular commodity at a future specified date.
12. ..... Index consists of major Public Sector Undertakings listed on BSE.
13. All the ..... indices of BSE are calculated and disseminated on BOLT.

Notes

14. The scope for dollar-linked index emerged from the background of Indian equity markets increasingly getting integrated with .....
15. A ..... member need not be a member of BSE cash segment.

5.10 Review Questions

1. When and why was SEBI established?
2. Has SEBI succeeded so far in being the regulator of securities market?
3. Why do you think RBI does not give SEBI sweeping powers?
4. Is it necessary for India to have a separate Securities and Exchange Board of India? If yes, elaborate.
5. What are the main indices used by the national level stock exchanges in India, and what is their significance?
6. "Stock trading is a boon as well as bane." Discuss.
7. How do you think the scams in Indian stock market could have been done away with?
8. Will BSE's bid to stimulate derivatives trading help? Why/ why not?
9. What is the difference between Sensex and NIFTY? Analyse the importance of each for Indian capital market.
10. "In the West, in the recent financial crisis, financial regulators resorted to unprecedented restrictions against short selling of shares of banks". Give three reasons to prove that this reaction flawed.
11. "Trading in derivatives encouraged investors to speculate". Comment.
12. On what basis we take 30 scrips in BSE index for calculating BSE SENSEX?
13. What does the BSE Power Index tell you? When and why was it introduced? Has it served the purpose of its introduction?

Answers: Self Assessment

1. BSEIndonext
2. Bombay Stock Exchange, National Stock Exchange
3. NSE
4. quasi-legislative, quasi-judicial, quasi-executive
5. Regulator
6. National Multi-commodity Exchange of India Limited (NMCEIL)
7. National Commodity & Derivatives Exchange
8. Multi commodity exchange of India Ltd - MCX of India Ltd (NCDEX)
9. Speculators
10. Hedging
11. forward
12. BSE PSU
13. sectoral
14. global capital markets
15. professional clearing

Notes

5.11 Further Readings

Online links

investor.sebi.gov.in

sebiedifar.nic.in

www.bseindia.come

www.sebi.com

www.sebi.gov.in

Notes

Unit 6: NABARD

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the introduction to NABARD
- Explain role of NABARD in Indian economy
- Describe the functions of NABARD

Introduction

National Bank for Agriculture and Rural Development, more popularly known as NABARD was established by an Act of Parliament on 12th July 1982 to implement the National Bank for Agriculture and Rural Development Act, 1981.

It replaced the Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of Reserve Bank of India, and Agricultural Refinance and Development Corporation (ARDC). It is one of the premiere agencies to provide credit in rural areas

NABARD was established in terms of the Preamble to the Act,

"for providing credit for the promotion of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting IRDP and securing prosperity of rural areas and for matters connected therewith in incidental thereto".

The main objectives of the NABARD as stated in the statement of objectives while placing the bill before the Lok Sabha were categorized as under:

1. The National Bank will be an apex organisation in respect of all matters relating to policy, planning operational aspects in the field of credit for promotion of Agriculture, Small Scale Industries, Cottage and Village Industries, Handicrafts and other rural crafts and other allied economic activities in rural areas.
2. The bank will serve as a refinancing institution for institutional credit such as long-term, short-term for the promotion of activities in the rural areas.

Notes

3. The bank will also provide direct lending to any institution as may be approved by the Central Government.

4. The bank will have organic links with the Reserve Bank and maintain a close link with in.

NABARD operates throughout the country through its 28 Regional Offices and one Sub-office, located in the capitals of all the states/union territories. Each Regional Office (RO) has a Chief General Manager (CGM) as its head, and the Head office has several Top executives like the Executive Directors (EDs), Managing Directors (MDs), and the Chairperson. It has 336 District Offices across the country, one Sub-office at Port Blair and one special cell at Srinagar. It also has 6 training establishments.

6.1 Role of NABARD

NABARD is set up as an Apex Development Bank with a mandate for facilitating credit flow for promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts. It also has the mandate to support all other allied economic activities in rural areas, promote integrated and sustainable rural development and secure prosperity of rural areas. In discharging its role as a facilitator for rural prosperity NABARD is entrusted with:

1. Providing refinance to lending institutions in rural areas,
2. Bringing about or promoting institutional development, and
3. Evaluating, monitoring and inspecting the client banks.

Besides this pivotal role, NABARD also:

1. Acts as a coordinator in the operations of rural credit institutions.
2. Extends assistance to the government, the Reserve Bank of India and other organizations in matters relating to rural development.
3. Offers training and research facilities for banks, cooperatives and organizations working in the field of rural development.
4. Helps the State Governments in reaching their targets of providing assistance to eligible institutions in agriculture and rural development.
5. Acts as regulator for cooperative banks and RRBs.

Some of the milestones in NABARD's activities are:

1. Refinance disbursement under ST-Agri & Others and MT-Conversion/Liquidity support aggregated ₹ 16952.83 crores during 2007-08.
2. Refinance disbursement under Investment Credit to Commercial Banks, State Cooperative Banks, State Cooperative Agriculture and Rural Development Banks, RRBs and other eligible financial institutions during 2007-08 aggregated ₹ 9046.27 crores.
3. Through the Rural Infrastructure Development Fund (RIDF) ₹8034.93 crores were disbursed during 2007-08. With this, a cumulative amount of ₹ 74073.41 crores has been sanctioned for 280227 projects as on 31st March 2008 covering irrigation, rural roads and bridges, health and education, soil conservation, drinking water schemes, flood protection, forest management etc.
4. Under Watershed Development Fund with a corpus of ₹ 613.71 crores as on 31st March 2008, 416 projects in 94 districts of 14 states have benefited.

Notes

5. Farmers now enjoy hassle free access to credit and security through 714.68 lakh Kisan Credit Cards that have been issued through a vast rural banking network.

6. Under the Farmers' Club Programme, a total of 28226 clubs covering 61789 villages in 555 districts have been formed, helping farmers get access to credit, technology and extension services.

Caselet

NABARD to assist 10 lakh Small Farmers using Self-help Group Model

The National Bank for Agriculture and Rural Development (NABARD), in a bid to step up its focus on the farm sector, plans to bring together about 10 lakh small and marginal farmers across the country in 2010-11 along the lines of the self-help group (SHG) model.

This will help farmers harness their collective bargaining power to access credit at competitive rates, improve productivity using quality inputs, and realise better price for their produce in the market, said Mr Umesh Chandra Sarangi, Chairman of NABARD.

The development bank, whose primary objective is to facilitate flow of credit for agriculture, rural infrastructure and rural development, and supervision of rural financial intermediaries, will organise joint liability groups (JLGs) comprising 7-10 farmers in the small and marginal category, he said.

"We have set a target of forming one lakh joint liability groups in the current financial year. About 10 lakh farmers will benefit by becoming members of the groups," said Mr Sarangi.

In the last couple of years, NABARD had organised around 30,000 JLGs across the country.

Pointing out that most of the farmers in India owned less than 2 acres of land, the NABARD chief said that by becoming a member of the JLG, small and marginal farmers who generally depend on informal sources of financing at usurious interest rates, can get credit from banks on competitive terms.

Ever since the SHG-Bank linkage programme was conceptualised and launched by NABARD in 1992, about 47 lakh self-help groups (as of March-end 2009), predominantly comprising poor women, have been able to access the formal banking sector in a sustainable and cost-effective manner.

By handling savings and internal lending, the SHGs have matured, acquired creditworthiness for themselves and earned the confidence of banks. As of March-end 2009, banks had an outstanding exposure of ₹ 22680 crores to 42 lakh odd members of SHGs.

NABARD is not averse to setting up a bank provided this does not interfere with its primary mandate of facilitating flow of credit for agriculture, rural infrastructure and rural development, said Mr Sarangi.

In his reply to a question on whether NABARD would leverage its long-standing experience in rural lending to get a banking license from RBI, the NABARD chief said, "Without compromising our primary mandate, which is refinancing and supporting the needs of the agriculture sector in the country, we will not be averse to any new ideas."

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Recently, NABARD appointed global management consultancy firm Boston Consulting Group (BCG) to prepare a report to restructure and diversify its operations to leverage its expertise in refinancing. The development bank is also seeking to implement a core banking solution.

Source: http://www.thehindubusinessline.in

Task

Find out what is the thrust area of NABARD activities in the changed focus of the new government and discuss it in detail.

6.2 Functions of NABARD

NABARD is an apex institution accredited with all matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas.

It is an apex refinancing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas.

Its mission includes promoting sustainable and equitable agriculture and rural development through effective credit support, related services, institution building and other innovative initiatives.

In pursuing this mission, NABARD focuses its activities on:

1. ***Credit functions,*** involving preparation of potential-linked credit plans annually for all districts of the country for identification of credit potential, monitoring the flow of ground level rural credit, issuing policy and operational guidelines to rural financing institutions and providing credit facilities to eligible institutions under various programmes.
2. ***Development functions,*** concerning reinforcement of the credit functions and making credit more productive.
3. ***Supervisory functions,*** ensuring the proper functioning of cooperative banks and regional rural banks.

Under all these categories, NABARD performs the following activities:

1. It takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.
2. It co-ordinates the rural financing activities of all the institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India and other national level institutions concerned with policy formulation.
3. It prepares, on annual basis, rural credit plans for all districts in the country; these plans form the base for annual credit plans of all rural financial institutions.
4. It undertakes monitoring and evaluation of projects refinanced by it.
5. It promotes research in the fields of rural banking, agriculture and rural development.

NABARD's refinance is available to State Co-operative Agriculture and Rural Development Banks (SCARDBs), State Co-operative Banks (SCBs), Regional Rural Banks (RRBs), Commercial

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Banks (CBs) and other financial institutions approved by RBI. While the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, State-owned corporations or co-operative societies, production credit is generally given to individuals.

Case Study

NABARD to tie up with Banks, NGOs to drive Organic Farming

To implement project in 7 districts in association with KSSF.

The programme will integrate the activities of over 10,000 farmers in the first phase.

The regional office of the National Bank for Agriculture and Rural Development (NABARD) is planning to promote organic farming in the State through banks and non-governmental organisations (NGOs).

The programme will integrate the activities of over 10,000 farmers with organic farming, in the first phase, according to Mr K. C. Shashidhar, Chief General Manager, Nabard, Kerala.

NGOs Meet

A meeting of NGO stakeholders convened here has decided to publish a white paper on the potential of organic farming in Kerala.

Addressing the meeting, Mr Shashidhar said that the apex bank plans to promote organic farming through Joint Liability Groups (JLGs).

Organic farming practices need to be encouraged using local knowledge of farmers. They also need to be integrated with the tested practices of research scientists and academia. To accomplish this Nabard will associate itself with Kerala Agricultural University.

"Our mission is to develop an organic farming approach, particularly in all the watershed development areas," Mr Shashidhar said.

"We will extend support, including capacity-building and financial assistance, for soil and water conservation measures through ongoing programmes."

NABARD will implement the project in seven districts in Kerala initially in association with the Kerala Social Services Forum, an umbrella NGO of the State to which as many as 36 NGOs are affiliated.

Training Programme

As a prelude to the formal launch of organic farming in the State through the bank, NABARD will also conduct a two-week training programme for farmers in organic farming.

The training programme is expected to create the right awareness about organic agricultural techniques, organic manures, production of bio-control agents such as organic pesticides and organic fungicides to the participants.

It will also take the participants through topics such as pesticide-free food production methods, post harvest management means, food security through organic farming and seed conservation etc.

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The farmers will also be taken for exposure visits to organic farms within the state and outside.

The 'Joint Liability Training' programme will be led by experts from agricultural fields along with NABARD district officials.

Question

Discuss the role of NABARD in agriculture and rural development.

Source: http://www.thehindubusinessline.in

6.3 Summary

- National Bank for Agriculture and Rural Development (NABARD) is an Apex Development Bank in India.
- It has been accredited with matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India.
- NABARD plays an important role in the development of agriculture and rural credit in India.
- It serves as an apex financing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas.
- It takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.
- It co-ordinates the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India (RBI) and other national level institutions concerned with policy formulation.
- It undertakes monitoring and evaluation of projects refinanced by it.

6.4 Keywords

Microfinance: The provision of financial services to low-income clients, including consumers and the self-employed.

Refinancing: The replacement of an existing debt obligation with a debt obligation bearing different terms.

Restructure: Reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable or better organized for its present needs.

6.5 Self Assessment

Fill in the blanks:

1. It takes measures towards institution building for improving ..... capacity of the credit delivery system.
2. NABARD prepares, ... plans for all districts in India.
3. NABARD includes promoting ..... and ..... agriculture and rural development.

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4. NABARD is an apex institution accredited with all matters concerning ....., ... and ..... in the field of credit for agriculture and other economic activities in rural areas.
5. NABARD acts as ..... for cooperative banks and RRBs.
6. NABARD helps the state governments in reaching their targets of providing assistance to eligible institutions in ..... and .....
7. NABARD operates throughout the country through its ..... Regional Offices and ..... Sub-office, located in the capitals of all the states/union territories.
8. Full form of NABARD is .....
9. NABARD co-ordinates the rural financing activities of all the institutions engaged in ..... work at the field level and maintains liaison with Government.
10. NABARD undertakes monitoring and evaluation of projects ..... by it.
11. The ..... plans form the base for annual credit plans of all rural financial institutions.
12. NABARD takes measures towards institution building for improving ..... capacity of the credit delivery system.
13. NABARD focuses its activities on development functions, concerning reinforcement of the credit functions and making credit more .....
14. NABARD has ..... training establishments.
15. NABARD helps the .....in reaching their targets of providing assistance to eligible institutions in agriculture and rural development.

6.6 Review Questions

1. Why was NABARD established?
2. Critically evaluate the performance of NABARD till now.
3. What is NABARD? What are its main achievements?
4. Examine the role of NABARD in Indian Microfinance.
5. Do you think NABARD has succeeded in helping the co-operative credit societies with their funds? Support your argument with factual reasons.
6. What do you see as the reason behind the Indian government's replacing ACD, RPCC and ARDC with NABARD? Do you think NABARD has justified it so far? Why/Why not?
7. NABARD focuses on credit, developmental and supervisory functions in the field of rural credit. What do you think it's sphere of working should be increased/decreased, in what manner?
8. Find which allied economic activities in rural areas are assisted/monitored/undertaken by NABARD and discuss their importance.
9. Examine the relationship between NABARD and Reserve Bank of India.
10. What do you see as the challenges ahead of NABARD in the context of current five year plan?
11. Where do you see NABARD to be heading towards through next 25 years and why?
12. Over the years, NABARD has resorted to passive funding - true/false? What are the advantages/disadvantages of it?

Notes

Answers: Self Assessment

1.	absorptive	2.	rural credit
3.	sustainable, equitable	4.	policy, planning, operations
5.	regulator	6.	agriculture, rural development
7.	28, one	8.	National Bank for Agriculture
9.	developmental and Rural Development	10.	refinanced
11.	rural credit	12.	absorptive
13.	productive	14.	6
15.	state governments		

6.7 Further Readings

Books

N. Lalitha and R. Dayanandan, *NABARD and Rural Transformation,* Dominant.

Tapan Kumar Shandilya and Umesh Prasad, *Agricultural Credit and NABARD,* Deep and Deep Publications.

Online links

www.nabcons.com

www.nabard.org

Notes

Unit 7: Non-banking Financial Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the concept of non-banking financial companies
- Explain the guidelines of non-banking financial companies
- Discuss the progress of non-banking financial companies
- Describe the prospects of non-banking financial companies
- Explain Industrial Finance Corporation of India (IFCI)
- Know about State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs)
- Define Small Industries Development Bank of India (SIDBI)
- Explain the operational policies of SIDBI

Notes

Introduction

The Reserve Bank of India defines a non-banking financial company as, "A Non-banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company)."

7.1 Concept of Non-banking Financial Companies

Non-banking financial companies frequently acts as:

1. Suppliers of loans and credit facilities,
2. Supporting investments in property,
3. Trading money market instruments,
4. Funding private education,
5. Wealth management such as managing portfolios of stocks and shares and underwrite stock and shares, TFCs and other obligations,
6. Retirement planning,
7. Advise companies in merger and acquisition,
8. Prepare feasibility, market or industry studies for companies,
9. Discounting services e.g., discounting of instruments.

However they are not allowed to take demand deposits from the general public and consequently have to find other means of funding their operations such as issuing debt instruments.

Depending upon their nature of activities, non-banking finance companies can be classified into the following categories:

1. Development finance institutions
2. Leasing companies
3. Investment companies
4. Housing finance companies
5. Venture capital companies
6. Discount and guarantee houses
7. Underwriting practitioners.

7.2 Guidelines of Non-banking Financial Companies

Recent years have witnessed significant increase in financial intermediation by the NBFCs. This is reflected in the proposal made by the latest Working Group on Money Supply for a new

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measure of liquidity aggregate incorporating NBFCs with public deposits worth ₹20 crores and above. For regulatory purposes, NBFCs have been classified into three categories:

1. those accepting public deposits,
2. those not accepting public deposits but engaged in financial business, and
3. core investment companies with 90 per cent of their total assets as investments in the securities of their group/holding/subsidiary companies.

The focus of regulatory attention is on NBFCs accepting public deposits. As per the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 1998, the quantum of public deposit in respect of NBFCs was linked to credit rating from an approved agency so as to enable the depositor to make informed decision. The NBFCs were also encouraged to broad-base their resources through borrowings from banks and financial institutions, inter-corporate deposits/ loans, secured bonds/debentures, etc., which were exempted from the definition of "public deposit". However, the Associations of NBFCs and the apex trade bodies brought to the notice of both the Government and the RBI the problem of asset-liability mismatches caused by frequent downgrading of the credit ratings of NBFCs and the consequent reduction in quantum of permissible public deposits. They also suggested that smaller NBFCs could be exempted from the requirement of credit rating for having public deposits up to a particular limit while larger NBFCs could be allowed higher limits of public deposits subject to minimum investment grade credit rating and higher capital adequacy requirements. The Task Force on NBFCs appointed by the Government of India submitted its report in October, 1998, which recommended rationalisation of regulations for NBFCs, improvement of the legislative framework for protecting the interests of depositors and development of NBFCs on sound and healthy lines. The modified regulatory framework for NBFCs based on the recommendations made by the Task Force provides for the following:

Caselet

RBI to Plug Regulatory Gaps in NBFC Biz

The Reserve Bank of India plans to strengthen the regulatory framework for non-deposit taking systemically important non-banking finance companies as tightening of the regulation for the banking sector has increased the incentives for regulatory arbitrage by moving business to NBFCs.

Pointing out that setting up an NBFC is a more attractive option as entry point norm for them (at present net owned funds of ₹ 2 crores) is low as compared to that for banks (₹ 300 crores) and that they are subject to relatively lighter touch regulation, the RBI, in its second financial stability report said "some concerns remain especially in the context of the rapidly expanding NBFC sector."

Among the reasons why regulatory gaps need to be plugged include NBFCs not being subject to any restrictions regarding investment in the capital market thereby leading to enhanced market risk; nor do they have any restrictions on setting up of subsidiaries, thereby allowing setting up of possibly opaque structures with concomitant transparency issues. Further, quality of corporate governance and management can give rise to serious concerns, the report said.

Another concern that arises is in the context of definition of an NBFC in terms of its "principal business" which makes it possible for an NBFC to conduct some other non-financial activity by deploying funds in non-financial assets, leading to a lack of level playing field vis-à-vis banks.

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Multiple regulators for non-banking financial entities in the country and an entity-based approach to regulation gives rise to possible regulatory gaps - functional activities remaining unregulated, gaps in regulation permitting surrogate raising of public funds, leveraged activities by entities like merchant banks, portfolio managers and brokerages not being subject to prudential regulation. These, according to the report, will need to be urgently addressed.

Referring to the fact that certain NBFCs, coming under the purview of other regulators, have been exempted from the regulatory purview of the RBI subject to certain conditions, the central bank said this has given rise to instances of certain functional activities of some exempted NBFCs (for example merchant banks) remaining unregulated.

Source: http://www.thehindubusinessline.in

7.2.1 Progress/Growth

Non-banking Financial Companies have registered significant growth in recent years both in terms of number and volume of business transactions. NBFCs started in a small way in the sixties and the seventies and tried to serve the needs of the savers and investors whose needs remained unfulfilled by the Banking system. In the eighties, there was virtually a boom, when entrepreneurs suddenly woke up to the tremendous possibilities offered in an economy chronically affected by the massive paucity of funds and a growing realization of enormous resource mobilisation capacity offered by the capital market. However, most of these new-borns ignored that rendering financial services was a complicated and demanding business, involving the continuous raising and deployment of funds in a judicious manner and involved the consistent identification and entry into newer and optimally lucrative areas of financial returns. Along with the growth of Indian economy, NBFCs have also grown gradually into institutions that can provide services similar to that of commercial banks in the country.

The growth of NBFCs in India was more pronounced in last two decades. Several factors have contributed to the growth of these institutions. Their tailor made services, customer-orientation, minimum procedures and simplicity, speed of operations, etc. have attracted more and more customers to them. The monetary and credit policy followed in the country in the recent past has left a section of borrowers outside the purview of banking system and these NBFCs increasingly hatred to these sections. Comprehensive regulation of the commercial Banks and the absence or less rigorous regulations over NBFCs have also contributed to the phenomenal growth or the latter in terms of heir numbers, clientele deposits and Net Owned Fund (NOF).

However, most of these companies possessed neither the inclination nor the mental and attitudinal ability to acquire these traits. A host of factors such as the erosion of margins due to over concentration of blue chip companies, a high rate of default by lessees, severe problems in sustaining consistent and adequate utilisation of resources, sales tax and turnover tax levied on lease by respective state government and dubious accounting practices by some companies, all combined in an unholy alliance to sound the death knell for most companies in this budding industry. This rapid growth in the business of NBFCs also brought in its wake the need for effective regulatory action to protect the interests of investors.

The Reserve Bank has started regulating the activities of NBFCs with the twin objectives of ensuring that they subserve the financial system efficiently and do not jeopardise the interest of depositors. In the backdrop of general sickness in the real estate market and some of the industrial activities coupled with steep decline in the value of some of the unquoted shares, the NPAs of NBFCs have registered an upward trend. The profitability of NBFCs has generally come under strain due to mandatory provisioning requirements against NPAs. The provisions in the RBI Act which, till recently were considered inadequate to deal with the growing number of weak and

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unscrupulous players, were expanded in January, 1997, vesting considerable powers with the Reserve Bank.

RBI has put in place a comprehensive regulatory and supervisory framework in order to discharge the heavy statutory responsibilities cast on it with a view to providing indirect protection to the depositors' interest and strengthening the NBFC sector. As a result, growth rate had slowed down, gradually leading to a negative growth rate in 1988. However, from 1989 the trend has changed for the better, there are a host of reasons that have led to the revival of interest in financial services. Firstly, the enormously progressive measured of liberalisation and dismantling of the hitherto control ridden economy have to a great extent opened up larger vistas of growth.

Registration is being granted to NBFCs on assessment and evaluation of various factors and as per the criteria laid down in the RBI Act. The applications for registration are subjected to thorough scrutiny. RBI has issued up to Aug. 24, 2009, approvals for registration of 336 NBFCs which are permitted to accept public deposits and to 12607 NBFCs which are non-public deposits taking companies. A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should have a minimum net owned fund of ₹ 25 lakhs (raised to ₹ 200 lakhs w.e.f April 21, 1999). RBI closely supervises those NBFCs, which accept public deposits, through a comprehensive mechanism comprising on-site examination, off-site surveillance, a sensitive market intelligence system and initiation of necessary supervisory action whenever necessary. The statutory auditors of NBFCs have been directed to report exceptions to compliance with RBI regulations to the Reserve Bank directly for punitive action. RBI has undertaken publicity campaign through print media all over the country to create awareness among the public about do's and don'ts in regard to making deposits with NBFCs. RBI has also been coordinating its efforts with State Government authorities and other enforcement bodies for checking unscrupulous activities of NBFCs and unincorporated bodies accessing public deposits illegally. At the same time, the well-run and managerially sound NBFCs are being encouraged to continue their genuine business operations. Bank credit to the NBFCs for their advances against commercial vehicles has recently been brought under the ambit of priority sector advances. The earlier ceilings on bank credit to NBFCs as a multiple of their NOF have been abolished for NBFCs registered with RBI.

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Number of NBFCs Registered with RBI (Till June 2010)

The following table shows the number of NBFCs registered with the Reserve Bank of India and the trend of registration of companies as NBFC since the last decade. The table also indicates registration of deposit accepting NBFCs of the total NBFCs registered with RBI.

Number of NBFCs Registered with the RBI

End June	Number of Registered NBFCs	Number of NBFCs-D	Number of NBFCs-ND-SI
2005	13,261	507	-
2006	13,014	428	149
2007	12,968	401	173
2008	12,809	364	189
2009	12,740	336	234
2010	12,630	308	260

Source: RBI
Note: For latest details about the NBFCs in India you can visit the RBI website www.rbi.org.in.

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7.2.2 Prospects

The forte of NBFCs has been credit delivery to areas not covered by banks and Financial Institution (FIs). By virtue of there past experience NBFCs know the tacit needs of retail customers much better and with more sensitivity than others do. As traditional boundaries between different categories of financial intermediaries are disappearing, NBFCs have to face stiff competition in retail financing specially from banks and FIs. Does it mean that NBFCs should move into the forte of financial intermediaries (i.e. working capital loans and term lending)? Given the fact that financial intermediary's business is dominated by the attendant risk and the banks' and top rung FIs' ability to raise funds at low cost, if NBFCs compete head-on, then they will be at loss owing to their high cost of mobilizing funds.

Though the evolutionary process of the NBFCs has made them nimble and agile, their main handicap is the small size of their balance sheet, resources and their distribution reach, which is region specific. The limited cushion available to them in times of difficulties pose a great threat to their very survival and restrict their opportunities to grow. The biggest challenge in front of NBFCs therefore is to increase their size. This could be by merging with each other.

There is just not place enough for so many small micro NBFCs. Therefore, those who still try to hang on without concrete plans or core strengths, are bound to die a very painful death. The newer layers are likely to bring in tremendous financial muscle. In the take-off period, they can afford to be over aggressive and their product sophistication is also likely to be superior.

Given such a situation, NBFCs must realize the plain fact that a certain amount of market share and size or a "critical mass" is vital for sheer survival. The NBFCs, in the next couple of years, will be faced with the relentless logic of Darwinism. A process of elimination is certain.

But a financial intermediary cannot be closed down like a cement plant or a soap factory as they have a set of financial claims both inward and outward with differing maturities and risks. So the most practical method would be consolidation by mergers. World over, troubled banks and non-banks have been bailed out by the mergers and acquisition route. This is apart from the numerous mergers done on purely commercial considerations. There should therefore be a call for immediate measures to facilitate mergers of NBFCs with “profitable” companies to avoid the risk of default in repayment of public deposits, bank, institutional funding and to make NBFCs grow in future.

Apart from mergers, other options waiting for NBFCs are to change the tracks and explore new areas. They have to extend their product portfolio to include asset management companies, housing finance firms and to venture into newly opened insurance sector for private participation. Examples of such initiatives are launch of associate company of Sundaram Finance to disburse housing loans, which has been the domain of HDFC and LIC Housing Finance. Entry of Kotak Mahindra Finance Limited, Sundaram Finance and Lakshmi General Finance into the insurance business is another example. In the medium term most NBFC's are looking at developing niche areas and concentrating on fee based income to offset the loss in fund based activities. Examples include the move of Ashok Leyland Finance to launch a finance portal that would be used to sell products of other financial intermediaries and to use its skill in collection to derive a pure service income. The benefits of such horizontal integration would be a diversification of the company's revenue stream which goes with the old saying of putting one's egg in different baskets.

Another new area which can be explored by NBFCs is the Internet.

Example: Recently the Morgan Stanley Dean Witter Internet research emphasized that Web is more important for retail financial services than for many other industries.

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Web based services involve use of Internet for delivery of financial products & services. The Internet has leveled the playing field and afforded open access to customers in the global marketplace. Internet financing could be a cost-effective delivery channel for NBFCs.

In the market of retail finance and financial loans, in order to beat the competition, NBFCs have to increase the quality of their service which is described as the convenience offered to the customer in terms of speed, accuracy and product features. Investors in future will also be looking for certain qualitative details like reputation of the management and the financial track record of the NBFC before they invest their monies. NBFCs stands a good chance to succeed as they have an advantage of being lower in operating cost as compared with other financial intermediaries because of their small size, efficient operation and fast decision making. NBFC's aggressive collection mechanism and lower proportion of big corporate loans gives them an edge in containing risk and also results in fewer amounts of NPAs which is critical in the financial sector.

RBI and other regulatory authorities have a very important role, if NBFCs have to deliver their cause. After strengthening of the regulatory framework in 1997, the mushrooming of NBFCs has slowed down and the RBI has been releasing the lists of companies which have been refused registration to caution the public. The authorities need to review the legislation and provide for punitive penalties for any unit mobilizing deposits without registration. To protect individual deposits held by NBFCs, the RBI have to tighten operating norms governing their operations.

However, the thrust of policy should be to relax its newly implemented regulatory framework and increase the amount of funds which equipment and leasing companies can raise as public deposits for the NBFC which are performing consistently well. The credit rating norms should also be relaxed. Apart from these measures their should be some incentives to the well managed NBFCs by giving them opportunity to become banks and by setting out very reasonable final guidelines for entry of NBFCs into insurance and other areas.

The role of NBFCs has become increasingly important from both the macro economic perspective and the structure of the Indian financial system. Over a period of time, one has to accept, that it is only those which are big enough and serious about being in the finance business will and must grow. Scamsters must get exemplary punishment. To survive and constantly grow, NBFCs have to focus on their core strengths while improving on weaknesses. They have to constantly search for new products and services in order to remain competitive. The coming years will be testing ground for the NBFCs and only those who will face the challenge and prove themselves will survive in the long run.

The industry comprising non-banking financial companies is heading towards consolidation. Sound companies with soundest of fundamental would emerge stronger, and weak companies with poor balance sheets would be weeded out of the system. NBFCs have survived all over the world and would continue to survive even in our country. However, the coming time would be quite crucial for NBFCs. From being a small business unit in a major industrial group, the financial services are going through a phase where they themselves are major business with each of its segment being a separate industry in itself. Size would be a major determinant of the survival of the NBFCs along with promoters credentials and group backing. To survive a lot of mergers and acquisitions are taking place in the industry. It is evident that only the top few will be able to withstand the test of times. Already more that 60% of the total business of the NBFCs is in the hands of around 50 players. However, there would also be a small NBFCs operating into niche markets. They would take advantage of their expertise, in their particular areas and operate at a premium. However, their operations would be local in nature and their ability to grow limited.

Notes

7.3 Industrial Finance Corporation of India (IFCI)

At the time of independence in 1947, India's capital market was relatively under-developed. Although there was significant demand for new capital, there was a dearth of providers. Merchant bankers and underwriting firms were almost non-existent. And commercial banks were not equipped to provide long-term industrial finance in any significant manner.

It is against this backdrop that IFCI Ltd. emerged as the first development finance institution set up in 1948 under the IFCI Act in order to pioneer long-term institutional credit to medium and large industries. It aims to provide financial assistance to industry by way of rupee and foreign currency loans, underwrites/subscribes the issue of stocks, shares, bonds and debentures of industrial concerns, etc. It has also diversified its activities in the field of merchant banking, syndication of loans, formulation of rehabilitation programmes, assignments relating to amalgamations and mergers, etc.

By the early 1990s, it was recognized that there was need for greater flexibility to respond to the changing financial system. It was also felt that IFCI should directly access the capital markets for its funds needs. It is with this objective that the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956. Subsequently, the name of the company was also changed to "IFCI Limited" with effect from October 1999.

IFCI has been able to achieve a financial turnaround with the consistent support and cooperation of all its stakeholders and is now endeavouring to re-position itself.

In addition to its core competence in long term lending to industrial and infrastructure sectors, IFCI aims to enhance its organizational value through better realization of its Non-performing Assets (NPAs) and unlocking of value of its investment portfolio including unquoted investments as well as real estate assets.

Focus

Until the establishment of ICICI in 1956 and IDBI in 1964, IFCI remained solely responsible for implementation of the government's industrial policy initiatives. It made a significant contribution to the modernization of Indian industry, export promotion, import substitution, pollution control, energy conservation and generation through commercially viable and market-friendly initiatives. Some sectors that have directly benefited from IFCI include:

1. Agro-based industry (textiles, paper, sugar)
2. Service industry (hotels, hospitals)
3. Basic industry (iron & steel, fertilizers, basic chemicals, cement)
4. Capital & intermediate goods industry (electronics, synthetic fibres, synthetic plastics, miscellaneous chemicals) and Infrastructure (power generation, telecom services).

IFCI has played a key role in the development of cooperatives in the sugar and textile sectors, besides acting as a nodal agency in both sectors. 371 cooperative societies in these sectors have been assisted by IFCI.

IFCI has promoted Technical Consultancy Organizations (TCOs), primarily in less developed states to provide necessary services to the promoters of small- and medium-sized industries in collaboration with other banks and institutions.

IFCI has also provided assistance to self-employed youth and women entrepreneurs under its Benevolent Reserve Fund (BRF) and the Interest Differential Fund (IDF).

Notes

IFCI has founded and developed prominent institutions like:

1. Management Development Institute (MDI) for management training and development
2. ICRA for credit assessment rating
3. Tourism Finance Corporation of India (TFCI) for promotion of the hotel and tourism industry
4. Institute of Labor Development (ILD) for rehabilitation and training of displaced and retrenched labor force
5. Rashtriya Gramin Vikas Nidhi (RGVN) for promoting, supporting and developing voluntary agencies engaged in uplifting rural and urban poor in east and northeast India.

IFCI, along with other institutions, has also promoted:

1. Stock Holding Corporation of India Ltd. (SHCIL)
2. Discount and Finance House of India Ltd. (DFHI)
3. National Stock Exchange (NSE)
4. OTCEI
5. Securities Trading Corporation of India (STCI)
6. LIC Housing Finance Ltd.
7. GIC Grih Vitta Ltd., and
8. Bio-tech Consortium Ltd. (BCL).

IFCI has also set up Chairs in reputed educational/management institutions and universities. A major contribution of IFCI has been in the early assistance provided by it to some of today's leading Indian entrepreneurs who may not have been able to start their enterprises or expand without the initial support from IFCI.

7.4 State Financial Corporations (SFCs)

SFCs are the State-level financial institutions which play a crucial role in the development of small and medium enterprises in the concerned States. They provide financial assistance in the form of term loans, direct subscription to equity/debentures, guarantees, discounting of bills of exchange and seed/special capital, etc. SFCs have been set up with the objective of catalysing higher investment, generating greater employment and widening the ownership base of industries. They have also started providing assistance to newer types of business activities like floriculture, tissue culture, poultry farming, commercial complexes and services related to engineering, marketing, etc.

IFCI was established to cater to the financial needs of industrial concerns in large scale corporate and co-operative sectors. Small and medium sized enterprises were outside the purview of IFCI. To meet the financial needs of small and medium enterprises, the government of India passed the State Financial Corporation Act in 1951, empowering the State Governments to establish development banks for their respective regions.

Under the Act, SFCs have been established by State Governments to meet the financial requirements of medium and small sized enterprises. There are 18 SFCs at present.

Notes

7.4.1 Objectives of State Financial Corporations

The objectives of state financial corporations are as under:

1. Provide financial assistance to small and medium industrial concerns. These may be from corporate or co-operative sectors as in case of IFCI or may be partnership, individual or joint Hindu family business. Under SFCs Act, "industrial concern" means any concern engaged not only in the manufacture, preservation or processing of goods, but also mining, hotel industry, transport undertakings, generation or distribution of electricity, repairs and maintenance of machinery, setting up or development of an industrial area or industrial estate, etc.
2. Provide long and medium-term loan repayable ordinarily within a period not exceeding 20 years.
3. Grant financial assistance to any single industrial concern under corporate or co-operative sector with an aggregate upper limit of Rupees Sixty lakhs. In any other case (partnership, sole proprietorship or joint Hindu family) the upper limit is Rupees 30 lakhs.
4. Provide financial assistance generally to those industrial concerns whose paid up share capital and free reserves do not exceed ₹ 3 crores.
5. To lay special emphasis on the development of backward areas and small scale industries.

7.4.2 Functions of State Financial Corporations

The functions of SFCs include

1. Grant of loans and advances to or subscribe to debentures of, industrial concerns repayable within a period not exceeding 20 years, with option of conversion into shares or stock of the industrial concern.
2. Guaranteeing loans raised by industrial concerns which are repayable within a period not exceeding 20 years.
3. Guaranteeing deferred payments due from an industrial concern for purchase of capital goods in India.
4. Underwriting of the issue of stock, shares, bonds or debentures by industrial concerns.
5. Subscribing to, or purchasing of, the stock, shares, bonds or debentures of an industrial concern subject to a maximum of 30 percent of the subscribed capital, or 30 percent of paid up share capital and free reserve, whichever is less.
6. Act as agent of the Central Government, State Government, IDBI, IFCI or any other financial institution in the matter of grant of loan or business of IDBI, IFCI or financial institution.
7. Providing technical and administrative assistance to any industrial concern or any person for the promotion, management or expansion of any industry.
8. Planning and assisting in the promotion and development of industries.

7.5 State Industrial Development Corporations (SIDCs)

Without Industrial Development there cannot be any higher standard of living for our people.

Jawaharlal Nehru

Notes

State Industrial Development Corporations have been established under the Companies Act, 1956, as wholly-owned undertakings of State Governments. They have been set up with the aim of promoting industrial development in the respective States and providing financial assistance to small entrepreneurs.

They are also involved in setting up of medium and large industrial projects in the joint sector/ assisted sector in collaboration with private entrepreneurs or wholly-owned subsidiaries. They are undertaking a variety of promotional activities such as preparation of feasibility reports; conducting industrial potential surveys; entrepreneurship training and development programmes; as well as developing industrial areas/estates.

Task Critically evaluate the functioning of SIDCs in India.

7.6 State Industries Development Bank of India (SIDBI)

SIDBI was established on April 2, 1990. The Charter establishing it, The Small Industries Development Bank of India Act, 1989 envisaged SIDBI to be "the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto".

The business domain of SIDBI consists of small scale industrial units, which contribute significantly to the national economy in terms of production, employment and exports. Small scale industries are the industrial units in which the investment in plant and machinery does not exceed ₹10 millions. About 3.1 millions such units, employing 17.2 millions persons account for a share of 36 per cent of India's exports and 40 per cent of industrial manufacture. In addition, SIDBI's assistance flows to the transport, health care and tourism sectors and also to the professional and self-employed persons setting up small-sized professional ventures.

7.6.1 Introduction

SIDBI was established to empower the Micro, Small and Medium Enterprises (MSME) sector with a view to contributing to the process of economic growth, employment generation and balanced regional development.

The vision of SIDBI is to emerge as a single window for meeting the financial and developmental needs of the MSME sector to make it strong, vibrant and globally competitive, to position SIDBI Brand as the preferred and customer-friendly institution and for enhancement of share-holder wealth and highest corporate values through modern technology platform four basic objectives are set out in the SIDBI Charter. They are:

1. Financing
2. Promotion
3. Development
4. Co-ordination

SIDBI was established for orderly growth of industry in the small scale sector. The Charter has provided SIDBI considerable flexibility in adopting appropriate operational strategies to meet these objectives. The activities of SIDBI, as they have evolved over the period of time, now meet

Notes

almost all the requirements of small scale industries which fall into a wide spectrum constituting modern and technologically superior units at one end and traditional units at the other.

The major issues confronting SSIs are identified to be:

1. Technology Obsolescence
2. Managerial Inadequacies
3. Delayed Payments
4. Poor Quality
5. Incidence of Sickness
6. Lack of Appropriate Infrastructure and
7. Lack of Marketing Network.

There can be many more similar issues hindering the orderly growth of SSIs.

Over the years, SIDBI has put in place financing schemes either through its direct financing mechanism or through indirect assistance mechanism and special focus programmes under its P&D initiatives. In its approach, SIDBI has struck a good balance between financing and providing other support services.

7.6.2 Operational Policies

The Small Industries Development Bank of India (SIDBI), was conceived as the principal financial institution at the apex level for promotion, financing and development of industry in the small, tiny and cottage sectors.

SIDBI has an overall responsibility for enacting policy and procedural guidelines with regard to the operations of SFCs. SIDBI has since been de-linked from IDBI after the SIDBI Act was amended last year and as a result, 51% holding of IDBI shares in SIDBI are in the process of being transferred to commercial banks and all-India financial institutions. Further, IDBI's share-holding in SFCs would also be transferred to SIDBI under the SFCs (Amendment) Act, 2000. All the discretionary powers hitherto vested with IDBI in the principal Act, now vest with SIDBI under the amended Act. SIDBI under the new dispensation has been entrusted with the overall responsibility to look after the interests of SFCs, including provision of adequate refinance facilities. The success of the reforms brought about by the amendments in the SFCs Act, as also the recommendations of the High Level Committee, would largely depend upon the responsiveness of SIDBI to the needs and aspirations of SFCs. This, undoubtedly, calls for strengthening SIDBI organisationally and financially to cope with this responsibility and meet the genuine refinance requirements of SFCs.

The operational limits prescribed under various provisions of the amended Act could be increased by the State Governments on the recommendations of SIDBI keeping in view the business requirements of SFCs. These limits relate to augmentation of share-capital base, borrowings from outside agencies, including floatation of bonds and debentures, limit of accommodation to industrial units, eligibility of industrial units to borrow from SFCs in terms of owned-funds, etc. Since limit of accommodation to individual units has been increased to ₹ 5 crores and ₹ 2 crores in the case of companies and individuals respectively with a provision to increase it further to ₹ 20 crores and ₹ 5 crores respectively on the recommendations of SIDBI, the SFCs were now in a position to finance comparatively bigger industrial units having large credit requirements. Consequently, the refinance requirements of SFCs have gone up substantially and they have started approaching SIDBI for meeting their requirements. In terms of the Act, SFCs cannot finance industrial units whose owned-funds exceed ₹ 10 crores. This limit could be increased to

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₹ 30 crores by the State Government on the recommendation of SIDBI. The SFCs, while approaching SIDBI for enhanced refinance limit, have also requested them to recommend the increase in this threshold limit to the State Government to enable them to avail of these relaxations. It has, however, been noticed that the response from SIDBI to the above request being made by SFCs has not been encouraging. SIDBI is reported to have expressed its reservations to increase the refinance limits as also enhancement in the level of owned-funds of the borrowing units. The reluctance on the part of SIDBI to release adequate refinance to eligible SFCs to enable them to finance medium scale industrial units appears to be retrograde step and tends to defeat the very purpose of enhancing the accommodation limit. In the absence of adequate availability of refinance from SIDBI and inability of SFCs to mobilize their own resources, the present trend of industrial units going away from SFCs to commercial banks and other financial institutions would continue unabated to the detriment of SFCs' interest.

Since the SFCs have been conceived as institutions of national importance engaged in the strategic task of promoting industrialisation in the rural and backward regions of the States, SIDBI and the State Governments must provide required support to enable them to play their envisaged developmental role in the national economy.

Case Study

Infrastructure Financing: NBFCs for enlarging Global Lenders' Pool

Elimination of the restrictive condition, whereby overseas lenders are required to have a direct exposure to infrastructure projects amounting to three times of what is being lent to NBFCs, has been sought.

Mumbai, April 7 Non-banking finance companies, dedicated to financing infrastructure projects, have moved the Reserve Bank of India to enlarge the pool of global lenders from whom they can borrow. They have also sought elimination of the restrictive condition whereby overseas lenders are required to have a direct exposure to infrastructure projects amounting to three times of what is being lent to NBFCs.

NBFCs in the infrastructure financing space want the pool of overseas lenders, from whom they can borrow, expanded to include reputed banks and bilateral financial institutions so that they can source loans on favourable terms and conditions.

The big NBFC players in the infrastructure space include Infrastructure Development Finance Company, SREI Infrastructure Finance, Power Finance Corporation and Rural Electrification Corporation, among others.

ECB Restrictions

As per RBI's External Commercial Borrowings (ECBs) policy, sourcing of funds has been restricted to multilateral/regional financial institutions and government-owned financial institutions.

Under the ECB policy, NBFCs can avail themselves of ECB up to $500 millions per financial year under the 'approval route' to finance import of equipments for leasing to infrastructure projects in India. The average maturity of the borrowing should be five years. The requirement of all-in-cost ceilings on ECB has been dispensed with until June 30, 2009.

Analysts say that the ECB policy encourages import of capital equipment by infrastructure developers/financiers to the detriment of domestic capital goods manufacturers.

Contd...

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"As it is, very few lending agencies are willing to invest in the infrastructure sector in emerging economies. Even if they do, they have their unique set of problems such as lengthy appraisal process, pre-condition like sourcing of inputs from lending countries, etc. This reduces the number of viable sourcing options for NBFCs," said a senior official with a leading NBFC.

NBFCs want the twin conditions whereby overseas lenders, at all times, are required to maintain the ratio of their direct lending to the infrastructure sector in India to their total ECB lending to NBFCs at 3:1 and that Authorised Dealer Category - I banks should obtain a certificate lenders to this effect, completely eliminated.

Smaller Players

"There are smaller regional/bilateral financial institutions which do not have the wherewithal to lend directly to infrastructure projects. They depend on domestic financial intermediaries (FIs) who have the expertise in financing such projects. Hence, they prefer to route their funds through local FIs for on-lending to small and medium infrastructure projects. Such overseas lenders will not be able to comply with the 3:1 ratio," the official explained.

The non-banking financiers want a level playing field vis-À-vis infrastructure companies when it comes to tapping ECB under the 'automatic route' so that the credit needs of the smaller infrastructure developers can be met without much ado.

While larger infrastructure players are able to source ECBs on their own, the smaller players are not in a position to tap the overseas market. Hence, the smaller project developers' bank on NBFCs for financing and the approval route causes unnecessary delays.

Question

Discuss the role of NBFCs in infrastructure development in India.

Source: http://www.thehindubusinessline.in

7.7 Summary

- A Non-banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.
- An NBFC cannot accept demand deposits.
- It is not a part of the payment and settlement system and as such cannot issue cheques to its customers.
- Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.
- The Industrial Finance Corporation of India (IFCI) was established on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term finance needs of the industrial sector.
- Several state level SFCs were established to foresee the demand for investment and help various centralized institutions in making the credit available to the people needed.

Notes

7.8 Keywords

Demand deposits: Funds deposited at a depository institution that are payable on demand — immediately or within a very short period.

Net owned funds: According to the RBI, Net owned Fund will consist of paid up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets.

7.9 Self Assessment

Fill in the blanks:

1. SIDBI was established to empower the ....., ... enterprises (MSME) sector.
2. IFCI was established to cater to the financial needs of industrial concerns in ..... and ..... sectors.
3. IFCI has promoted ....., primarily in less developed states.
4. The forte of NBFCs has been credit delivery to areas not covered by ..... and financial institution.
5. ..... are financial institutions that provide banking services without meeting the legal definition of a bank.
6. IFCI has played a key role in the development of cooperatives in the ..... and ..... sectors.
7. 'Deposit' includes and shall be deemed always to have included any receipt of money by way of ..... or in any other form.
8. NBFCs cannot accept deposits from ..... except deposits by debit to NRO account of NRI provided such amount does not represent inward remittance or transfer from NRE/FCNR (B) account.
9. All non-banking financial companies are to be registered under the .....
10. The role of NBFCs has become increasingly important from both the macro economic perspective and the structure of the Indian ..... system.
11. ..... has diversified its activities in the field of merchant banking, syndication of loans, formulation of rehabilitation programmes, assignments relating to amalgamations and mergers, etc.
12. Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of .....
13. ..... under the new dispensation has been entrusted with the overall responsibility to look after the interests of SFCs, including provision of adequate refinance facilities.
14. IFCI has been able to achieve a financial turnaround with the consistent support and cooperation of all its .....
15. The main handicap of an NBFC is the small size of their ....., ... and their ....., which is region specific.

7.10 Review Questions

1. What is the rationale behind the existence of industrial development corporations at the state level in India?

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2. What is the contribution of the state level industrial development corporation of India, in the growth of Indian Economy?
3. What are NBFCs? Why are they needed especially in a developing economy?
4. Evaluate the performance of NBFCs in India.
5. What are the main reasons for RBI making the laws stringent for the NBFCs? What will you suggest to check the issues further?
6. Do you think that SIDBI has done justice with its objective so far? Support your argument with factual reasoning.
7. "NBFCs are doing functions similar to banks". What is difference between banks & NBFCs?
8. Can all NBFCs accept deposits and what are the requirements for accepting Public Deposits?
9. Are Secured debentures treated as Public Deposit? If not who regulates them?
10. "It is said that rating of NBFCs is necessary before it accepts deposit" Is it true? Who rates them?
11. Can an NBFC which is yet to be rated accept public deposit? When a company's rating is downgraded, does it have to bring down its level of public deposits immediately or over a period of time?
12. In case an NBFC defaults in repayment of your deposit what course of action would you take?
13. Can an NBFC pre-pay its public deposits? If yes, what are the conditions for that?

Answers: Self Assessment

1. micro, small and medium
2. large scale corporate, co-operative
3. Technical Consultancy Organizations (TCOs)
4. banks
5. Non-bank financial companies (NBFCs)
6. sugar, textile
7. deposit or loan
8. NRIs
9. Companies Act, 1956
10. financial
11. IFCI
12. banks
13. SIDBI
14. stakeholders
15. balance sheet, resources, distribution reach

7.11 Further Readings


Online links

www.cidap.gov.in

www.rbi.org.in

www.thehindubusinessline.com

Unit 8: Insurance Sector

Notes

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Objectives

After studying this unit, you will be able to:

- Define public insurance
- Explain private insurance
- Describe life insurance
- Define general insurance

Notes

Introduction

Insurance may be described as a social device to reduce or eliminate risk of life and property. Under the plan of insurance, a large number of people associate themselves by sharing risk, attached to individual.

The risk, which can be insured against include fire, the peril of sea, death, incident, & burglary. Any risk contingent upon these may be insured against at a premium commensurate with the risk involved.

Insurance is actually a contract between 2 parties whereby one party called insurer undertakes in exchange for a fixed sum called premium to pay the other party happening of a certain event.

Insurance is a contract whereby, in return for the payment of premium by the insured, the insurers pay the financial losses suffered by the insured as a result of the occurrence of unforeseen events.

With the help of insurance, large number of people exposed to a similar risk make contributions to a common fund out of which the losses suffered by the unfortunate few, due to accidental events, are made good.

Indian insurance companies play a key role in India's financial sector. With India's population becoming more affluent and globalized, insurance is growing rapidly. This increasing market is creating considerable competition among Indian insurance companies in an industry that 20 years ago was relatively small.

8.1 Public and Private Sector Insurance

The concept of insurance is intimately related to security. Insurance acts as a protective shield against risk and future uncertainties. Traditionally, a risk-averse behavior has been a characteristic feature of Indians who preferred a "low & certain" disposable income to a "high & uncertain" one.

Hence insurance has become a close associate of Indians since 1818, when Oriental Life Insurance Company was started by Europeans in Kolkata to cater to the needs of their own community. The age was characterized by intense racial discrimination as Indian insurance policy holders were charged higher premiums than their foreign counterparts. The first Indian Insurance Company to cover Indian lives at normal rates was Bombay Mutual Life Assurance Society which was established in the year 1870.

By the dawn of the 20 th century, new insurance companies started mushrooming up. In order to regulate the insurance business in India and to certify the premium rate tables and periodic valuations of the insurance companies, the Life Insurance Companies Act and the Provident Fund Act were passed to regulate the Insurance Business in India in 1912. Such statistical estimates made by actuaries revealed the disparity that existed between Indian and foreign companies.

The Indian Insurance Sector went through a full circle of phases from being unregulated to completely regulated and then being partly deregulated which is the present situation. A brief on how the events folded up is discussed as follows:

The Insurance Act of 1938 was the first legislation governing all forms of insurance to provide strict state controls over insurance business.

In 19th January, 1956, the life insurance in India was completely nationalized through the Life Insurance Corporation Act of 1956. At that time, there were 245 insurance companies of both Indian and foreign origin. Government accomplished its policy of nationalization by acquiring

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the management of the companies. Bearing this objective in mind, the Life Insurance Corporation (LIC) of India was created on 1st September, 1956 which has grown in leaps and bounds henceforth, to become the largest insurance company in India.

The General Insurance Business (Nationalization) Act of 1972 was formulated with the objective of nationalizing nearly 100 general insurance companies and subsequently amalgamating them into four basic companies namely National Insurance, New India Assurance, Oriental Insurance and United India Insurance which have their headquarters in four metropolitan cities.

The Insurance Regulatory and Development Authority (IRDA) Act of 1999 deregulated the insurance sector in India and allowed the entry of private companies into the insurance sector. Moreover, the flow of Foreign Direct Investment (FDI) was also restricted to 26 % of the total capital held by the Indian Insurance Companies.

While LIC is the sole operator in the public sector, the following are a few examples of private companies in India are as under:

Examples: 1. ICICI Prudential Life Insurance

2. HDFC Standard Life

3. SBI Life Insurance

4. Metlife India.

8.2 Insurance Regulatory and Development Authority (IRDA)

The mission of IRDA is to protect the interests of the insurance policyholders and to regulate, promote and ensure orderly growth of the insurance industry. This required effective legislation. Therefore, in 1999, the governing legal framework was significantly strengthened with the enactment of the Insurance Regulatory and Development Authority (IRDA) Act.

8.2.1 Functions

Section 14 of IRDA Act, 1999 lays down the duties, powers and functions of IRDA.

1. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.
2. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include:
   (a) issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;
   (b) protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;
   (c) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents;
   (d) specifying the code of conduct for surveyors and loss assessors;
   (e) promoting efficiency in the conduct of insurance business;

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(f) promoting and regulating professional organisations connected with the insurance and re-insurance business;

(g) levying fees and other charges for carrying out the purposes of this Act;

(h) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;

(i) control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);

(j) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

(k) regulating investment of funds by insurance companies;

(l) regulating maintenance of margin of solvency;

(m) adjudication of disputes between insurers and intermediaries or insurance intermediaries;

(n) supervising the functioning of the Tariff Advisory Committee;

(o) specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

(p) specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

(q) exercising such other powers as may be prescribed.

8.2.2 Role of IRDA

Insurance regulator IRDA was set up as there felt the need:

1. To set up an independent regulatory body, that provides greater autonomy to insurance companies in order to improve their performance.
2. To enable the insurance companies to act as independent companies with economic motives.
3. To protect the interest of holders of insurance policies.
4. To amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972.
5. To end the monopoly of the Life Insurance Corporation of India and General Insurance Corporation and its subsidiaries.

IRDA has ensured a satisfactory progress for the insurance industry in India since liberalisation. It is due to various efforts made by it that the public confidence in the industry is positive today and the industry on the whole is far more dynamic and has scored well on number of parameters.

In the year 2000, IRDA started giving licenses to private insurers and ICICI prudential and HDFC Standard Life insurance became the first private insurers to sell a policy.

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In 2001, as a result of the IRDA's initiatives for insurance market liberalization, as much as 16 private sector companies including joint ventures with leading foreign insurance companies entered the Indian insurance sector. Of this, 10 were under the life insurance category and six under general insurance. Thus in all there are 28 players (15-life insurance of which, 14 are private insurers and 13-general insurance of which 9 are private) in the Indian insurance industry till date. The same year, Royal Sundaram Alliance became the first non life insurer to sell a policy.

In the year 2002, IRDA allowed Banks to sell the insurance plans. As TPAs enter the scene, insurers started setting non-life claims in the cashless mode.

Insurance premium per capita in India has increased to $16.90 and overall penetration in India stood at 3.28 per cent of the gross domestic product in 2003. India's overall world rankings in terms of total premium volumes improved from 23rd in 2000 to 19th in 2003 and its share in the world market increased from 0.41 per cent to 0.59 per cent during the same period.

In the 2004 budget, the Government proposed for increasing the foreign equity stake to 49%, this is yet to be effected. Under the current guidelines, there is a 26 percent equity cap for foreign partners in direct insurance and reinsurance Company.

For the year ending 31st March, 2005, the first year premium of the life insurance industry grew by 260 per cent to ₹ 25,350 crores, as compared to ₹ 9,709 crores in the year 2000-01. Similarly, the non-life insurance industry also witnessed a 180-per cent growth, writing a gross premium of ₹ 18,095.25 crores in 2004-05 - up from ₹ 10,087.03 crores in 2000-01.

As insurance companies are trustees of public money, IRDA adopted a rigorous system of scrutiny of applications based on financial strength, track record and reputation of the promoters, with regard to compliance with regulations and the strength of internal control systems, product innovations, technical and managerial skills, commitment to contribute to India's development as a regional insurance hub and an international financial centre for setting up insurance companies.

In addition, it laid down stringent norms relating to solvency and has reinforced with appropriate regulations the investment of funds by insurance companies to ensure that they are financially strong. One example of IRDA's effective way of working was demonstrated when the sudden exit of both the promoters of AMP Sanmar Life Insurance Company Limited did not create any panic amongst the company's policyholders. Similarly, the issue of Life Insurance Corporation of India's (LIC) solvency margin was handled carefully. The country's premier life insurer today meets the stipulated solvency norms. The IRDA also issued micro-insurance regulations to increase the spread of insurance in the country, particularly among the neediest segments

Along with the liberalisation programme, measures to raise standards of corporate governance and market conduct, strengthening protection of policyholders' interests have also been introduced. This has helped the transition from the state monopoly to free market with remarkable ease.

In addition, IRDA has continuously worked to develop the market through new ideas and initiatives with inputs from various stakeholders. The focus on aggressive marketing has made insurance a sunrise industry in the country attracting young talent. The industry has successfully experimented with new distribution channels and bringing down the transactions costs. The Unit Linked Policies (ULIPs) brought a new dimension in the sale of insurance products forcing the IRDA to come out with its own set of guidelines to successfully regulate these products. While the improvements may not look dramatic, the direction and speed is an indicator of India's emergence on the global scene.

Today, IRDA has many applications from prospective insurers and it is expected of the industry to improve the insurance penetration to at least 5 per cent in the next five years.

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8.2.3 The Road Ahead

The insurance industry has successfully completed the first phase of reforms by having a smooth transition from a state-controlled monopolistic structure to a free market competitive industry and the stage is set for consolidating the gains made in the first phase of reforms. Despite the suggestions by many an analyst, IRDA does not do any "mystery shopping" to uncover rebating and payment of commission in excess of levels stipulated in the Insurance Act, 1938.

In future, IRDA expects further segmentation in the market with some companies becoming financial conglomerates, others transforming themselves into niche players.

The country is in the midst of demographic changes and an increasing older population will demand annuities and pensions related products. Though the life insurers have added value to the market by introducing a number of new products, there have been some reports of market misconduct such as rebating and mis-selling of keyman insurance covers, which has not been good for the image of the industry. IRDA has to ensure that the insurers curb such practices. The life insurance industry has witnessed frequent churning of agents and relatively high rate of policy lapses, which is again not a good indicator for the industry.

IRDA has to ensure that the life insurance segment attracts more participants. Needless to say, the unit-linked policy will continue to attract more policyholders because of the rise in stock markets and with the announcement of new guidelines by the IRDA. There are a number of issues, which need to be addressed on the ULIP policies. The IRDA has been working on them. The objective is to protect the interest of the policyholders, particularly in the areas of design of products, transparency with regard to the definition of charges, amount of charges, partial withdrawal, top-up premiums, advocacy issues and sales illustrations, advertisement material and others.

In future, the bancassurance channel is very likely to witness an increasing importance given the reach and the strong relationship between the customer and the banker. In addition, some of the areas that require greater attention are rural, social and health sectors. The penetration in these sectors is still low given the huge potential and IRDA should encourage the players to exploit it.

8.2.4 Foreign Direct Investment in Insurance Sector

Over the past years, Indian insurance industry has shown a remarkable trend of growth. The annual sales of all life insurance companies and general insurance is to the tune of ₹ 2.25 lakhs crores a year. But like every other industry, the insurance industry also needs capital to grow and for this IRDA had proposed to the government that the FDI limit should be enhanced to 49% from the present level of 26% and that foreign reinsurance companies need to be allowed to open branch offices in India. Both the proposals were considered by the Parliament and will take sometime to be cleared. Amendments have to be made to the bill to bring in the change.

On Dec 22, 2008, Indian govt., decided to press ahead with liberalization of the insurance sector. At the fag end of its term and in a truncated parliament session the government of India tabled two bills to amend the laws applicable to the insurance sector. The two bills-The Insurance Laws (Amendments) Bill and the Life Insurance Corporation (Amendment) Bill-were introduced in the Rajya Sabha and Lok Sabha respectively.

The aim is obviously to keep the focus on privatization with dilution of public control and provision of a greater role for foreign firms in the insurance sector. This emphasis comes through from the four principal elements of the current legislative effort. The first is to permit public insurance companies to mobilize additional money from the markets. The second is to relax the cap on foreign direct investment or ownership by foreign players in the insurance sector as a whole. The third is to reduce the capital requirements for private players in certain

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areas, such as the health insurance sector. And the fourth is to emphasis self-regulation with capital adequacy over structural regulation of the sector.

It is believed by all the industry specialists that the increase in FDI would help customers with better products, more options and better service levels from the insurance players in the industry.

The minimum investment limit for health insurance companies is proposed to be fixed at ₹50 crores. At present, the companies entering the insurance business — life or general insurance — are required to have a minimum paid-up capital of ₹ 100 crores.

The move to lower the investment limit is expected to encourage companies with less capital to launch health insurance business and increase the penetration of this important segment.

In the case of the general insurance sector, besides raising the FDI cap from 26 to 49 per cent, the relevant bill allows the four state-owned general insurance companies — Oriental Insurance Company, New India Assurance, United India Insurance and National Insurance Company — to tap capital markets for funds after obtaining permission from the government. The bill also allows insurance companies to raise newer capital through newer instruments on the pattern of banks.

Moreover, in a move widely seen as aimed at helping Lloyds of London in the first instance, the bill seeks to allow foreign re-insurance companies to open offices and conduct business in the country with a minimum capital of ₹ 200 crores. Thus far, only the General Insurance Corporation could provide reinsurance in India. In addition, to make entry into the rapidly expanding health insurance market easier for private players, the bill proposes to reduce minimum investment limit for health insurance companies from ₹ 100 crores to ₹ 50 crores. Also, the bill seeks to do away with the requirement that promoters have to divest specified part of their equity after ten years, allowing promoters to retain control of these corporations. Finally, as part of the new regulatory framework, a Life Insurance Council and General Insurance Council are to be set up as self-regulating bodies.

While these are major changes, the big story is what this government or any version of it that may come to power after the next election has in store for the Life Insurance Corporation. The Life Insurance Corporation Amendment Bill is presented as an innocent piece of legislation aimed at increasing the capital base of LIC, to bring it on par with private insurers. The problem arises when this is read along with the changes being pushed through in the general insurance sector. The government plans to allow government-owned insurance companies to mobilize money from the capital market, allowing for a dilution of the government's shareholding. And this comes along with the decision to raise the cap on foreign direct investment in the insurance sector from 26 per cent to 49 per cent. If in time, these provisions are extended to cover the LIC, the government would recapitalize LIC not with its own money but with money mobilized from the market and from foreign investors.

This fear stems from the implicit effort to homogenize the insurance sector, bringing the LIC on par with the private sector. This does signify a move to accelerate the shift in the form of regulation away from direct control through public ownership of institutions in the life and general insurance sectors to self-regulation based on IRDA norms and guidelines and capital adequacy requirements. The use of capital adequacy is reflected in the provision in the bill to cap the sovereign guarantee provided to those insured by the LIC and replacing it with a provision that a part of the surplus-which is the excess of assets over liabilities actuarially calculated-must be treated as a solvency margin and placed in a reserve fund, which the corporation can access in times of need. As of now, 95 per cent of these surpluses are distributed to policy holders as bonuses and the rest is transferred to the government as dividend against its ₹ 5 crores investment. The bill provides for the transfer to policyholders to be capped anywhere between 90 and 95 per cent, with the balance divided between the government and the reserve fund. Thus, state control and state guarantee are to be replaced with self regulation, capital adequacy and solvency margins. This is clearly a sign of long-term intentions.

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It should be clear that these bills are aimed at making the insurance sector private dominated, self-regulated and "competitive". Is there a case for such a transition? There is much evidence on the adverse consequences of such competition and the beneficial effects of government intervention in the insurance sector. The insurance industry delivers "products" that are promises to pay, in the form of contracts, which help lessen the incidence of uncertainty in various spheres. The insured pays to fully or partially insulate herself from risks such as an accident, fire, theft or sickness or provide for dependents in case of death. In theory, to enter such a contract, the insured needs information regarding the operations of the insurer to whom she pays in advance large sums in the form of premia, in lieu of a promise that the latter would meet in full or part the costs of some future event, the occurrence of which is uncertain. These funds are deployed by the insurer in investments being undertaken by agents about whose competence and reliability the policy holder makes a judgment based on the information she has. The viability of those projects and the returns yielded from them determine the ability of the insurer to meet the relevant promise. To the extent that the different kinds of information required are imperfectly available, the whole business is characterised by a high degree of risk.

This makes excessive competition in insurance a problem. In an effort to drum up more business and earn higher profits, insurance companies could underprice their insurance contracts, be cavalier with regard to the information they seek about policy holders, and be adventurous when investing their funds by deploying them in high-risk, but high-return ventures. Not surprisingly, countries where competition is rife in the insurance industry, such as the US, have been characterised by a large number of failures. As far back as 1990, a Subcommittee of the US House of Representatives noted in a report on insurance company insolvencies revealingly titled "Failed Promises", that a spate of failures, including those of some leading companies, was accompanied by evidence of "rapid expansion, overreliance on managing general agents, extensive and complex reinsurance arrangements, excessive underpricing, reserve problems, false reports, reckless management, gross incompetence, fraudulent activity, greed and self-dealing." The committee argued that "the driving force (of such 'deplorable' management practices) was quick profits in the short run, with no apparent concern for the long-term well-being of the company, its policyholders, its employees, its reinsurers, or the public." The case for stringent regulation of the industry was obvious and forcefully made.

Things have not changed much since, as the failure and $150 billion bail-out of global insurance major American International Group (AIG) in September made clear. AIG was the world's biggest insurer when assessed in terms of market capitalisation. It failed because of huge marked-to-market losses in its financial products division, which wrote insurance on fixed-income securities held by banks. But these were not straightforward insurance deals based on due diligence that offered protection against potential losses. It was a form of investment in search of high returns, which allowed banks to circumvent regulation and accumulate risky assets. As the Financial Times (September 17, 2008) noted, "banks that entered credit default swaps with AIGFP could assure auditors and regulators that the risk of the underlying asset going bad was protected, and with a triple A rated counterparty." That is, AIG used policy-holder money and debt to invest like an investment bank through its financial products division. When a lot of its assets turned worthless AIG could not be let go, because that would have systemic implications. The alternative was nationalization.

It is in this background that we need to address the question of the "efficiency" of competition from private entrants. To start with, against the promised private gains in terms of the efficiency of service providers, we need to compare the potential private loss in the form of increased risk and the social loss in the form of the inability of the state as a representative of social interest to direct investments by the insurance industry. Further, if insolvencies become the order of the day, there could be private losses as well as social losses because the state is forced to emerge as the "insurer of last resort". The losses may far exceed the gains, implying that the industry should be restructured with the purpose of realising in full the advantages of public ownership.

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Role of Underwriters

Underwriters assume great significance as they play an important role for every issuing company. This role can be understood by going through the following points:

1. The issuing company is relieved from the risk the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.
2. The company is assured of getting minimum subscription within the stipulated time, a statutory time, a statutory obligation to be fulfilled by the issuing company.
3. Underwriters undertake the burden of highly specialized function of distributing securities.
4. Underwriters provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued, etc.
5. Public confidence on the issue enhances when underwritten by reputed underwriters.

Caselet

IRDA's Guidelines on Outsourcing get Mixed response from BPOs

Norms to make insurer responsible for outsourcing arrangement.

'Core' Problems

Only 'non-core' functions like house keeping, data entry, etc., can be outsourced.

Most 'core' functions that cannot be outsourced in India are outsourced in the West.

One way out for insurers could be forming joint ventures with back office companies.

The Insurance Regulatory and Development Authority's (IRDA) recent norms on outsourcing may prompt insurers to increase the quantum of back office work they give out to third party vendors in the medium term.

However, it will deter Indian back office companies from moving up the value chain as they remain stuck with low-end processing-related work, say industry watchers.

In its draft guidelines on outsourcing, IRDA had defined the processes that could be outsourced and those that should be done in-house. Core functions such as product design, claims, IT support and policy servicing were functions that could not be outsourced. Non-core functions include house keeping, Web site management, internal audit, payroll management, HR services, data entry, medical check-ups, tele-marketing and call centre for outbound calling among others.

"Lot of insurance companies are waiting for norms on outsourcing to come through…now it is good for them to know what they can outsource and what they can't. I expect the new guidelines to open up the market in the medium term," said Mr Sanjay Venkataraman - Executive Vice-President and Head-Asia Business Unit, Firstsource Solutions.

End-to-end Responsibility

Firstsource Solutions works with one of the largest private insurance players in India. Mr Aparup Sengupta, Managing Director and CEO of Essar Group-promoted Aegis BPO, believes the new norms are designed to formally place end-to-end responsibility of the outsourcing arrangement on the insurer. "Insurance companies can no longer pass on the

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contingent risks to the outsourcing agents alone since their skin will also be in the game," said Mr Sengupta.

As mentioned earlier, many of the non-core functions are already getting outsourced to third party players.

On the flip side, core activities such as claims processing, IT support and policy servicing are generally outsourced to back office companies by firms in the US and UK. In India, a small sub-section within claims processing - namely, data entry work related to procurement and lodging of insurance claims - is outsourced. Settlement of insurance claims is still very much done in-house by the insurer. "Majority of the functions prescribed by the IRDA as core are generally outsourced in the Western World. Since these cannot be outsourced by Indian insurers, it is a dampener in terms of the future revenue outlook for back office firms," a senior industry watcher said.

Forming Joint Venture

Some companies, like the Mumbai-based Datamatics, feel that clients who still want to outsource some of the core functions could do so by forming a joint venture with a back office company. "This ensures that the core functions are still dealt with by the insurer...We are having some conversations on similar lines with prospective customers," said Mr Rahul Kanodia, Vice-Chairman and Chief Executive, Datamatics.

Source: http://www.thehindubusinessline.in

8.3 Terminology Used

Though the space does not provide the liberty to discuss each and every term used in the insurance sector, yet the most important of them all are being discussed in an alphabetical order as under:

Contract of Insurance: A contract of insurance is a contract of utmost good faith technically known as uberrima fides. The doctrine of disclosing all material facts is embodied in this important principle, which applies to all forms of insurance.

At the time of taking a policy, policyholder should ensure that all questions in the proposal form are correctly answered. Any misrepresentation, non-disclosure or fraud in any document leading to the acceptance of the risk would render the insurance contract null and void.

Cover note: Document evidencing issuance of an insurance policy and gives a summary of the information given in a certificate of insurance.

Excess: A secondary insurance policy covering a loss in excess of that covered under a primary policy; may be referred to as excess policy.

Hazard: Insurance that covers property damage caused by fire, wind, storms, and other similar risks. Sometimes earthquakes and floods are also covered, while other times they are not.

Indemnity: Indemnity insurance compensates the beneficiaries of the policies for their actual economic losses, up to the limiting amount of the insurance policy. It generally requires the insured to prove the amount of its loss before it can recover. Recovery is limited to the amount of the provable loss even if the face amount of the policy is higher.

Insurable Interest: Insurable interest is defined as legal interest in another person's life or in the protection of property from injury, loss, destruction or pecuniary damage.

Insured: A person whose interests are protected by an insurance policy; a person who contracts for an insurance policy that indemnifies him against loss of property or life or health etc.

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Maturity: An agreed date when an endowment policy ends and the proceeds, including any bonuses, are payable.

Premium: Insurance Premium is the payment made by the policy holder to the insurance company on a regular time span. This payment has to be made by the insured person till the maturity of the insurance. Insurance Premium may vary from company to company along with the coverage limit.

Notes The insurance premium generally increases with the increase in the risk perception of the company about that person.

In case of medical insurance or mediclaim, the cost of premium is more for the smokers than the non-smokers because the insurance company considers that the smoker possesses a greater risk of health hazard than the non-smoker. Hence the cost of premium is directly proportional to the risk associated.

In case of the car insurance, the cost of premium is generally higher than a older one because the insurance company considers that the younger driver is more prone to accident than the latter.

In case of Life Insurance, the insurance company considers the aged person to be more prone to death. Hence it charges a higher premium than from him. But when it comes to a younger person seeking life insurance, then the premium charged from him is less. The reason behind it is that in normal conditions a younger person stands more chance in living a longer life span.

Renewal: A renewal is a new policy or a standard certificate from an insurance company, stating that the conditions of your old policy will stay in effect for a specified period of time.

Risk (Peril): Insurance companies generally label a particular risk as a "peril" which may cause a loss or damage. A peril may include such things as fire, earthquake, windstorm, flood, or theft to name just a few.

Insurer is liable for any loss proximately caused by a peril insured against, but he is not liable for any loss which is not proximately caused by a peril insured against.

Notes Proximate cause means the active, efficient cause that sets in motion a train of events which brings about a result, without the intervention of any force started and working actively from a new and independent source.

Sum Assured: At the time of signing a life insurance contract, the insurer and the buyer of the policy, the insured, agree on an amount that would be payable if the insured dies. This amount, the Sum Assured (SA), is payable to the persons appointed as nominees by the insured at the time of signing the contract. In a life cover, SA is the reason the insured pays the premium.

There are no formal rules for arriving at SA, but it should ideally be sufficient to see the dependents of the insured through till they are able to fend for themselves. On this premise, financial planners suggest that the SA should equal the insured's income for six years or be 10 times the annual living expenses of the insured and also cover his liabilities like home loans. A high SA would not only push up the premium, but may also make a medical check-up necessary.

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The relationship of SA with the premium depends on the type of insurance policy. Broadly, life insurance policies can be divided into traditional ones and Unit-linked Insurance Plans (ULIPs). In traditional plans, including term policies, SA determines the premium. In a ULIP, however, where the money of the insured is exposed to equities in addition to debt instruments, the premium determines SA. The insurer will typically let you choose an amount 5-50 times the premium as SA.

Sum Insured: The maximum amount that an insurance company will pay out in the event of a claim.

Caution SA is a pre-agreed sum that an insurer pays to the nominee if the insured dies. The Sum Insured (SI), on the other hand, is the compensation paid to the insured for his losses. So, in case of a claim in a health policy of ₹ 5 lakhs, the insurer will pay only for the cost incurred up to ₹ 5 lakhs. In a life cover, the entire SA is paid to the nominee if the insured dies.

Underwriting: Insurance underwriters evaluate the risk and exposures of potential clients. They decide how much coverage the client should receive, how much they should pay for it, or whether even to accept the risk and insure them. Underwriting involves measuring risk exposure and determining the premium that needs to be charged to insure that risk. The function of the underwriter is to acquire-or to "write"-business that will make the insurance company money, and to protect the company's book of business from risks that they feel will make a loss. In simple terms, it is the process of issuing insurance policies.

Each insurance company has its own set of underwriting guidelines to help the underwriter determine whether or not the company should accept the risk. The information used to evaluate the risk of an applicant for insurance will depend on the type of coverage involved. For example, in underwriting automobile coverage, an individual's driving record is critical. As part of the underwriting process for life or health insurance, medical underwriting may be used to examine the applicant's health status (other factors may be considered as well, such as age & occupation). The factors that insurers use to classify risks should be objective, clearly related to the likely cost of providing coverage, practical to administer, consistent with applicable law, and designed to protect the long-term viability of the insurance program.

The underwriters may either decline the risk or may provide a quotation in which the premiums have been loaded or in which various exclusions have been stipulated, which restrict the circumstances under which a claim would be paid. Depending on the type of insurance product (line of business), insurance companies use automated underwriting systems to encode these rules, and reduce the amount of manual work in processing quotations and policy issuance. This is especially the case for certain simpler life or personal lines (auto, homeowners) insurance.

8.4 Life Insurance

Life insurance is a contract that pledges payment of an amount to the person assured (or his nominee) on the happening of the event insured against.

The contract is valid for payment of the insured amount during:

1. The date of maturity, or
2. Specified dates at periodic intervals, or
3. Unfortunate death, if it occurs earlier.

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Among other things, the contract also provides for the payment of premium periodically to the Corporation by the policyholder. Life insurance is universally acknowledged to be an institution, which eliminates 'risk', substituting certainty for uncertainty and comes to the timely aid of the family in the unfortunate event of death of the breadwinner.

By and large, life insurance is civilisation's partial solution to the problems caused by death. Life insurance, in short, is concerned with two hazards that stand across the life-path of every person:

1. That of dying and prematurely leaving a dependent family to fend for itself.
2. That of living till old age without visible means of support.

8.4.1 Calculation of Life Insurance Amount/Premium

Individuals getting a life insurance cover have to pay the monthly/quarterly/half yearly/ yearly premium/life insurance rate, which depends on the amount insured. The premium amount also increases or decreases with different life insurance plans, age of the individual etc. The company pays the full insurance amount either on the death of the individual or the expiry of the policy which ever is earlier. Life insurance policy can be renewed after the expiry. Some insurance companies offer a discount while renewing the policies of existing clients. The insurance is done after a medical examination of the individual being insured.

8.4.2 Advantages

A good life insurance programme does more than just replace the loss of income that occurs if the insured person dies. Life insurance offers following benefits:

Protection

Savings through life insurance guarantee full protection against risk of death of the saver. Also, in case of demise, life insurance assures payment of the entire amount assured (with bonuses wherever applicable) whereas in other savings schemes, only the amount saved (with interest) is payable.

Aid to Thrift

Life insurance encourages 'thrift'. It allows long-term savings since payments can be made effortlessly because of the 'easy installment' facility built into the scheme. (Premium payment for insurance is monthly, quarterly, half yearly or yearly).

Example: The Salary Saving Scheme (of LIC) popularly known as SSS, provides a convenient method of paying premium each month by deduction from one's salary. In this case the employer directly pays the deducted premium to LIC.

Liquidity

In case of insurance, it is easy to acquire loans on the sole security of any policy that has acquired loan value. Besides, a life insurance policy is also generally accepted as security, even for a commercial loan.

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Tax Relief

Life Insurance is the best way to enjoy tax deductions on income tax and wealth tax. This is available for amounts paid by way of premium for life insurance subject to income tax rates in force.

Assessees can also avail of provisions in the law for tax relief. In such cases the assured in effect pays a lower premium for insurance than otherwise.

Money when it is Needed

Life insurance comes as a policy that has a suitable insurance plan or a combination of different plans that can be effectively used to meet certain monetary needs that may arise from time-to-time like those of children's education, start-in-life or marriage provision or even periodical needs for cash over a stretch of time.

Alternatively, policy money can be made available at the time of one's retirement from service and used for any specific purpose, such as, purchase of a house or for other investments. Also, loans are granted to policyholders for house building or for purchase of flats (subject to certain conditions).

8.4.3 Types

Life Insurance policy is the most popular and taken by the most number of people. Many of us buy life insurance policies, because we want to make sure our loved ones remain financially secure after we die. Insurance companies offer both individual as well as group insurance policies.

Types of Life Insurance Available:

1. ***Whole Life Assurance:*** In whole life assurance, insurance company collects premium from the insured for whole life or till the time of his retirement and pays claim to the family of the insured only after his death.
2. ***Endowment Assurance:*** In case of endowment assurance, the term of policy is defined for a specified period say 15, 20, 25 or 30 years. The insurance company pays the claim to the family of assured in an event of his death within the policy's term or in an event of the assured surviving the policy's term.
3. ***Assurances for Children:*** These can be divided into two forms, viz.
   (a) *Child's Deferred Assurance:* Under this policy, claim by insurance company is paid on the option date which is calculated to coincide with the child's eighteenth or twenty first birthday. In case the parent survives till option date, policy may either be continued or payment may be claimed on the same date. However, if the parent dies before the option date, the policy remains continued until the option date without any need for payment of premiums. If the child dies before the option date, the parent receives back all premiums paid to the insurance company.
   (b) *School Fee Policy:* School fee policy can be availed by effecting an endowment policy, on the life of the parent with the sum assured, payable in instalments over the schooling period.
4. ***Term Assurance:*** The basic feature of term assurance plans is that they provide death risk-cover. Term assurance policies are only for a limited time, claim for which is paid to the family of the assured only when he dies. In case the assured survives the term of policy, no claim is paid to the assured.

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5. ***Annuities:*** Annuities are just opposite to life insurance. A person entering into an annuity contract agrees to pay a specified sum of capital (lump sum or by installments) to the insurer. The insurer in return promises to pay the insured a series of payments until insured's death. Generally, life annuity is opted by a person having surplus wealth and wants to use this money after his retirement.

   There are two types of annuities, namely:

   (a) *Immediate Annuity:* In an immediate annuity, the insured pays a lump sum amount (known as purchase price) and in return the insurer promises to pay him in installments a specified sum on a monthly/quarterly/half-yearly/yearly basis.

   (b) *Deferred Annuity:* A deferred annuity can be purchased by paying a single premium or by way of installments. The insured starts receiving annuity payment after a lapse of a selected period (also known as Deferment period).

6. ***Money Back Policy:*** Money back policy is a policy opted by people who want periodical payments. A money back policy is generally issued for a particular period, and the sum assured is paid through periodical payments to the insured, spread over this time period. In case of death of the insured within the term of the policy, full sum assured along with bonus accruing on it is payable by the insurance company to the nominee of the deceased.

Did u know? **What are ULIPs ?**

ULIPs (unit-linked insurance policies) are life insurance policies where the insurance cover is bundled with an investment benefit under a single contract; the customer gets insurance cover as well as investment returns based on market performance. As in mutual funds, there are different options like predominantly equity-oriented investments, pure debt investments, government securities investments, etc, which the customer can choose, depending on his or her risk appetite. The most important point is that the risk under ULIPs is borne by the policyholder.

The primary advantage of ULIPs is that the customer gets the advantages of both insurance and mutual fund investment in a single contract. An in-house team invests and manages the premiums and gets the customer a return. ULIPs also offer tax deduction of up to ₹ 1,00,000 from the gross total income under Section 80C of the Income Tax Act, 1961. Returns from ULIPs are exempt from tax, subject to the conditions under Section 10(10D). The downside is that, generally, there are limited guarantees, and market risks are passed on to the customer completely. Returns could be lucrative if the market is upbeat, but the unit value could decline if the market goes down.

IRDA has prescribed a minimum sum assured equal to 50 per cent of the total annualised premium during the entire policy term or five times the annualised premium, whichever is higher. This regulation is aimed at maintaining the basic characteristic of a life insurance policy, where life cover should be the primary benefit. Till the policyholder turns 60 years old, the sum assured cannot be reduced by partial withdrawals. This is aimed at protecting the life insurance cover.

Premium Holiday: If the policyholder stops paying premium instalments after paying premiums for three years, the risk premiums and the applicable charges can be adjusted from the balance in the account value, till such time as the balance in the account reduces to one year's premium. This would help policyholders who are unable to pay premiums owing to a temporary disruption in income because of change in employment, or any

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other sudden drop in income. The premium holiday option ensures continued insurance protection by transferring the risk premium and charges due from the account value, which is built up over a period. But the policy would lapse and this benefit would not be available if premium payments are stopped within three years.

Top-up Premiums: Top up premiums are irregular dump-in amounts allowed in a ULIP. Up to now, there were no restrictions; it was possible, for example, to dump in ₹1 crores in a ULIP and invest the entire amount in the market. But this vitiates the basic characteristic of the policy by making the insurance component insignificant. To plug this loophole, IRDA has prescribed that a sum assured must back any dump-in that exceeds 25 per cent of normal premium, which will be constant throughout the term of the policy. Any appropriation towards a dump-in can take place only if the normal premiums are paid.

Withdrawals from ULIPs: Earlier, withdrawals from ULIPs were possible even within a year of issue. Depending on the option selected, they were reduced from the sum assured, resulting in dilution of death benefits to the nominees. Now, withdrawals will be allowed only after three years. The new guidelines provide that except for withdrawals made during the two years immediately preceding death, no other withdrawals can be reduced from the sum assured. But once the customer is past the age of 60, all withdrawals can be reduced from the sum assured.

Lock-in Period: A top-up premium cannot be withdrawn for three years. This places ULIPs on par with mutual fund contributions under Section 80C of the Income Tax Act, 1961. The only relaxation in this condition is on withdrawal of top-up premiums made during the last three years of the policy contract.

Settlement Options: The policyholder has settlement options, to receive the policy benefits in various forms, rather than a lump sum. For example, the company can give the policyholder an option to receive the maturity benefit in the form of a monthly pension. IRDA has restricted such extended periods of settlement to five years from the date of maturity. The company should also make clear the inherent risk involved in extended periods of settlement.

8.4.4 Major Players

The main player of this sector is Life Insurance Corporation of India (LIC). But the sector is very strong and well built. Let us go through brief composition of all the institutions of this sector.

Bajaj Allianz Life Insurance

Bajaj Allianz Life Insurance is a union between Allianz SE, one of the largest Insurance Company and Bajaj Finserv. Allianz SE is a leading insurance conglomerate globally and one of the largest asset managers in the world, managing assets worth over a Trillion (Over INR. 55, 00,000 Crores). Allianz SE has over 115 years of financial experience and is present in over 70 countries around the world.

At Bajaj Allianz Life Insurance is customer delight and their philosophy is to ensure excellent insurance and investment solutions by offering customised products, supported by the best technology.

Birla Sun Life Insurance Company Limited

Birla Sun Life Insurance pioneered the unique Unit Linked Life Insurance Solutions in India. Within 4 years of its launch, BSLI cemented its position as a leading player in the Private Life

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Insurance Industry. With the focus on Investment Linked Insurance Products, supported with protection products to maintain leadership in product innovation, it relies on Multi Distribution Channels like Direct Sales Force, Alternate Channels and Group offering convenient channels of purchase to customers. BSLI was the first to have issued policies over the Internet and to have an operational Business Continuity Plan.

BSLI works with a mission to help people mitigate risks of life, accident, health and money at all stages and under all circumstances and also to enhance the financial future of its customers, including enterprises.

HDFC Standard Life Insurance Company Limited

HDFC Standard Life Insurance Company Ltd. is one of India's leading private insurance companies, which offers a range of individual and group insurance solutions. It is a joint venture between Housing Development Finance Corporation Limited (HDFC Limited), India's leading housing finance institution and a Group Company of the Standard Life Plc, UK.

HDFC Standard Life Insurance Company has a range of individual and group solutions, which can be easily customised to specific needs. Their group solutions have been designed to offer complete flexibility combined with a low charging structure.

ICICI Prudential Life Insurance Company

ICICI Prudential Life Insurance Company is a joint venture between ICICI Bank — one of India's foremost financial services companies-and Prudential plc — a leading international financial services group headquartered in the United Kingdom. Total capital infusion stands at ₹ 47.80 billion, with ICICI Bank holding a stake of 74% and Prudential plc holding 26%.

The company began its operations in December 2000 after receiving approval from Insurance Regulatory Development Authority (IRDA). Today, their nationwide team comprises of 2099 branches.

ICICI Prudential is the first life insurer in India to receive a National Insurer Financial Strength rating of AAA (Ind) from Fitch ratings. As obvious, the company has a commitment to deliver world-class financial solutions to customers all over India.

ING Vysya Life Insurance Company Limited

ING Vysya Life Insurance Company Limited is a global financial institution of Dutch origin offering banking, insurance and asset management to over 85 million private, corporate and institutional clients in over 40 countries. In India, it started its business in September, 2001. With a diverse workforce of approximately 125,000 people, ING is dedicated to setting the standard in helping our clients manage their financial future.

ING Life follows a "customer centric approach" while designing its products. The Company's product portfolio offers products that cater to every financial requirement, at all life stages. ING Life has developed an exclusive tool - the LifeMaker, a simple tool which helps the customers choose a plan most suitable to them, based on their needs, requirements and current life stage. This tool helps build a complete financial plan for life at every lifestage, whether the requirement is Protection, Savings, Retirement or Investment.

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Life Insurance Corporation of India

Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

LIC functions with 2048 fully computerized branch offices, 100 divisional offices, 7 zonal offices and the Corporate office. LIC's Wide Area Network covers 100 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line Kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

LIC continues to be the dominant life insurer even in the liberalized scenario of Indian insurance and is moving fast on a new growth trajectory surpassing its own past records. LIC has issued over one crores policies during the current year. It has crossed the milestone of issuing 1,01,32,955 new policies by 15th October 2005, posting a healthy growth rate of 16.67% over the corresponding period of the previous year.

From then to now, LIC has crossed many milestones and has set unprecedented performance records in various aspects of life insurance business. The same motives which inspired our forefathers to bring insurance into existence in this country inspire us at LIC to take this message of protection to light the lamps of security in as many homes as possible and to help the people in providing security to their families.

Max New York Life Insurance Company Ltd.

Max New York Life Insurance Company Ltd. is a joint venture between New York Life; a Fortune 100 company and Max India Limited; one of India's leading multi-business corporations. The company has positioned itself on the quality platform. In line with its vision to be the Most Admired Life Insurance Company in India, it has developed a strong corporate governance model based on the core values of excellence, honesty, knowledge, caring, integrity and teamwork. The strategy is to establish itself as a Trusted Life Insurance Specialist through a quality approach to business.

Incorporated in 2000, Max New York Life started commercial operation in 2001. In line with its values of financial responsibility, Max New York Life has adopted prudent financial practices to ensure safety of policyholder's funds.

The company has multi-channel distribution that includes the agency distribution, partnership distribution, bancassurance, distribution focused on emerging markets and alliance marketing through employed sales force. The company currently has 33 bancassurance relationships, 14 corporate agency tie-ups and direct sales force at 14 locations.

Max New York Life offers a suite of flexible products. It now has 36 products covering both life and health insurance and 8 riders that can be customized to over 800 combinations enabling customers to choose the policy that best fits their need. Besides this, the company offers 6 products and 7 riders in group insurance business.

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MetLife India Insurance Company Limited (MetLife)

MetLife India Insurance Company Limited (MetLife) is an affiliate of MetLife, Inc. and was incorporated as a joint venture between MetLife International Holdings, Inc., The Jammu and Kashmir Bank, M. Pallonji and Co. Private Limited and other private investors. It serves its customers by offering a range of innovative products to individuals and group customers at more than 600 locations through its bank partners and company-owned offices.

MetLife, Inc., through its affiliates, reaches more than 70 million customers in the Americas, Asia Pacific and Europe. Affiliated companies, outside of India, include the number one life insurer in the United States (based on life insurance in force), with over 140 years of experience and relationships with more than 90 of the top one hundred FORTUNE 500 companies. The MetLife companies offer life insurance, annuities, automobile and home insurance, retail banking and other financial services to individuals, as well as group insurance, reinsurance and retirement and savings products and services to corporations and other institutions.

Kotak Mahindra Old Mutual Life Insurance

Kotak Mahindra Old Mutual Life Insurance is a joint venture between Kotak Mahindra Bank Ltd., its affiliates and Old Mutual plc. The company is one of the fastest growing insurance companies in India and has shown remarkable growth since its inception in 2001.

The group's mission is to emerge as the leading company offering a comprehensive range of life insurance and pension products at competitive prices, ensuring high standards of customer satisfaction and world class operating efficiency, and become a model life insurance company in India in the post liberalization period.

SBI Life Insurance Company Limited

SBI Life Insurance Company Limited is a joint venture between the State Bank of India and BNP Paribas Assurance. SBI Life Insurance is registered with an authorized capital of ₹ 2000 crores and a Paid-up capital of ₹ 1000 crores. SBI owns 74% of the total capital and BNP Paribas Assurance the remaining 26%.

State Bank of India enjoys the largest banking franchise in India. Along with its 7 Associate Banks, SBI Group has the unrivalled strength of over 14,500 branches across the country, arguably the largest in the world.

BNP Paribas Assurance is the life and property & casualty insurance unit of BNP Paribas - Euro Zone's leading Bank. BNP Paribas, part of the world's top 6 group of banks by market value and a European leader in global banking and financial services, is one of the oldest foreign banks with a presence in India dating back to 1860. BNP Paribas Assurance is the fourth largest life insurance company in France, and a worldwide leader in Creditor insurance products offering protection to over 50 million clients. BNP Paribas Assurance operates in 41 countries mainly through the bancassurance and partnership model.

SBI Life has a unique multi-distribution model encompassing Bancassurance, Agency and Group Corporate.

SBI Life extensively leverages the SBI Group as a platform for cross-selling insurances products along with its numerous banking product packages such as housing loans and personal loans. SBI's access to over 100 million accounts across the country provides a vibrant base for insurance penetration across every region and economic strata in the country ensuring true financial inclusion.

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Agency Channel, comprising of the most productive force of more than 63,000 Insurance Advisors, offers door to door insurance solutions to customers.

Tata AIG Life Insurance Company Limited (Tata AIG Life)

Tata AIG Life is a joint venture company, formed by the Tata Group and American International Group, Inc. (AIG). Tata AIG Life combines the Tata Group's pre-eminent leadership position in India and AIG's global presence as one of the world's leading international insurance and financial services organization. The Tata Group holds 74 per cent stake in the insurance venture with AIG holding the balance 26 per cent. Tata AIG Life provides insurance solutions to individuals and corporates. Tata AIG Life Insurance Company was licensed to operate in India on February 12, 2001 and started operations on April 1, 2001.

Reliance Life Insurance

Reliance Life Insurance offers products that fulfill savings and protection needs. Its aim is to emerge as a transnational Life Insurer of global scale and standard.

Reliance Life Insurance is an associate company of Reliance Capital Ltd., a part of Reliance - Anil Dhirubhai Ambani Group. Reliance Capital is one of India's leading private sector financial services companies, and ranks among the top 3 private sector financial services and banking companies, in terms of net worth. Reliance Capital has interests in asset management and mutual funds, stock broking, life and general insurance, proprietary investments, private equity and other activities in financial services.

Aviva Insurance

Aviva is UK's largest and the world's fifth largest insurance Group. It is one of the leading providers of life and pensions products to Europe and has substantial businesses elsewhere around the world. In India, Aviva has a long history dating back to 1834. At the time of nationalisation it was the largest foreign insurer in India in terms of the compensation paid by the Government of India. Aviva was also the first foreign insurance company in India to set up its representative office in 1995.

In India, Aviva has a joint venture with Dabur. Aviva holds a 26 per cent stake in the joint venture and the Dabur group holds the balance 74 per cent share.

With a strong sales force of over 30,000 Financial Planning Advisers (FPAs), Aviva has initiated an innovative and differentiated sales approach to the business. Through the "Financial Health Check" (FHC) Aviva's sales force has been able to establish its credibility in the market. The FHC is a free service administered by the FPAs for a need-based analysis of the customer's long-term savings and insurance needs. Depending on the life stage and earnings of the customer, the FHC assesses and recommends the right insurance product for them.

Aviva pioneered the concept of Bancassurance in India, and has leveraged its global expertise in Bancassurance successfully in India. Currently, Aviva has Bancassurance tie-ups with ABN Amro Bank, The Lakshmi Vilas Bank Ltd., Punjab & Sind Bank, IndusInd Bank, Co-operative Banks and Regional Rural Banks.

When Aviva entered the market, most companies were offering traditional life products. Aviva started by offering the more modern Unit Linked and Unitised With Profit products to the customers, creating a unique differentiation.

Aviva has 223 Branches in India supporting its distribution network. Through its Bancassurance partner locations, Aviva products are available in close to 3,000 towns and cities across India.

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Aviva is also keen to reach out to the underprivileged that have not had access to insurance so far. Through its association with Basix (a micro financial institution) and other NGOs, it has been able to reach the weaker sections of the society and provide life insurance to them.

Sahara India Life Insurance Company Ltd. (SILICL)

Sahara India Life Insurance Company Ltd. (SILICL) is today the first wholly Indian-owned Life Insurance Company in the private sector. They launched the operations on 30th October 2004 after being granted license to operate as a life insurer in India by Insurance Regulatory and Development Authority on 6 February 2004 .

Shriram Life Insurance Company

Shriram Life Insurance Company is the joint venture between the Shriram Group and the Sanlam Group.

The Shriram Group is one of the largest and well-respected financial services conglomerates in India. The Group's main line of activities in financial services include chit fund, truck financing, consumer durable financing, stock broking, insurance broking and life insurance.

Sanlam Life Insurance Limited, a part of the Sanlam Group, is one of the largest providers of life insurance in South Africa with 3.2 million individual policies under administration. It has a significant presence across South Africa, United Kingdom and Namibia and is a major provider of life insurance, retirement annuities, saving and investment products, personal loans, home loans and trust services to individuals.

Bharti AXA Life Insurance

Bharti AXA Life Insurance is a joint venture between Bharti, one of India's leading business groups with interests in telecom, agri business and retail, and AXA, world leader in financial protection and wealth management. The joint venture company has a 74% stake from Bharti and 26% stake of AXA.

The company launched national operations in December 2006. Today, Their business philosophy is built around the promise of making people "Life Confident".

Future Generali

Future Generali is a joint venture between the India-based Future Group and the Italy-based Generali Group. Future Generali is present in India in both the Life and Non-Life businesses as Future Generali India Life Insurance Co. Ltd. and Future Generali India Insurance Co. Ltd.

Future Group is one of India's leading business houses with multiple businesses spanning across the consumption space. While retail forms the core business activity of Future Group, group subsidiaries are present in consumer finance, capital, insurance, leisure and entertainment, brand development, retail real estate development, retail media and logistics.

Established in Trieste on December 26, 1831, Generali is an international group present in more than 40 countries with insurance companies and companies mostly operating in the financial and real estate sectors. Over the years, the Generali Group has reconstructed a significant presence in Central Eastern Europe and has started to develop business in the principal markets of the Far East, including China and India.

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IDBI Fortis Life Insurance Co. Ltd.

IDBI Fortis Life Insurance Co. Ltd. is a joint venture between three leading financial conglomerates - India's premier development and commercial bank, IDBI, India's leading private sector bank, Federal Bank and Europe's premier Bancassurer, Fortis, each of which enjoys a significant status in their respective business segments. In this venture, IDBI owns 48% equity while Federal Bank and Fortis own 26% equity each.

IDBI Fortis launched its first set of products across India in March 2008, after receiving the requisite approvals from the Insurance Regulatory Development Authority (IRDA). Today, the group offers its services through a vast nationwide network across the branches of IDBI Bank and Federal Bank in addition to a sizeable network of advisors and partners.

IDBI Bank Ltd. is India's premier industrial development bank. Created in 1956 to support India's industrial backbone, IDBI Bank has since evolved into a powerhouse of industrial and retail finance. Today, it is amongst India's foremost commercial banks, with a wide range of innovative products and services, serving retail and corporate customers in all corners of the country from over 538 branches and more than 921 ATMs.

Federal Bank is one of India's leading private sector banks, with a dominant presence in the state of Kerala. It has a strong network of over 600 branches and 600 ATMs spread across India. The bank provides over four million retail customers with a wide variety of financial products. Federal Bank is one of the first large Indian banks to have an entirely automated and interconnected branch network.

Fortis is an international insurance group composed of Insurance Belgium, a leader in life and non-life insurance in Belgium distributing its insurance products through the network of Fortis Bank and independent insurance brokers and Insurance International with subsidiaries in the UK, France, Hong Kong, Luxembourg (Non-life), Germany, Turkey, Russia and Ukraine, and joint ventures in Luxembourg (Life), Portugal, China, Malaysia, Thailand and India.

Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited

Canara HSBC Life, is popular for providing its customers simplicity and excellence. The shareholding pattern of the Joint Venture is as follows - Canara Bank holds 51% equity, HSBC Insurance (Asia Pacific) Holdings Ltd 26% and Oriental Bank of Commerce 23%. The Venture has an initial paid up capital of INR 325 crores which will further increase in line. The Company commenced business 16th of June, 2008 after receiving requisite approvals from the Insurance Regulatory Development Authority (IRDA).

AEGON Religare Life Insurance Company Limited

AEGON, one of the world's largest life insurance and pension groups, Religare, one of India's leading integrated financial services groups and Bennett, Coleman & company, India's largest media house, have come together to launch AEGON Religare Life Insurance Company Limited. The business philosophy is to help people plan their life better. In an industry first, AEGON Religare Life Insurance offers policy servicing on the phone via Interactive Voice Response System (IVR) by issuing the customer a T-Pin for authentication. It is also the first company to include the customer's medical report in the policy kit.

AEGON's businesses serve over 40 million customers in over 20 markets throughout the Americas, Europe and Asia, with major operations in the United States, the Netherlands and the United Kingdom. With headquarters in The Hague, the Netherlands, AEGON companies employ almost 32,000 people worldwide. The company's common shares are listed on four stock exchanges: Amsterdam, London, New York and Tokyo.

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Religare Enterprises Limited (REL) is one of the leading integrated financial services groups of India. REL's businesses are broadly clubbed across three key verticals - the Retail, Institutional and Wealth spectrums, catering to a diverse and wide base of clients. REL offers a multitude of investment options and a diverse bouquet of financial services with its pan India reach.

Bennett, Coleman & Co. Ltd. (BCCL), part of the Times Group, is India's largest media house. It reaches out to 2468 cities and towns all over India. The group owns and manages powerful media brands like The Times of India, The Economic Times, Maharashtra Times, Navbharat Times, Femina, Filmfare, Grazia, Top Gear, Radio Mirchi, Zoom, Times Now, Times Music, Times OOH, Private Treaties and indiatimes.com.

Task

Compare the performances of various life insurance companies in India and make an analysis of the same.

Case Study

IRDA's New Guidelines are a Step in the Right Direction

With the latest guidelines, new products may appear more attractive than older ones. But investors may stand to lose if they change policies.

The Insurance Regulatory and Development Authority (IRDA) has continued its drive towards reforming the most criticised insurance product. In comparison to its earlier guidelines, the latest circular is likely to have far-reaching impact on the way ULIPs are sold in the market.

The most notable change in the recent guidelines pertain to surrender charges, five-year lock-in period, a cap on difference between gross yield to net yield for investment periods less than 10 years and a minimum guaranteed return on pension products. First, the details on the changes:

Surrender charges that punished policyholders for early discontinuance have undergone substantial changes. IRDA has recommended two slabs, one for an annual premium up to ₹ 25,000 and other for investment above this threshold. For an annualised premium of up to ₹ 25,000, the first year surrender charges are capped at 20 per cent of the premium or fund value subject to a maximum of ₹ 3,000, while this goes down to as low as 5 per cent or ₹ 1000 for surrendering in the fourth year. From the fifth year, ULIPs will not suffer any surrender charges.

Surrender Charges

Policies with annual premium of above ₹ 25,000 will suffer lower charges but the maximum charges are almost twice that in the other case. The new rule is far superior to the practice of deducting 30-40 per cent of the first year's premium when the policy holder discontinues the premium within the first three years.

The minimum three-year lock-in period in ULIP, which actually triggered this episode, would henceforth be extended to five years. The biggest advantage of the change is that policyholders, instead of suffering higher upfront charge, would henceforth pay the distribution charges evenly till the lock-in period, thereby a higher amount of the premium will go towards investment.

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Continuing its macro management of the net yield to policyholders, the regulator has fixed net yields for periods less than 10 years. In its earlier guidelines it has prescribed the difference between gross yield (return) to net yield at 300 basis points (3 percentage points) for a policy maturity of 10 years and 225 basis points for maturity above 15 years. Now, a difference of 400 basis points has been prescribed for five years, which gradually reduces to 300 basis points in the tenth year. The charges still appear higher in comparison to mutual funds that are allowed annual expenses of 2.25 per cent (mortality charges, if added, will further increase charges).

According to the new regulation, unit-linked pension plans would carry a minimum guarantee of 4.5 per cent (if all premiums are paid) and no partial withdrawal will be allowed during the accumulation period.

It appears attractive but there is catch, IRDA retains the right to review this guaranteed rate according to macroeconomics developments. This means that the return can vary over the term of the policy and investors will not be sure of the maturity value. On vesting date policyholders can commute up to one-third of the accumulated value as lump sum. As insurers are required to guarantee the return, major portion of the premium may find its way into debt instruments.

If the pension plan without any rider is not generating a minimum return of at least 8 per cent that has been guaranteed under PPF (it has favourable tax treatment in the proposed Direct Taxes Code compared to these pension plans) investor interest in pension plans is likely to wane at least for those investing up to ₹ 70,000 towards retirement.

What to do?

With the new set of guidelines, new products may appear more attractive than older ones. Investors who bought ULIPs in earlier years may be tempted to surrender their products in favour of new ones. Should they?

It may not be prudent to close the existing policy in favour of new products that are likely to be launched from September mainly on account of charges.

Consider this, an investor invested ₹ 1 lakh on June 2009. After deducting premium allocation charge of 30 per cent, the rest would have been invested in equity. Assume in the one year the investment has grown at 30 per cent and the current value is ₹ 91,000 (risk charge is ignored for the calculation). If the policyholder surrenders it he would suffer a charge of 30 per cent of the first year premium - ₹ 30,000. The fund value of ₹ 61,000 will be transferred to suspense account for next two years without any accretion, after which he will be paid the sum. Alternatively if he is continuing the existing policy for another 9 years and if it earns 10 per cent net of charges, the maturity value will be ₹ 16.4 lakhs.

As it's too early to predict the product structure, let's look at a case where he buys a new ULIP for a nine-year term and it has a 20 per cent premium allocation and other charges for first two years. If the ULIP earns 10 per cent net of charges, the maturity value will be ₹ 13.7 lakhs.

If he invests the old policy proceeds of ₹ 61,000 after two years at a net interest of 10 per cent the maturity value will be ₹ 1.20 lakhs. His investment would then be worth ₹ 15 lakhs, still short of the sum he would made on his older policy. Hence it is advisable for the investors to continue with the current policy since it has already suffered charges.

Question

Make a critical analysis of new guidelines issued by IRDA form customers as well as insurance companies' point of view.

Source: http://www.thehindubusinessline.in

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8.5 General Insurance

General Insurance is a legal agreement entered between Insured and Insurer due to which due to the consideration, the Insurer agrees to indemnify the Insured, for the loss or damage or liability created due an accident which is covered under the policy subject to the terms and conditions of the contract.

8.5.1 Advantages

Any insurance relieves policy holders from the financial burden in the event the risk covered materializes. This is a very important advantage of holding an insurance policy. It helps one cope with hard times and secures the financial state of an individual at all times.

Some of the benefits of holding a General Insurance Policy are as under-

Medical and Health insurance — take care of your medical bills if you need to undergo any medical treatment.

Accident Insurance — takes care of expenses incurred in relation to an accident. For example, compensation to be paid to aggrieved party in case you are the defaulting party, medical bills, cost of repairs etc.

Motor vehicle/ Auto insurance — takes care of the cost of repairs to your motor vehicle in case of an accident. Optionally, it also takes care of compensation for damage occurring due to the fault of any other party. Most insurance policies also provide a cover against theft or damage to the motor vehicle. Insurance cover is also available for two/ three wheelers.

Travel Insurance — takes care of expenses incurred due to any unforeseen event during travel.

Pet insurance — as the name suggests it takes care of certain expenses incurred for your pets. For example, if your pet is ill and you need to spend money at the vet, the insurance company takes care of payments.

Home Insurance — it covers expenses incurred in the event of robbery or damage to property in case of fire, earthquake etc. Mortgage insurance is a variant of home insurance that takes care of loan or mortgage payments in the event of a contingency.

Unemployment Insurance — this type of insurance keeps one financially secure in the event of loss of employment.

Personal liability Insurance — this kind of insurance is relatively new in the insurance sector. It takes care of any liability arising while conducting one's profession. Doctors, lawyers and other professionals at risk of being sued by their clients may find this insurance very beneficial.

8.5.2 Types

Also known as non-life insurance, general insurance is normally meant for a short-term period of twelve months or less. Recently, longer-term insurance agreements have made an entry into the business of general insurance but their term does not exceed five years. General insurance can be classified as follows:

Fire Insurance: Fire insurance provides protection against damage to property caused by accidents due to fire, lightening or explosion, whereby the explosion is caused by boilers not being used for industrial purposes. Fire insurance also includes damage caused due to other perils like storm, tempest or flood, burst pipes, earthquake, aircraft, riot, civil commotion, malicious damage, explosion, etc.

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Marine Insurance: Marine insurance basically covers three risk areas, namely, hull, cargo and freight. The risks which these areas are exposed to are collectively known as "Perils of the Sea". These perils include theft, fire, collision etc.

Marine Cargo: Marine cargo policy provides protection to the goods loaded on a ship against all perils between the departure and arrival warehouse. Therefore, marine cargo covers carriage of goods by sea as well as transportation of goods by land.

Marine Hull: Marine hull policy provides protection against damage to ship caused due to the perils of the sea. Marine hull policy covers three-fourth of the liability of the hull owner (shipowner) against loss due to collisions at sea. The remaining 1/4th of the liability is looked after by associations formed by shipowners for the purpose (P and I clubs).

Miscellaneous: As per the Insurance Act, all types of general insurance other than fire and marine insurance are covered under miscellaneous insurance. Some of the examples of general insurance are motor insurance, theft insurance, health insurance, personal accident insurance, money insurance, engineering insurance etc.

8.5.3 Major Players

The main player of this sector is General Insurance Corporation or GIC as it is widely known as. Let us know in brief about the main players of the sector. The reading has been arranged in alphabetical order.

1. ***Bajaj Allianz General Insurance Co. Ltd.:*** It deals in motor, home, health and travel insurance.
2. ***ICICI Lombard General Insurance Co. Ltd:*** It deals in personal, business, NRI and rural insurance.
3. ***IFFCO Tokio General Insurance Co. Ltd. :*** It deals in various general insurance products.
4. ***National Insurance Co. Ltd. :*** National Insurance Company Limited was incorporated in 1906 with its registered office in Kolkata. Consequent to passing of the General Insurance Business Nationalisation Act in 1972, 21 Foreign and 11 Indian Companies were amalgamated with it and National became a subsidiary of General Insurance Corporation of India (GICI) which is fully owned by the Government of India. After the notification of the General Insurance Business (Nationalisation) Amendment Act, on 7th August 2002, National has been de-linked from its holding company GIC and presently operating as a Government of India undertaking.

   National Insurance Company Ltd (NIC) is one of the leading public sector insurance companies of India, carrying out non life insurance business. Headquartered in Kolkata, NIC's network of about 1000 offices, manned by more than 16,000 skilled personnel, is spread over the length and breadth of the country covering remote rural areas, townships and metropolitan cities. NIC's foreign operations are carried out from its branch offices in Nepal.

   Befittingly, the product ranges, of more than 200 policies offered by NIC cater to the diverse insurance requirements of its 14 million policyholders. Innovative and customized policies ensure that even specialized insurance requirements are fully taken care of.

   National transacts general insurance business of fire, marine and miscellaneous insurance. The company offers protection against a wide range of risks to its customers. The Company is privileged to cater its services to almost every sector or industry in the Indian economy viz.

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Banking, Telecom, Aviation, Shipping, Information Technology, Power, Oil & Energy, Agronomy, Plantations, Foreign Trade, Healthcare, Tea, Automobile, Education, Environment, Space Research etc.

National Insurance is the second largest non life insurer in India having a large market presence in Northern and Eastern India.

NIC has been accorded "AAA/STABLE" financial strength rating by CRISIL rating agency, which reflects the highest financial strength to meet policyholders' obligations.

5. ***The New India Assurance Co. Ltd. :*** Established by Sir Dorab Tata in 1919, New India is the first fully Indian owned insurance company in India.

   New India was a pioneer among the Indian Companies on various fronts, right from insuring the first domestic airlines in 1946 to satellite insurance in 1980. The latest addition to the list of firsts is the insurance of the INSAT-2E.

   With a wide range of policies New India has become one of the largest non-life insurance companies, not only in India, but also in the Afro-Asian region. It offers personal, industrial, commercial, liability and social insurance.

6. ***Oriental Insurance Company Ltd :*** The Oriental Insurance Company Ltd was incorporated at Bombay on 12th September 1947. The Company was a wholly owned subsidiary of the Oriental Government Security Life Assurance Company Ltd and was formed to carry out General Insurance business. The Company was a subsidiary of Life Insurance Corporation of India from 1956 to 1973 (till the General Insurance Business was nationalized in the country). In 2003 all shares of our company held by the General Insurance Corporation of India has been transferred to Central Government.

   The Company is a pioneer in laying down systems for smooth and orderly conduct of the business. The strength of the company lies in its highly trained and motivated work force that covers various disciplines and has vast expertise. Oriental specializes in devising special covers for large projects like power plants, petrochemical, steel and chemical plants. The company has developed various types of insurance covers to cater to the needs of both the urban and rural population of India. The Company has a highly technically qualified and competent team of professionals to render the best customer service.

   Its main objective is to contribute to the socio economic objectives of the nation by being a vibrant and viable organization catering to the growing insurance needs of the community. Towards this end we will strive for effective management of business operations.

7. ***Reliance General Insurance:*** Reliance General Insurance is one of India's leading private general insurance companies with over 94 customized insurance products catering to the corporate, SME and individual customers. The Company has launched innovative products like India's first Over-The-Counter health & home insurance policies. Reliance General Insurance has an extended network of over 200 offices spread across 173 cities in 22 states, a wide distribution channel network, 24x7 customer service assistance and a full fledged website. It is also India's first insurance company to be awarded the ISO 9001:2000 certification across all functions, processes, products and locations pan-India.

8. ***Royal Sundaram Alliance Insurance Co. Ltd :*** It deals in accident, car, family, home, health, hospital and travel insurance.

9. ***Tata AIG General Insurance Company Limited (Tata AIG General):*** Tata AIG General is a joint venture company, formed by the Tata Group and American International Group, Inc. (AIG). Tata AIG General combines the Tata Group's pre-eminent leadership position in

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India and AIG's global presence as the world's leading international insurance and financial services organization. The Tata Group holds 74 per cent stake in the insurance venture with AIG holding the balance 26 percent. Tata AIG General Insurance Company, which started its operations in India on January 22, 2001, offers complete range of general insurance for motor, home, accident & health, travel, energy, marine, property and casualty, liability as well as several specialized financial line.

10. ***United India Insurance Co. Ltd.:*** UI is a leading General Insurance Company with more than three decades of experience in Non-life Insurance business. Formed by the merger of 22 companies consequent to nationalisation of General Insurance, it head quarters at Chennai. Its corporate mission is to provide Insurance protection to all, to ensure customer satisfaction, to function on sound business principles and to help minimise national waste and to help develop the Indian economy.

11. ***Cholamandalam MS General Insurance:*** It is a joint venture between The Murugappa Group and Mitsui Sumitomo Insurance Group.

    The Murugappa Group, headquartered in Chennai, India. It has 29 companies under its umbrella, of which eight are listed and actively traded on the National Stock Exchange and the Bombay Stock Exchange. With 40 units spread across 12 states in India, the Murugappa Group is one of India's oldest business houses. It has a presence in The UK, The USA, Australia, Canada, South Africa, UAE, Thailand, and China.

    Mitsui Sumitomo Insurance Group is one of the largest insurance groups in the world. Today the group operates in non-life insurance, life insurance, financial services and risk management services.

12. ***HDFC ERGO General Insurance Co. Ltd.:*** HDFC ERGO General Insurance Company Limited is a 74:26 joint venture between HDFC Limited, India's premier Housing Finance Institution & ERGO International AG, the primary insurance entity of Munich Re Group.

    HDFC ERGO focuses on providing the "Right Insurance Solution" for all. They offer a complete range of general insurance products ranging from Motor, Health, Travel, Home and Personal Accident in the retail space and customized products like Property, Marine and Liability Insurance in the corporate space.

    HDFC ERGO has been expanding its presence across the country and is present across 46 cities with 52 branch offices. The company has a right balance of distribution channel comprising of Dealerships, Brokers, Retail and Corporate Agents, Bancassurance and Direct Sales Team.

13. ***Star Health and Allied Insurance Company Limited:*** It works with a mission of ultimate Customer Satisfaction and provide healthcare options.

14. ***Apollo DKV Insurance Company Limited:*** Committed to bring world class health care within the reach of every individual, Apollo Hospitals Group has joined hands with DKV, a world leader in the field of health insurance. The joint venture is poised to make good the conviction of both the partners that Indian health insurance market is on the brink of explosive growth.

Apart from the above discussed organisations, there are several other players like Export Credit Guarantee Corporation of India Ltd, Agriculture Insurance Co. of India Ltd., Future Generali India Insurance Company Limited, Universal Sompo General Insurance Co. Ltd., Shriram General Insurance Company Limited, Bharti AXA General Insurance Company Limited and Raheja QBE General Insurance Company Limited that deal in various general insurance products and services.

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Notes Internet access in India has doubled every year over the last five years and forecasts predict this growth to quadruple every year over the next three years. According to e-marketer report on India online, in 2007, about 33.2 million people in India accessed internet and that's about 2.9% of Indian population. This figure is going to be 71.6 million people, which will be about 6% of population by 2011. Considering limited access of human-insurance agents in rural areas, there will more demand of purchasing insurance online from these areas, followed by semi-urban areas. The insurance portals that are active in online distribution are www.icicilombard.com, www.bajajallianz.co.in, www.insurancemall.in, www.bimaonline.com, www.insurancepandit.com.

Recently, Compare - Choose: Buy portals like Bonsai Insurance Broker's www.insurancemall.in, have been developed for providing comparison of different types of insurance policies, their premiums and their purchase online. The policy details are stored digitally and all transactions are made over secure channels. E-insurance offers a new gateway of incomes and provides additional market penetration, which is a need of an hour for Indian Insurance Segment.

The First Movers in e-Distribution of Insurance goes to 3 companies in India:

1. ICICI Lombard General Insurance
2. Bajaj Allianz General Insurance
3. www.insurancemall.in (Created by Bonsai Insurance Broking)

8.6 Summary

- The insurance sector in India has come to a full circle from being an open competitive market to nationalisation and back to a liberalised market again.
- Tracing the developments in the Indian insurance sector reveals the 360-degree turn witnessed over a period of almost two centuries.

8.7 Keywords

Insurance: A social device to reduce or eliminate risk of life and property.

Rating: An opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

8.8 Self Assessment

Fill in the blanks:

1. United India Insurance is a leading General Insurance Company with more than three decades of experience in ..... Insurance business.
2. IDBI Fortis Life Insurance Co Ltd is a joint venture between ..... leading financial conglomerates.
3. Future Generali is a joint venture between the India-based Future Group and the ..... based Generali Group.

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4. The Insurance Regulatory and Development Authority (IRDA) Act of 1999 deregulated the insurance sector in India and allowed the entry of ..... into the insurance sector.
5. Insurance is actually a contract between 2 parties whereby one party called insurer undertakes in exchange for a fixed sum called .....
6. Insurance ..... analyze insurance applications, determining whether they should be accepted or rejected.
7. The periodic payment made on an insurance policy is known as .....
8. ..... is a document evidencing issuance of an insurance policy and gives a summary of the information given in a certificate of insurance.
9. Travel Insurance takes care of expenses incurred due to any ..... during travel.
10. In ULIPs the withdrawals are allowed only after ..... years.
11. The term ULIP stand for .....
12. The basic feature of ..... plans is that they provide death risk-cover.
13. Life insurance policy can be renewed ..... the expiry.
14. ..... means the active, efficient cause that sets in motion a train of events which brings about a result.
15. Annuities are ..... to life insurance.

8.9 Review Questions

1. What do you mean by insurance? What are the main insurance companies in public sector in India?
2. Critically evaluate the effect of IRDA on insurance sector of India.
3. "Insurance sector in India has come of age". Comment.
4. Which insurance company do you prefer for general insurance and why?
5. If you were to join the insurance sector in India, which company would you prefer to join as an employee and why?
6. What is more important – life insurance or general insurance and why? (You cannot say both are equally important)
7. Analyse the role of underwriters in Indian Insurance sector.
8. Do you think IRDA has successfully performed its functions till date? Justify your statement with factual reasoning.
9. What are the main challenges ahead of IRDA in particular and Indian Insurance sector in general for the future?
10. What do you see as the main advantages of Life insurance? Is there any lacuna in the life insurance industry in India? If yes, suggest measures to improve it.
11. Where do you think are the main possibilities for general insurance industry in India to work upon and get at par with those of developed economies?
12. What do you see as the main advantage of the insurance companies to start selling their products online? Why wasn't it done earlier?

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Answers: Self Assessment

1.	Non-life	2.	three
3.	Italy	4.	private companies
5.	premium	6.	underwriters
7.	premium	8.	Cover note
9.	unforeseen event	10.	three
11.	unit-linked insurance policy	12.	term assurance
13.	after	14.	Proximate cause
15.	opposite		

8.10 Further Readings

Books

Compendium on Industrial Policy & Procedure, Ministry of Industry, India.

Reserve Bank of India Bulletin, 2006, 2007, 2008, 2009.

Statistics on Working of Capital Issues Control, Ministry of Finance, India.

Online links

www.cidap.gov.in

www.thehindubusinessline.com

www.rbi.org.in

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Unit 9: Mutual Funds

CONTENTS

Objectives

After studying this unit, you will be able to:

- State Unit Trust of India
- Explain types of mutual funds
- Discuss significance of mutual funds
- Describe performance evaluation

Introduction

According to Chapter 1, Securities and Exchange Board of India (Mutual Funds) Regulations, December 9, 1996, a "mutual fund" means a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments. They raise money by selling shares of the fund to the public, much like any other type of company can sell stock in itself to the public. Mutual funds then take the money they receive from the sale of their shares (along with any money made from previous investments) and use it to purchase various investment vehicles, such as stocks, bonds and money market instruments.

In return for the money they give to the fund when purchasing shares, shareholders receive an equity position in the fund and, in effect, in each of its underlying securities. For most mutual funds, shareholders are free to sell their shares at any time, although the price of a share in a

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mutual fund will fluctuate daily, depending upon the performance of the securities held by the fund. Benefits of mutual funds include diversification and professional money management. Mutual funds offer choice, liquidity, and convenience, but charge fees and often require a minimum investment.

There are many types of mutual funds, including aggressive growth fund, asset allocation fund, balanced fund, blend fund, bond fund, capital appreciation fund, open fund, clone fund, closed fund, crossover fund, equity fund, fund of funds, global fund, growth fund, growth and income fund, hedge fund, income fund, index fund, international fund, money market fund, municipal bond fund, prime rate fund, regional fund, sector fund, specialty fund, stock fund, and tax-free bond fund.

9.1 Unit Trust of India

Unit Trust of India was created by the UTI Act passed by the Parliament in 1963. For more than two decades, it remained the sole vehicle for investment in the capital market by the Indian citizens.

The Indian Government were allowed public sector banks in mid- 1980s to open mutual funds. The real vibrancy and competition in the MF industry came with the setting up of the Regulator SEBI and its laying down the MF Regulations in 1993. UTI maintained its pre-eminent place till 2001, when a massive decline in the market indices and negative investor sentiments after Ketan Parekh scam created doubts about the capacity of UTI to meet its obligations to the investors. This was further compounded by two factors; namely, its flagship and largest scheme US 64 was sold and re-purchased not at intrinsic NAV but at artificial price and its Assured Return Schemes had promised returns as high as 18% over a period going up to two decades..!!

Fearing a run on the institution and possible impact on the whole market Government came out with a rescue package and change of management in 2001. Subsequently, the UTI Act was repealed and the institution was bifurcated into two parts. UTI Mutual Fund was created as a SEBI registered fund like any other mutual fund. The assets and liabilities of schemes where Government had to come out with a bail-out package were taken over directly by the Government in a new entity called Specified Undertaking of UTI, SUUTI. SUUTI holds over 27% stake Axis Bank. In order to distance Government from running a mutual fund the ownership was transferred to four institutions; namely SBI, LIC, BOB and PNB, each owning 25%. Certain reforms like improving the salary from PSU levels and affecting a VRS were carried out UTI lost its market dominance rapidly and by end of 2005, when the new shareholders actually paid the consideration money to Government its market share had come down to close to 10%!

A new board was constituted and a new management inducted. Systematic study of its problems role and functions was carried out with the help of a reputed international consultant. Fresh talent was recruited from the private market, organizational structure was changed to focus on newly emerging investor and distributor groups and massive changes in investor services and funds management carried out. Once again UTI has emerged as a serious player in the industry. Some of the funds have won famous awards, including the Best Infra Fund globally from Lipper. UTI has been able to benchmark its employee compensation to the best in the market, has introduced Performance Related Payouts and ESOPs.

The UTI Asset Management Company has its registered office at: UTI Tower, Gn Block, Bandra - Kurla Complex, Bandra (East), Mumbai - 400 051. It has over 70 schemes in domestic MF space and has the largest investor base of over 9 million in the whole industry. It is present in over 450 districts of the country and has 100 branches called UTI Financial Centres or UFCs. About 50% of the total IFAs in the industry work for UTI in distributing its products! India Posts, PSU Banks and all the large Private and Foreign Banks have started distributing UTI products.

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The total average Assets Under Management (AUM) for the month of June 2008 was ₹ 530 billion and it ranked fourth. In terms of equity AUM it ranked second and in terms of Equity and Balanced Schemes AUM put together it ranked FIRST in the industry. This measure indicates its revenue- earning capacity and its financial strength.

Besides running domestic MF Schemes UTI AMC is also a registered portfolio manager under the SEBI (Portfolio Managers) Regulations. It runs different portfolios for is HNI and Institutional clients. It is also running a Sharia Compliant portfolio for its Offshore clients. UTI tied up with Shinsei Bank of Japan to run a large size India-centric portfolio for Japanese investors.

For its international operations UTI has set up its 100% subsidiary, UTI International Limited, registered in Guernsey, Channel Islands. It has branches in London, Dubai and Bahrain. It has set up a Joint Venture with Shinsei Bank in Singapore. The JV has got its license and has started its operations.

In the area of alternate assets, UTI has a 100% subsidiary called UTI Ventures at Banglore. This company runs two successful funds with large international investors being active participants. UTI has also launched a Private Equity Infrastructure Fund along with HSH Nord Bank of Germany and Shinsei Bank of Japan.

9.2 Types of Mutual Funds

Most funds have a particular strategy they focus on when investing. For instance, some invest only in Blue Chip companies that are more established and are relatively low risk. On the other hand, some focus on high-risk start up companies that have the potential for double and triple digit growth. Finding a mutual fund that fits your investment criteria and style is important.

Types of mutual funds are:

Value stocks: Stocks from firms with relative low Price to Earning (P/E) Ratio, usually pay good dividends. The investor is looking for income rather than capital gains.

Growth stock: Stocks from firms with higher low Price to Earning (P/E) Ratio, usually pay small dividends. The investor is looking for capital gains rather than income.

Based on company size, large, mid, and small cap: Stocks from firms with various asset levels.

Income stock: The investor is looking for income which usually come from dividends or interest. These stocks are from firms which pay relative high dividends. This fund may include bonds which pay high dividends. This fund is much like the value stock fund, but accepts a little more risk and is not limited to stocks.

Index funds: The securities in this fund are the same as in an Index fund. The number and ratios or securities are maintained by the fund manager to mimic the Index fund it is following.

Enhanced index: This is an index fund which has been modified by either adding value or reducing volatility through selective stock-picking.

Stock market sector: The securities in this fund are chosen from a particular marked sector such as Aerospace, retail, utilities, etc.

Defensive stock: The securities in this fund are chosen from a stock which usually is not impacted by economic down turns.

International: Stocks from international firms.

Real estate: Stocks from firms involved in real estate such as builder, supplier, architects and engineers, financial lenders, etc.

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Socially responsible: This fund would invests according to non-economic guidelines. Funds may make investments based on such issues as environmental responsibility, human rights, or religious views. For example, socially responsible funds may take a proactive stance by selectively investing in environmentally-friendly companies or firms with good employee relations. Therefore the fund would avoid securities from firms who profit from alcohol, tobacco, gambling, pornography etc.

Balanced funds: The investor may wish to balance his risk between various sectors such as asset size, income or growth. Therefore the fund is a balance between various attributes desired.

Tax efficient: Aims to minimize tax bills, such as keeping turnover levels low or shying away from companies that provide dividends, which are regular payouts in cash or stock that are taxable in the year that they are received. These funds still shoot for solid returns; they just want less of them showing up on the tax returns.

Convertible: Bonds or Preferred stock which may be converted into common stock.

Junk bond: Bonds which pay higher that market interest, but carry higher risk for failure and are rated below AAA.

Mutual funds of mutual funds: This funds that specializes in buying shares in other mutual funds rather than individual securities.

Open ended: A type of mutual fund that does not have restrictions on the amount of shares the fund will issue. If demand is high enough, the fund will continue to issue shares no matter how many investors there are. Open-end funds also buy back shares when investors wish to sell.

Closed ended: This fund has a fixed number of shares. The value of the shares fluctuates with the market, but fund manager has less influence because the price of the underlining owned securities has greater influence.

Exchange traded funds (ETFs): Baskets of securities (stocks or bonds) that track highly recognized indexes. Similar to mutual funds, except that they trade the same way that a stock trades, on a stock exchange.

9.3 Significance of Mutual Funds

Mutual funds have emerged as the best in terms of variety, flexibility, diversification, liquidity as well as tax benefits. Besides, through MFs investors can gain access to investment opportunities that would otherwise be unavailable to them due to limited knowledge and resources.

MFs have the capability to provide solutions to most investors' needs, however, the key is to do proper selections and have a process for monitoring.

1. ***Diversification:*** The best mutual funds design their portfolios so individual investments will react differently to the same economic conditions. For example, economic conditions like a rise in interest rates may cause certain securities in a diversified portfolio to decrease in value. Other securities in the portfolio will respond to the same economic conditions by increasing in value. When a portfolio is balanced in this way, the value of the overall portfolio should gradually increase over time, even if some securities lose value.
2. ***Professional management:*** Most mutual funds pay topflight professionals to manage their investments. These managers decide what securities the fund will buy and sell.
3. ***Regulatory oversight:*** Mutual funds are subject to many government regulations that protect investors from fraud.
4. ***Liquidity:*** It's easy to get your money out of a mutual fund. Write a check, make a call, and you've got the cash.

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5. ***Convenience:*** You can usually buy mutual fund shares by mail, phone, or over the Internet.
6. ***Low Cost:*** Mutual fund expenses are often no more than 1.5 percent of your investment. Expenses for Index Funds are less than that, because index funds are not actively managed. Instead, they automatically buy stock in companies that are listed on a specific index:
   (a) Transparency
   (b) Flexibility
   (c) Choice of schemes
   (d) Tax benefits
   (e) Well regulated


Task

Discuss the main limitations as you analyse in the functioning of the companies involving mutual funds.

9.4 SEBI and Mutual Funds

To protect the interest of the investors, SEBI formulates policies and regulates the mutual funds. It notified regulations in 1993 (fully revised in 1996) and issued guidelines from time to time. MF either promoted by public or by private sector entities including one promoted by foreign entities are governed by these Regulations. As a result, the Indian mutual fund industry witnessed robust growth and stricter regulation from SEBI since 1996.

9.4.1 Guidelines for Selling and Marketing Mutual Funds

Investors can purchase and sell mutual fund units through various types of intermediaries - individual agents, distribution companies, national/regional brokers, banks, post offices etc. as well as directly from Asset Management Companies (AMCs), including the Unit Trust of India

Investors of Mutual Funds can be broadly classified into three categories:

1. Those who want product information, advice on financial planning and investment strategies.
2. Those who require only a basic level of service and execution support i.e. delivering and collecting application forms and cheques, and other basic paperwork and post sale activities.
3. Those that prefer to do it all themselves, including choice of investments as well as the process/paperwork related to investments.

To cater to different types of investors, the Mutual Fund industry comprising of AMCs and intermediaries at present offers the following two levels of services:

Value Added Services

This includes product information and advice on financial planning and investment strategies. The advice encompasses analyzing an investor's financial goals depending upon the segment of investor, assessing his/her resources, determining his/her risk bearing capacity/preference and then using this information to recommend an asset allocation/specific investment/s that are in tandem with the investor's needs. Investors may also receive information on taxation, estate planning and portfolio rebalancing to remain aware about the changes/developments in

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market conditions and adjust the portfolios from time to time according to their needs. In such advisory services, the emphasis is on building an ongoing relationship with the investor/s. In India, given that mutual funds are relatively new, there is a low level of awareness amongst investors about the working and benefits of Mutual Funds. Also, very few investors take an organized approach to financial planning. Therefore, it is clear that the vast majority of investors would benefit significantly from the value-added services enumerated above.

Basic Services

This includes providing the basic information on schemes launched to investors, assisting them in filling application forms, submission of application forms along with cheques at the respective office/s, delivering redemption proceeds and answering scheme related queries investor/s may have. What investors receive here is convenience and access to mutual funds through agents and employees of brokers who visit them and facilitate the paperwork related to investment.

These services are also given through the branches and front office staff of AMCs and intermediaries. These are transaction-oriented service where investors make the investment decisions themselves, and rely on the AMC and intermediary mostly for execution and logistics support.

Recommendations

1. While institutions can continue to be serviced by AMCs and intermediaries, it is proposed that AMCs and the intermediary community focus more on individual investors and take every effort to:
   (a) Provide high quality advice and product information to such customers.
   (b) Explain and position this service in such a way that clients recognize it as a specialized and value added service, a task which may be difficult to accomplish on their own.
   (c) Convince investors that the transaction and intermediation cost they are paying is justified in lieu of the long-term benefits accruing from such counseling and guidance.
2. The Mutual Fund industry has to now take the more difficult but long-term sustainable route of gathering assets from individual investors by providing them value added, financial planning services and ensuring that Mutual Funds are an integral part of their overall portfolio. Only if this happens will AMCs and intermediaries command higher margins and levels of profitability, and not suffer from the low margins associated with dispensing only basic types of service/s.

   While doing this, the mutual fund industry in India should take care to ensure that:
   (a) Each investor, institutional or individual, receives the exact level of service they choose and correct advice based on clear and concrete facts and figures. Correspondingly, the intermediation and transaction cost investors incur should reflect the value of the service and advice they receive.
   (b) Mutual Funds are accurately represented and appropriately positioned to investors, whichever channel or mode they choose to invest in. The industry should safeguard the investor's right towards correct description of the product, good service, transparency and ability to take informed decisions.
   (c) There is comprehensive knowledge and understanding of Mutual Funds amongst all individuals instrumental in selling the Mutual fund schemes to investors including employees of intermediaries, individual agents and financial planners.

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3. The Association of Mutual Funds in India (AMFI) Certification is designed to be a professional qualification that provides intermediaries with a thorough understanding of mutual funds and how to present them appropriately to clients. The AMFI certification is needed both for individuals and corporate distributors. The certification is required for all individuals selling and representing mutual funds to clients, whether they are employees of an intermediary organization or they are an individual financial planner/agent.

Code of Conduct for Intermediaries

1. Take necessary steps to ensure that the clients' interest is protected.
2. Adhere to SEBI Mutual Fund Regulations and guidelines related to selling, distribution and advertising practices. Be fully conversant with the key provisions of the offer document as well as the operational requirements of various schemes.
3. Provide full and latest information of schemes to investors in the form of offer documents, performance reports, fact sheets, portfolio disclosures and brochures, and recommend schemes appropriate for the client's situation and needs.
4. Highlight risk factors of each scheme, avoid misrepresentation and exaggeration, and urge investors to go through offer documents/key information memorandum before deciding to make investments.
5. Disclose all material information related to the schemes/plans while canvassing for business.
6. Abstain from indicating or assuring returns in any type of scheme, unless the offer document is explicit in this regard.
7. Maintain necessary infrastructure to support the AMCs in maintaining high service standards to investors, and ensure that critical operations such as forwarding forms and cheques to AMCs/registrars and dispatch of statement of account and redemption cheques to investors are done within the time frame prescribed in the offer document and SEBI Mutual Fund Regulations.
8. Avoid colluding with clients in faulty business practices such as bouncing cheques, wrong claiming of dividend/redemption cheques, etc.
9. Avoid commission driven malpractices such as:
   (a) Recommending inappropriate products solely because the intermediary is getting higher commissions there from.
   (b) Encouraging over transacting and churning of mutual fund investments to earn higher commissions, even if they mean higher transaction costs and tax for investors.
10. Avoid making negative statements about any AMC or scheme and ensure that comparisons if any, are made with similar and comparable products. 3.11 Ensure that all investor related statutory communications (such as changes in fundamental attributes, exit/entry load, exit options, and other material aspects) are sent to investors reliably and on time.
11. Maintain confidentiality of all investor deals and transactions.
12. When marketing various schemes, remember that a client's interest and suitability to their financial needs is paramount, and that extra commission or incentive earned should never form the basis for recommending a scheme to the client.
13. Intermediaries will not rebate commission back to investors and avoid attracting clients through temptation of rebate/gifts etc.

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14. A focus on financial planning and advisory services ensures correct selling, and also reduces the trend towards investors asking for pass back of commission.

15. All employees engaged in sales and marketing should obtain AMFI certification. Employees in other functional areas should also be encouraged to obtain the same certification.

Caselet

SEBI Favours Self-regulation for Mutual Funds

The Securities and Exchange Board of India (SEBI) on Wednesday mooted the idea of Self-regulatory Organisation (SRO) for the mutual fund industry.

Under the proposed plan, the Association of Mutual Funds in India (AMFI) would act as the SRO with parts of the powers with SEBI being delegated to the apex body of the mutual fund industry.

"Idea of SRO would help and support SEBI better in regulating the mutual funds," the SEBI Chairman, Mr G.N. Bajpai, said at a function organised to release the Hindi edition of the AMFI workbook and also the launch of the certification course on the e-learning portal of NSE.IT.

He said this would help the mutual funds to regulate themselves in a better way.

Currently the proposal was still in the conceptual stage and details would be known after consulting with AMFI and mutual funds, he said adding that the delegation of powers would be in phases.

The SEBI Chairman also said the market regulator was also looking at the replacement of external auditors of asset management companies of mutual funds in the wake of international accounting scandals.

Mr Bajpai suggested that mutual funds should expand the distribution network to small towns and for this they should groom their distributors. He also said that mutual funds should bring professionalism through the AMFI certification programme.

On the suggestion from the industry to allow them to manage pension funds, Mr Bajpai said he would discuss the matter with the Government.

Source: http://www.thehindubusinessline.in

9.4.2 Recent Developments

On July 1, 2009, the Securities and Exchange Board of India has put a cap of one per cent on the maximum amount an asset management company can retain from the exit load or the Contingent Deferred Sales Charges (CDCs) on mutual funds for marketing and selling expenses.

"Of the exit load or CDSC charged to the investor, a maximum of one per cent of the redemption proceeds shall be maintained in a separate account which can be used by the AMC to pay commissions to the distributors and to take care of other marketing and selling expenses", SEBI said in a circular. The balance should be credited to the scheme immediately.

In another notice to Asset Management Companies (AMCs), market regulator SEBI has pitched for portfolio diversification. On June 5, 2009, SEBI asked mutual funds to bring down their investment in money market instruments of a single entity to within 30 per cent limit by September 5. According to guidelines, no mutual fund scheme can invest more than 30 per cent of its net assets in money market instruments, like commercial papers, of a single issuer.

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On August 1, 2009, SEBI had banned the entry load charged by fund houses from August 1. In the new regime, distributors would have to negotiate the commission with customers and be paid through a different cheque.

Also, distributors would have to disclose the commission they were being paid for similar products. In yet another move, the market regulator had asked fund houses to stop discriminating between high networth and retail investors and charge them the same exit load.

However, the move was seen by the regulator as being unfair to retail investors since the exit load was not applicable for investors who put in at least ₹ 5 crore, as per SEBI norms. Investors with large amounts but less than ₹ 5 crore could bargain for a lower exit load, thus laying the maximum burden on small investors.

Following this move, the regulator directed fund houses to bring parity in exit loads for all classes of investors, irrespective of the plans and the amount of investment and asked mutual funds to reduce the lock-in period, or the time before which investors will have to pay a penalty for exiting a scheme, from three years to one year.

9.5 Performance Evaluation

Let us start the discussion of the performance of mutual funds in India from the day the concept of mutual fund took birth in India. The year was 1963. Unit Trust of India invited investors or rather those who believed in savings, to park their money in UTI Mutual Fund. For 30 years it goaled without a single second player. Though the 1988 year saw some new mutual fund companies, but UTI remained in a monopoly position. The performance of mutual funds in India in the initial phase was not even closer to satisfactory level. People rarely understood, and of course investing was out of question. But yes, some 24 million shareholders were accustomed with guaranteed high returns by the beginning of liberalization of the industry in 1992. This good record of UTI became marketing tool for new entrants. The expectations of investors touched the sky in profitability factor. However, people were miles away from the preparedness of risks factor after the liberalization.

The Assets Under Management of UTI was ₹ 67bn. by the end of 1987. Let me concentrate about the performance of mutual funds in India through figures. From ₹ 67bn. the Assets Under Management rose to ₹ 470 bn. in March 1993 and the figure had a three times higher performance by April 2004. It rose as high as ₹ 1,540bn.

The Net Asset Value (NAV) of mutual funds in India declined when stock prices started falling in the year 1992. Those days, the market regulations did not allow portfolio shifts into alternative investments. There were rather no choices apart from holding the cash or to further continue investing in shares. One more thing to be noted, since only closed-end funds were floated in the market, the investors disinvested by selling at a loss in the secondary market.

Did u know? **What are NAV and SIP?**

Net Asset Value (NAV): The NAV of a scheme is the rupee value of one unit of that scheme. Broadly, it is calculated by dividing the total value of the fund by the number of units. More specifically,

NAV = (Market Value of the fund's investments + Current assets + Accrued Income - Current Liabilities - Accrued Expenses)/Number of units outstanding.

Notes

Systematic Investment Plan (SIP): An SIP is an investment strategy offered by mutual fund houses, where one invests fixed amounts at regular pre-determined intervals (monthly or quarterly) in a mutual fund scheme. The number of units one gets each time depends on the prevailing Net asset value at the time of the investment. The higher the NAV, the lower the number of units and the lower the NAV the more units the investor will receive.

Mutual Funds are subject to market risk. Please read the offer document carefully before investing. Terms and Conditions apply.

The performance of mutual funds in India suffered qualitatively. The 1992 stock market scandals, the losses by disinvestments and of course the lack of transparent rules in the where about rocked confidence among the investors. Partly owing to a relatively weak stock market performance, mutual funds have not yet recovered, with funds trading at an average discount of 1020 percent of their net asset value.

The supervisory authority adopted a set of measures to create a transparent and competitive environment in mutual funds. Some of them were like relaxing investment restrictions into the market, introduction of open-ended funds, and paving the gateway for mutual funds to launch pension schemes.

The measure was taken to make mutual funds the key instrument for long-term saving. The more the variety offered, the quantitative will be investors. At last to mention, as long as mutual fund companies are performing with lower risks and higher profitability within a short span of time, more and more people will be inclined to invest until and unless they are fully educated with the dos and don'ts of mutual funds.

9.6 Mutual Fund Companies in India

The concept of mutual funds in India dates back to the year 1963. The era between 1963 and 1987 marked the existence of only one mutual fund company in India with ₹ 67bn Assets Under Management (AUM), by the end of its monopoly era, the Unit Trust of India (UTI). By the end of the 80s decade, few other mutual fund companies in India took their position in mutual fund market. The new entries of mutual fund companies in India were SBI Mutual Fund, Canbank Mutual Fund, Punjab National Bank Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund.

The succeeding decade showed a new horizon in Indian mutual fund industry. By the end of 1993, the total AUM of the industry was ₹ 470.04 bn. The private sector funds started penetrating the fund families. In the same year the first Mutual Fund Regulations came into existence with re-registering all mutual funds except UTI. The regulations were further given a revised shape in 1996.

Kothari Pioneer was the first private sector mutual fund company in India which has now merged with Franklin Templeton. Just after ten years with private sector player's penetration, the total assets rose up to ₹ 1218.05 bn. Today there are 33 mutual fund companies in India.

The major mutual fund companies in India are being discussed below:

ABN AMRO Mutual Fund

ABN AMRO Mutual Fund was setup on April 15, 2004 with ABN AMRO Trustee (India) Pvt. Ltd. as the Trustee Company. The AMC, ABN AMRO Asset Management (India) Ltd. was incorporated on November 4, 2003. Deutsche Bank A G is the custodian of ABN AMRO Mutual Fund.

Notes

Birla Sun Life Mutual Fund

Birla Sun Life Mutual Fund is the joint venture of Aditya Birla Group and Sun Life Financial. Sun Life Financial is a global organization evolved in 1871 and is being represented in Canada, the US, the Philippines, Japan, Indonesia and Bermuda apart from India. Birla Sun Life Mutual Fund follows a conservative long-term approach to investment. Recently it crossed AUM of ₹ 10,000 crores.

Bank of Baroda Mutual Fund (BOB Mutual Fund)

Bank of Baroda Mutual Fund or BOB Mutual Fund was setup on October 30, 1992 under the sponsorship of Bank of Baroda. BOB Asset Management Company Limited is the AMC of BOB Mutual Fund and was incorporated on November 5, 1992. Deutsche Bank AG is the custodian.

ING Vysya Mutual Fund

ING Vysya Mutual Fund was setup on February 11, 1999 with the same named Trustee Company. It is a joint venture of Vysya and ING. The AMC, ING Investment Management (India) Pvt. Ltd. was incorporated on April 6, 1998.

Prudential ICICI Mutual Fund

The mutual fund of ICICI is a joint venture with Prudential Plc. of America, one of the largest life insurance companies in the US of A. Prudential ICICI Mutual Fund was setup on 13th of October, 1993 with two sponsorers, Prudential Plc. and ICICI Ltd. The Trustee Company formed is Prudential ICICI Trust Ltd. and the AMC is Prudential ICICI Asset Management Company Limited incorporated on 22nd of June, 1993.

State Bank of India Mutual Fund

State Bank of India Mutual Fund is the first Bank sponsored Mutual Fund to launch offshore fund, the India Magnum Fund with a corpus of ₹ 225 cr. approximately. Today it is the largest Bank sponsored Mutual Fund in India. They have already launched 35 Schemes out of which 15 have already yielded handsome returns to investors. State Bank of India Mutual Fund has more than ₹ 5,500 Crores as AUM. Now it has an investor base of over 8 Lakhs spread over 18 schemes.

Unit Trust of India Mutual Fund

UTI Asset Management Company Private Limited, established in Jan 14, 2003, manages the UTI Mutual Fund with the support of UTI Trustee Company Private Limited. UTI Asset Management Company presently manages a corpus of over ₹20000 Crore. The sponsorers of UTI Mutual Fund are Bank of Baroda (BOB), Punjab National Bank (PNB), State Bank of India (SBI), and Life Insurance Corporation of India (LIC). The schemes of UTI Mutual Fund are Liquid Funds, Income Funds, Asset Management Funds, Index Funds, Equity Funds and Balance Funds.

Standard Chartered Mutual Fund

Standard Chartered Mutual Fund was set up on March 13, 2000 sponsored by Standard Chartered Bank. The Trustee is Standard Chartered Trustee Company Pvt. Ltd. Standard Chartered Asset Management Company Pvt. Ltd. is the AMC which was incorporated with SEBI on December 20,1999.

Notes

Case Study

Mutual Funds Turning to Capital Protection Funds

Equity market's volatility pushes investors to other schemes.

While the equity market is rather unpredictable at this time, debt and money markets have become a more attractive proposition for investors.

Mutual funds, capitalising on the same, are turning to capital protection funds, which provide both the security of being invested in fixed income instruments along with the higher-returns-potential of the equity side of investment.

UTI, SBI, Sundaram, IDFC, Franklin Templeton are some of the fund houses that have launched capital protection funds.

"These are for investors who are conservative and prefer their investments to be in the form of bank deposits. There is potential upside and virtually no downside to these funds. But there is no guarantee of capital protection here," said Mr Dhirendra Kumar, Chief Executive Officer, Value Research.

A capital protection fund is a close-ended fund which invests 80 per cent of its corpus in fixed income securities such as corporate bond papers, government securities and other money market instruments. The rest of its corpus - 20 per cent - will be in equities.

At the end of the fund's tenure, the capital invested is protected through returns from fixed income securities while the returns on the investment itself would be from the equity investments of the fund.

Capital Guarantee

"The capital guarantee is done via investments in high quality debt papers," said Mr Dwijendra Srivastava, Head-Fixed Income, Sundaram Mutual, whose fund house plans to launch 12 more capital protection funds in the next 16-18 months.

"Also, these funds are structured in such a manner that investors cannot exit before the end of the tenure."

After 2008, fixed income as an asset class has become more popular with investors.

"The capital protection fund is an investor need. These funds are not meant for super HNIs or informed investors. The fund is for those who are averse to losing capital and want to stay invested for the long haul," said Mr Srivastava.

With redemption pressures continuing to affect the industry, it seems that fund houses are turning to products like capital protection funds to lure investors and to ensure that they stay invested for a longer period.

Question

Make a analysis on mutual funds investment vs. stock market investment.

Source: http://www.thehindubusinessline.in

Notes

9.7 Summary

- Mutual funds can be described as open-ended funds operated by an investment company which raises money from shareholders and invests in a group of assets, in accordance with a stated set of objectives.
- In return for the money they give to the fund when purchasing shares, shareholders receive an equity position in the fund and, in effect, in each of its underlying securities.
- For most mutual funds, shareholders are free to sell their shares at any time, although the price of a share in a mutual fund will fluctuate daily, depending upon the performance of the securities held by the fund. Benefits of mutual funds include diversification and professional money management.
- There are many types of mutual funds like Value stocks, Growth stock, Based on company size, large, mid, and small cap, Income stock, Index funds, Enhanced index, Stock market sector, Defensive stock, International, Real estate, Socially responsible, Balanced funds, Tax efficient, Convertible, Junk bond, Mutual funds of mutual funds, Closed end, Exchange traded funds, etc.
- Mutual funds have emerged as the best in terms of variety, flexibility, diversification, liquidity as well as tax benefits.
- Besides, through MFs investors can gain access to investment opportunities that would otherwise be unavailable to them due to limited knowledge and resources.
- MFs have the capability to provide solutions to most investors' needs, however, the key is to do proper selections and have a process for monitoring.

9.8 Keywords

Balanced funds: The investor may wish to balance his risk between various sectors such as asset size, income or growth. Therefore the fund is a balance between various attributes desired.

Defensive stock: The securities in this fund are chosen from a stock which usually is not impacted by economic down turns.

Offer document: Any document by which a mutual fund invites public for subscription of units of a scheme.

9.9 Self Assessment

Fill in the blanks:

1. Most funds have a particular ..... they focus on when investing.
2. Tax efficient mutual fund aims to ..... tax bills, such as keeping turnover levels low or shying away from companies that provide dividends.
3. UTI Mutual Fund was created as a ..... registered fund.
4. Unit Trust of India was created by the UTI Act passed by the Parliament in .....
5. ..... are the stocks from firms with relative low Price to Earning (P/E) Ratio, usually pay good dividends.
6. Morgan Stanley is a worldwide financial services company and it's leading in the market in ....., ... and credit services.

Notes

7. SEBI may during the pendency of any proceeding of suspension or cancellation also order suspension for launching of any scheme not exceeding ..... months.
8. Mutual Funds are subject to .....
9. An SIP is an investment strategy offered by mutual fund houses, where one invests fixed amounts at regular ..... in a mutual fund scheme.
10. The higher the ....., the lower the number of units.
11. AMFI is an abbreviation for .....
12. On July 1, 2009, the Securities and Exchange Board of India has put a cap of one per cent on the maximum amount an asset management company can retain from the exit load or the ..... on mutual funds for marketing and selling expenses.
13. SEBI has directed fund houses to bring parity in exit loads for all classes of investors, irrespective of the plans and the amount of investment and asked mutual funds to reduce the .....
14. In India, given that mutual funds are relatively new, there is a ..... level of awareness amongst investors about the working and benefits of Mutual Funds.
15. ..... can purchase and sell mutual fund units through various types of intermediaries.

9.10 Review Questions

1. Critically evaluate the performance of UTI in the last decade.
2. What have been the major points of concern for Indian mutual funds market in past 5 years?
3. Where do you see Indian Mutual Fund market heading towards in next 5 years and why?
4. What has been the biggest limitation of the government supported mutual funds in India?
5. What do you think is better in performance and why – public mutual funds/private mutual funds?
6. How do analyse Indian Mutual fund market as compared to that of developed economies?
7. What are the five main reasons for mutual funds to have got so popular in recent times?
8. What are the challenges ahead of the regulatory authorities in India in order to manage/ regulate AMCs?
9. Analyse the recent regulations of SEBI with respect to mutual funds. Has the industry taken them with open arms? Why/ Why not?
10. It is mandatory to disclose that the "mutual funds are subject to market risks". What are these risks?

Answers: Self Assessment

1.	strategy	2.	minimize
3.	SEBI	4.	1963
5.	Value stocks	6.	securities, investment management

Notes

7. three
8. market risk
9. pre-determined intervals
10. NAV
11. Association of Mutual Funds in India
12. contingent deferred sales charges
13. lock-in period
14. low
15. Investors

9.11 Further Readings


Online links

www.induscorpque.com

www.rbi.com

www.sebi.org

Notes

Unit 10: Financial Services

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the concept of financial services
- Describe the role of financial services
- Discuss emerging trends in financial services
- State the nature of financial services
- Know the types of financial services

Introduction

Financial services refer to services provided by the finance industry. The finance industry encompasses a broad range of organizations that deal with the management of money. Among these organizations are banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises.

10.1 Concept of Financial Services

Financial services can be defined as the products and services offered by institutions like banks of various kinds for the facilitation of various financial transactions and other related activities in the world of finance like loans, insurance, credit cards, investment opportunities and money management as well as providing information on the stock market and other issues like market trends.

Notes

The Gramm-Leach-Bliley Act enacted in the late 1990s brought the term financial services into prominence when it repealed earlier laws which forbade a bank or any financial institution from venturing into fields like insurance and investment. The result was the merger of many organizations offering the above mentioned services under one banner giving rise to a new type of banking popularly known as Commercial Banking and a number of organizations like Citibank came into existence purely as service providers.

The Finance services industry though a highly profitable Industry with respect to earnings does not count for a large share of the market and also employs a lesser number of people as compared to some of the other Industries. Some of the major service providers and commercial banks in this field are:

1. Citibank
2. HSBC
3. Standard Chartered
4. Citigroup
5. Merrill Lynch
6. Morgan Stanley
7. ING (Investment)
8. American Express (Credit Card)
9. VISA (Credit Card)
10. Allianz (Insurance)

10.2 Role of Financial Services

During the last decade, there has been a broadening and deepening of financial markets. Several new instruments and products have been introduced. Existing sectors have been opened to new private players. This has given a strong impetus to the development and modernization of the financial sector. New players have adopted international best practices and modern technology to offer a more sophisticated range of financial services to corporate and retail customers. This process has clearly improved the range of financial services and service providers available to Indian customers. The entry of new players has led to even existing players upgrading their product offerings and distribution channels. This continued to be witnessed in 2002-03 across key sectors like commercial banking and insurance, where private players achieved significant success.

These changes have taken place against a wider systemic backdrop of easing of controls on interest rates and their realignment with market rates, gradual reduction in resource pre-emption by the government, relaxation of stipulations on concessional lending and removal of access to concessional resources for financial institutions. Over the past few years, the sector has also witnessed substantial progress in regulation and supervision. Financial intermediaries have gradually moved to internationally acceptable norms for income recognition, asset classification, and provisioning and capital adequacy.

This process continued in 2002-03, with RBI announcing guidelines for risk-based supervision and consolidated supervision. While maintaining its soft interest rate stance, RBI cautioned banks against taking large interest rate risks, and advocated a move towards a floating rate interest rate structure.

Notes

The past decade was also an eventful one for the Indian capital markets. Reforms, particularly the establishment and empowerment of Securities and Exchange Board of India (SEBI), market-determined prices and allocation of resources, screen-based nationwide trading, dematerialisation and electronic transfer of securities, rolling settlement and derivatives trading have greatly improved both the regulatory framework and efficiency of trading and settlement. On account of the subdued global economic conditions and the impact on the Indian economy of the drought conditions prevailing in the country, 2002-03 was a subdued year for equity markets. Despite this, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) ranked third and sixth respectively among all exchanges in the world with respect to the number of transactions. The year also witnessed the grant of approval for setting up of a multi-commodity exchange for trading of various commodities.

In the midst of these positive developments, a key issue that continues to impact the Indian financial sector adversely is that of asset quality and consequent pressure on capital. The liberalisation and globalisation of the Indian economy led to a process of restructuring and consolidation across several sectors of the economy. Several units that were set up in a protectionist environment became unviable in the new paradigm of competition in the global market place. Volatility in global commodity prices has a major impact on Indian companies.

This has led to non-performing loans and provisioning for credit losses becoming a key area of concern for the Indian financial system. The NPA problem in India, viewed in the context of comparison with other Asian economies, does not pose an insoluble systemic problem; at 8% of GDP, the NPA levels are significantly lower than the levels of 30-40% seen in other Asian economies. The key problems in India have been the inability of banks to quickly enforce security and access their collateral, and the capital constraints in recognising large loan losses. Recent measures taken by the Government have attempted to address both these problems. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act creates a long-overdue framework for resolving the distressed credit problem in India, by providing legal support to the resolution process and thereby encourages the flow of capital into this specialised sector. The proposal for swapping high-yield Government securities held by banks into lower-yield securities, thereby realising mark-to-market gains and utilising the same to make additional provisions, would also strengthen the balance sheets of banks.

Notes Non-performing Asset means an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by The Reserve Bank of India.

Ninety Days Overdue

With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days overdue' norm for identification of NPAs, form the year ending March 31, 2004. Accordingly, with effect form March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where:

1. interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a Term Loan,
2. the account remains 'out of order' for a period of more than 90 days, in respect of an overdraft/cash credit (OD/CC),
3. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

Contd....

Notes

4. interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purpose, and

5. any amount to be received remains overdue for a period of more than 90 days in respect of other.

Reasons

Banks are in the risk business. In the process of providing financial services, they assume various kinds of risks viz. credit risk, market risk, operational risk, interest risk, forex risk and country risk. Among these different types of risks, credit constitutes the most dominant asset in the balance sheet, accounting for about 60% of total assets. The credit risk is generally made up of transaction risk (default risk) and portfolio risk. The risk management is a complex function and requires specialized skills and expertise. Any loophole on the part of the management can lead into a big NPA for a bank.

Problems due to NPA

The Indian banking sector is facing a serious problem of NPA. The extent of NPA is comparatively higher in public sectors banks. Some of the problems due to NPA:

1. Owners do not receive a market return on their capital. In the worst case, if the bank fails, owners lose their assets. In modern times, this may affect a broad pool of shareholders.

2. Depositors do not receive a market return on savings. In the worst case if the bank fails, depositors lose their assets or uninsured balance. Banks also redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.

3. Non-performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital and, by extension, labour and natural resources. The economy performs below its production potential.

4. Non-performing loans may spill over the banking system and contract the money stock, which may lead to economic contraction. This spillover effect can channelize through illiquidity or bank insolvency; (a) when many borrowers fail to pay interest, banks may experience liquidity shortages. These shortages can jam payments across the country, (b) illiquidity constraints bank in paying depositors e.g. cashing their paychecks. Banking panic follows. A run on banks by depositors as part of the national money stock become inoperative. The money stock contracts and economic contraction follows (c) undercapitalized banks exceeds the banks capital base.

5. Lending by banks has been highly politicized. It is common knowledge that loans are given to various industrial houses not on commercial considerations and viability of project but on political considerations; some politician would ask the bank to extend the loan to a particular corporate and the bank would oblige. In normal circumstances banks, before extending any loan, would make a thorough study of the actual need of the party concerned, the prospects of the business in which it is engaged, its track record, the quality of management and so on. Since this is not looked into, many of the loans become NPAs.

Contd....

Notes

The loans for the weaker sections of the society and the waiving of the loans to farmers are another dimension of the politicization of bank lending. Most of the depositor's money has been frittered away by the banks at the instance of politicians, while the same depositors are being made to pay through taxes to cover the losses of the bank.

RBI Guidelines to Tackle the NPA Problem

To improve the efficiency and profitability, the NPA has to be scheduled. Various steps have been taken by government to reduce the NPA. It is highly impossible to have zero percentage NPA. But at least Indian banks can try competing with foreign banks to maintain international standard.

Various steps have been taken by the government and RBI to recover and reduce NPAs. Some of them are:

1. One time settlement/compromise scheme
2. Lok adalats
3. Debt Recovery Tribunals
4. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002
5. Corporate Reconstruction Companies
6. Credit information on defaulters and role of credit information bureaus.

Apart from these, RBI has been off late relaxing NPA norms to help the economy not only sustain itself in the time of the global crisis but also grow in such times. One such example can be seen in the January 2009 relaxation in the norm made by the Reserve Bank of India which now state that all accounts which were standard accounts on September 1, 2008 would be treated as standard accounts on restructuring provided the restructuring is taken up on or before January 31, 2009 and the restructuring package is put in place within a period of 120 days from the date of taking up the restructuring package.

The period for implementing the restructuring package has also been extended from 90 days to 120 days in respect of those accounts. The special regulatory treatment will also be available to 'standard' and 'sub-standard accounts'. These provisions would be in addition to the usual provisions as per the current regulation.

Further liberalising the prudential norms for the treatment of non-performing assets in the context of ongoing slowdown in the Indian economy, Certain modifications are necessary as the spillover effects of the global downturn had started affecting the Indian economy particularly from September 2008 creating stress for the otherwise viable units, said RBI.

Earlier special regulatory treatment was extended to commercial real estate exposures restructured for the first time as well as to exposures (other than commercial real estate, capital markets and personal/consumer loans) which were viable but were facing temporary cash flow problems and needed a second restructuring.

The RBI which had announced liberalisation of NPA norms earlier had received representation that the accounts which turned non-performing between September and December 2008 were excluded from the special regulatory treatment extended in December 2008.

Contd....

Notes

The period of 90 days allowed for restructuring may not be adequate in view of the large number of accounts potentially requiring restructuring.

Also drawing power has been affected due to decline in inventory prices necessitating conversion of irregular portions of working capital limits into Working Capital Term Loan (WCTL) on restructuring.

However, as the borrowers may be unable to provide further tangible security in the current context, accounts even after restructuring will be classified as NPAs. The condition of WCTL being fully secured by tangible security may, therefore, be relaxed, said RBI.

Meanwhile RBI has asked all non- banking finance companies (NBFCs) that the rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. Boards of NBFCs were, therefore, advised to lay out appropriate internal principles and procedures in determining interest rates.

Note: The detail discussion on NPA management is given in Unit 15.

During the year the RBI operationalised the corporate debt restructuring forum, which has a made significant progress in building lender consensus on restructuring. The next major initiative would be the operationalisation of an asset reconstruction company, and the development of a market for distressed credit similar to those in other countries.

The increasing disintermediation in the corporate credit market, slowdown in creation of new capital assets as companies focus on improving existing capacity utilisation and improving working capital efficiency of Indian corporates has led to lower demand for credit from the corporate sector in the past two years. This has been replaced by the huge retail finance opportunity. Existing low penetration levels, increasing affordability of credit and rising income levels have led to a growing demand for retail credit. This has been strengthened by the tax incentives for acquiring residential property, leading to a particularly high growth in housing finance. Going forward, the infrastructure, retail and small and medium enterprise segments would provide large growth opportunities, while the manufacturing sector is expected to continue its consolidation phase, with selective additions to capacity. However, success in these segments presents several challenges. Retail and SME banking requires extremely effective distribution systems that are capable of offering flexibility and convenience to the customer, while maintaining cost-efficiency for banks. At the same time, banks need to put in place high-quality credit modelling and data mining systems. This is essential to appropriately assess and price risk and allocate capital in a manner that would optimise risk-adjusted returns. The Indian financial system would also witness greater activity in the debt markets, as originators of credit increasingly seek to proactively manage their portfolios by structuring and selling down loan portfolios to entities that have capital to deploy but lack the origination and structuring capabilities.

India has made considerable progress in the post-1991 period. The country's macroeconomic fundamentals have improved and external vulnerability has been sharply reduced. Reforms in the financial sector have appropriately addressed the pre-1991weaknesses in the sector and improved its competitive strength domestically as well as globally. Individual players now need to adopt proactive competitive strategies that will enable them to capture the emerging opportunities. Exposure to global practices has made the Indian customer more discerning and demanding.

Notes

There has been a clear shift towards those entities that are able to offer products and services in the most innovative and cost-efficient manner. The financial sector will need to adopt a customer-centric business focus. It will also have to create value for its shareholders as well as its customers, competing for the capital necessary to fund growth as well as for customer market share.

10.3 Prudential Norms for Capital Adequacy

Capital adequacy standards form an integral part of prudential banking sector regulation. Capital standards all over the world are converging at the behest of the Basel Committee on Banking Supervision towards the so called Basel II norms.

Capital adequacy is an indicator of the financial health of the banking system. It is measured by the Capital to Risk-weighted Asset Ratio (CRAR), defined as the ratio of a bank's capital to its total risk-weighted assets. Financial regulators generally impose a capital adequacy norm on their banking and financial systems in order to provide for a buffer to absorb unforeseen losses due to risky investments. A well adhered to capital adequacy regime does play an important role in minimizing the cascading effects of banking and financial sector crises.

With a view to adopting the Basle Committee framework on capital adequacy norms which takes into account the elements of risk in various types of assets in the balance sheet as well as off-balance sheet business and also to strengthen the capital base of banks, Reserve Bank of India decided in April 1992 to introduce a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure.

Essentially, under the above system the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned weights according to the prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis.

Capital Funds

1. ***Capital funds of Indian banks:*** For Indian banks, 'capital funds' would include the following elements:

   (a) Elements of Tier I capital

      (i) Paid-up capital, statutory reserves, and other disclosed free reserves, if any.

      (ii) Capital reserves representing surplus arising out of sale proceeds of assets.

   (b) Equity investments in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods, should be deducted from Tier I capital.

   (c) In the case of public sector banks which have introduced Voluntary Retirement Scheme (VRS), in view of the extra-ordinary nature of the event, the VRS related Deferred Revenue Expenditure would not be reduced from Tier I capital.

   (d) Elements of Tier II capital

      (i) *Undisclosed reserves and cumulative perpetual preference shares:* These often have characteristics similar to equity and disclosed reserves. These elements have the capacity to absorb unexpected losses and can be included in capital, if they represent accumulations of post-tax profits and not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses. Cumulative perpetual preference shares should be fully paid-up and should not contain clauses which permit redemption by the holder.

Notes

(ii) *Revaluation reserves:* These reserves often serve as a cushion against unexpected losses, but they are less permanent in nature and cannot be considered as 'Core Capital'. Revaluation reserves arise from revaluation of assets that are undervalued on the bank's books, typically bank premises and marketable securities. The extent to which the revaluation reserves can be relied upon as a cushion for unexpected losses depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets, the subsequent deterioration in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation, etc. Therefore, it would be prudent to consider revaluation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as revaluation reserves.

(iii) *General provisions and loss reserves*: Such reserves, if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, can be included in Tier II capital. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets.

(iv) *Hybrid debt capital instruments:* In this category, fall a number of capital instruments which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital.

(v) *Subordinated debt:* To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the Reserve Bank of India. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier II capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier II capital. Subordinated debt instruments eligible to be reckoned as Tier II capital will be limited to 50 percent of Tier I capital.

In the case of public sector banks, the bonds issued to the VRS employees as a part of the compensation package, net of the unamortised VRS Deferred Revenue Expenditure, could be treated as Tier II capital, subject to compliance with the terms and conditions stipulated.

(e) Banks should indicate the amount of subordinated debt raised as Tier II capital by way of explanatory notes/remarks in the Balance Sheet as well as in Schedule 5 under 'Other Liabilities & Provisions'.

(i) The Investment Fluctuation Reserve would be eligible for inclusion in Tier II capital.

(ii) Banks are allowed to include the 'General Provisions on Standard Assets' and 'Investment Fluctuation Reserve' in Tier II capital. However, the provisions

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on standard assets and 'Investment Fluctuation Reserve' together with other 'general provisions/loss reserves' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

(f) Tier II elements should be limited to a maximum of 100 percent of total Tier I elements for the purpose of compliance with the norms.

(g) A bank's aggregate investment in Tier II bonds issued by other banks and financial institutions shall be permitted up to 10 percent of the investing banks total capital. The total capital for this purpose will be the same as reckoned for the purpose of Capital Adequacy.

2. ***Capital funds of foreign banks operating in India:*** For foreign banks, 'capital funds' would include the following elements:

(a) Elements of Tier I capital

(i) Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

(ii) Statutory reserves kept in Indian books.

(iii) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

Important:

The foreign banks are required to furnish to Reserve Bank, (if not already done), an undertaking to the effect that the banks will not remit abroad the remittable surplus retained in India and included in Tier I capital as long as the banks function in India.

These funds may be retained in a separate account titled as 'Amount Retained in India for Meeting Capital to Risk-weighted Asset Ratio (CRAR) Requirements' under 'Capital Funds'.

An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to Reserve Bank.

It should be noted that once the banks treat any part of the remittable profits as capital funds for capital adequacy purposes, these funds cannot be hedged.

(iv) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.

(v) Interest-free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.

(vi) The net credit balance, if any, in the inter-office account with Head Office/ overseas branches will not be reckoned as capital funds. However, any debit balance in Head Office account will have to be set-off against the capital.

(b) Elements of Tier II capital

(i) To the extent relevant, elements of Tier II capital as indicated above in respect of Indian banks will be eligible.

Notes

(c) The elements of Tier I & Tier II capital do not include foreign currency loans granted to Indian parties.

Minimum requirement of capital funds

Banks were required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) norm of 8 percent on an ongoing basis up to the year ending 31 March 1999. With effect from the year ending 31 March 2000, banks are required to maintain a minimum CRAR of 9 percent on an ongoing basis.

Issue of subordinated debt for raising Tier II capital

(a) The Reserve Bank has given autonomy to Indian banks to raise rupee subordinated debt as Tier II capital, subject to the terms and conditions given. It should be ensured that the terms & conditions are strictly adhered to.

(b) Foreign banks also would not require prior approval of RBI for raising subordinated debt in foreign currency through borrowings from Head Office for inclusion in Tier II capital.

(c) The banks should submit a report to Reserve Bank of India giving details of the Subordinated debt issued for raising Tier II capital, such as, amount raised, maturity of the instrument, rate of interest together with a copy of the offer document, soon after the issue is completed.

3. ***Risk adjusted assets and off-balance sheet items***

(a) Risk adjusted assets would mean weighted aggregate of funded and non-funded items. Degrees of credit risk expressed as percentage weightings, have been assigned to balance sheet assets and conversion factors to off-balance sheet items.

(b) Banks' investments in all securities should be assigned a risk weight of 2.5 percent for market risk. This will be in addition to the risk weights assigned towards credit risk since, in line with best practices, some capital cushion should also be provided for market risk in addition to credit risk.

(c) The value of each asset/item shall be multiplied by the relevant weights to produce risk adjusted values of assets and off-balance sheet items. The aggregate will be taken into account for reckoning the minimum capital ratio.

4. ***Reporting requirements***

(a) Banks should furnish an annual return indicating:

(i) Capital funds,

(ii) Conversion of off-Balance Sheet/non-funded exposures,

(iii) Calculation of risk weighted assets, and

(iv) Calculations of capital to risk assets ratio.

(b) In the case of Indian banks having branches abroad, the break-up and aggregate in respect of domestic and overseas operations will have to be furnished. Two officials who are authorised to sign the statutory returns submitted to Reserve Bank should sign the returns.

5. ***Capital Adequacy for Subsidiaries***

(a) The Basel Committee on Banking Supervision has proposed that the New Capital Adequacy Framework should be extended to include, on a consolidated basis, holding

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companies that are parents of banking groups. On prudential considerations, it is necessary to adopt best practices in line with international standards, while duly reflecting local conditions.

(b) Accordingly, banks may voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk weights applicable to the bank's own assets. Banks should earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switchover to unified balance sheet for the group as a whole is adopted after sometime. The additional capital required may be provided in the bank's books in phases.

10.4 Emerging Trends in Financial Services

Every industry undergoes periodic changes and in that context the financial services industry is certainly not an exception. The only exception is that changes in the financial services industry have occurred more rapidly as compared to other industries, the most probable reason being its dynamic nature. Emerging trends in the financial services industry provide a definitive clue to the ongoing changes and here are some of those to help you get a better understanding:

Increased Automation

With rapid advancements in Information Technology and allied systems and processes, the financial services industry has witnessed increased automation over the years. Financial projects are still managed under the watchful eyes of highly qualified professionals, but the actual processing and transacting is being done by automated software systems. It is certainly a positive development because automated systems eliminate the chances of human errors and inaccuracies and also allow firms to handle large financial projects with veritable ease.

Diminishing Size Limitations

At the beginning, financial services outsourcing was embraced mostly by business heavyweights such as Goldman Sachs, Lehman Brothers, Morgan Stanley, Citi Group etc. Things however have changed over the years as can be seen from the dramatic increase in the number of Small & Medium Enterprises (SMEs) hiring financial outsourcing services. Business size is no longer a criterion for choosing financial services outsourcing, something that is good news for both SMEs and small outsourcing service providers that cater to niche market segments.

Rapidly Expanding Wider Presence

There was a time when financial services were limited to a few advantageous geographical locations like Mumbai. However, due to rising demand for financial services, other locations like countries such as Ahmedabad, New Delhi, Chandigarh, Kolkata, etc., have also started offering financial services. It signifies that financial services industry now enjoys a wide presence and is not limited to a few regional pockets. And that is good because businesses now have a lot more options to choose from.

Introduction of Web Technology

Predicting the future is never easy, but in the use of web technology for the financial services industry, there are a number of trends and technologies that are in their early stages and show significant promise for the sector.

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In addition, websites can offer dialog-based or even voice-based assistance for users of the site. This is will make it much easier to service complex financial products online to both consumers and to agents.

Finally, with the ubiquity of mobile phones and the increasing market penetration, more and more information and communication will be channeled through these routes. To manage this effectively, it is important to choose a content management solution that will allow these channels to be used without the need for complex and time consuming reuse of information.

Wireless networking has lead to the market place being flooded with all sorts of new internet appliances, mobile devices and gadgets that provide users a low-cost alternative to PCs.

Handhelds, PDAs, Smartphones, Blackberries, Tablet PCs, Notebooks/Laptops name just a few of the options now available and manufacturers are continually trying to launch new devices in an attempt to provide the right hybrid device that sits somewhere between the Smartphone and the PDA. This trend is likely to continue for the foreseeable future.

Case Study

Swiss Re Portal

The Swiss Re Portal is a free personalised workspace tailored to the needs of their customers, investors, the media and other interested groups. It contains customizable industry news feeds, exclusive sigma data for download and direct access to e-business applications.

Swiss Re Portal offers many benefits:

1. Personal and target content (you design your own personal workspace)
2. Easy access to all e-business applications
3. Insurance/reinsurance information from over 300 sources available at the fingertips

Example: "http://www.swissre.com" then click on "About Swiss Re Portal" for more info. You will need to register to get a full appreciation of the personalisation functionality.

Technology

"http://www.plumtree.com/products/platform"

Questions

1. What do you think is the advantage of a free personalised workspace in today's world?
2. What do you analyse as the biggest opportunity for Swiss Re Portal?

10.5 Nature of Financial Services

Consumers of this sector are often key decision makers — investors, corporate executives, investment fund managers, or members of the public—who need time-critical support for determining actions and strategies. Thus the financial publishing industry directly supports homeowners in choosing a mortgage, investors in choosing stocks, and corporate executives in providing the information they need to manage their organizations. Accuracy, legal validity, predictability, and timely publication are also crucial in financial services.

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The industry also is experiencing a growing demand for customized, personalized services. Financial institutions that can quickly create personalized knowledge products have a competitive advantage.

Information offered by the financial services industry tends to have the following characteristics:

1. Financial data tends to be very personal in nature. Customers of financial information are generally very particular about the exact types of information that they personally need.
2. Financial data must be accessible. Users must be able to find the information they need quickly.
3. Financial data must be accurate. Mistakes can lead to incorrect or misguided decision-making, with potentially dire results.

The financial services industry is very competitive. Since financial information is considered a commodity, many consumers seek out companies that can provide easy access to that information.

Example: A company without a Web portal is at a competitive disadvantage, since consumers of financial data now expect the option of obtaining their information from the Web.

Therefore, the business challenges facing the financial services industries include:

1. Providing personalized and customized on-demand information
2. Meeting competitive pressures to create new, distinctive, and high-value information products
3. Delivering accurate information that is current and readily available Solution requirements and components Solution requirements.

Financial services companies distribute large numbers of documents, each containing a high density of raw financial data that is extremely important for supporting financial-based decisions. Consumers of this information are often key decision-makers who need time-critical support for determining actions and strategies.

Example: The financial publishing industry directly supports homeowners in choosing a mortgage, investors in choosing stocks, and corporate CEOs in managing their organisations.

Financial services sector requires an infrastructure that supports the creation of accurate, legally valid documents in a predictable and timely manner. Finally, the financial services institutions that can quickly create customized financial products, reports and other personalized knowledge products have a competitive advantage over other financial services institutions.

10.6 Types of Financial Services

Out of the varied financial services that the financial market offers, the most important ones are discussed under:

Banking Services

The primary operations of banks include:

1. Keeping money safe while also allowing withdrawals when needed
2. Issuance of checkbooks so that bills can be paid and other kinds of payments can be delivered by post

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3. Provide personal loans, commercial loans, and mortgage loans (typically loans to purchase a home, property or business)
4. Issuance of credit cards and processing of credit card transactions and billing
5. Issuance of debit cards for use as a substitute for checks
6. Allow financial transactions at branches or by using Automatic Teller Machines (ATMs)
7. Provide wire transfers of funds and electronic fund transfers between banks
8. Facilitation of standing orders and direct debits, so payments for bills can be made automatically
9. Provide overdraft agreements for the temporary advancement of the bank's own money to meet monthly spending commitments of a customer in their current account
10. Provide charge card advances of the bank's own money for customers wishing to settle credit advances monthly.
11. Provide a check guaranteed by the bank itself and prepaid by the customer, such as a cashier's check or certified check
12. Notary service for financial and other documents.

Other Types of Bank Services

Private banking - Private Banks provide banking services exclusively to high net worth individuals. Many financial services firms require a person or family to have a certain minimum net worth to qualify for private banking services. Private banks often provide more personal services, such as wealth management and tax planning, than normal retail banks.

Capital market bank - bank that underwrite debt and equity, assist company deals (advisory services, underwriting and advisory fees), and restructure debt into structured finance products.

Bank cards - include both credit cards and debit cards. Bank of America is the largest issuer of bank cards.

Credit card machine services and networks - companies which provide credit card machine and payment networks call themselves "merchant card providers".

Foreign Exchange Services

Foreign exchange services are provided by many banks around the world. Foreign exchange services include:

Currency Exchange - where clients can purchase and sell foreign currency banknotes

Wire Transfer - where clients can send funds to international banks abroad

Foreign Currency Banking - banking transactions are done in foreign currency.

Investment Services

Asset management: The term usually given to describe companies which run collective investment funds.

Hedge fund management: Hedge funds often employ the services of "prime brokerage" divisions at major investment banks to execute their trades.

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Custody services: Custody services and securities processing is a kind of 'back-office' administration for financial services. Assets under custody in the world was estimated to $65 trillion at the end of 2004.

Insurance Services

Insurance brokerage: Insurance brokers shop for insurance (generally corporate property and casualty insurance) on behalf of customers. Recently a number of websites have been created to give consumers basic price comparisons for services such as insurance, causing controversy within the industry.

Insurance underwriting: Personal lines insurance underwriters actually underwrite insurance for individuals, a service still offered primarily through agents, insurance brokers, and stock brokers. Underwriters may also offer similar commercial lines of coverage for businesses. Activities include insurance and annuities, life insurance, retirement insurance, health insurance, and property & casualty insurance.

Reinsurance: Reinsurance is insurance sold to insurers themselves, to protect them from catastrophic losses.

Other Financial Services

Intermediation or advisory services: These services involve stock brokers (private client services) and discount brokers. Stock brokers assist investors in buying or selling shares.

Primarily internet-based companies are often referred to as discount brokerages, although many now have branch offices to assist clients. These brokerages primarily target individual investors. Full service and private client firms primarily assist execute trades and execute trades for clients with large amounts of capital to invest, such as large companies, wealthy individuals, and investment management funds.

Private equity: Private equity funds are typically closed-end funds, which usually take controlling equity stakes in businesses that are either private, or taken private once acquired. Private equity funds often use leveraged buyouts (LBOs) to acquire the firms in which they invest. The most successful private equity funds can generate returns significantly higher than provided by the equity markets.

Venture capital: Venture capital is a type of private equity capital typically provided by professional, outside investors to new, high-potential-growth companies in the interest of taking the company to an IPO or trade sale of the business.

Task List the main venture capitalists of India.

Angel investment: An angel investor or angel (known as a business angel or informal investor in Europe), is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity. A small but increasing number of angel investors organize themselves into angel groups or angel networks to share research and pool their investment capital.

Conglomerates: A financial services conglomerate is a financial services firm that is active in more than one sector of the financial services market e.g. life insurance, general insurance, health insurance, asset management, retail banking, wholesale banking, investment banking, etc. A key rationale for the existence of such businesses is the existence of diversification benefits

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that are present when different types of businesses are aggregated i.e. bad things don't always happen at the same time. As a consequence, economic capital for a conglomerate is usually substantially less than economic capital is for the sum of its parts.

Case Study

Services from NIIT

NIIT had to provide a solution for providing production support to a client who is a global leader in the field of Insurance and Financial services. The client organization provides solutions in the areas of Life, Defined Contribution/ Pension, Group Insurance, Annuity and Mutual Funds and had many type of customers that were associated with the above business lines, such as Participants, Sponsors, Producers, Brokers and TPAs.

To provide services to these customers around the Business lines, the company had a variety of IT Solutions, which were built on numerous technology platforms; ranging from mainframe, legacy systems to e-business solutions. In addition to these, it also had batch applications that enabled data communication between mainframe systems, other systems and the e-business solutions. All these business applications were real-time and mission-critical. Therefore, ensuring good health and 24*7 availability of these applications were of prime importance to the client.

The client also had a large team of dedicated professionals who supported the e-business applications for all operational issues including production. These professionals were drawn from the development team and were highly experienced, hence expensive. Therefore, the company was looking at ways to reduce production support costs and also free up these highly experienced resources to utilise them in new projects.

NIIT Solution: The IT environment within the organisation encompassed the following:

1. Web Applications
2. Web Services
3. Batch Applications
4. Utilities

The Production support activity was defined along two lines, including BA Support and Technical Support. While BA support comprised BA inbox, Librarian inbox, monitoring 24 × 7 services and data sync activity, Tech support included Monitoring production inboxes 24 × 7 × 365, raising issues by creating tickets and working through them to closure; coordinating with the application team, infrastructure team, and IMB helpdesk, fixing bugs, undertaking enhancements and suggesting measures for the improvement in production support processes.

NIIT Technologies proposed to be the client's production support partner, to care for all its production issues. NTL prepared a transition plan for the take-over of the work. To build customer confidence, the entire transitioning was planned as a three phase activity. The phases were defined as the KT Session, Shadowing and Take over. After the successful transitioning, NIIT Technologies started handling the entire operation independently and continues to do so till date. In the process, NIIT Technologies delivered complete customer satisfaction and met defined and agreed SLAs.

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Business Benefits

1. The client was able to reduce production support cost by 30-40 percent.
2. It was also able to free up its highly experienced resources for better utilisation.

Questions

1. What were the benefits that the client organization reaped out of the solution provided by NTL?
2. Do you suggest anything else than what NTL did?

Source: www.niit.com

10.7 Summary

- Financial services refer to services provided by the finance industry.
- The finance industry encompasses a broad range of organizations that deal with the management of money.
- Among these organizations are banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises.
- Financial services sector in India has been growing with time and technology.
- There are many financial innovations that have been done by various organizations in the field.

10.8 Keywords

Angel Investor: An angel investor is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.

Offer: A company's proposal for binding its market access and treatment levels.

Prudential: An objective of market regulation by financial authorities: to protect investors and depositors, to avoid instability or crises.

10.9 Self Assessment

Fill in the blanks:

1. A financial services ..... is a financial services firm that is active in more than one sector of the financial services market.
2. Private equity funds are typically....., which usually take controlling equity stakes in businesses that are either private, or taken private once acquired.
3. Primarily internet-based companies are often referred to as .....
4. ..... provide banking services exclusively to high net worth individuals.
5. ..... is the term usually given to describe companies which run collective investment funds.
6. ..... can be defined as the products and services offered by institutions like banks of various kinds for the facilitation of various financial transactions and other related activities.

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7. ..... is a type of private equity capital typically provided by professional, outside investors to new, high-potential-growth companies.
8. During the last decade, there has been a ..... and deepening of financial markets.
9. The entry of new players has led to even existing players ..... their product offerings and distribution channels.
10. A key issue that continues to impact the Indian financial sector adversely is that of ..... and consequent pressure on capital.
11. Several units that were set up in a ..... environment became unviable in the new paradigm of competition in the global market place.
12. ..... creates a long-overdue framework for resolving the distressed credit problem in India.
13. The increasing disintermediation in the corporate credit market and improving working capital efficiency of Indian corporates has led to ..... demand for credit from the corporate sector.
14. The financial sector needs to adopt a ..... business focus.
15. At the beginning, financial services ..... was embraced mostly by business heavyweights such as Goldman Sachs, Lehman Brothers.

10.10 Review Questions

1. Find out what are the main financial services that the commercial banks of India are engaged in, and enlist them one by one.
2. Which are the main private banks operating in India? What are their most important financial services?
3. What is advantage of a wide portfolio for companies offering financial services in economies like that of India?
4. What do you think remain to be the limitations of financial service sector in India?
5. Is there any difference in the financial services being offered by the developed economies and their counterparts at developing economies? If yes, discuss them in details.
6. Critically evaluate the functioning of financial services sector in India in past 5 years.
7. What are the main challenges in front of RBI to manage NPA issue?
8. Compare Indian NPA problems with those of East Asian countries and suggest methods to control the problems due to NPAs in India.
9. How has introduction of web technology changed the Indian scenario of financial services?
10. What advantages do you see by the other types of banking services?
11. Analyse the emerging trends in the services on offer by Indian financial market and make a report on it.

Answers: Self Assessment

1. conglomerate
2. closed-end funds
3. discount brokerages
4. Private Banks

Notes

5. Asset management
6. Financial services
7. Venture capital
8. broadening
9. upgrading
10. asset quality
11. protectionist
12. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act
13. lower
14. customer-centric
15. outsourcing

10.11 Further Readings

Books

Ian Whyte, Liz Croft, Ann Norton, *Management in the Financial Services Industry,* Financial World Publishing.

Radha Purswani, *Financial Market Innovations - Emerging Trends,* ICFAI.

Online links

www.fraserfinancial.com

www.savvion.com

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Unit 11: Leasing

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the meaning of leasing
- State the types of leasing
- Discuss financial, legal and tax aspects of leasing

Introduction

A lease is a contract conferring a right on one person (called a tenant or lessee) to possess property belonging to another person (called a landlord or lessor) to the exclusion of the owner landlord. It is a rental agreement between landlord and tenant. The relationship between the tenant and the landlord is called a tenancy, and the right to possession by the tenant is sometimes called a leasehold interest. A lease can be for a fixed period of time (called the term of the lease) but may be terminated sooner. The consideration for the lease is called rent or the rental.

11.1 Meaning of Leasing

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Notes

Under normal circumstances, an owner of property is at liberty to do what they want with their property, including destroy it or hand over possession of the property to a tenant. However, if the owner has surrendered possession to another (i.e. the tenant) then any interference with the quiet enjoyment of the property by the tenant in lawful possession is unlawful.

Caselet

Parsvnath offers ₹ 1,651 cr for Leasing Prime Rly Land

To develop 15.5-hectare plot in New Delhi's Sarai Rohilla.

Deal Details

Developer to pay amount over 5.5 years for 90-year lease

Required to use 4.5 hectare for building housing and other facilities for Railways.

Can use remaining land to build premium housing, commercial projects, hotels and civic facilities.

Parsvnath Developers has emerged the highest bidder for developing a 15.5-hectare plot of the Railways in a key area in the Capital, Sarai Rohilla.

It has offered to pay ₹ 1,651.51 crores to the Railways for a 90-year lease of the plot.

From the total plot, the developer is required to use 4.5 hectares for building housing and other facilities for the Railways. The company can use the remaining 11 hectares to build premium housing, commercial projects, hotels and civic facilities. Rail Land Development Authority (RLDA), the nodal agency that is implementing the project, received financial bids from two players on Thursday. The second bidder was Indiabulls Real Estate Ltd, which offered around ₹ 1,200 crores, said sources in the know.

The winning bidder has to pay up 20 per cent of the amount within the first three months of receiving the letter of acceptance, after which it has an 18-month moratorium period. The remaining amount has to be paid off over the next four years. In effect, the amount has to be paid in about five-and-a-half years.

"We have won the bid for ₹ 1651.51 crores," said Mr Pradeep Jain, Chairman, Parsvnath Developers. On how Parsvnath will fund the deal, Mr Jain said, "For the first two years, we already have a financial closure…We have FDI backing for this project. Private equity firm Red Fort Capital will partner with us."

In May 2008, RLDA had awarded the same plot to another firm ABW Infrastructure; but the project was cancelled after the company defaulted in making timely payments. ABW had won the bid for ₹ 1,026 crores. The company had to pay 50 per cent or ₹ 513 crores within the first month, and the remaining amount was to be paid-up within two years. In effect, the revised payment conditions in the tender are softer on the developer this time round.

"This is very aggressive pricing. It's good the market is gaining strength," said Mr Manish Aggarwal, Executive Director-Investment Services, Cushman and Wakefield, India. When contacted, Indiabulls official refused to comment on the bid.

Source: http://www.thehindubusinessline.in

11.2 Types of Leasing

A lease contract can be classified on various characteristics in following categories:

1. Finance Lease and Operating Lease

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2. Sales & Lease Back and Direct Lease
3. Single Investor and Leveraged Lease
4. Domestic and International Lease

Let us understand each of them one by one.

Finance Lease

A Finance lease is mainly an agreement for just financing the equipment/asset, through a lease agreement. The owner lessor transfers to lessee substantially all the risks and rewards incidental to the ownership of the assets (except for the title of the asset). In such leases, the lessor is only a financier and is usually not interested in the assets. These leases are also called "Full Payout Lease" as they enable a lessor to recover his investment in the lease and derive a profit. Finance lease are mainly done for such equipment/assets where its full useful/ economic life is normally utilized by one user - i.e. Ships, aircrafts, wagons etc.

Generally a finance lease agreement comes with an option to transfer of ownership to lessee at the end of the lease period.

Normally lease period is the major part of economic life of the asset.

Operating Lease

An operating lease is one in which the lessor does not transfer all risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The operating lease is normally for such assets which can be used by different users without major modification to it. The lessor provides all the services associated with the assets, and the rental includes charges for these services. The lessor is interested in ownership of asset/ equipment as it can be lent to various users, during its economic life.

Examples:
1. Earth moving equipments,
2. Mobile cranes,
3. Computers,
4. Automobiles, etc.

Sale and Lease Back

In this type of lease, the owner of an equipment/asset sells it to a leasing company (lessor) which leases it back to the owner (lessee).

Direct Lease

In direct lease, the lessee and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.

1. ***Bipartite lease:*** There are only two parties in this lease transaction, namely
   (a) Equipment supplier-cum-financer (lessor) and
   (b) Lessee.

   The lessor maintains the assets and if necessary, replace it with a similar equipment in working condition.

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2. ***Tripartite lease:*** In such lease there are three different parties

   (a) Equipment supplier

   (b) Lessor (financier) and

   (c) Lessee.

   In such leases sometimes the supplier ties up with financiers to provide financing to lessee, as he himself is not in position to do so.

Single Investor Lease

This is a bipartite lease in which the lessor is solely responsible for financing part. The funds arranged by the lessor (financier) have no recourse to the lessee.

Leveraged Lease

This is a different kind of tripartite lease in which the lessor arranges funds from another party linking the lease rentals with the arrangement of funds. In such lease, the equipment is part financed by a third party (normally through debt) and a part of lease rental is directly transferred to such lender towards the payment of interest and installment of principal.

Domestic Lease

A lease transaction is classified as domestic if all the parties to such agreement are domiciled in the same country.

International Lease

If the parties to a lease agreement domiciled in different countries, it is known as international lease. This lease can be further classified as:

1. Import lease and
2. Cross border lease.

Import Lease: In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country. The lessor imports the assets and leases it to the lessee.

Cross Border Lease: When the lessor and lessee are domiciled in different countries, it is known as cross border lease. The domicile of asset supplier is immaterial.

Notes The term of the lease may be fixed, periodic or of indefinite duration. If it is for a specified period of time, the term ends automatically when the period expires, and no notice needs to be given, in the absence of legal requirements.

The term's duration may be conditional, in which case it lasts until some specified event occurs, such as the death of a specified individual. A periodic tenancy is one which is renewed automatically, usually on a monthly or weekly basis. A tenancy at will lasts only as long as the parties wish it to, and be terminated without penalty by either party.

It is common for a lease to be extended on a "holding over" basis, which normally converts the tenancy to a periodic tenancy on a month by month basis.

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11.3 Financial Aspect

Lease financing enables the lessee to have finance for huge investments in land, building, plant & machinery etc., up to 100%, without requiring any immediate down payment.

Additional Sources of Funds: Leasing facilitates the acquisition of equipments/assets without necessary capital outlay and thus has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

Less costly: Leasing as a method of financing is a less costly method than other alternatives available.

Ownership preserved: Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long-term finance, e.g. equity or debentures, normally dilute the ownership of the promoters.

Avoids conditionality: Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on board etc.

Flexibility in structuring rental: The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor made that the lessee is bale to pays the rentals from the funds generated from operations.

Simplicity: A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation.

Tax Benefit: By suitable structuring of lease rentals a lot of tax advantages can be derived. If the lessee is in tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized faster to than in a case where it owned by the lessee, since depreciation is allowable at the prescribed rates.

Obsolescence risk is averted: In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with latest technology.

A lease agreement offers various advantages to lessor as well. Let us discuss those advantages one by one.

1. ***Full Security:*** The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset in case of default by the lessee.
2. ***Tax Benefit:*** The greatest advantage to the lessor is the tax relief by way of depreciation.
3. ***High Profitability:*** The leasing business is highly profitable, since the rate of return is more than what the lessor pays on his borrowings. Also the rate of return is more than in case of lending finance directly.
4. ***Trading on Equity:*** The lessor usually carry out their business with high financial leverage, depending more on debt fund rather equity.
5. ***High Growth potential:*** The leasing industry has a high growth potential. Lease financing enables the lessee to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital.

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11.4 Legal Aspect

As such there is no separate law regulating lease agreements, but it being a contract, the provisions of the Indian Contract Act, 1872 are applicable to all lease contracts. There are certain provisions of law of contract, which are specifically applicable to leasing transactions. Since lease also involves motor vehicles, provisions of the Motor Vehicles Act are also applicable to specific lease agreements. Lease agreements are also subject to Indian Stamp Act.

Let us discuss in short, the Indian Contract Act, 1872 related to leasing.

Contract: A contract is an agreement enforceable by law. The essential elements of a valid contract are – Legal obligation, lawful consideration, competent parties, free consent and not expressly declared void.

Discharge of Contracts: A contract me by discharged in following ways – By performance, by frustration (impossibility of performance), by mutual agreement, by operation of law and by remission.

Remedies for Breach of Contract: Non-performance of a contract constitutes a breach of contract. When a party to a contract has refused to perform or is disabled from performing his promise, the other party may put an end to the contract on account of breach by the other party. The remedies available to the aggrieved party are – Damages or compensations, specific performance, suit for injunction (restrain from doing an act), suit for Quantum Meruit (claim for value of the material used).

Provisions Related to Indemnity and Guarantee: The provisions contained in the Indian Contract Act, 1872 related to indemnity and guarantee are related to lease agreements. Main provisions are as under:

1. ***Indemnity:*** A contract of indemnity is one whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person.

   Example: A person executes an indemnity bond favoring the lessor thereby agreeing to indemnify him of the loss of rentals, cost and expenses that the lessor may be called upon to incur on account of lease of an asset to the lessee.

   The person who gives the indemnity is called the 'indemnifier' and the person for whose protection it is given is called the 'indemnity-holder' or 'indemnified'.

   In case of lease agreements, there is an implied contact of indemnity, where lessee will have to make good any loss caused to the asset by his conduct or by the act of any other person, during the lease term.

2. ***Guarantee:*** A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability third person in case of his default. A contract of guarantee involves three persons - 'surety' who gives guarantee, principal debtor and creditor. A contract of guarantee is a conditional promise by the surety that if the debtor defaults, he shall be liable to the creditor.

3. ***Bailment:*** The provisions of the law of contract relating to bailment are specifically applicable to leasing contracts. In fact, leasing agreement is primarily a bailment agreement, as the elements of the two types of transactions are similar.

   (a) There are minimum two parties to a bailment i.e. bailor who delivers the goods and bailee - to whom the goods delivered for use. The lessor and lessee in a lease contract bailor and bailee respectively.

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(b) There is delivery of possessions/transfer of goods from the bailor to the bailee. The ownership of the goods remains with the bailor.

(c) The goods in bailment should be transferred for a specific purpose under a contract.

(d) When the purpose is accomplished the goods are to be returned to the bailor or disposed off according to his directions.

Hence lease agreements are essentially a type of bailment.

Following are the main provisions related to lease.

1. ***Liabilities of lessee:*** A lessee is responsible to take reasonable of the leased assets. He should not make unauthorized use the assets. He should return the goods after purpose is accomplished. He should pay the lease rental when due and must insure and repair the goods.
2. ***Liabilities of lessor:*** A lessor is responsible for delivery of goods to lessee. He should take back the possession of goods when due. He must disclose all defects in the assets before leasing. He must ensure the fitness of goods for proper use.
3. ***Remedies to the lessor:*** The lessor can forfeit the assets and claim damages in case of breach by lessee. The lessor can repossession of the assets in case of any breach by the lessee.
4. ***Remedies to the lessee:*** Where the contract is repudiated for lessor's breach of any obligation, the lessee may claim damages less resulting from termination. The measure of damages is increased lease rentals (if any) the lessee has to pay on lease other asset, plus the damages for depriving him from the of the leased asset from the date of termination of the date expiry of lease term.
5. ***Lease of a leased asset:*** The lessee must not do any act, which is not consistent with the terms of the lease agreement. Lease agreements, generally, expressly exclude the right to sublease the leased asset. Thus, one should not sub-lease the leased assets, unless the lease agreement expressly provides.
6. ***Effect of sub-lease:*** The effect of a valid sub-lease is that the sub-lease becomes a lease of the original lessor as well. The sublease and the original lessor have the same right and obligations against each other as between any lessee and lessor.
7. ***Effect of termination of main lease:*** A right to sub-lease restricted to the operation of the main lease agreement. Thus, termination of the main lease will automatically terminate the sub-lease. This may create complications for sub-lessee.

So far we have discussed the main provisions related to the Indian Contract Act, 1872. Now let us discuss the other laws related to leasing.

1. ***Motor Vehicles Act:*** Under this act, the lessor is regarded as dealer and although the legal ownership vests in the lessor, the lessee is regarded owner as the owner for purposes or registration of the vehicle under the Act and so on. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is treated as financier.
2. ***Indian Stamp Act:*** The Act requires payment of stamp duty on all instruments/documents creating a right/liability in monetary terms. The contracts for equipment leasing are subject to stamp duty, which varies from state to state.
3. ***RBI NBFCs Directions:*** RBI Controls mainly working of Leasing Finance Companies. It does, not in any manner, interfere with the leasing activity.

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Lease Documentation and Agreement

A lease transaction involves a lot of formalities and various documents. The lease agreements have to be properly documented to formalize the deal between the parties and to bind them. Documentation is necessary to overcome any sort of confusion in future. It is also legally required, since it involves payment of stamp duty. Without proper documentation, it will be very difficult to prove your claim in competent court, in case of any dispute.

The essential requirements of documentation of lease agreements are that the person(s) executing the document should have the legal capacity to do so; the documents should be in prescribed format; should be properly stamped, witnessed and the duly executed and stamped documents should be registered, where necessary with appropriate authority.

Now, let us discuss in short, the formalities required.

To, take a decision whether to finance a lease or lease an asset, the lessor/financier requires a lot of commercial document of the lessee e.g. balance sheet for last 3 years, MOA & AOA, copies of board resolution etc. After taking a decision to lease/finance the asset, a lease agreement is created. The lease agreement specifies legal rights and obligations of the lessor and lessee. Usually a maser lease agreement is signed which stipulates all the conditions that govern the lease. This sets out the qualitative terms in the main part of the document while the equipment details, credit limits, rental profile and other details are provided in the attached schedules.

To simplify the process of executing and integrating the specific lease arrangement, the master lease agreement provides that:

1. The lease of equipment is governed by the provisions of the master lease agreement;
2. The details of the leased equipment shall be communicated to by the lessor to the lessee; and
3. The lessee's consent and confirm that the details to be provided by the lessor shall be final and binding on the lessee.

Clauses in Lease Agreement: There is no standard lease agreement, the contents differ from case to case. Yet a typical lease agreement shall contain following clauses:

1. ***Nature of lease:*** This clause specifies whether the lease is an operating lease, a financial lease or a leveraged lease. It also specifies that the lessor agrees to lease the equipment to the lessee and the lessee agrees to take on lease from the lessor subject to terms of the lease agreement, the leased asset.
2. Description of equipment.
3. Delivery and re-delivery of asset.
4. Lease period and lease rentals.
5. Uses of assets allowed.
6. ***Title:*** Identification and ownership of equipment.
7. Repairs and maintenance.
8. Alteration and improvements.
9. ***Possession:*** must detail - charges, liens and any other encumbrances.
10. Taxes and charges.
11. Indemnity clause.

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12. Inspection by lessor.
13. ***Sub-leasing:*** prohibition or allowed.
14. Events of defaults and remedies.
15. Applicable law, jurisdiction and settlement.

Apart from the main/master lease agreement the attachments consists of:

1. Guarantee agreement
2. Promissory note
3. Receipt of goods
4. Power of attorney
5. Collateral security and hypothecation agreement.

Case Study

Cos turn to Need-based Leasing of Commercial Space

Many firms going in for quarter-to-quarter short-term approach.

'Gaining ground'

IT, ITES account for nearly 80 per cent of commercial office space

Potential tenants are looking at a 6-12 month projection for renting space

Need-based leasing of IT space seems to be 'gaining ground' in commercial real estate. For the last few years, IT firms had been maintaining a healthy bench and going aggressive on hiring. This, in turn, meant taking a two-three year view of space requirement, and accordingly inking specific clauses or options with developers to book upcoming space based on business projections.

Real estate consultants now say that with global financial crisis clouding long-term business plans and decision-making, many infotech companies and corporates are favouring a need-based leasing of space or, at best, are taking a one-year view.

"Many companies, including IT firms, are starting to looking at a quarter-to-quarter approach rather than taking a 12-24 month view they would take earlier. Unless these companies get fresh commitment in the form of long-term IT contracts with their clients, I expect them to start taking up space based on the actual requirement," Mr Anuj Puri, Chairman and Country Head, Jones Lang LaSalle Meghraj, said.

Hard & Soft Clauses

Large tenants, he said, would earlier keep 'hard' and 'soft' clauses, with the former being definitive agreements to take up space, and the latter more of an option for leasing space over a slightly longer timeframe. "The soft options are out of favour in these extraordinary times," he pointed out.

A senior official of a large Delhi-based real estate company agreed that potential tenants were looking at a one-year projection when it came to renting space. "It is definitely a more short-term view, and it is logical given the current scenario. The impact of this on real estate developers is not monetary, but more in terms of a reduced visibility in space

Contd...

Notes

demand. It is now more about taking a call on future requirement…There is always a risk that one may be left with vacant space," the official said.

At present, IT and ITES account for nearly 80 per cent of commercial office space.

Reserve Space

"Clients are certainly not seeing that far ahead (two-three years) and are focusing on the 6-12 month business plans. As a result, long-term pre-commitments and soft options are on a decline. Also the window on reserve space option (space that is kept-off the market and offered as option to corporates to take up within a specific timeframe) has come down drastically," says Mr Kaustuv Roy, Director, Tenant Strategies & Solutions at Cushman & Wakefield.

Echoing a similar view, Mr Lakshmi Narayanan, President and CEO of Bangalore-based Real Estate Bank India (REBI), said the outer limit of projection that infotech companies are now willing to take is one year.

Question

Need-based leasing of IT space seems to be 'gaining ground' in commercial real estate. Discuss.

Source: http://www.hinduonnet.com

11.5 Tax Aspect

Unfortunately, the tax benefits which leasing companies enjoy in the developed countries are not available to the Indian leasing companies. Tax benefits arising out of depreciation, investment allowance of deposit scheme, etc., are not conducive to the growth and promotion of leasing companies. Investment allowance (u/s 32A) was abolished from 1st April 1987, and in its place an investment deposit scheme (u/s 32 AB) has been introduced. Under this scheme, the amount of deduction is limited to 20 per cent of the profit of eligible business or profession as per the audited accounts. However, this scheme excludes certain categories of leasing. The latest position is that even this has been abolished as announced in the budget of 1990-91.

In addition to the above, the Finance Act, 1987, had introduced Section 115J of Income-tax Act, 1961 which provided for a minimum tax of 30 per cent on the book profits of a company. The leasing companies brought within the orbit of this new tax provision faced uneasiness; now this has been abolished, as announced in the budget 1990-91.

Sales Tax Problems

Leasing companies are also facing the problems of sales tax. The 46th Amendment to the Indian Constitution, which came into force from February 1983, has empowered the State governments to levy sales tax on the transfer of rights or to the use of any goods for valuable consideration. As a result, the legal position of finance lease is a "deemed sale" under the State Sales Tax Act. The governments of Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Tamil Nadu, and West Bengal have already amended their sales tax Acts in accordance with the 46th amendment to the Constitution. Hence, leasing companies are required to pay sales tax at higher rates on a lease transaction as they are not being allowed to use 'G' forms. This makes leasing more expensive, as the cost of the asset acquired under lease finance gets enhanced to the extent of sales tax paid by the leasing companies. This is bound to cripple the leasing industry, which is still in the nascent stage. In view of the burden created by sales tax, the Central Government should take immediate steps and formulate guidelines,

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ensuring uniform legislation among various States. It should ensure uniformity in the scope and contents of the sales tax. The facility of using 'G' should also be extended to leasing companies.

Prabhu, Chairman, Canara Bank in his chairman's speech in June 1989 remarked that there were certain avoidable constraints restraining the lease finance from becoming a major source of corporate finance. The levy of sales tax on rentals by many State governments makes leasing unattractive. The benefits of lease finance, in terms of accelerated modernisation and industrial growth, are to that extent adversely affected. Yet another problem is in obtaining approval for issue of 'C' Forms by lessors under the Central Sales Tax.

It is noticed from the analysis of the questionnaire responses that 100 per cent of the respondents suggested that Section 115J of the Income-tax Act, 1961, and sales tax on lease rentals should be abolished with immediate effect. About three fourths of the respondents expressed that the investment allowance and investment deposit scheme should be extended to the leasing companies. The leasing companies would feel relieved since Section 115 has been scrapped.

Rigid Procedure for Import Leasing

In India, leasing industry has high potential in areas like import leasing or international leasing. Recently, a few leasing companies entered the arena of import leasing. The Import and Export Policy for 1985-88 has laid down the following eligibility criteria for leasing companies to do import leasing.

The memorandum and articles of association of the leasing company must specifically provide for leasing as one of the objectives. The leasing company must have a minimum paid-up share capital and reserves of ₹1 crores. The share of leasing company must be listed in a recognized stock exchange. Thus, leasing of imported equipment has been restricted a meagre part of the industry. A number of respondents indicated the problems of import leasing and made the following suggestions:

1. Import of OGL items to be permitted without approval the Joint Chief Controller of Imports and Exports (JCCI & E).
2. The Chief Controller of Imports and Exports (CCI&E) has to reduce the period for giving permission for import leasing.

11.6 Summary

- Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments.
- Under normal circumstances, an owner of property is at liberty to do what they want with their property.
- However, if the owner has surrendered possession to another (i.e. the tenant) then any interference with the quiet enjoyment of the property by the tenant in lawful possession is unlawful.
- A lease contract can be classified on various characteristics in many categories like Finance Lease and Operating Lease; Sales & Lease back and Direct Lease; Single investor and Leveraged lease and Domestic and International lease.
- There are many financial, legal and tax related aspects of leasing.
- Financially, leasing is more advantageous than harmful.

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- But in India, the tax benefits given to the leasing companies are not substantially as good as their counterparts in developed economies.

11.7 Keywords

A contract of Indemnity: A contract whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person.

Contract: A contract is an agreement enforceable by law.

Lease: Lease is a contract conferring a right on one person (called a tenant or lessee) to possess property belonging to another person (called a landlord or lessor) to the exclusion of the owner landlord.

11.8 Self Assessment

Fill in the blanks:

1. The 46th Amendment to the Indian Constitution, has empowered the State Governments to levy sales tax on the ..... of rights.
2. The tax benefits which leasing companies enjoy in the developed countries are ..... to the Indian leasing companies.
3. To, take a decision whether to finance a lease or lease an asset, the lessor/financier requires a lot of commercial document of the .....
4. The provisions of the ..... relating to bailment are specifically applicable to leasing contracts.
5. In an import lease, the lessor and the lessee are domiciled in the ..... country.
6. A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability third person in case of his ..... .
7. A lease can be for a fixed period of time but may be terminated ..... .
8. The ..... is the receiver of the services or the assets under the lease contract.
9. A Finance lease is mainly an agreement for just financing the ....., through a lease agreement.
10. An ..... lease is one in which the lessor does not transfer all risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period.
11. In ..... type of lease, the owner of an equipment/asset sells it to a leasing company which leases it back to the owner.
12. In ..... lease, the lessee and the owner of the equipment are two different entities.
13. In Tripartite lease there are three different parties, viz. ....., ... and ..... .
14. Single investor lease is a bipartite lease in which the ..... is solely responsible for financing part.
15. A lease transaction is classified as ..... if all the parties to such agreement are domiciled in the same country.

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11.9 Review Questions

1. Analyse the regulatory authority that the RBI has been able to exercise over the leasing companies operating in India for last 5 years.
2. Why do you think has the govt. of India fixed a rigid procedure for import leasing?
3. Present a comparative analysis of the tax benefits that the leasing companies have in developed countries and their counterparts have here in India.
4. Is there any flaw in the provisions related to indemnity and guarantee? Support your argument with reasons.
5. Which is the most common type of lease that you generally witness across and which is the rarest? What do you think to be the reasons behind them?
6. Is the rigid leasing system in India beneficial or not for the industry in general? Analyse and give reasons for your answer.
7. Examine the problems of sales tax that are being witnessed by the lasing companies in India.
8. Suggest methods to simplify the process of executing and integrating the specific lease arrangement.
9. The termination of the main lease will automatically terminate the sub-lease, which may create complications for sub-lessee. Which complications do you think may arise?
10. Examine the legal aspect with respect to the leasing companies in India.
11. Analyse the advantages of various types of lease under practice in India.

Answers: Self Assessment

1.	transfer	2.	unavailable
3.	lessee	4.	law of contract
5.	same	6.	default
7.	sooner	8.	lessee
9.	equipment/asset	10.	operating
11.	Sale and Lease Back	12.	direct
13.	Equipment supplier, Lessor, Lessee	14.	lessor
15.	domestic		

11.10 Further Readings

Books

Charles W.L. Hill, *International Business,* Tata McGraw Hill Co. Ltd., New Delhi

Thakur, Burton & Srivastava, *International Management,* Tata McGraw Hill Co. Ltd., New Delhi

Sharan V., *International Financial Management,* Prentice Hall of India, New Delhi

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Online links

www.fraserfinancial.com

www.savvion.com

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Unit 12: Hire Purchasing

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the concept of hire purchase
- Discuss legal framework
- Describe taxation of hire purchase

Introduction

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed an option to purchase the goods by paying all the installments. Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of the last installment.

12.1 Concept

A hire purchase agreement is defined in the Hire Purchase Act, 1972 as peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations:

1. Payments to be made in installments over a specified period.
2. The possession is delivered to the hirer at the time of entering into the contract.
3. The property in goods passes to the hirer on payment of the last installment.
4. Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods.

5. The hirer/purchase is free to return the goods without being required to pay any further installments falling due after the return.

Features of Hire Purchase Agreement

1. Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
2. Each installment is treated as hire charges.
3. The ownership of the goods passes from the seller to the buyer on the payment of the last installment.
4. In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charges.
5. The hirer has the right to terminate the agreement any time before the property passes. That is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charges on the goods in question.

Task

What are biggest advantages of hire-purchase agreements? List them in order of importance.

12.2 Legal Framework

There is no exclusive legislation dealing with hire purchase transaction in India. The Hire Purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far. The provisions of the Act are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

1. The format/contents of the hire-purchase agreement,
2. Warrants and the conditions underlying the hire-purchase agreement,
3. Ceiling on hire-purchase charges,
4. Rights and obligations of the hirer and the owner.

In absence of any specific law, the hire purchase transactions are governed by the provisions of the Indian Contract Act and the Sale of Goods Act. Let us discuss the provisions of Sale of Goods Act.

In a contract of hire purchase, the element of sale is inherent as the hirer always has the option to purchase the movable asset by making regular payment of hire charges and the property in the goods passes to him on payment of the last installment. So in this context we will discuss the provisions of Sales of Goods Act, which apply to hire purchase contract.

Contract of Sale of Goods: A contract of sales of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. It includes both an actual sale and an agreement to sell.

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Essential Ingredients of a Sale: A contract of sale is constituted of following elements:

1. ***Two parties*** namely the buyer and the seller, both competent to contract to effectuate the sale.
2. ***Goods:*** The subject matter of the contract.
3. ***Money consideration:*** price of the goods.
4. ***Transfer of ownership*** of the general property in goods from the seller to the buyer.
5. Essentials of a valid contract under the Indian Contract Act.

Sale and Agreement to Sell

The distinction between an agreement to sell and a sale is fundamental. The former is a contract pure and simple. At the time of the contract the property in the goods does not pass, but the buyer acquires a right in person to the transfer of the property upon the happening of an event or the fulfilment of a condition. A sale on the other hand is more than a contract. Its effect is to transfer to the buyer forthwith a right in the property in the goods. Under an agreement to sell the seller remains the owner until the agreement to sell becomes a sale, under a sale the buyer becomes the owner forthwith. In details:

1. A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. There may be a contract of sale between one part-owner and another.
2. A contract of sale may be absolute or conditional.
3. Where under a contract of sale the property in the goods in transferred from the seller to the buyer, the contract is called a sale, but where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell.
4. An agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred.

Example:

1. ***Contract for the Sale of Goods***

   Paragraph 1. ……, hereinafter referred to as Seller, and ……, hereinafter referred to as Buyer, hereby agree on this …… day of ……., in the year ……., to the following terms.

   A. *Identities of the Parties*

   Paragraph 2. Seller, whose business address is ……., in the city of ……, state of ……, is in the business of …….. Buyer, whose business address is ……., in the city of ……., state of ……., is in the business of …… .

   B. *Description of the Goods*

   Paragraph 3. Seller agrees to transfer and deliver to Buyer, on or before ……. [date], the below-described goods:

   .....

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C. *Buyer's Rights and Obligations*

Paragraph 4. Buyer agrees to accept the goods and pay for them according to the terms further set out below.

Paragraph 5. Buyer agrees to pay for the goods:

(i) In full upon receipt

(ii) In installments, as billed by Seller, and subject to the separate installment sale contract of ……. [date] between Seller and Buyer.

(iii) Half upon receipt, with the remainder due within 30 days of delivery.

Paragraph 6. Goods are deemed received by Buyer upon delivery to Buyer's address as set forth above.

Paragraph 7. Buyer has the right to examine the goods upon receipt and has …… days in which to notify seller of any claim for damages based on the condition, grade, quality or quality of the goods. Such notice must specify in detail the particulars of the claim. Failure to provide such notice within the requisite time period constitutes irrevocable acceptance of the goods.

D. *Seller's Obligations*

Paragraph 8. Until received by Buyer, all risk of loss to the above-described goods is borne by Seller.

Paragraph 9. Seller warrants that the goods are free from any and all security interests, liens, and encumbrances.

E. *Attestation*

Paragraph 10. Agreed to this …… day of ……., in the year ……

By: ……. Official Title: …….

On behalf of …….……., Seller

I certify that I am authorized to act and sign on behalf of Seller and that Seller is bound by my actions. ……. [initial]

By: ……. Official Title: …….

On behalf of ……., Buyer

I certify that I am authorized to act and sign on behalf of Buyer and that Buyer is bound by my actions. ……. [initial]

[NOTARY STAMP HERE]

…….

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Example:

…….

Agreement to Sell

This AGREEMENT TO SELL is executed at New Delhi, on this ……. day of ……. by and between;

Sh. ……. S/o ……. R/o ……. hereinafter called "THE FIRST PARTY".

IN FAVOUR OF

Sh. ……. S/o ……. R/o ……., hereinafter called "THE SECOND PARTY".

The expression of the terms the 'FIRST PARTY' and the 'SECOND PARTY' wherever they occur in the body of this Agreement to Sell, shall mean and include them, their legal heirs, successors, legal representatives, administrators, executors, transferee(s), beneficiary(ies), legatee(s), probatee(s), nominees and assignee(s).

AND WHEREAS the FIRST PARTY for his bonafide needs and requirements have agreed to sell, convey, transfer and assign to the SECOND PARTY and the SECOND PARTY has agreed to purchase the along with proportionate, undivided, indivisible and impartible ownership rights in the said freehold land underneath the said building measuring ……. square yards, bearing No. ……., situated at ……., with all rights, title and interest, easements, privileges and appurtenances thereto, with all fittings, fixtures, electricity and water connections, structure standing thereon, with all rights in common driveway, entrances, passages, staircase and other common facilities and amenities provided therein, hereinafter referred to as "THE SAID PORTION OF THE SAID PROPERTY" for a total sale consideration of ₹. ……. (Rupees ……. …….).

NOW THIS AGREEMENT TO SELL WITNESSETH AS UNDER:

That in consideration of the sum of ₹. ……/- (Rupees …….), out of which a sum of ₹. ……/- (Rupees …….), as advance money has been received by the FIRST PARTY from the SECOND PARTY, in the following manner; the receipt of which the FIRST PARTY hereby admits and acknowledges and the remaining balance sum of ₹. ;/- (Rupees …….), will be received by the FIRST PARTY from the SECOND PARTY, at the time of registration of the Sale Deed, the FIRST PARTY do hereby agree to grant, convey, sell, transfer and assign all his rights, titles and interests in the said portion of the said property, fully described above, together with proportionate undivided, indivisible and impartible ownership rights in the freehold land underneath the said building to the SECOND PARTY, on the terms and conditions herein contained provided that nothing herein stated shall confer or deemed to have conferred upon the SECOND PARTY exclusively any right or title to the common driveway, passages, staircase, overhead water tanks, sewers, water meters and other common facilities to the exclusion of the FIRST PARTY and or the SECOND PARTY or owners or occupants of the other units of the said building.

Notes

That the actual physical vacant possession of the said portion of the said property will be delivered by the FIRST PARTY to the SECOND PARTY, at the time of the registration of the Sale Deed, after receiving the full consideration.

That on or before ……., the FIRST PARTY will execute and get the Sale Deed of the said portion of the said property registered, in favour of the SECOND PARTY or his nominee/s, on receipt of the full and final balance amount, failing which either party shall be entitled to get the Sale Deed registered through the court of law by SPECIFIC PERFORMANCE OF THE CONTRACT, at the cost and expenses of the defaulting party.

That the FIRST PARTY hereby assures the SECOND PARTY that the FIRST PARTY has neither done nor been party to any act whereby the FIRST PARTY's rights and title to the said portion of the said property may in any way be impaired or whereby the FIRST PARTY may be prevented from transferring the said portion of the said property.

That the FIRST PARTY hereby declares and represents that the said portion of the said property is not subject matter of any HUF and that no part of the said portion of the said property is owned by any minor.

That the FIRST PARTY assures the SECOND PARTY that the said portion of the said property is free from all kinds of encumbrances such as prior Sale, Gift, Mortgage, Will, Trust, Exchange, Lease, legal flaw, claims, prior Agreement to Sell, Loan, Surety, Security, lien, court injunction, litigation, stay order, notices, charges, family or religious dispute, acquisition, attachment in the decree of any court, hypothecation, Income Tax or Wealth Tax attachment or any other registered or unregistered encumbrances whatsoever, and if it is ever proved otherwise, or if the whole or any part of the said portion of the said property is ever taken away or goes out from the possession of the SECOND PARTY on account of any legal defect in the ownership and title of the FIRST PARTY then the FIRST PARTY will be liable and responsible to make good the loss suffered by the SECOND PARTY and keep the SECOND PARTY saved, harmless and indemnified against all such losses and damages suffered by the SECOND PARTY.

That the house tax, water and electricity charges and other dues and demands if any payable in respect of the said portion of the said property shall be paid by the FIRST PARTY up to the date of handing over the possession and thereafter the SECOND PARTY will be responsible for the payment of the same.

That no common parts of the building shall be used by the SECOND PARTY or other owners/ occupants of the said building for keeping/chaining pets, dogs, birds or for storage of cycles, motor cycles nor the common passage shall be blocked in any manner.

That the proportionate common maintenance charges will be paid by all the occupants/owners of the said building in proportion of the area occupied by them.

That the SECOND PARTY shall have full right of access through staircase to the top terrace at all reasonable times to get the overhead tank repaired/cleaned etc. and to install T.V. Antenna.

That the SECOND PARTY shall have, as a matter of right, right to use all entrances, passages, staircases and other common facilities as are available in the said building.

That a separate electric meter and water meter have been provided in the said building for the exclusive use of the owner(s)/occupants of the said portion of the said property.

That in the event of the building being damaged or not remaining in existence on any account whatsoever then the SECOND PARTY shall have the proportionate rights in the land alongwith other owners of the building and shall have the right to raise construction in proportion to the one as now being sold conveyed and being transferred under this Agreement to Sell.

Notes

That the SECOND PARTY have full right to nominate or assign this Agreement to Sell in favour of any person or persons, be it a firm, body corporate or association of person and the FIRST PARTY shall have no objection to it.

That pending completion of the sale, the FIRST PARTY neither shall enter into any agreement of sale in respect of the said property or any part thereof nor shall create any charges, mortgage, lien or any arrangement, in respect of the said property in any manner whatsoever.

That the photostat copies of all relevant documents in respect of the said property have been delivered by the FIRST PARTY to the SECOND PARTY.

That all the expenses of the Sale Deed viz. Stamp Duty, Registration charges, etc. shall be borne and paid by the SECOND PARTY.

That this transaction has taken place at New Delhi. As such, Delhi Courts shall have exclusive jurisdiction to entertain any dispute arising out of or in any way touching or concerning this Deed.

IN WITNESS WHEREOF, the FIRST PARTY and the SECOND PARTY have signed this AGREEMENT TO SELL at New Delhi, on the date first mentioned above in the presence of the following witnesses.

WITNESSES:

1. FIRST PARTY.
2. SECOND PARTY.

……..

Sales v/s Bailment: In a sales, there is a conveyance of property in goods from seller to the buyer for a price and the buyer becomes the owner of goods and can deal with them in the manner he likes. In case of leasing there is a mere transfer of possession of goods from the bailor to the bailee.

Sales v/s Mortgage, Pledge and Hypothecation: The essence of contract of a sale is the transfer of general property in the goods. A mortgage is a transfer of interest in the goods from a mortgagor to mortgagee to secure a debt. A pledge is a bailment of goods by one person to another to secure payment of a debt. A hypothecation is an equitable charge on goods without possession, but not amounting to mortgage. The essence and purpose of these contract is to secure a debt. All the three differ from sale, since the ownership in the goods is not transferred which is an essential condition of sale.

Sale v/s Hire Purchase: A hire purchase agreement is a kind of bailment whereby the owner of the goods lets them on hire to another person called hirer, on payment of certain stipulated periodical payments as hire charges or rent. If the hirer makes payments regularly, he gets an option to purchase the goods on making the full payment. Before this option is exercised, the hirer may return the goods without any obligation to pay the balance rent. The hirer is however, under no compulsion to exercise the option and purchase the goods at the end of the agreement period.

A hire purchase contract, therefore, differs from sale in the sense that:

1. In a hire purchase the possession of the goods is with the hirer while the ownership vests with the original owner.
2. There is no agreement to buy but only an option is given to hirer to buy the goods under certain conditions, and
3. The ownership in the goods passes to the hirer when he exercises his option by making the full payment.

Notes

Case Study

Case 1: Balfour vs. Balfour

Balfour v Balfour [1919] 2 KB 571 is a leading English contract law case. It held that there is a rebuttable presumption against an intention to create a legally enforceable agreement when the agreement is domestic in nature.

Mr Balfour was a civil engineer, and worked for the Government as the Director of Irrigation in Ceylon (now Sri Lanka). Mrs Balfour was living with him. In 1915, they both came back to England during Mr Balfour's leave. But Mrs Balfour got rheumatic arthritis. Her doctor advised her to stay, because a jungle climate was not conducive to her health. As Mr Balfour's boat was about to set sail, he promised her £30 a month until she came back to Ceylon. They drifted apart, and Mr Balfour wrote saying it was better that they remain apart. In March 1918, Mrs Balfour sued him to keep up with the monthly £30 payments. In July she got a decree nisi and in December she obtained an order for alimony.

At first instance, Sargant J held that Mr Balfour was under an obligation to support his wife. Under the judgement, the Court of Appeal unanimously held that there was no enforceable agreement, although the depth of their reasoning differed.

Question

Why do you think did the court did not take the promise as a contract between two parties?

Case Study

Case 2: Merritt vs. Merritt

Merritt v Merritt [1970] 1 WLR 1211 is again, an English contract law case, on the matter of creation legal relations. Whilst under the principles laid out in Balfour v Balfour, domestic agreements between spouses are rarely legally enforceable, this principle was rebutted where two spouses who formed an agreement over their matrimonial home were not on good terms.

Mr Merritt and his wife jointly owned a house. Mr Merritt left to live with another woman. They made an agreement (signed) that Mr Merritt would pay Mrs Merritt a monthly sum, and eventually transfer the house to her, if Mrs Merritt kept up the monthly mortgage payments. When the mortgage was payed Mr Merritt refused to transfer the house.

In this case, the nature of the dealings, and the fact that the Merritt's were separated when the signed the contract, allowed the court to assume that this was more than a domestic arrangement.

Questions

1. How is this case different than that of Balfour vs. Balfour?
2. Why did the court held the contract to be one with legal binding?

Source: en.wikipedia.org

Notes

Goods: The subject matter of a contract of sale is the 'goods'. 'Goods' mean every kind of movable property excluding money and auctionable claims. Besides, growing crops, standing trees and other things attached to or forming part of land, also fall in the meaning of goods, provided these are agreed to be severed from land before sale or under the contract of sale.

Further, stocks, shares, bonds, goodwill, patent, copyright, trademarks, water, gas, electricity, ships and so on are all regarded as goods.

Destruction of goods before making of contract: Where in a contract for sale of specific goods, at the time of making the contract, the goods, without knowledge of the seller, have perished or become so damaged as no longer to answer to their description in the contract, the contract is null and void. This rule, however, does not apply in case of unascertained goods.

Destruction of goods after the agreement to sell but before sale: Where in an agreement to sell specific goods, if the goods without any fault on the part of the seller, have perished or become so damaged as no longer answer to their description in the agreement, the agreement becomes void, provided the ownership has not passed to the buyer. If the title to the goods has already passed to the buyer he must pay for the goods though the same cannot be delivered.

Document of title to goods: A document of title to goods is one which entitles and enables its rightful holder to deal with the goods represented by it, as if he were the owner. It is used in the ordinary course of business as proof of ownership, possession or control of goods, e.g. cash memo, bill of lading, dock warrant, warehouse keeper's or wharfingers certificate, lorry receipt, railway receipt and delivery order.

Price: The price means the money consideration for transfer of property in goods from the seller to the buyer. The price may be ascertained in any of the following modes:

1. The price may be expressly stated in the contact.
2. The price may be left to be fixed in manner provided in the contract.
3. Where the price is neither expressed in the contract nor there is any provision for its determination, it may be ascertained by the course of dealings between the parties.
4. It may be a 'reasonable price'.
5. It may be agreed to be fixed by 'third party valuation'.

The most usual mode is however, by expressly providing price in the contract.

EM or security deposit: In certain contract the buyer pays an amount in advance as earnest money deposit or as a security deposit, for the due performance on his part of the contract.

Though the amount of earnest money is adjustable towards the price of the goods, it differs from the price in the sense that while payment towards the prices is recoverable, EM is liable to be forfeited if the buyer fails to perform his part and the contract goes off.

Doctrine of caveat emptor (Let the buyer beware): If the buyer relies on his own skill and judgment and takes the risk of the suitability of the goods for his purpose, it is no part of the seller's obligation to caution the buyer of the defects in the goods or to give to the buyer an article suitable for his purpose.

If the buyer relies on his own skill and judgment and the goods turn out to be defective, he cannot hold the seller responsible for the same. This is known as the 'doctrine of caveat emptor' or 'let the buyer beware'. This applies to all sale contracts invariably, except in following cases:

1. When the buyer makes known to the seller the particular purpose for which he requires the goods and relies on the seller's skill and judgment.

Notes

2. When the goods are sold by description by a manufacturer or seller who deals in goods of that description, the seller is bound to deliver the goods of merchantable quality.
3. When the purpose for which the goods are purchased is implied from the conduct of the parties or from the nature or description of the goods, the condition of quality or fitness for that particular purpose is annexed by the usage of trade.
4. When the seller either fraudulently misrepresents or actively conceals the latent defects.

Transfer of property in goods: The property in goods is said to be transferred from the seller to the buyer when the latter acquires the proprietary rights over the goods and the obligations linked thereto. The transfer of property in goods is the essence of a contract of sale.

The moment when the property in goods passes from the seller to the buyer is significant from the point that risks associated with the goods follow the ownership, irrespective of the delivery. If the goods are damaged or destroyed, the loss is borne by the person who is the owner of the goods at the time of damage or destruction. The two essential requirements for transfer of property in the goods are:

1. Goods must be ascertained and
2. The parties must intend to pass the property in the goods.

Performance of a sale contract: Performance of a sale contract implies, as regards the seller to deliver the goods, and as regards the buyer to accept the delivery and make payment for them, in accordance with the terms of the contract. Unless there is a contract to the contrary, delivery of the goods and payment of the price are concurrent conditions and are to be performed simultaneously.

Delivery of goods: 'Delivery' means 'voluntary transfer of possession of goods from one person to another'. Delivery may be (a) actual (b) symbolic or (c) constructive.

Delivery is said to be actual when the goods are handed over physically. A symbolic delivery takes place where the goods are bulky and incapable of actual delivery.

Example: A car is delivered by handing over the keys to the buyer.

A constructive delivery is a delivery by attornment which takes place when the person in possession of the goods acknowledges that he holds the goods on behalf and at the disposal of the other person.

Acceptance of delivery: The buyer is said to have accepted the goods, when he signifies his assent that he has received the goods under, and in performance of the contract of sale. A buyer cannot reject the goods after he has accepted them. A buyer is deemed to have accepted the goods, when:

1. He intimates to the seller, his acceptance, or
2. He retains the goods, beyond a reasonable time, without intimating to the seller that he has rejected them, or
3. He does any act in relation to the goods which is consistent with the ownership of the seller.

Hire Purchase Agreement

A hire purchase agreement is in many ways similar to a lease agreement, in so far as the terms and conditions are concerned.

Notes

The important clauses in a hire purchase agreement are:

1. ***Nature of Agreement:*** Stating the nature, term and commencement of the agreement.
2. ***Delivery of Equipment:*** The place and time of delivery and the hirer's liability to bear delivery charges.
3. ***Location:*** The place where the equipment shall be kept during the period of hire.
4. ***Inspection:*** That the hirer has examined the equipment and is satisfied with it.
5. ***Repairs:*** The hirer to obtain at his cost, insurance on the equipment and to hand over the insurance policies to the owner.
6. ***Alteration:*** The hirer not to make any alterations, additions and so on to the equipment, without prior consent of the owner.
7. ***Termination:*** The events or acts of hirer that would constitute a default eligible to terminate the agreement.
8. ***Risk:*** Risk of loss and damages to be borne by the hirer.
9. ***Registration and fees:*** The hirer to comply with the relevant laws, obtain registration and bear all requisite fees.
10. ***Indemnity clause:*** The clause as per Contract Act, to indemnify the lender.
11. ***Stamp duty:*** Clause specifying the stamp duty liability to be borne by the hirer.
12. ***Schedule:*** Schedule of equipments forming subject matter of agreement.
13. Schedule of hire charges.

The agreement is usually accompanied by a promissory note signed by the hirer for the full amount payable under the agreement including the interest and finance charges.

Caselet

Higher Deposit Limit sought for unrated Hire Purchase Cost

In a recent Credit Policy representation to the Reserve Bank Governor, the Association of Leasing & Financial Services Cos (ALFS) has urged the apex bank to increase the deposit acceptance limit of unrated Hire Purchase and Leasing Companies (HPLCs) from the existing one-and-a-half times to at least three times their Net Owned Funds (NOF).

It is further suggested that rating should not be used as a regulatory tool, particularly when it was an option only.

The deposit acceptance limit for unrated HPLCs was prescribed in 1998 following the recommendations of the Task Force on NBFCs, with a clear understanding that the limit would be reviewed in the light of regulatory experience over such companies, said Mr Mahesh Thakkar, Executive Director of ALFS.

The level of confidence enjoyed by HPLCs today, according to him, is far more than what it was in 1998. It is high time the RBI gave some relief to the well-run HPLCs, which have survived the turmoil in this sector in the last three years, he pointed out.

Contd...

Notes

ALFS is of the view that with all other sources of funding drying up, public deposits raised by these companies through their clean track record and personalised service is the only mode of funding available.

Pointing out that the Deferred Tax accounting standard, under AS-22, now made mandatory by ICAI, has had a severe impact on leasing companies, the association has stated that even in a country like Pakistan, deferred tax accounting was mandatory for all except leasing companies. ALFS has urged the RBI to give NBFCs a time-frame of at least five years to absorb the impact of this standard on the net owned funds of the NBFCs.

Seeking steps to create a suitable recovery mechanism for HPLCs, viewed as a pre-requisite for payment of liabilities and public deposits like DRTs for the NBFC sector, the association has cited problems with regard to re-possession of assets given under HP/Lease, in case of default, with the police authorities. Authorities, it is pointed out, are quite categorical about the fact that police support in repossessing assets cannot be provided in the absence of any clear law on this.

On the Bill to amend the proposed creation and enforcement of security interest by banks and FIs, it is suggested that the committee under Mr M.R.Umarji (which drafted the Bill) does not include HP/Leasing activities on the grounds that these were "title retention contracts and do not involve security interest creation".

The association has sought insertion of a new clause in the Bill, saying "Hire purchase/ leasing contracts being title retention contracts, give full authority to HPLCs to reposess any asset given under HP/Lease agreement, in case of default."

Welcoming the report of the Indian Bank Association (IBS) Working Group on financing for purchase of vehicles through HPLCs, under the chairmanship of Mr R.V. Shastri, ALFS has stated that while the recommendations have been accepted by the Ministry of Finance and the RBI, the commercial banks were yet to start implementing these in practice.

The apex bank has been urged to instruct banks to start considering proposals from the NBFC sector for on-lending to the commercial vehicles sector.

Source: http://www.thehindubusinessline.in

12.3 Taxation

The taxation aspects of hire purchase transaction can be divided into three parts:

1. Income Tax,
2. Sales Tax, and
3. Interest Tax.

Let us see each of them one by one.

Income Tax Aspect

Hire purchase, as a financing alternative, offers tax benefits both to the hire-vendor (hire purchase finance company) and the hirer.

Income tax assessment of the hire purchase or hirer: The hirer is entitled to:

1. The tax shield on depreciation calculated with reference to the cash purchase price and
2. The tax shield on the finance charges.

Notes

Even though the hirer is not the owner he gets the benefit of depreciation on the cash price of the asset/equipment. Also he can claim finance charges (difference of hire purchase price and cash price) as expenses. If the agreement provides for the option of purchasing the goods as any time or of returning the same before the total amount is paid, no deduction of tax at source is to be made from the consideration of hire paid to the owner.

Income tax assessment of the owner or financer: The consideration for hire/hire charges/income received by the hire vendor/financer is liable to tax under the head profits and gains of business and profession where hire purchase constitute the business (mainstream activity) of the assessee, otherwise as income from other sources. The hire income from house property is generally taxed as income from house property.

Normal deductions (except depreciation) are allowed while computing the taxable income.

Sales Tax Aspect

The salient features of sales tax pertaining to hire purchase transactions after the Constitution (Forty Sixth Amendment) Act, 1982, are as discussed in following points:

1. ***Hire purchase as sale:*** Hire purchase, though not sale in the true sense, is deemed to be sale. Such transactions as per se are liable to sales tax. Full tax is payable irrespective of whether the owner gets the full price of the goods or not.
2. ***Delivery v/s transfer of property:*** A hire purchase deal is regarded as a sale immediately the goods are delivered and not on the transfer of the title to the goods. The quantum of sales tax is the sales price, thus the sales tax is charged on the whole amount payable by the hirer to the owner. The sales tax on a hire purchase sale is levied in the state where the hire purchase agreement is executed.
3. ***Rate of tax:*** The rate of sales tax on hire purchase deals vary from state to state. There is, as a matter of fact, no uniformity even regarding the goods to be taxed. If the rates undergo a change during the currency of a hire purchase agreement, the rate in force on the date of the delivery of the goods to the hirer is applicable.

Interest Tax Aspect

The hire purchase finance companies, like other credit/finance companies, have to pay interest tax under the Interest Tax Act, 1974. According to this Act, interest tax is payable on the total amount of interest earned less bad debts in the previous year at a rate of 2 percent. The tax is treated as a tax deductible expense for the purpose of computing the taxable income under the Income Tax.

12.4 Summary

- A hire purchase agreement is defined in the Hire-purchase Act, 1972 as peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with some specific stipulations.
- In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed an option to purchase the goods by paying all the instalments.
- There is no exclusive legislation dealing with hire purchase transaction in India.

Notes

- In a contract of hire purchase, the element of sale is inherent as the hirer always has the option to purchase the movable asset by making regular payment of hire charges and the property in the goods passes to him on payment of the last instalment.
- The taxation aspects of hire purchase transaction can be divided into three parts, viz. Income Tax, Sales Tax and Interest Tax.
- Each type has its own aspect related to the hire purchase agreement.

12.5 Keywords

Document of title to goods: A document of title to goods is one which entitles and enables its rightful holder to deal with the goods represented by it, as if he were the owner.

Goods: The subject matter of a contract of sale is the 'goods'.

Hire purchase: It is a mode of financing the price of the goods to be sold on a future date.

Security deposit: In certain contract the buyer pays an amount in advance as earnest money deposit or as a security deposit, for the due performance on his part of the contract.

12.6 Self Assessment

Fill in the blanks:

1. The hire purchase finance companies, have to pay interest tax under the Interest Tax Act,..... .
2. ..... means 'voluntary transfer of possession of goods from one person to another'.
3. The buyer is said to have ..... the goods, when he signifies his assent that he has received the goods under, and in performance of the contract of sale.
4. A ..... delivery is a delivery by attornment which takes place when the person in possession of the goods acknowledges that he holds the goods on behalf and at the disposal of the other person.
5. A hire purchase agreement is defined in the Hire Purchase Act, ...
6. Under ..... system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
7. The ..... is free to return the goods without being required to pay any further installments falling due after the return.
8. The ..... of the goods passes from the seller to the buyer on the payment of the last installment.
9. The hirer has the right to ..... the agreement any time before the property passes.
10. In absence of any specific law, the hire purchase transactions are governed by the provisions of the ..... and the ..... .
11. A ..... of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.
12. A ..... is a transfer of interest in the goods from a mortgagor to mortgagee to secure a debt.
13. If the hirer makes payments ....., he gets an option to purchase the goods on making the full payment.

Notes

14. ..... mean every kind of movable property excluding money and auctionable claims.
15. The ..... means the money consideration for transfer of property in goods from the seller to the buyer.

12.7 Review Questions

1. Analyse the Doctrine of Caveat Emptor.
2. What do you think to be the similarities between a hire purchase agreement and a lease agreement?
3. What do you analyse as the main differences between hire purchase contract and sales?
4. Critically evaluate the legal framework of hire purchase agreements in India.
5. Despite all the odds, why do you think are hire purchase agreements increasing day by day?
6. What according to you is the most important thing to be remembered while making a hire-purchase agreement and why?
7. Examine the income, sales and interest tax aspects of Hire and purchase agreement.
8. "A hire purchase agreement is in many ways similar to a lease agreement." Justify the statement with proper reasoning.
9. How do you think a hire-purchase agreement to be different than an agreement to sell?
10. What are the main challenges ahead of the Indian financial structure as regards the hire-purchasing?
11. Analyse the difference between amount of earnest money and the price.

Answers: Self Assessment

1. 1974
2. Delivery
3. accepted
4. constructive
5. 1972
6. hire purchase
7. hirer/purchaser
8. ownership
9. terminate
10. Indian Contract Act, Sale of Goods Act
11. contract of sales
12. mortgage
13. regularly
14. 'Goods'
15. price

12.8 Further Readings


Online links

www.deonixion.com

www.sebi.com

www.rbi.org

Notes

Unit 13: Factoring and Forfeiting

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the meaning of factoring and forfeiting
- Describe the mechanics of factoring and forfeiting
- Define discounting of bills
- Explain rediscounting of bills

Introduction

Receivables constitute a significant portion of current assets of firm. But, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems:

1. the problem of raising funds to finance the receivables, and
2. the problems relating to collection, delays and defaults of the receivables.

A small firm may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a case, a firm may avail the services of specialised institutions engaged in receivables management, called factoring firms.

At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of ₹ 25 crores to undertake factoring services covering the western zone.

Notes

13.1 Meaning of Factoring and Forfeiting

Factoring may broadly be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution called the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former.

Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts (account receivables) with or without recourse to the client - thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

The term "factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, the definition of factoring as under:

"*Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:*

1. *Finance*
2. *Maintenance of accounts*
3. *Collection of debts*
4. *Protection against credit risks*".

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

1. To trade or professional debtors
2. Across national boundaries
3. When notice of assignment has been given to the debtors.

The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the "factor" as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer (s).

The forfeiting owes its origin to a French term 'a forfait' which means to forfeit (or surrender) ones' rights on something to some one else. Forfeiting is a mechanism of financing exports:

1. by discounting export receivables
2. evidenced by bills of exchanges or promissory notes
3. without recourse to the seller (viz; exporter)
4. carrying medium to long-term maturities
5. on a fixed rate basis up to 100% of the contract value.

In other words, it is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.

Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfaiting usually takes place where

the credit is for long date maturities and there is prohibition for extending the facility where the credits are maturing in periods less than one year.

Caselet

Bill on 'Factoring' coming in Budget Session: Minister

The Centre will, in the upcoming Budget session of Parliament, introduce a Bill on 'factoring' so as to provide a comprehensive legal and regulatory framework for such services, Mr Namo Narain Meena, Minister of State for Finance, has said.

The proposed legislation would provide adequate protection for major players to further develop the factoring business in India, Mr Meena said here on Wednesday. Factoring covers a range of services including receivable financing, sales ledger administration, accounts receivable collection and management, and credit protection.

What's Factoring?

Factoring business had not made much progress in India due to the absence of a consolidated legal framework for such business. Although the concept of factoring services was not very new for India, there are only few players in the market, Mr Meena pointed out. Mr Meena highlighted that the Department of Financial Services has already prepared a draft factoring Bill in consultation with various stakeholders including the Ministry of Micro, Small and Medium Enterprises. The proposed legislation will be conducive to increasing lending to SMEs, he said. Among the various risks faced by SMEs, which are largely unorganised, a major one is delay or default of payment by counterparty.

Source: http://www.thehindubusinessline.in

13.2 Mechanics of Factoring and Forfeiting

Mechanics for Factoring

Factoring business is generated by credit sales in the normal course business. The main function of factor is realisation of sales. Once the transaction takes place, the role of factor step in to realise the sales/collect receivables. Thus, factor act as a intermediary between the seller and till and sometimes along with the seller's bank together.

The mechanism of factoring is summed up as below:

1. An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
2. The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
3. When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
4. The factor may provide advance finance to the selling firm conditions of the agreement so require.

Notes

Mechanics for Forfeiting

The exporter and importer negotiate the proposed export sale contract. Then the exporter approaches the forfeiter to ascertain the terms of forfeiting. The forfeiter collects details about the importer, supply and credit terms, documentation etc.

Forfeiter ascertains the country risk and credit risk involved. The forfeiter quotes the discount rate. The exporter then quotes a contract price to the overseas buyer by loading the discount rate, commitment fee etc. on the sale price of the goods to be exported. The exporter and forfeiter sign a contract. Export takes place against documents guaranteed by the importer's bank. The exporter discounts the bill with the forfeiter and the latter presents the same to the importer for payment on due date or even sell it in secondary market.

13.3 Discounting of Bills

In addition to the rendering of factoring services, banks financial institutions also provide bills discounting facilities provide finance to the client.

Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India.

According to the Indian Negotiable Instruments Act, 1881:

"The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument."

The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Following are the dissimilarities and similarities between the services.

Dissimilarities/Differences

The two services differ from each other in the following respects:

Bills Discounting

1. It is a provision of finance against bills.
2. Advances are made against the bills.
3. The drawer undertakes the responsibility of collecting the bills and remitting the proceeds to financing agency.
4. Bills discounted may be rediscounted several times before the maturity.
5. Bill discounting is always with recourse, i.e. in case of default the client will have to make good the loss.
6. Bill financing is individual transaction oriented i.e. each bill is separately assessed on its merits and got discounted purchased.
7. Bill finance is always 'In Balance Sheet' financing i.e. both the amounts of receivables and bank credit are reflected in the balance sheet of the clients as current assets and current liabilities respectively.

   This is because of the 'with recourse' nature of the facility.

Notes

8. The drawee or the acceptor of the bills is in full knowledge of the bank's charge on the receivables arising from the sale of goods and services.

Factoring

1. Factoring renders all services like maintenance of sales ledger, advisory services, etc. in addition to the provision of finance.
2. Trade debts are purchased by assignment.
3. Factoring undertakes to collect the bills of the client.
4. Debts purchased for factoring cannot be rediscounted, they can only be refinanced.
5. Factoring may be with or without recourse.
6. Whereas in factoring, bulk is provided against several unpaid trade generated invoices in batches. It follows the principle of 'whole turnover'.
7. In full factoring services facility is 'off balance sheet' arrangement, as the client company completes his double entry accounting by crediting the factor for consideration value.
8. Factoring services like 'undisclosed factoring' are confidential in nature i.e. the debtors are not aware of the arrangements. Thus, the large industrial houses availing such facility can successfully claim of running business of their own without any outside financial support.

Similarities

1. Both provide short-term finance.
2. Both get the account receivables discounted which the client would have otherwise received from the buyer at the end of credit period.

13.4 Rediscounting of Bills

Presently banks purchase/discount/negotiate bills under Letter of Credit (LC) only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks could not, therefore, extend fund-based credit facilities (including bills financing) to a non-constituent borrower or a non-constituent member of a consortium/multiple banking arrangement.

Further, the practice of drawing bills of exchange claused 'without recourse' and issuing letters of credit bearing the legend 'without recourse' is discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act. Banks therefore, do not open LCs and purchase/discount/negotiate bills bearing the 'without recourse' clause.

However, Reserve Bank of India (RBI) in notification to banks dated 3rd August 2007 has advised that:

1. In cases where negotiation of bills drawn under LC is restricted to a particular bank, and the beneficiary of the LC is not a constituent of that bank, the bank concerned may negotiate such an LC, subject to the condition that the proceeds will be remitted to the regular banker of the beneficiary. However, the prohibition regarding negotiation of unrestricted LCs of non-constituents will continue to be in force.

Notes

2. The banks may negotiate bills drawn under LCs, on 'with recourse' or 'without recourse' basis, as per their discretion and based on their perception about the credit worthiness of the LC issuing bank. However, the restriction on purchase/discount of other bills (the bills drawn otherwise than under LC) on 'without recourse' basis will continue to be in force.

Task

Find out the situations under which the banks cannot rediscount the bills.

Case Study

PNB enters Factoring Business

Picks up 30% stake in IFFSL; to focus on SMEs initially.

Punjab National Bank (PNB) has forayed into factoring business through the joint venture route. The joint venture company, India Factoring & Finance Solutions Pvt Ltd (IFFSL), on Wednesday commenced commercial operations simultaneously in New Delhi, Mumbai and Chennai.

To begin with, IFFSL will focus on domestic factoring and provide this financing solution primarily to small and medium enterprises (SMEs) and small-scale industries, PNB Chairman and Managing Director, Mr K. R. Kamath, said.

Factoring is a financial transaction where a business sells its accounts receivable to a third party called 'factor', which undertakes the activity of financing the receivables, administration of debt and collection of debt.

PNB has a 30 per cent stake in IFFSL and has already pumped in ₹ 30 crore into the venture. IFFSL has commenced operations with an initial paid-up capital of ₹ 100 crore, according to Mr Mohan Tanksale, Chairman of IFFSL, and an Executive Director of PNB.

Malta-based FIMBank Plc has 49 per cent stake in IFFSL. The remaining stake is with other joint venture partners - Italy-based Banca IFIS and Blend Financial Services of Mumbai.

Mr Kamath also said that regulatory approvals have been sought for IFFSL to provide international factoring/forfeiting. "Once the regulatory approval is received, IIFSL will provide both domestic and international factoring," he said.

Legal Framework

He also highlighted that factoring business in India has not made much progress due to lack of consolidated legal framework for the business. However, there has been growing realisation that factoring can be a solution for receivable management of the SME sector, Mr Kamath noted. In India, SMEs employ about 60 million people and account for about 45 per cent of total exports (in value terms) from the country.

Question

Discuss the impact of factoring on bank's business.

Source: http://www.thehindubusinessline.in

Notes

13.5 Summary

- Factoring may be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution.
- Forfeiting is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.
- In addition to the rendering of factoring services, banks financial institutions also provide bills discounting facilities provide finance to the client.
- The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument.

13.6 Keywords

Account receivables: Any trade debt arising from the sale of goods/services by the client to the customer on credit.

Client: He is also known as supplier. It may be a business institution supplying the goods/ services on credit and availing of the factoring arrangements.

Customer: A person or business organisation to whom the goods/services have been supplied on credit. He may also be called as debtor.

Eligible debt: Debts, which are approved by the factor for making prepayment.

Open account sales: Where in an arrangement goods/services are sold/supplied by the client to the customer on credit without raising any bill of exchange or promissory note.

Prepayment: An advance payment made by the factor to the client up to a certain percent of the eligible debts.

Retention: Margin maintained by the factor.

13.7 Self Assessment

Fill in the blanks:

1. Banks do not open LCs and purchase/discount/negotiate bills bearing the ..... clause.
2. The bill of exchange is an instrument in writing containing an ..... order.
3. Factoring services like 'undisclosed factoring' are ..... in nature.
4. Factoring undertakes to ..... the bills of the client.
5. The forfeiting owes its origin to a French term .....
6. ..... may broadly be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution.
7. For ..... in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables.

Notes

8. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the ..... as a result of which the title to the goods/services represented by the said receivables passes on to the factor.
9. Factoring business is generated by ..... in the normal course business.
10. The agreement provides the ..... and the ..... understanding reached between the two for rendering factor service.
11. The ..... may provide advance finance to the selling firm conditions of the agreement so required.
12. The ..... and ..... negotiate the proposed export sale contract.
13. ..... ascertains the country risk and credit risk involved.
14. The bill of exchange is an instrument in writing containing an ..... order.
15. ..... is individual transaction oriented.
16. The main function of factor is realisation of ..... .

13.8 Review Questions

1. How is bills discounting and factoring different from each other?
2. What is more important factoring or forfeiting and why?
3. Can factoring and forfeiting be used as:
   (a) Compliments and/or
   (b) Substitutes and/or
   (c) Unrelated activities.

   Support your argument with reasons.
4. Discuss the mechanisms of factoring and forfeiting.
5. How do you see the provisions for rediscounting of bills?
6. What makes discounting of bills, a profitable activity?
7. If you become a forfeiter tomorrow, what will be the prime factor you would be taking care of and why?
8. Examine the effect of RBI notifications for the rediscounting of bills on Indian banks.
9. Illustrate the similarities in discounting of bills and factoring by the help of examples.
10. According to you, what is the journal entry for purchase bill discount?
11. Forfeiting has potential risk of non-payment in general. Why/why not?

Answers: Self Assessment

1.	'without recourse'	2.	unconditional
3.	confidential	4.	collect
5.	'forfait'	6.	Factoring
7.	investment	8.	factor

Notes

9. credit sales
10. basis, scope
11. factor
12. exporter, importer
13. Forfeiter
14. unconditional
15. Bill financing
16. sales

13.9 Further Readings

Online links

www.forfeiting.com

www.forfeiting.com

www.languages.ind.in

Notes

Unit 14: Merchant Banking

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain meaning of the merchant banking
- Describe role of the merchant banking
- Explain the functions of the merchant banking
- Discuss SEBI guidelines regarding merchant banking
- State the underwriting services in India

Introduction

In banking, a merchant bank is a financial institution primarily engaged in offering financial services and advice to corporations and to wealthy individuals. The term can also be used to describe the private equity activities of banking. The chief distinction between an investment bank and a merchant bank is that a merchant bank invests the banks own capital in a client company whereas an investment bank purely distributes (and trades) the securities of that company in its capital raising role. Both merchant banks and investment banks provide fee based corporate advisory services including in relation to mergers and acquisitions.

14.1 Meaning

A merchant bank can be defined as a bank that deals mostly in (but is not limited to) international finance, long-term loans for companies and underwriting. Merchant banks do not provide regular banking services to the general public.

Notes

Their knowledge in international finances make merchant banks specialists in dealing with multinational corporations.

14.2 Role

In the past the role of the merchant banker was to arrange the necessary capital and ensure that the transaction would be implemented i.e. a financial intermediary facilitating the flow of capital among the concerned parties. But today, a merchant banker plays multiple roles which include those of an entrepreneur, a management advisor, an investment banker, and a transaction broker.

This shows that the breadth and depth of a merchant bankers activity has changed over the years.

A merchant bank deals with the commercial banking needs of international finance, long term company loans, and stock underwriting. A merchant bank does not have retail offices where one can go and open a savings or checking account. A merchant bank is sometimes said to be a wholesale bank, or in the business of wholesale banking. This is because merchant banks tend to deal primarily with other merchant banks and other large financial institutions.

The most familiar role of the merchant bank is stock underwriting. A large company that wishes to raise money from investors through the stock market can hire a merchant bank to implement and underwrite the process. The merchant bank determines the number of stocks to be issued, the price at which the stock will be issued, and the timing of the release of this new stock. The merchant bank files all the paperwork required with the various market authorities, and is also frequently responsible for marketing the new stock, though this may be a joint effort with the company and managed by the merchant bank. For really large stock offerings, several merchant banks may work together, with one being the lead underwriter.

Merchant bankers offer customised solutions to solve the financial problems of their clients. Advice is sought in areas of financial structuring. Merchant bankers study the working capital practices that exist within the company and suggest alternative policies. They also advise the company on rehabilitation and turnaround strategies, which would help companies to recover from their current position. They also provide advice on appropriate risk management strategies like hedging strategies.

These financial intermediaries arrange loans, for their clients, by analysing their cash flow pattern, so that the terms of borrowing meet the clients cash requirements. They also offer assistance in loan documentation procedures.

Merchant bankers assist the management of the client company to successfully restructure various activities, which include mergers and acquisitions, divestitures, management buyouts, joint venture among others. They also play a lead role to help companies achieve the objectives of these restructuring strategies, the merchant banker participates in different activities at various stages which include understanding the objectives behind the strategy (objectives could be either to obtain financial, marketing, or production benefits), and help in searching for the right partner in the strategic decision and financial valuation of the proposal.

14.3 Functions

Merchant Banks are popularly known as "issuing and accepting houses". They offer a package of financial services. Unlike in the past, their activities are now primarily non-fund based. One of the basic requirements of merchant banks is highly professional staff with skills and worldwide contacts. The basic function of merchant banks is marketing corporate and other securities, that is guaranteeing sales and distribution of securities.

Notes

All the aspects – origination, underwriting and distribution of the sale of industrial securities are handled by them. They are experts and good judges of the type, timing and terms of issues and make them acceptable to investors under prevailing preferences and market conditions, and at the same time afford the borrowing company, flexibility and freedom that it needs to meet possible future contingencies. They guarantee the success of issues by underwriting them. They also provide all the services related to receiving applications, allotment, collecting money, sending share certificates and so on.

The merchant banker normally does not assume all the risk himself while underwriting the issue. Merchant banks offer services also to investors. The range of activities offered by merchant banks is much wider than sponsoring public issues of industrial securities. They offer project finance, syndication of credit, corporate advisory services, mutual fund investments, investment management etc. Let us go through the most important services of Merchant Banks.

Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising the project report with the financial institutions or banks. It also includes filling up of application forms with relevant information for obtaining funds from financial institutions and obtaining government approval.

Issue Management

Management of issue involves marketing of corporate securities viz. equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as an intermediary whose main job is to transfer capital from those who own it to those who need it. After taking action as per SEBI guidelines, the merchant banker arranges a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions. Pricing of issues is done by the companies in consultant with the merchant bankers.

Underwriting of Public Issue

Underwriting is a guarantee given by the underwriter that in the event of under subscription, the amount underwritten would be subscribed by him. Banks/Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

Caselet

Merchant Bankers willing to take less for PSU Offerings

Seek to generate more business.

Merchant bankers continue to quote a nominal fee for book-running and lead managing the public sector offering even after recent selection norm changes substantially lowered the weight for bid price.

According to sources in the Government, one merchant banker had bid for the Coal India IPO assignment at a fee as low as 0.000001 per cent. Public sector issuer sources said the

Contd...

Notes

changed rules last month, which put greater weight (70 per cent) on quality - technical expertise and experience - over that on quoted fees (30 per cent) has not influenced the bidding pattern.

"The pool of registered merchant bankers sports almost similar qualitative standards. Therefore, the quoted fee determines short-listing. Competitive pressure for public sector offerings forces the merchant bankers to keep the fees low, often highly loss making or stay out," said a top official of public sector enterprise.

Market sources say while the going rate for merchant banking fees for a private issuer of a comparable size is around 3 per cent, the rate for PSU offerings remains close to zero.

"This is not a charitable exercise. Merchant bankers extract marketing mileage and seek more future business from the Government-run organisations to serve their commercial interest indirectly. But they also to make up for the huge cost, which runs into crores of rupees, through other means, which are strictly not clean," said the managing director of a listed private company.

Mr Prithvi Haldea, primary market expert and the Chairman of Prime Database, told Business Line that the environment was not conducive to a fair and transparent method of selecting quality services.

"The Government needs to pay a reasonable fee to merchant bankers for the best services so that the issues do not suffer. In the context of the Government's plan to raise huge sum (₹ 40,000 crores) in 2010-11 through several offloading of shares or fresh issues, the technical qualification should be the primary criterion for selection of merchant bankers. Fixing of an upfront payment to the selected book-runners and lead managers for each issue considering the cost involved can ensure better response and quality rendering of services."

This fiscal, the lead managers for the SJVN Ltd issue were JM Financial, IDFC Capital, IDBI Capital and SBI Capital Markets. Citibank, Deutsche Bank, DSP Merrill Lynch, Morgan Stanley, Enam Securities and Kotak Securities have been appointed to act as book running lead managers for the Coal India Limited IPO.

For EIL, the government has short-listed HSBC Holdings Plc, ICICI Securities, SBI Capital Markets and IDFC Capital to manage the public offering. UBS AG, Kotak Mahindra Capital, Enam Securities and IDBI Capital Market Services, Avendus Capital, Edelweiss Capital and Centrum Broking also competed for EIL issue. Hindustan Copper Ltd, which would view the bids after June 24, has obtained several bids, according to sources.

Source: http://www.thehindubusinessline.in

Managers, Consultants or Advisers to the Issue

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies can appoint one or more agencies as managers to the issue.

Portfolio Management

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and government securities. Portfolio management refers to maintaining proper combinations of securities in a manner that they give maximum return with minimum risk.

Notes

Advisory Service relating to Mergers and Takeovers

A merger is a combination of two companies into a single company where one survives and other loses its corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the two companies.

Case Study

Role of Merchant Banks in Tata Corus Acquisition

On January 31, 2007, Tata Steel Limited (Tata Steel), one of the leading steel producers in India, acquired the Anglo Dutch steel producer Corus Group Plc (Corus) for US$ 12.11 billion (€ 8.5 billion). The process of acquisition concluded only after nine rounds of bidding against the other bidder for Corus - the Brazil based Companhia Siderurgica Nacional (CSN).

While Tata Steel had earlier roped in merchant bankers ABN Amro and Detusche Bank as their financial advisors for the Corus bid in 2007, it had to later hire UK-based merchant bankers NM Rothschild & Sons as financial advisor for the then proposed acquisition. This was clearly a move taken by Tata to topple its Brazilian rival.

As a result of the services provided by Rothschild, the Tatas made the winning bid of 608 pence a share as against CSN's final bid of 603 pence a share in the ninth round of bidding. CSN reportedly pulled out thereafter. The Tata bid was 34% higher than its original bid.

This acquisition was the biggest overseas acquisition by an Indian company. Tata Steel emerged as the fifth largest steel producer in the world after the acquisition. The acquisition gave Tata Steel access to Corus' strong distribution network in Europe.

Question

Analyse the role of Rothschild in Tata's acquisition of Corus.

Source: www.business-standard.com
www.rediff.com/money/tatacorus.html

Off Shore Finance

The merchant bankers help their clients in the following areas involving foreign currency.

1. Long term foreign currency loans
2. Joint ventures abroad
3. Financing exports and imports
4. Foreign collaboration arrangements

Non-resident Investment

The services of merchant banker includes investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management, and operational services like purchase and sale of securities.

Notes

Loan Syndication

Loan syndication refers to assistance rendered by merchant bankers to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from banks or financial institutions.

Corporate Counselling

Corporate counselling covers the entire field of merchant banking activities viz. project counselling, capital restructuring, public issue management, loan syndication, working capital, fixed deposit, lease financing acceptance credit, etc.

Task

Compare the working of merchant banks in India with those of European Union and discuss where we need to move ahead to match the pace.

14.4 SEBI Guidelines regarding Merchant Banking

1. Without holding a certificate of registration granted by the Securities and Exchange Board of India, no person can act as a merchant banker.
2. Only a body corporate other than a non-banking financial company shall be eligible to get registration as merchant banker.
3. The categories for which registration may be granted are given below:
   (a) *Category I:* to carry on the activity of issue management and to act as adviser, consultant, manager, underwriter, portfolio manager.
   (b) *Category II:* to act as adviser, consultant, co-manager, underwriter, portfolio manager.
   (c) *Category III:* to act as underwriter, adviser or consultant to an issue.
   (d) *Category IV:* to act only as adviser or consultant to an issue.
4. The capital requirement depends upon the category. The minimum net worth requirement for acting as merchant banker is given below:
   (a) Category I - ₹ 5 crores
   (b) Category II - ₹ 50 lakhs
   (c) Category III - ₹ 20 lakhs
   (d) Category IV - Nil.
5. An application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied issue a certificate of registration in Form B of the SEBI (Merchant Bankers) Regulations, 1992.
6. ₹ 5 lakhs which should be paid within 15 days of date of receipt of intimation regarding grant of certificate.
7. The validity period of certificate of registration is three years from the date of issue.

Notes

8. For renewal, three months before the expiry period, an application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied renew certificate of registration for a further period of 3 years.
9. ₹ 2.5 lakhs which should be paid within 15 days of date of receipt of intimation regarding renewal of certificate.
10. The person whose registration is not current shall not carry on the activity as merchant banker from the date of expiry of validity period.

14.5 Underwriting Services in India

The word "underwriter" is said to have come from the practice of having each risk-taker write his or her name under the total amount of risk that he or she was willing to accept at a specified premium. In a way, this is still true today, as new issues are usually brought to market by an underwriting syndicate in which each firm takes the responsibility (and risk) of selling its specific allotment.

Thus underwriting can be understood as the process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities (both equity and debt). It is also the process of issuing insurance policies.

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. The lead taken by public financial institutions has encouraged banks, insurance companies and stock brokers to underwrite on a regular basis. The various types of underwriters differ in their approach and attitude towards underwriting:

1. ***Development banks like IFCI, ICICI and IDBI:*** They follow an entirely objective approach. They stress upon the long-term viability of the enterprise rather than immediate profitability of the capital issue. They attempt to encourage public response to new issues of securities.
2. ***Institutional investors like LIC and AXIS:*** Their underwriting policy is governed by their investment policy.
3. ***Financial and development corporations:*** They also follow an objective policy while underwriting capital issues.
4. ***Investment and insurance companies and stock-brokers:*** They put primary emphasis on the short term prospects of the issuing company as they cannot afford to block large amount of money for long periods of time.

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. Under it, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

Notes

14.6 Summary

- Merchant Banking is an important service provided by a number of financial institutions that helps in the growth of the corporate sector which ultimately reflects into the overall economic development of the country.
- The activities of the merchant banking in India is very vast in nature of which includes the management of the customers securities, management of the portfolio, the management of projects and counseling as well as appraisal, the management of underwriting of shares and debentures, the circumvention of the syndication of loans and management of the interest and dividend, etc .
- Merchant banks were expected to perform several functions like issue management, underwriting, portfolio management, loan syndication, consultant, advisor and host of other activities.
- SEBI was also made all powerful to regulate the activities of merchant banks in the best interest of investors and economy.
- Apart, merchant banking was the necessity of banks themselves which were in need of non-fund based income so as to improve their profitability margins by all means in the changed economic scenario.

14.7 Keywords

Merchant Banker: A bank that deals mostly in (but is not limited to) international finance, long-term loans for companies and underwriting.

Underwriting: Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company.

14.8 Self Assessment

Fill in the blanks:

1. Underwriting of ..... has become very popular due to the development of the capital market and special financial institutions.
2. Corporate ..... covers the entire field of merchant banking activities.
3. The validity period of certificate of registration is ..... years from the date of issue.
4. Development banks stress upon the ..... of the enterprise.
5. A ..... is a combination of two companies into a single company where one survives and other loses its corporate existence.
6. The person whose registration is not current shall not carry on the activity as merchant banker from the date of ..... of validity period.
7. Without holding a certificate of registration granted by the ....., no person can act as a merchant banker.
8. A merchant bank invests a ..... capital in a client company.
9. An ..... bank purely distributes the securities of that company in its capital raising role.

Notes

10. Their knowledge in ..... make merchant banks specialists in dealing with multinational corporations.
11. The most familiar role of the merchant bank is stock ..... .
12. The merchant bank files all the paperwork required with the various market .....
13. Merchant Banks are popularly known as ..... .
14. ..... includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising the project report.
15. ..... refers to investment in different kinds of securities.

14.9 Review Questions

1. What is the significance of merchant banking in Indian context?
2. What are the SEBI guidelines regarding merchant banking?
3. Write a critical evaluation of the underwriting services in India.
4. Elucidate upon the functions of merchant banks.
5. Do you think merchant banks in India have been playing the role as needed for them?
6. Comment on the significance of the underwriters in India.
7. Elucidate upon the effect of the SEBI guidelines regarding merchant banking in India.
8. Analyse cases to examine how merchant banks have helped their clients in the field of offshore financing. Cite at least 3 Indian cases to explain the same.
9. "Merchant banks act as an intermediary whose main job is to transfer capital from those who own it to those who need it." Comment.
10. Examine the growth of merchant banking in India since 1991.
11. Where does the merchant banking in India stand when compared to their global counterparts, especially those of US and UK?

Answers: Self Assessment

1.	capital issues	2.	counseling
3.	three	4.	long-term viability
5.	merger	6.	expiry
7.	Securities and Exchange Board of India	8.	bank's own
9.	investment	10.	international finances
11.	underwriting	12.	authorities
13.	issuing and accepting houses	14.	Project counselling
15.	Portfolio		

14.10 Further Readings

Notes

Books

Gurusamy, *Merchant Banking and Financial Services,* Thomson Learning.

Machiraju, H.R., *Merchant Banking: Principles and Practice,* New Age International Pvt. Ltd.

Online links

www.canarabank.com

www.indbankonline.com

www.onemine.org

www.pnbindia.in

Notes

Unit 15: Management of NPAs by Banks

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the meaning of NPAs and its provisioning norms
- Explain the tools available to manage NPAs

Introduction

This unit tells you about the NPA management in banks. When a loan asset fails to contribute any income on the stipulated dates – every quarter in case of working capital loan and half yearly basis on term loans – to the owners, it is known as NPA. Till the mid-80's there was no uniformity of approach, among banks in booking income from various kinds of loan assets. For instance, many banks had long stopped the practice of debiting the loan accounts with interest in the health code categories of 'recalled, 'protested', 'decreed' and 'bad and doubtful' assets, While others continued to book interest on some of these categories of advances. We may recall that there were eight categories of advances based on health code system in 1985. These were (i) satisfactory; (ii) irregular; (iii) sick – viable; (iv) sick non-viable; (v) debt recalled; (vi) suit filed; (vii) Decreed debt and (viii) Bad and doubtful account

Notes

15.1 Meaning of NPA

As per Reserve Bank of India's guidelines, income on loans is to be recognised on receipt basis (as against accrual basis) and if it has not been received for a specified period, the same asset is to be treated as non-performing. The basis for doing so is given below:

1. ***Term Loan:*** Term Loan account will be treated as NPA if interest or installment of principal is in arrears for any two quarters out of four quarters, though the default may not be continuously for two quarters during the year. The default may be considered by applying the concept of past due i.e. if not paid within 30 days from the due date.
2. ***Cash Credit and Overdrafts:*** A cash credit or overdraft account will be treated as NPA if the account remains out of order for a period of two quarters. An account should be treated as "out of order" if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Caution In case where the principal operating account is less than the sanctioned limit/ drawing power but there are no credits continuously for six months as on the date of balance sheet or credit are not enough to cover the interest debited during the same period, these accounts should also be treated as "out of order".

3. ***Bills Purchased and Discounted:*** The bills purchased/discounted account should be treated as NPA if the bill remains overdue and unpaid for a period of two quarters.
4. ***Other Accounts:*** Any other credit facility should be treated as NPA if any amount to be received in respect of that facility remains past due for a period of two quarters. An amount should be considered past due, when it remains outstanding for 30 days beyond the due date.

Notes

Classification of NPA

The RBI has issued guidelines to banks for classification of assets into four categories.

1. ***Standard Assets:*** These are loans which do not have any problem are less risk.
2. ***Sub-standard Assets:*** With effect from 31st March 2005, a sub standard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.
3. ***Doubtful Assets:*** With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

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Notes

4. ***Loss Assets:*** A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

15.2 Provisioning Norms given by RBI

The following are the key provisioning norms issued by RBI:

(i) ***General:*** The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.

(ii) ***Loss assets:*** Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

(iii) ***Doubtful assets:***

1. 100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

2. In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Remained doubtful upto 1 year	20%
One year to three year	30%
More than three year	100%

3. Banks are permitted to phase the additional provisioning consequent upon the reduction in the transition period from substandard to doubtful asset from 18 to 12 months over a four year period commencing from the year ending March 31, 2005, with a minimum of 20 % each year.

(iv) ***Sub-standard Assets***

1. A general provision of 10 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

2. The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 20 per cent on the outstanding balance. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent.

Did u know? **What is the meaning of unsecured exposure?**

Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than 10 percent, *ab-initio*, of the outstanding exposure.

Notes

'Exposure' shall include all funded and non--funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters etc.

(v) ***Standard assets:*** As a countercyclical measure, the provisioning requirements for all types of standard assets stands amended as below, w.e.f. November 15, 2008. Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

(a) Direct advances to agricultural and SME sectors at 0.25 per cent;

(b) All other loans and advances at 0.40 per cent

Notes

Brief View of Provisioning

1. ***Standard Assets:*** general provision of a minimum of 0.25%
2. ***Sub-standard Assets:*** 10% on total outstanding balance, 10 % on unsecured exposures identified as sub-standard and 100% for unsecured "doubtful" assets.
3. ***Doubtful Assets:*** 100% to the extent advance not covered by realizable value of security. In case of secured portion, provision may be made in the range of 20% to 100% depending on the period of asset remaining sub-standard
4. ***Loss Assets:*** 100% of the outstanding

Case Study

Union Bank's NPA Position set to Improve

Union Bank of India recorded an average annual growth rate of over 25 per cent in business and 23 per cent in profit in the last five years. But in the last two quarters, the non-performing assets have gone up.

In an interview to Business Line Mr M.V. Nair, who will be completing his five-year term as Chairman and Managing Director of the bank in March, talks about his achievements and explains why the bank's NPAs are high.

Have you achieved everything that you planned since you took charge of the bank?

I had a five-year term and a clear plan. After I took charge, I had made an assessment of the bank. It was consistently growing. But the challenge was to prepare it for the next 20 years and for a high level growth. Being a public sector bank, it needed a complete transformation. It took me about one year to figure out how to do it.

Our team prepared a transformation plan. We focused on technology and the entire process. We re-branded our services. We looked at changing the age profile of our staff. It's now a completely transformed bank. Profitability has seen a substantial increase. Our cost-to-income ratio has come down from 48 per cent to 40 per cent.

Your NPAs have been growing. Why?

We had already projected that NPAs will peak during Q2 of 2010-11. Thereafter, NPA levels are expected to improve. The main reasons for slippages during the second quarter

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Notes

are Agricultural Debt Waiver and Relief Scheme, which came to an end in June. The farmers could not take benefits of the scheme and failed to pay their share of dues and hence around ₹ 400 crores has turned NPAs during the quarter. Secondly, few big accounts having international business became NPAs during the quarter which resulted in slippages to the tune of ₹ 300 crores. These are all one-time exceptional events and shall not have any repeat impact.

We also started identifying the NPAs through core banking solution. There were some additions to NPAs from restructured accounts also. However, such NPAs accounted for 11.34 per cent of total restructured advances, which is within our guidance of 15 per cent. All these aspects put together resulted in an increase in NPAs.

But we have geared up for recovery and upgradation due to which our NPAs are likely to reduce from 2.79 per cent in September 2010 to 2.30 per cent by March 2011. In the next financial year, our NPAs position will show marked improvement.

Are your overseas plans on track?

Our full-fledged overseas branch in Kong Hong was opened in 2008. In a span of two years the branch has crossed business-mix of $1 billion. We made a profit in first year itself. The business is mainly from Indian corporates and trade finance requirements.

We are planning our second full fledged branch in Antwerp, Belgium. We have a representative office in Dubai, from where we cover GCC and African region. In West Asia, we have entered into tie-ups with exchange companies and mobilised 84,000 NRI accounts.

We propose to convert the representative office in London to a subsidiary. We are opening representative offices in Toronto and Johannesburg. Right now, overseas operations are 2 per cent of the balance sheet. Our plan is to increase it to 3.5 per cent by 2012 and close to 20 per cent by 2020.

How much capital have you asked from the government?

We have asked for around ₹ 1,600 crores. We should be able to get it through a preferential issue. The Government holding can go up from 55 per cent to around 60 per cent. Then, we have two possibilities. We can either go for a rights issue, or follow-on public offer as and when required. Capital adequacy could go above 13 per cent, which should give us an elbow room for the next two-three years.

Is credit growth a challenge?

The Reserve Bank of India's guidance is that credit will grow at 20 per cent and deposit at 18 per cent. As on October 29, deposit growth is at 18.5 per cent and credit at 22 per cent. Both projections are broadly in line now. But the busy season has just started. If the trend continues, achieving 20 per cent growth in credit by March is not a concern. The only point of concern is that last year, in the second half credit growth was high. This year, growth has to happen on a base which was high. The environment supports credit growth — IIP numbers were good, vehicle sales are high, consumer durables sales are good. Festive season should support growth in credit.

When are you launching wealth management services?

We are in discussions with two or three players for wealth management. We want to launch it after we launch our mutual fund business through Union KBC Asset Management Company. Mutual Funds will be launched by December. We are waiting for final approval from the Securities and Exchange Board of India.

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Notes

You talked about HR initiatives. What is the impact?

Thanks to fast track promotions, the average employee age has come down to 45 years from 50 in just five years. It may come down to 40 by 2012. We have appointed consultancy firm Hewitt to look at performance management system. We are looking at key result areas for 200 important positions. Based on their recommendations, we will form performance incentive scheme and career progression and succession planning scheme.

Do you expect a slowdown in housing loans after the latest RBI prescriptions?

I don't think so. There is a genuine need for housing in India and demand is quite obvious. The trend of growth in individual housing loans is also good. However, the regulator has to be forward looking. The RBI's concern is on need for banks to be transparent with the customers about interest rates and to understand the repaying capacity of the borrower at normal lending rate.

Similarly, low margin-based housing loans are being offered by some entities. This has led to stipulation for maximum loan-to-value ratio (LTV) at 80 per cent. In fact, majority of housing loans by Indian banks is around this LTV. But as I said, the RBI has to have a forward looking approach. Even if these prescriptions lead to some firming up in interest rates on housing loans, its demand may not be impacted. Nonetheless, housing prices are a concern, particularly in Tier-I cities where rising trend is observed.

The RBI has allowed additional LAF window for a month. Will it help ease the liquidity situation?

The RBI had announced temporary liquidity easing measures which were effective up to November 7. After this, net LAF outstanding amount again increased to a level beyond the RBI's comfort zone. In the recent policy, the RBI has indicated comfort zone of liquidity as (+/-) one per cent of net demand and time liabilities of banks, which comes close to ₹ 52,000 crores. Current borrowing through LAF window is almost twice the comfort zone on the deficit side. Therefore, re-introduction of liquidity easing measures is a welcome move. Particularly, extension up to December 16 is positive for the market sentiment as it also covers the period of third quarter advance tax outflows. As an immediate market reaction, we have seen call rates coming down. There is huge government balances with the RBI (₹ 77,736 crores as of October 30) and the system may see the positive impact as the government starts drawing down its balances

Question

Discuss the key reasons behind the improvement of bank's NPAs position.

Source: http://www.thehindubusinessline.in

15.3 Factors Contributing to NPAs

These are the major factors which are responsible for the higher non-performing assets in the banks:

1. Banks have poor credit discipline
2. Inadequate credit and risk management
3. Diversion of funds by promoters
4. Funding of non-viable projects

Notes

5. In the early 1990s PSBs started suffering from acute capital inadequacy and lower/negative profitability. The parameters set for their functioning did not project the paramount need for these corporate goals
6. The banks had little freedom to price products, cater products to chosen segments or invest funds in their best interest
7. Audit and control functions were not independent and thus unable to correct the effect of serious flaws in policies and directions
8. Banks were not sufficiently developed in terms of skills and expertise to regulate the humongous growth in credit and manage the diverse risks that emerged in the process
9. Inadequate mechanism to gather and disseminate credit information amongst commercial banks.

Task Make a comparison of NPAs between HDFC Bank and SBI Bank for the last five years.

15.4 NPA Management Tools

During the past few years NPAs are increasing continually. This was due to show ineffective recovery of bank credit, lacuna in credit recovery system, inadequate legal provision etc. Various steps have been taken by the government to recover and reduce NPAs.

15.4.1 Preventive Measures of NPA

Formation of the Credit Information Bureau (India) Limited (CIBIL)

With a view to developing an institutional mechanism for sharing of information on borrowers/potential borrowers among banks and financial institutions, Credit Information Bureau (India) Ltd. (CIBIL) was formally launched on May 5, 2004, for collecting, processing and sharing credit information on the borrowers of credit institutions and serve as an effective mechanism for curbing the growth of Non-performing Assets (NPAs).

Did u know? CIBIL is India's first credit information bureau.

Promoters

CIBIL'S equity is held by State Bank of India, Housing Development Corporation Limited, Dun & Bradstreet Information Services India Private Limited and Trans Union International Inc. The shareholding pattern is in the proportion of 40:40:10:10 respectively.

Coverage

CIBIL is a composite credit Bureau, which caters to both commercial and consumer segments. The consumer Credit Bureau covers credit availed by individuals while the Commercial Credit Bureau covers credit availed by non-individuals such as partnership firms, proprietary concerns, private and public limited companies, etc.

Notes

Members of CIBIL

Banks, Financial Institutions, State Financial Corporations, Non-Banking Financial Companies, Housing Finance Companies and Credit Card Companies are Members of CIBIL.

Operation of CIBIL

For credit grantors to gain a complete picture of the payment history of credit applicant, they must be able to gain access to the applicant's complete credit record that may be spread over different institutions. CIBIL collects commercial and consumer credit-related data and collates such data to create and distribute credit reports to Members.

Sources of Information

CIBIL primarily gets information from its Members only and at a subsequent stage will supplement it with public domain information in order to create a truly comprehensive snapshot of an entity's financial track record.

Type of Information Available

CIBIL will be a world-class bureau dealing in both positive information such as total outstanding group decides feasibility and viability of the proposals in terms of the policies and guidelines evolved by CDR Standing Forum.

15.4.2 NPA Management – Resolution

1. ***Compromise and One Time Settlement:***

   Negotiation

   (a) Know your NPAs

   (b) Know your borrowal account

   (c) Know the history

   (d) Know the reasons for loans going bad

   (e) Do not try to knock of settlements in one sitting

   (f) Finalise compromise amount

   (g) Look forward to the borrower fulfilling commitment

   If the negotiation and compromise resolutions fail, then the option left with only is to proceed against the borrower legally to ensure quickest possible action.

2. ***Restructuring and Rehabilitation:*** Banks are free to design and implement their own policies for restructuring/rehabilitation of the NPA accounts. Re-schedulement of payment of interest and principal after considering the Debt service coverage ratio, contribution of the promoter and availability of security.

3. ***Corporate Debt Restructuring:*** The mechanism of corporate debt restructuring for multiple banking accounts/accounts under loan syndication/consortium accounts with aggregate principal outstanding exposure of ₹. 20 cr and above from banks and institutions was introduced to ensure timely and transparent mechanism for restructuring the corporate debts on viable entities facing temporary financial difficulties. The minimum exposure limit of ₹. 20 cr under eligibility criteria includes both fund based and non-fund based facilities.

Notes

4. ***Debt Recovery Tribunal (DRT):*** The banks and FIs can enforce their securities by initiating recovery proceeding under the Recovery if Debts due to Banks and FI Act, 1993 (DRT Act) by filing an application for recovery of dues before the Debt Recovery Tribunal constituted under the Act.

5. ***Lok Adalats:*** Lok Adalats are made for the recovery of small NPAs upto 20 lacs. It is a speedy way to recover the NPAs. Some of the main characteristics of NPAs are as follows:

   (a) Recovery of small NPAs up to ₹ 20 Lacs

   (b) Speedy Recovery

   (c) Veil of Authority

   (d) Soft Defaulters

   (e) Less expensive

   (f) Easier way to resolve

6. ***Proceeding under Code of Civil Procedure:*** For claims below ₹ 10 lacs, the banks and FIs can initiate proceedings under the Code of Civil Procedure of 1908, as amended, in a Civil Court.

7. ***Board for Industrial & Financial Reconstruction (BIFR)/AAIFR:***

   (a) BIFR has been given the power to consider revival and rehabilitation of companies under the Sick Industrial Companies (Special Provisions) Act of 1985 (SICA), which has been repealed by passing of the Sick Industrial Companies (Special Provisions) Repeal Bill of 2001.

   (b) The board of Directors shall make a reference to BIFR within sixty days from the date of finalization of the duly audited accounts for the financial year at the end of which the company becomes sick.

   (c) The company making reference to BIFR to prepare a scheme for its revival and rehabilitation and submit the same to BIFR the procedure is same as laid down under the CPC.

   (d) The shelter of BIFR misused by defaulting and dishonest borrowers.

   (e) It is a time consuming process.

8. ***National Company Law Tribunal***

   (a) In December 2002, the Indian Parliament passed the Companies Act of 2002 (Second Amendment) to restructure the Companies Act, 1956 leading to a new regime of tackling corporate rescue and insolvency and setting up of NCLT.

   (b) NCLT will abolish SICA, have the jurisdiction and power relating to winding up of companies presently vested in the High Court and jurisdiction and power exercised by Company Law Board.

   (c) The second amendments seeks to improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by providing specialized qualification for the appointment of members to the NCLT.

   (d) However, the quality and skills of judges, newly appointed or existing, will need to be reinforced and no provision has been made for appropriate procedures to evaluate the performance of judges based on the standards.

Notes

9. ***Sale of NPA to other Banks***

   (a) A NPA is eligible for sale to other banks only if it has remained a NPA for at least two years in the books of the selling bank

   (b) The NPA must be held by the purchasing bank at least for a period of 15 months before it is sold to other banks but not to bank, which originally sold the NPA

   (c) The NPA may be classified as standard in the books of the purchasing bank for a period of 90 days from date of purchase and thereafter it would depend on the record of recovery with reference to cash flows estimated while purchasing

   (d) The bank may purchase/sell NPA only on without recourse basis

   (e) If the sale is conducted below the net book value, the short fall should be debited to P&L account and if it is higher, the excess provision will be utilized to meet the loss on account of sale of other NPA.

10. ***SARFESI (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest) Act, 2002***

   (a) SARFESI provides for enforcement of security interests in movable (tangible or intangible assets including accounts receivable) and immovable property without the intervention of the court.

   (b) The bank and FI may call upon the borrower by way of a written legal notice to discharge in full his liabilities within 60 days from the date of notice, failing which the bank would be entitled to exercise all or any of the rights set out under the Act.

Caselet

Banks find DRT a better Recovery Mechanism

Lok Adalats have not proved to be a good means of effecting recoveries from bad loans, statistics show. The 'public courts' have accounted for only 5 to 8 per cent of delinquent loans recovered in the last couple of years. Also, as the Chairman and Managing Director of Indian Bank, Mr. M.S. Sundara Rajan, observes, borrowers often do not honour the commitment reached in Lok Adalats.

However, banks have found the mechanism of Debts Recovery Tribunal and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, more helpful. SARFAESI empowers banks to recover their non-performing assets without the intervention of the Court. A borrower aggrieved by the action of the bank can file an appeal with DRT and then with the Debt Recovery Appellate Tribunal (DRAT), but not with any civil court. The borrower has to deposit 50 per cent of the dues before an appeal with DRAT.

Many bankers have told *Business Line* that it is easier to recover small-ticket bad loans, of around ₹ 1 crores, because they are typically backed by securities and borrowers come forward to negotiate.

On the other hand, the large borrowers are seen to have sufficient 'muscle' and succeed in stalling the recovery process.

In addition to DRTs and the SARFAESI, the 11 registered asset reconstruction companies that buy off the bad loans from banks and make the recovery by themselves, seem to have found favour with banks.

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Notes

The total amount of financial assets acquired by these 11 entities rose 25 per cent in the year July 2008-June 2009. At the end of the period, the total assets with them stood at ₹ 51,542 crores.

Source: *Introduction to Banking Management*, G. Vijayaragavan Iyengar

15.5 Summary

- The Indian banking sector is facing a serious problem of NPA.
- The extent of NPA is comparatively higher in public sectors banks.
- Brief View of Provisioning
  - Standard Assets – general provision of a minimum of 0.25%
  - Sub-standard Assets – 10% on total outstanding balance, 10 % on unsecured exposures identified as sub-standard and 100% for unsecured "doubtful" assets.
  - Doubtful Assets – 100% to the extent advance not covered by realizable value of security. In case of secured portion, provision may be made in the range of 20% to 100% depending on the period of asset remaining sub-standard
  - Loss Assets – 100% of the outstanding
- With a view to developing an institutional mechanism for sharing of information on borrowers /potential borrowers among banks and financial institutions, Credit Information Bureau (India) Ltd. (CIBIL) was formally launched on May 5, 2004, for collecting, processing and sharing credit information on the borrowers of credit institutions and serve as an effective mechanism for curbing the growth of Non-performing Assets (NPAs).
- The key resolution tools used by banks for NPAs management are DRT, Lok Adalats, BIFR etc.

15.6 Keywords

CIBIL: Credit Information Bureau (India) Limited

Doubtful Assets: With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub standard category for a period of 12 months.

Loss Assets: A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.

NPA: When a loan asset fails to contribute any income on the stipulated dates – every quarter in case of working capital loan and half yearly basis on term loans – to the owners, it is known as NPA.

Standard Assets: These are loans which do not have any problem are less risk.

Sub-standard Assets: With effect from 31st March 2005, a sub standard asset would be one, which has remained NPA for a period less than or equal to 12 months.

Notes

15.7 Self Assessment

Fill in the blanks:

1. The assets which remained doubtful for a period of ……. years required a provision of 30%.
2. ……should be written off.
3. Term Loan account will be treated as NPA if interest or installment of principal is in arrears for any ……out of four quarters.
4. A ……will be treated as NPA if the account remains out of order for a period of two quarters.
5. With effect from 31st March 2005, a ……would be one, which has remained NPA for a period less than or equal to 12 months.
6. Lok Adalats are made for the recovery of small NPAs upto……..
7. For claims below……, the banks and FIs can initiate proceedings under the Code of Civil Procedure of 1908, as amended, in a Civil Court.
8. The ……which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 20 per cent on the outstanding balance.

State whether the following statements are true or false:

9. Sub-standard assets remained NPA for a period less than or equal to 12 months.
10. Doubtful assets remained in the sub standard category for a period of 18 months.
11. Banks can make 50% provisions on loss assets.
12. The provisions towards Standard Assets need not be netted from gross advances.
13. Large amount of loans are the reasons of rising NPAs in banks.
14. CIBIL is India's first credit information bureau.
15. CIBIL is a composite credit bureau.

15.8 Review Questions

1. The RBI has issued guidelines to banks for classification of assets into different categories. What are those guidelines?
2. RBI is the key regulator of banking industry in India. Discuss the key measures taken by RBI for regulating the banking sector.
3. "As per Reserve Bank of India's guidelines, income on loans is to be recognised on receipt basis (as against accrual basis) and if it has not been received for a specified period, the same asset is to be treated as non-performing." Discuss.
4. In recent years the NPAs are increasing with a rapid rate. Why?
5. Discuss the impact of NPAs on Indian banking industry.
6. Suppose you are the bank manager of HDFC bank and you have to take some necessary steps to reduce the bank's NPAs. What will be your action to reduce the NPAs?
7. Why it is important to control the rising of NPAs?

Notes

8. "Banks are required to maintain some provisions for doubtful assets." Discuss.
9. How banks sale their NPAs to other banks?
10. "Treatment of term loans as NPA is different from cash credit or overdraft." Discuss.

Answers: Self Assessment

1.	1 to 3	2.	Loss assets
3.	two quarters	4.	cash credit or overdraft account
5.	sub-standard asset	6.	20 lacs
7.	₹ 10 lacs	8.	unsecured exposures
9.	True	10.	False
11.	False	12.	True
13.	False	14.	True
15.	True		

15.9 Further Readings

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Online links

www.rbi.org.in

www.business.gov.in

Notes

Unit 16: Venture Capital

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the meaning of venture capital
- Explain the features of venture capital
- Define techniques of venture capital
- Discuss Indian venture capital scenario

Introduction

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockfeller Group financed the new technology companies.

The concept became popular during 1960s and 1970s when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. The American Research and Development was formed as the first venture organization which financed over 100 companies and made profit over 35 times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries.

Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs management and to use advanced technology to launch new products and companies in the market place.

Undoubtedly, it is the venture capitalist's extraordinary skill and ability to assess and manage enormous risks and extort from them tremendous returns that has attracted more entrants.

Notes

Innovative, hi-tech ideas are necessarily risky. Venture capital provides long-term start-up costs to high risk and return projects. Typically, these projects have high mortality rates and therefore are unattractive to risk averse bankers and private sector companies.

Venture capitalist finances innovation and ideas, which have potential for high growth but are unproven. This makes it a high risk, high return investment. In addition to finance, venture capitalists also provide value-added services and business and managerial support for realizing the venture's net potential.

16.1 Meaning of Venture Capital

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.

There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in highly risky project with the objective of earning a high rate return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked.

These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (Venture Capital firms) take an active interest in guiding the assisted firms.

A young, high tech company that is in the early stage of financing and is not yet ready to make a public offer of securities may seek venture capital. Such a high risk capital is provided venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Thus, a Venture Capitalist (VC) may provide the seed capital unproven ideas, products, technology oriented or start up firms. The venture capitalists may also invest in a firm that unable to raise finance through the conventional means.

16.2 Features of Venture Capital

"Venture Capital combines the qualities of a banker, stock market investor and entrepreneur in one."

The main features of venture capital can be summarised as follows:

1. ***High Degrees of Risk:*** Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.

Notes

2. ***Equity Participation:*** Venture capital financing is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.

3. ***Long-term Investment:*** Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.

4. ***Participation in Management:*** In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".

5. ***Achieve Social Objectives:*** It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.

6. ***Investment is Liquid:*** A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing.

It is lost when the company goes into liquidation.

Task

List some of the venture capitalists operating under your territory and analyse if their services miss any of the features discussed above.

16.3 Techniques of Venture Capital

Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

1. ***Early Stage Financing:***
   - (a) Seed Capital & Research and Development Projects
   - (b) Start Ups
   - (c) Second Round Finance
2. ***Later Stage Financing:***
   - (a) Development Capital
   - (b) Expansion Finance
   - (c) Replacement Capital
   - (d) Turn Arounds
   - (e) Buy Outs.

Notes

Early Stage Financing

This stage includes the following:

1. ***Seed Capital and R&D Projects:*** Venture capitalists are more often interested in providing seed finance i. e. making provision of very small amounts for finance needed to turn into a business. Research and development activities are required to be undertaken before a product is to be launched. External finance is often required by the entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development phase, where a sample of the product is tested before it is finally commercialised "venture capitalists/firms/funds are always ready to undertake risks and make investments in such R & D projects promising higher returns in future.

2. ***Start Ups:*** The most risky aspect of venture capital is the launch of a new business after the research and development activities are over. At this stage, the entrepreneur and his products or services are as yet untried. The finance required usually falls short of his own resources. Start-ups may include new industries/businesses set up by the experienced persons in the area in which they have knowledge. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Still other start-ups occur when a new company with inadequate financial resources to commercialise new technology is promoted by an existing company.

3. ***Second Round Financing:*** It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually three to seven years.

Later Stage Financing

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital.

1. ***Development Capital:*** It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/plant, expansion of marketing and distributing facilities, launching of product into new regions and so on. The time scale of investment is usually one to three years and falls in medium risk category.

2. ***Expansion Finance:*** Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of exiting businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

3. ***Buy Outs:*** It refers to the transfer of management control by creating a separate business by separating it from their existing owners. It may be of two types.

   (a) *Management Buyouts (MBOs):* In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.

Notes

(b) M*anagement Buyins (MBIs):* Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties: a management team, a target company and an investor (i.e. Venture capital institution). MBIs are more risky than MBOs and hence are less popular because it is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

4. ***Replacement Capital:*** Another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association of a well known name. The time scale of investment is one to three years and involve low risk.

5. ***Turnarounds:*** Such form of venture capital financing involves medium to high risk and a time scale of three to five years. It involves buying the control of a sick company which requires very specialised skills. It may require rescheduling of all the company's borrowings, change in management or even a change in ownership. A very active "hands on" approach is required in the initial crisis period where the venture capitalists may appoint its own chairman or nominate its directors on the board.

In nutshell, venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capitalists evaluate technology and study potential markets besides considering the capability of the promoter to implement the project while undertaking early stage investments. In later stage investments, new markets and record of the business/entrepreneur is closely examined.

16.4 Indian Venture Capital Scenario

In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals.

The Indian Venture Capital (VC) market has been getting more active by the day. During the last year or so, almost all the major global VC firms have either established an on-ground presence in India or raised significant India-dedicated funds. In 2006, VC investment levels increased by more than 300% to almost $7.5 billion from $2.2 billion in 2005. This quantum leap was not the result of a low base-as 2005 was a record year in itself.

Notes

Caselet

Govt. Plans ₹ 3,000 crores Venture Capital Fund for Drug Discovery

Government is willing to look at the industry's demand for a single regulatory authority to do away with multiple regulatory bodies.

The Government is planning to set up a ₹ 3,000 crores venture capital fund to give a fillip to drug discovery and strengthen the pharma infrastructure in the country. The National Institute of Public Finance & Policy (NIPFP) is set to finalise the bid document and the expression of interest for setting up the find will be issued this month.

Speaking at the National Convention on Biopharma, organised by the Department of Pharmaceuticals and FICCI, Mr Ashok Kumar, Secretary, Department of Pharmaceuticals, said that the Government had issued an expression of interest for technical and financial bids for the selection of a global level consultant (GLC) for preparation of a detailed project report (DPR) for developing India as a drug discovery and pharma innovation hub by 2020.

The selection of a consultant would be made this month and the report is expected to be ready by year end.

Mr Kumar also said that the Government was willing to look at the industry's demand for a single regulatory authority to do away with multiple regulatory bodies.

The biopharma market in India is growing at 15 per cent annually. By 2020, the market is projected to be worth over $200 billions, driven by a shift in usage from conventional drugs to biopharma products.

Mr. Kumar released the 'Vision 2020' paper on a bio pharma strategy for India, prepared by PricewaterhouseCoopers and Association of Biotechnology Led Enterprises (ABLE).

The document spells out the challenges before the biopharma industry and suggests key action areas. For the medium term, it suggests that in the area of research and development, India would need to build protein characterisation laboratories and GLP-certified animal study facilities; create a national animal breeding facility, expand viral testing facilities; provide financial assistance for ensuring compliance with global standards; promote the development of pro-clinical providers; provide practical support for clinical trials and simplify the procedures for importing and exporting biologics.

As for the regulatory framework, the report states that it is imperative to simplify the procedure for approving biologics; create an independent inspection facility and modify the regulations on process validation.

The report states that if India was to become the world leading provider of affordable biopharmaceutical products by 2020, it cannot simply count on biosimilars and vaccines; it must also become a source of innovation.

More specifically, it should aim to have at least 10 original biologics on the local market and at least two on the global market by 2020.

Source: http://www.thehindubusinessline.in

What is driving this VC investment boom? The most important fact is Indian GDP growth coming within striking range of double-digits. Annual growth rates of 7-9% are unheard of in mature western economies, and global investors want high returns. Furthermore, several key

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sectors of the Indian economy (IT/BPO, telecom, pharma/healthcare, financial services, retail and automotive components) that are investment targets are experiencing even higher growth than the said levels (of 7-9%). Other key attractions include: an economy well positioned to mine the opportunities of globalisation, an increased appetite for innovation and entrepreneurship, well-regulated and fully functional capital markets and a spurt in consumerism powered by the young demographic profile. Clearly, the liberalisation of the economy has also had a significant impact, laying the foundation for a relatively stable macroeconomic environment in combination with high growth.

However, on the regulatory side, many investors would like to see the government use the current momentum to push forward with further deregulation. Some recent regulations, they fear, have not been well thought through. Examples of these include the introduction of FBT on stock options and the recent news on preference share capital requiring compliance with ECB guidelines on interest/dividend coupon caps and end-use restrictions (that is, compliance with external debt norms, unless the shares are fully-convertible). For the VC industry, the new end-use restrictions are particularly harmful as funds raised via preference shares cannot be used for general corporate purposes, funding of working capital, repayment of existing loans and acquisition of shares and/or real-estate. At present, it is estimated that about 30% of the Indian VC/PE investments are structured as preference share capital. Unless this gets revised, the percentage might well come down. This is in sharp contrast with many western markets, where an even higher and ever-increasing percentage of VC investments are structured with a layer of preference share capital-also referred to as 'hybrid capital.

Case Study

Technology Development and Information Company of India Ltd.

TDICI was incorporated in January 1988 with the support of the ICICI and the UTI. The country's first venture fund managed by the TDICI called VECAUS (Venture Capital Units Scheme) was started with an initial corpus of ₹20 crores and was completely committed to 37 small and medium enterprises. The first project of the TDICI was loan and equity to a computer software company called Kale Consultants.

Present Status: At present the TDICI is administering two UTI -mobilised funds under VECAUS-I and II, totaling ₹120 crores. the ₹20 crores invested under the first fund, VECAUS-I, has already yielded returns totaling ₹ 16 crores to its investors.

Some of the projects financed by the TDICI are discussed below:

MASTEK , a Mumbai based software firm, in which the TDICI invested ₹42 lakhs in equity in 1989, went public just three years later, in November 1992. It showed an annual growth of 70-80 percent in the turnover.

TEMPTATION FOODS, located in PUNE, which exports frozen vegetables and fruits, went public in November 1992. The TDICI invested ₹50 lakhs in its equity.

RISHABH INSTRUMENTS of Nasik got ₹40 lakh from the TDICI. It manufactures a range of meters used in power stations in collaboration with the ABB Metra Watt of Germany. After making cash losses totaling ₹25 lakhs in two bad years, it turned around in 1989 and showed an increase of over 70 percent in the turnover.

Contd...

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SYNERGY ART FOUNDATION, which runs art galleries in Mumbai and Chennai and plans to set up in Pune and Delhi too, had received ₹25 lakhs from the TDICI as convertible loans which were converted into equity on march 31, 1994. Most of this money has been used for the company's innovative art library scheme at least paintings to corporate clients.

Questions

1. How has TDICI gained through its venture funds?
2. How do you think can TDICI gain further?

Source: www.indiape.com

16.5 Private Equity

Private equity refers to a type of investment aimed at gaining significant, or even complete, control of a company in the hopes of earning a high return. As the name implies, private equity funds invest in assets that either are not owned publicly or that are publicly owned but the private equity buyer plans to take private. Though the money used to fund these investments comes from private markets, private equity firms invest in both privately and publicly held companies.

Private equity has become an increasingly mainstream asset for sophisticated investors. Private equity entails investment in nonpublic companies at various stages of development and encompasses venture, buyout and mezzanine investing. Investors typically invest in private equity assets either through individual funds, usually limited partnerships with a specified investment stage and geographic focus, or via a fund of funds, through which commitments are made to multiple underlying funds. Some investors may also invest directly into unquoted companies, often on a co-investment basis alongside individual funds. Secondary investment – the acquisition of an interest in a private equity fund from the original investor before the end of the fund's fixed life—is also embraced within the broad definition of private equity. When investing in private equity through funds or funds of funds, an investor makes an initial commitment of capital that is then "called" or drawn down as the investment managers of the underlying funds find investment opportunities. Capital is chiefly returned to the investor via distributions on the sale or recapitalization of individual unquoted companies by the underlying funds, although in some cases investors may also receive earnings-derived distributions.

Concept of Private Equity

Private equity is essentially a way to invest in some asset that isn't publicly traded, or to invest in a publicly traded asset with the intention of taking it private. Unlike stocks, mutual funds, and bonds, private equity funds usually invest in more illiquid assets, i.e. companies. By purchasing companies, the firms gain access to those companies' assets and revenue sources, which can lead to very high returns on investments. Another feature of these private equity transactions is their extensive use of debt in the form of high-yield bonds. By using debt to finance acquisitions, private equity firms can substantially increase their financial returns. The debt used in buyouts has a relatively fixed cost, so if a private equity fund's return on assets (ROA) is greater than this cost, the fund's return on equity (ROE) is higher than if it hadn't borrowed money. The same principle applies in reverse, however, making these leveraged buyouts potentially very risky; if the acquired company's ROA is lower than the cost of the debt used to buy it, then the private equity fund's ROE is less than if hadn't used debt. The firm would lose money on the investment *and* still have to pay back the loans, a situation similar to having *negative equity* in the housing market.

Notes

Factors affecting Private Equity

The following are the key factors which affect the growth of private equity:

1. ***Raising Capital:*** The company may need a large inflow of capital for long-term productivity investments such as research and development. Rather than waiting several quarters (or years) to gather sufficient capital, the company may choose to sell part of its interests in exchange for the ability to pursue development projects sooner. This may be especially true of highly time-sensitive industries such as technology (e.g. software, telecommunications, and Internet services), where a few quarters may make a critical difference in a company's ability to gain (or maintain) a market advantage.
2. ***Increasing Regulation of Public Markets:*** Second, given the increasing regulation and scrutiny in the public markets over the last several years, some companies may wish to avoid having their destinies controlled—or at least heavily influenced—by public shareholders. In a public company, shareholders have the right to cast votes with regard to any number of issues critical to the company. In a private equity transaction, such rights typically do not exist. Accordingly, a company can raise capital without relinquishing operating control to external shareholders. Nevertheless, a private equity firm does retain some control, such as the ability to influence the composition of management teams. Often, a private equity firm may take an interest in a company on the condition that the company install new management—which ideally will improve operating results and drive profits.
3. ***Effect on Public Markets:*** For stock market investors, the real question is how the private equity market has affected public markets and what its likely effects will be in the future. Many analysts argue that the increase in private equity deals has actually benefited some aspects of the stock market; the reason is that, with so many companies going private, it's become harder for public investors to gain exposure to industries where private equity has been especially influential. Small- to mid-size firms in the energy and finance industries are prime examples. With the increase in private equity deals, the availability of publicly traded shares of such companies has decreased. This decrease in supply has caused the remaining shares to increase in price; as there are fewer available, each becomes more valuable.
4. ***Rising Stock Prices:*** Private equity can boost a company's stock price if people think a buyout is likely. Companies that are perceived as likely targets of private equity buyouts have seen their stock prices rise in anticipation of the transaction. Given recent trends in the private equity industry, investors often feel safe in assuming that private equity firms will pay a hefty premium over a company's market value.

Private Equity in India

The Indian economy has been enjoying a period of sustained growth at around 8 per cent a year. The latest boom has attracted the attention of private equity houses who have been participating in an unprecedented number of investment deals. In sharp contrast to the time private equity funds invested in India from a base overseas (for example Singapore), many private equity firms have now established a presence in the country, spurred on by a bullish market and some spectacular and well documented exits. This reflects the importance of understanding local markets and working closely with promoters (families or controlling shareholders), as well as the benefits of local decision making.

The Indian private equity market is different from that of Europe or the United States in that small family-owned and family-managed businesses account for a high proportion of the market

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and therefore investment opportunities. The average deal size in India is significantly lower than in China or South Korea, for instance, but 8,000 companies are listed on Indian exchanges, a huge number by any standard, and the rising performance of the stock market since 2004 has resulted in substantial wealth creation for families with majority stakes in listed companies.

Among non-listed family companies there has been a traditional reluctance to share ownership and surrender control. However, there are signs that private equity firms are willing to play a more active advisory role in parallel with their ability to raise growth capital — a prospect that owners and promoters are starting to find attractive. As well as providing capital and financial expertise, private equity firms are in a unique position to introduce new disciplines and much needed structural reforms, for example looking closely at the quality of management teams or challenging companies to introduce leadership succession plans.

There has been phenomenal growth in the value of private equity investment in India over the past decade. With an expanding domestic market and additional opportunities brought by globalisation, the impact of private equity on Indian business is likely to increase further in the coming years.

16.6 Summary

- Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth.
- Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.
- A Venture Capitalist (VC) may provide the seed capital unproven ideas, products, technology oriented or start up firms.
- The venture capital involves high degrees of risk.
- Venture capital financing is an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.
- Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.
- Venture capital funds take an active interest in the management of the assisted firms.
- Venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.
- Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely Early Stage Financing and Later Stage Financing.
- In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships.

16.7 Keywords

Management Buyins (MBIs): Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company.

Management Buyouts (MBOs): In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/investors to acquire an existing product line/business.

Notes

Turnarounds: Such form of venture capital financing involves medium to high risk and a time scale of three to five years.

16.8 Self Assessment

Fill in the blanks:

1. TDICI was incorporated in January 1988 with the support of the ..... and the .....
2. Venture capital firms finance both early and later stage investments to maintain a balance between ..... and .....
3. For the VC industry, the new end-use restrictions are particularly harmful as funds raised via ..... shares cannot be used for general corporate purposes.
4. One aspect of financing is to provide funds for the purchase of ..... shares of owners.
5. Venture Capital Institutions (VCIs) provide larger funds during ..... financing.
6. ..... refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public.
7. The ..... was formed as the first venture organization.
8. It is the venture capitalist's extraordinary skill and ability to ..... and ..... enormous risks and extort from them tremendous returns.
9. Venture capital is a form of equity financing especially designed for funding high ..... and high ..... projects.
10. Venture capital companies provide the necessary risk capital to the ..... so as to meet the promoters' contribution as required by the financial institutions.
11. Venture capital financing is a ..... investment.
12. Venture capital combines the qualities of ....., ... and entrepreneur in one.
13. A venture capital is not subject to ..... on demand.
14. Venture capitalists perceive low risk in ventures requiring finance for ..... purposes.
15. In ..... venture capital institutions provide funds to enable the current operating management/investors to acquire an existing product line/business.

16.9 Review Questions

1. What is the basis of lending venture capital? Are internet/technology companies given first priority for funding these days?
2. Is it true that most investors are ready and willing to invest and fund quickly? If not, explain with reasons.
3. Who is an angel? How does angel investing differ from venture capital?
4. In the past year, what has been the most interesting IPO or acquisition in the industry you want to enter?

Notes

5. Where do venture capitalists get their money from? Do you think venture capitalists in India have been investing it in the right places?
6. After making a detailed analysis of this unit, what do you think are the main types of companies and industries that venture capitalists invest in?
7. How do venture capitalists realize a return on their investment?
8. What's the difference between venture capital and private equity? What impact does corporate venture investing have on the venture industry?
9. "Venture capital combines the qualities of banker, stock market investor and entrepreneur in one". Justify.
10. Differentiate between Buy-ins and Buy-outs. What do you see as the role of venture capitalists in each of them?
11. Which stage do you think is most crucial in the investment process by venture capitalists and why?

Answers: Self Assessment

1.	ICICI, UTI	2.	risk, profitability
3.	preference	4.	existing
5.	second round	6.	Development Capital
7.	American Research and Development	8.	assess, manage
9.	risk, reward	10.	entrepreneurs
11.	long-term	12.	banker, stock market investor
13.	repayment	14.	expansion
15.	Management Buyouts (MBOs)		

16.10 Further Readings


Online links

www.entrepreneur.com

www.findarticles.com

www.investorquestions.com

Notes

Unit 17: Credit Rating

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the regulatory framework of credit rating
- Define credit rating process
- List the credit rating agencies

Notes

Introduction

According to SEBI, "rating" means an opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

A credit rating estimates the credit worthiness of an individual, corporation, or even a country. It is an evaluation made by credit bureaus of a borrower's overall credit history.

17.1 Regulatory Framework

The regulatory framework for the credit rating agencies is determined under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The following are the main highlights:

17.1.1 Conditions of Certificate and Validity Period

1. The certificate granted to certify a company as a credit rating agency is, subject to the following conditions, namely:
   (a) the credit rating agency shall comply with the provisions of the Act, the regulations made under and the guidelines, directives, circulars and instructions issued by the Board from time to time on the subject of credit rating.
   (b) where any information or particulars furnished to the Board by a credit rating agency:
      (i) is found to be false or misleading in any material particular; or
      (ii) has undergone change subsequently to its furnishing at the time of the application for a certificate; the credit rating agency shall forthwith inform the Board in writing.
2. The period of validity of certificate of registration shall be three years.

17.1.2 Renewal of Certificate

A credit rating agency, if it desires a renewal of the certificate granted to it, has to make to the Board, an application for the renewal of the certificate of registration. Such application for renewal of certificate of registration made under sub-regulation has to be accompanied by a non refundable application fee as specified in the Second Schedule of SEBI.

A renewal application has to be made not less than three months before expiry of the period of the validity of the certificate.

The application for renewal made under sub-regulation is to be accompanied by a renewal fee as specified in the second schedule. As far as possible a renewal application is dealt with in the same manner as if it were an application for the grant of a fresh certificate.

Did u know? **What are the conditions where certificate is not granted?**

If, after considering an application, the Board is of the opinion that a certificate should not be granted or renewed, as the case may be, it may, after giving the applicant a reasonable opportunity of being heard, reject the application.

Notes

17.1.3 Effect of Refusal to Grant Certificate

An applicant whose application for the grant of a certificate has been rejected, shall not undertake any rating activity.

If the Board is satisfied that it is in the interest of the investors, it may permit the credit rating agency to complete the rating assignments already entered into by it, during the pendency of the application or period of validity of the certificate.

The Board may, in order to protect the interests of investors, issue directions with regard to the transfer of records, documents or reports relating to the activities of a credit rating agency, whose application for the grant or renewal of a certificate has been rejected.

The Board may also appoint a person to take charge of the records, documents or reports relating to the rating activities of a credit rating agency and for this purpose also determine the terms and conditions of such appointment.

17.1.4 Code of Conduct

Every credit rating agency has to abide by the Code of Conduct contained in the Third Schedule.

Every credit rating agency has to enter into a written agreement with each client whose securities it proposes to rate, and every such agreement shall include the following provisions, namely:

1. the rights and liabilities of each party in respect of the rating of securities shall be defined;
2. the fee to be charged by the credit rating agency shall be specified;
3. the client shall agree to a periodic review of the rating by the credit rating agency during the tenure of the rated instrument;
4. the client shall agree to co-operate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the clients securities and shall in particular provide to the latter, true, adequate and timely information for the purpose;
5. the credit rating agency shall disclose to the client the rating assigned to the securities of the latter through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client;
6. the client shall agree to disclose, in the offer document:
   (a) the rating assigned to the client's listed securities by any credit rating agency during the last three years and
   (b) any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client
7. the client shall agree to obtain a rating from at least two different rating agencies for any issue of debt securities whose size is equal to or exceeds, rupees one hundred crores.

17.1.5 Monitoring of Ratings

Every credit rating agency has to, during the lifetime of securities rated by it continuously monitor the rating of such securities.

Every credit rating agency has to shall disseminate information regarding newly assigned ratings, and changes in earlier rating promptly through press releases and websites, and, in the case of securities issued by listed companies, such information shall also be provided simultaneously to the concerned regional stock exchange and to all the stock exchanges where the said securities are listed.

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Caselet

RBI to Review, Monitor Credit Rating Agencies

Mumbai, April 23 Reserve Bank of India has decided to review and monitor the performance of credit rating agencies, for continuation of their accreditation. The move is aimed at ensuring greater accountability in the quality of the rating process and methodologies.

According to the G-20 Working Group recommendations, all credit rating agencies whose ratings are used for regulatory purposes will be subject to regulatory oversight regime, which includes registration and compliance with the International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals. "The Reserve Bank of India will liaise with SEBI, on the issue of rating agencies' adherence to the IOSCO Code of Conduct Fundamentals," the recommendation said.

RBI has accorded accreditation to four rating agencies registered with market regulator SEBI.

This will allow them to use their rating for assigning risk weights within the framework of the Basel II Accord, which has been implemented with effect from March.

Prior to this, RBI had undertaken a review of the rating agencies' practices and procedures to ensure that they comply with the criteria prescribed for accreditation in the Basel II Framework. Regulations for credit-rating agencies had been framed by SEBI many years ago. However, with ratings now spanning many products such as bank loans, commercial paper and security receipts issued by asset reconstruction companies, the RBI wanted oversight on rating agencies to be strengthened.

Source: http://www.thehindubusinessline.in

17.1.6 Procedure for Review of Rating

Every credit rating agency has to carry out periodic reviews of all published ratings during the lifetime of the securities.

If the client does not co-operate with the credit rating agency so as to enable the credit rating agency to comply with its obligations, the credit rating agency shall carry out the review on the basis of the best available information.

Provided that if owing to such lack of co-operation, a rating has been based on the best available information, the credit rating agency shall disclose to the investors the fact that the rating is so based.

A credit rating agency cannot withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company.

17.1.7 Internal Procedures to be Framed

Every credit rating agency has to frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of -

1. the Securities and Exchange Board of India (Insider Trading) Regulations, 1992;

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2. the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995; and
3. other laws relevant to trading of securities.

17.1.8 Disclosure of Rating Definitions and Rationale

Every credit rating agency -

1. has to make public the definitions of the concerned rating, along with the symbol and,
2. has to also state that the ratings do not constitute recommendations to buy, hold or sell any securities.

Every credit rating agency has to make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

Where any information is called for by the Board from a credit rating agency for the purposes of these regulations, including any report relating to its activities, the credit rating agency has to furnish such information to the Board -

1. within a period specified by the Board or
2. if no such period is specified, then within a reasonable time.

Every credit rating agency has to, at the close of each accounting period, furnish to the Board copies of its balance sheet and profit and loss account.

All the credit rating agencies have to comply with such guidelines, directives, circulars and instructions as may be issued by the Board from time to time, on the subject of credit rating.

17.1.9 Appointment of Compliance Officer

Every credit rating agency has to appoint a compliance officer who is responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc issued by the Board or the Central Government.

The compliance officer immediately and independently reports to the SEBI any non-compliance observed by him.

17.1.10 Maintenance of Books of Accounts Records etc.

Every credit rating agency has to keep and maintain, for a minimum period of five years, the following books of accounts, records and documents, namely:

1. copy of its balance sheet, as on the end of each accounting period;
2 a copy of its profit and loss account for each accounting period;
3. a copy of the auditor's report on its accounts for each accounting period;
4. a copy of the agreement entered into, with each client;
5. information supplied by each of the clients;
6. correspondence with each client;
7. ratings assigned to various securities including upgradation and down gradation (if any) of the ratings so assigned;

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8. rating notes considered by the rating committee;
9. record of decisions of the rating committee;
10. letter assigning rating;
11. particulars of fees charged for rating and such other records as the Board may specify from time to time.

Every credit rating agency has to intimate to the Board the place where the books of account, records and documents required to be maintained under these regulations are being maintained.

Every credit rating agency has to, within two month's from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report, insofar as they relate to the activity of rating of securities.

Caution Every credit rating agency has to treat, as confidential, information supplied to it by the client and no credit rating agency can disclose the same to any other person, except where such disclosure is required or permitted by under or any law for the time being in force.

17.1.11 Rating Process

1. Every credit rating agency has to:
   (a) specify the rating process;
   (b) file a copy of the same with the Board for record; and file with the Board any modifications or additions made therein from time to time.
2. Every credit rating agency shall, in all cases, follow a proper rating process.
3. Every credit rating agency shall have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating.
4. All rating decisions, including the decisions regarding changes in rating, are taken by the rating committee.
5. Every credit rating agency has to be staffed by analysts qualified to carry out a rating assignment.
6. Every credit rating agency has to inform the Board about new rating instruments or symbols introduced by it.
7. Every credit rating agency, has to, while rating a security, exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate.
8. A credit rating agency cannot rate securities issued by it.
9. Rating definition, as well as the structure for a particular rating product, cannot be changed by a credit rating agency, without prior information to the Board.
10. A credit rating agency has to disclose to the concerned stock exchange through press release and websites for general investors, the rating assigned to the securities of a client, after periodic review, including changes in rating, if any.

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17.1.12 Restriction on Rating of Securities issued by Promoters or by certain other Persons

Definitions

In this chapter, unless the context otherwise requires:

1. "associate" , in relation to a promoter, includes a body corporate in which the promoter holds ten percent or more, of the share capital;
2. "promoter" means a person who holds ten percent or more, of the shares of the credit rating agency.

Securities issued by Promoter

1. No credit rating agency can rate a security issued by its promoter.
2. In case promoter is a lending institution, its Chairman, director or employee cannot be a Chairman, director or employee of credit rating agency or its rating committee.

Securities issued by certain Entities, Connected with a Promoter or Rating Agency not to be Rated

1. No credit rating agency can, rate a security issued by an entity, which is:
   (a) a borrower of its promoter; or
   (b) a subsidiary of its promoter; or
   (c) an associate of its promoter; if
      (i) there are common Chairman, Directors between credit rating agency and these entities;
      (ii) there are common employees;
      (iii) there are common Chairman, Directors, Employees on the rating committee.
2. No credit rating agency can rate a security issued by its associate or subsidiary, if the credit rating agency or its rating committee has a Chairman, director or employee who is also a Chairman, director or employee of any such entity.

Provided that the Credit Rating Agency may, subject to the provisions of sub-regulation rate a security issued by its associate having a common independent director with it or rating committee if:

1. such an independent director does not participate in the discussion on rating decisions, and
2. the Credit Rating Agency makes a disclosure in the rating announcement of such associate (about the existence of common independent director) on its Board or of its rating committee, and that the common independent director did not participate in the rating process or in the meeting of its Board of Directors or in the meeting of the rating committee, when the securities rating of such associate was discussed.

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Notes For the purposes of this sub-regulation the expression 'independent director' means a director who, apart from receiving remuneration as a director, does not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board of the company, may affect the independence of the judgment of such director.

Securities Already Rated

Nothing applies to securities whose rating has been already done by a credit rating agency before the commencement of these regulations, and such securities may, subject to the provisions of the other Units of these regulations, continue to be rated, without the need to comply with the restrictions imposed by the regulations contained in this unit.

17.1.13 Procedure for Inspection and Investigation

The Board may appoint one or more persons as inspecting officers, to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies.

The purposes referred to in sub-regulation may be the following, namely:

1. to ascertain whether the books of account, records and documents are being maintained properly;
2. to ascertain whether the provisions of the Act and these regulations are being complied with;
3. to investigate into complaints received from investors, clients or any other person on any matter having a bearing on activities of the credit rating agency;
4. in the interest of the securities market or in the interest of investors.

The inspections ordered by the Board do not ordinarily go into an examination of the appropriateness of the assigned ratings on the merits. Inspections to judge the appropriateness of the ratings may be ordered by the Board, only in case of complaints which are serious in nature. Inspections are carried out either by the officers of the Board or independent experts, with relevant experience or combination of both.

Notice before Inspection or Investigation

Before ordering an inspection or investigation, the Board gives no less than ten days written notice to the credit rating agency for that purpose. Nevertheless, where the Board is satisfied that in the interest of the investors, no such notice is given, it, by an order in writing, directs that the inspection or investigation of the affairs of the credit rating agency be taken up without such notice.

During the course of an inspection or investigation, the credit rating agency against whom the inspection or is being carried out is bound to discharge all its obligations.

Task Find out what are the obligations of credit rating agency on inspection or investigation by the Board and list them.

Notes

Submission of Report to the Board

The inspecting officer, as soon as possible, on completion of the inspection or investigation, submits a report to the Board. If directed to do so by the Board, he may submit an interim report.

Action on Inspection or Investigation Report

The Board or the Chairman , after consideration of inspection or investigation report take such action as the Board or Chairman deems fit and appropriate including action under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

17.1.14 Procedure for Action in Case of Default

Liability for Action in Case of Default

Substituted by SEBI (Procedure For Holding Enquiry by Enquiry officer and Imposing Penalty) Regulation, 2002, w.e.f. 27-9-2002. Prior to its substitution it read as follows.

Communication of Findings etc. to the Credit Rating Agency

The Board shall, after consideration of the inspection report or the interim report referred to in regulation 32, communicate the findings of the inspecting officer to the credit rating agency and give it a reasonable opportunity of being heard in the matter.

On receipt of the explanation, if any, from the credit rating agency, the Board may call upon the credit rating agency to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and these regulations.

Substituted by the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing penalty) Regulations, 2002.w.e.f. 27-9-2002. Prior to its substitution it read as follows.

Liability for Action in Case of Default

1. A credit rating agency which:
   (a) fails to comply with any condition subject to which a certificate has been granted; or
   (b) contravenes any of the provisions of the Act or these regulations or any other regulations made under the Act;

   shall be dealt with in the manner provided under the Securities and Exchange Board of India (Procedure for holding Enquiry by Enquiry officer and Imposing penalty) Regulations, 2002 and shall be liable to either of the penalties specified as under.
2. The penalties referred to in the above sub-regulation are:
   (a) suspension of registration; or
   (b) cancellation of registration.

Manner of making Order of Suspension and Cancellation

No order of suspension or of cancellation of the certificate of registration, is passed by the Board, except after holding an enquiry in accordance with the procedure specified.

Notes

The holding of such an enquiry shall not be necessary in cases where:

1. the credit rating agency is declared insolvent or is wound up; or
2. the credit rating agency fails to pay to the Board registration fees or renewal fee as per these regulations.

An opportunity of hearing shall be given before any action against the credit rating agency is taken.

Manner of Holding Enquiry before Suspension or Cancellation

1. For the purpose of holding an enquiry, the Board may appoint one or more enquiry officers.
2. The enquiry officer issues to the credit rating agency a notice at the registered office or the principal place of business of the credit rating agency, setting out the grounds on which action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of such notice.
3. The credit rating agency, may, within fourteen days from the date of receipt of such notice, furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by the Board from the credit rating agency.
4. The enquiry officer has to give a reasonable opportunity of hearing to the credit rating agency, to enable it to make its submission in support of its reply.
5. Before the enquiry officer, the credit rating agency may either appear in person or through any person duly authorised on this behalf.

No lawyer or advocate is permitted to represent the credit rating agency at the enquiry. However, where a lawyer or an advocate has been appointed by the board as a presenting officer, it is lawful for the credit rating agency to present his case through a lawyer or advocate.

If it is considered necessary, the enquiry officer may request the Board to appoint a presenting officer to present its case. The enquiry officer, after taking into account all relevant facts and submissions made by the credit rating agency, submits a report to the Board and recommend the penalty, if any to be imposed upon the credit rating agency as also the grounds on the basis of which the proposed penalty is justified.

Show-cause Notice and Order

On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice to the credit rating agency, as to why the penalty as proposed by the enquiry officer should not be imposed.

The credit rating agency has to, within fourteen days of the date of receipt of the show-cause notice, send a reply to the Board. And the Board, after considering the reply of the credit rating agency to the show-cause notice, shall as soon as possible passes such order as it deems fit.

Every order passed by the Board is self-contained and has to give reasons for the conclusions stated therein, including justification of the penalty if any imposed by that order. The Board also sends to the credit rating agency, a copy of the order passed.

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17.1.15 Effect of Suspension and Cancellation of Registration of Credit Rating Agency

On and from the date of suspension of the certificate of registration, the credit rating agency ceases to carry on any rating activity during the period of suspension and shall be subject to such directions of the Board with regard to any records, documents securities or reports that may be connected with in its rating activities, as the Board may specify.

On and from the date of cancellation of the certificate of registration, the credit rating agency:

1. ceases to carry in any rating activity and
2. is subject to such directions of the Board with regard to the transfer of records, documents, securities or reports connected with its rating activities which may be in its custody or control as the Board may specify.

Notwithstanding the suspension or cancellation of certificate of a credit rating agency, if the Board is satisfied that it is in the interest of the investors to grant such permission, the Board grants to the credit rating agency permission to carry on such activities relating its assignments undertaken prior to such suspension or cancellation, as the Board may specify.

Publication of Order of Suspension or Cancellation

The order of suspension or cancellation of certificate of registration is published by the Board in at least two daily newspapers.

Appeal to the Securities Appellate Tribunal

Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

17.2 Credit Rating Process

Credit ratings are calculated from financial history and current assets and liabilities. Typically, a credit rating tells a lender or investor the probability of the subject being able to pay back a loan. However, in recent years, credit ratings have also been used to adjust insurance premiums, determine employment eligibility, and establish the amount of a utility or leasing deposit.

A poor credit rating indicates a high risk of defaulting on a loan, and thus leads to high interest rates, or the refusal of a loan by the creditor. The credit rating process can be categorized in four steps namely:

1. ***Receiving the completed application form:*** This is the first step in the rating process. The company that wants it to achieve a credit rating approaches the appropriate credit rating agency and submits the completed application form. As soon as the agency receives the completed form, the movement towards the next step starts.
2. ***Representatives visiting the company:*** Thereafter, the representatives of the credit rating agency visit the company that requested for the rating.
3. ***Analysts having a short discussion with the management of the company:*** This step ensures the agencies about the vision and operational nitty gritties of the company and helps the credit rating agency in the preparation of the credit report.

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4. ***Preparation of a rating report, assigning a rating and sending the copy of the report to the company and NSIC.*** As the last step of the rating process, the rating report is prepared. Under this report, the rating is assigned and copy of the same is sent to the company as well as the NSIC for further use of the prospective investors.

Rating Scale

Your rating will reflect two components, Financial Strength and Performance Capability. Ratings will be assigned on the following rating scale:

Example:

		Financial Strength		
		High	**Moderate**	**Low**
Performance Capability	**Highest**	SE 1A	SE 1B	SE 1C
	High	SE 2A	SE 2B	SE 2C
	Moderate	SE 3A	SE 3B	SE 3C
	Weak	SE 4A	SE 4B	SE 4C
	Poor	SE 5A	SE 5B	SE 5C

A company with high Performance Capability and high Financial Strength will be rated 'SE2A', while one with weak Performance Capability and low Financial Strength will be rated 'SE4C'.

17.3 Credit Rating Agencies

As we all know, credit rating agencies are registered and regulated by the Securities and Exchange Board of India. The following is the eligibility criteria for an individual to be registered as a credit rating agency:

1. the applicant is set up and registered as a company under the Companies Act, 1956;
2. the applicant has, in its Memorandum of Association, specified rating activity as one of its main objects;
3. the applicant has a minimum net worth of rupees five crores. Provided that a credit rating agency existing at the commencement of these regulations, with a net worth of less than rupees five crores, shall be deemed to have satisfied this condition, if it increases its net worth to the said minimum within a period of three years of such commencement.
4. the applicant has adequate infrastructure, to enable it to provide rating services in accordance with the provisions of the Act and these regulations;
5. the applicant and the promoters of the applicant, referred to in regulation 4 have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the Board;
6. neither the applicant, nor its promoter, nor any director of the applicant or its promoter, is involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors;
7. neither the applicant, nor its promoters, nor any director, of its promoter has at any time in the past been convicted of any offence involving moral turpitude or any economic offence;
8. the applicant has, in its employment, persons having adequate professional and other relevant experience to the satisfaction of the Board;

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9. neither the applicant, nor any person directly or indirectly connected with the applicant has in the past been -
   (a) refused by the Board a certificate under these regulations or
   (b) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act.

Notes For the purpose of this clause, the expression "directly or indirectly connected person" means any person who is an associate, subsidiary, inter-connected or group/ company of the applicant or a company under the same management as the applicant.

10. the applicant, in all other respects, is a fit and proper person for the grant of a certificate;
11. grant of certificate to the applicant is in the interest of investors and the securities market.

Caution The Securities and Exchange Board however, does not consider an application unless the applicant is promoted by a person belonging to any of the following categories, namely:

1. a public financial institution, as defined in section 4 A of the Companies Act, 1956 (1 of 1956);
2. a scheduled commercial bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934 (2 of 1934);
3. a foreign bank operating in India with the approval of the Reserve Bank of India;
4. a foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least five years experience in rating securities;
5. any company or a body corporate, having continuous net worth of minimum rupees one hundred crores as per its audited annual accounts for the previous five years prior to filing of the application with the Board for the grant of certificate under these regulations.

The main credit rating agencies in India are:

1. Credit Rating Information Services of India Limited (CRISIL)
2. Investment Information and Credit Rating Agency of India (ICRA)
3. Credit Analysis & Research Limited (CARE)
4. Duff & Phelps Credit Rating India Private Ltd. (DCR India)
5. ONICRA Credit Rating Agency of India Ltd.

Let us know a brief about each of them.

Credit Rating Information Services of India Limited (CRISIL)

Established in 1987, CRISIL is India's leading Ratings, Research, Risk and Policy Advisory company. CRISIL delivers opinions and solutions that:

1. Make markets function better, and

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2. Help clients mitigate and manage their business & financial risks,

3. Help shape public policy.

CRISIL offers domestic and international customers a unique combination of local insights and global perspectives, delivering independent information, opinions and solutions that help them make better informed business and investment decisions, improve the efficiency of markets and market participants, and help shape infrastructure policy and projects. Its integrated range of capabilities includes credit ratings; research on India's economy, industries and companies; investment research outsourcing; fund services; risk management and infrastructure advisory services.

Investment Information and Credit Rating Agency of India (ICRA)

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

ICRA information products, Ratings, and solutions reflect independent, professional and impartial opinions, which assist businesses enhance the quality of their decisions and help issuers access a broader investor base and even lesser known business entities approach the money and capital markets.

As an early entrant in the Credit Rating business, ICRA Limited is one of the most experienced Credit Rating Agencies in the country today. ICRA Rates rupee denominated debt instruments issued by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and municipalities, among others. ICRA also Rates structured obligations and sector-specific debt obligations such as instruments issued by Power, Telecom and Infrastructure companies. The other services offered include Corporate Governance Rating, Stakeholder Value and Governance Rating, Corporate Governance Assesment, Credit Risk Rating of Debt Mutual Funds, Rating of Claims Paying Ability of Insurance Companies, Project Finance Rating, and Line of Credit Rating. ICRA, along with National Small Industries Corporation Limited (NSIC), has launched a Performance and Credit Rating Scheme for Small Scale Enterprises in India. The service is aimed at enabling Small and Medium Enterprises (SMEs) improve their access to institutional credit, increase their competitiveness, and raise their market standing.

Credit Analysis & Research Limited (CARE)

Credit Analysis & Research Ltd. (CARE Ratings) is a full service rating company that offers a wide range of rating and grading services across sectors. CARE Ratings methodologies are in line with the best international practices.

CARE Ratings has completed over 5846 rating assignments having aggregate value of about ₹16,594 bn (as at March 31, 2009), since its inception in April 1993. CARE is recognised by Securities and Exchange Board of India (SEBI), Government of India (GoI) and Reserve Bank of India (RBI) etc.

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CARE has seven offices in India located at - Mumbai, Delhi, Kolkata, Chennai, Hyderabad, Bangalore and Ahmedabad.

The ratings division of CARE has over a decade long experience in rating debt instruments/ Enterprise ratings covering the full spectrum of Universe comprising:

1. Industrial Companies
2. Service companies
3. Infrastructure companies
4. Banks
5. Financial Institutions (FIs)
6. Non-bank Finance Companies (NBFCs)
7. Public Sector Undertakings (PSUs)
8. State Government Undertakings
9. Municipal Corporations
10. Structured Finance Transactions
11. Securitization Transactions
12. SMEs
13. SSI
14. Micro Finance Institutions

In addition to debt ratings CARE Ratings has experience in providing the following specialized grading/rating services:

1. Corporate Governance Ratings
2. IPO grading
3. Mutual Fund Credit Quality Ratings
4. Insurance Claims Paying Ability Ratings
5. Issuer Ratings
6. Grading of Construction Entities
7. Grading of Maritime Training Institutes
8. LPG/SKO Ratings

CARE Ratings is well equipped to rate all types of debt instruments like Commercial Paper, Fixed Deposit, Bonds, Debentures, Hybrid instruments, Structured Obligations, Preference Shares, Loans, Asset Backed Securities (ABS), Residential Mortgage Backed Securities (RMBS) etc.

CARE Ratings has been recognized by statutory authorities and other agencies in India for rating services. The authorities/agencies include: Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), Director General, Shipping and Ministry of Petroleum and Natural Gas (MoPNG), Government of India (GoI), National Housing Bank (NHB), National Bank for Agriculture and Rural Development (NABARD), National Small Scale Industries Commission (NSIC). CARE Ratings has also been recognized by RBI as an Eligible Credit Rating Agency (ECRA) for Basel II implementation in India.

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CARE Ratings has significant presence in all sectors including Banks/FIs, Corporate, Public finance. Coverage of CARE Ratings has extended to more than 1075 entities over the past decade and is widely accepted by investors, issuers and other market participants. CARE Ratings have evolved into a valuable tool for credit risk assessment for institutional and other investors, and over the years CARE has increasingly become a preferred rating agency.

CARE's Credit Rating is an opinion on the relative ability and willingness of an issuer to make timely payments on specific debt or related obligations over the life of the instrument. CARE rates rupee denominated debt of Indian companies and Indian subsidiaries of multinational companies. CARE ratings are not recommendations to buy/sell or hold any security.

Duff & Phelps Credit Rating India Private Ltd. (DCR India)

DCR India or Duff & Phelps Credit Rating India Private Ltd. is one of the top credit rating agencies in India. Over the years, DCR India has been providing excellent services to its clients.

Duff & Phelps Credit Rating India Private Ltd. (DCR India) has played an important role in rating India's forex debt obligations. The services provided by Duff & Phelps Credit Rating India Private Ltd. (DCR India) are considered to be at par with other leading providers of credit rating services in India like Credit Rating Information Services of India Limited (CRISIL), ONICRA Credit Rating Agency of India Ltd., Investment Information and Credit Rating Agency of India (ICRA), Operation Research Group & Marketing & Research Group and Credit Analysis & Research Limited (CARE).

ONICRA Credit Rating Agency of India Ltd.

ONICRA, a path breaking innovative organization analysis data and provides individual credit rating solutions that enable the lender or service provider to take a valued judgment on financial and other transactions. ONICRA facilitates over 100,000 transactions per day through a single window clearance on a national basis in the TELECOM, BANKING, INSURANCE, HEALTH AND EDUCATION SECTOR.

Over the years, ONICRA has developed a long list of esteemed clients. The client list of ONICRA includes some of India's top 500 companies like Airtel, Mahindra & Mahindra, Reliance, Volkswagon, HDFC and Genpact, etc.

ONICRA has been acknowledged as pioneers in this field by the Ministry of Finance in the Economic Survey (1993-1994). It is also recognized and empanelled by the likes of NSIC (National Small Industries Corporation) for SSI (Small Scale Industry) assessment. Their ratings have also been accepted by the Indian Banks Association.

Case Study

Indian Insurers' Credit Ratings seen Stable

'Ownership change likely if foreign partners can't provide more capital'.

Mumbai, Sept. 24 The credit ratings of Indian insurance companies - both life and non-life - are unlikely to be affected in the near future despite the global financial crisis affecting the foreign stakeholders of these companies.

But if the foreign partners are unable to bring in additional capital in the long term due to the global slowdown, it could mean a change of ownership for Indian insurance companies, said analysts.

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In the wake of the financial crisis, a number of companies in the banking and insurance sector across the world have faced downgrades, either due to their exposure to Lehman Brothers and AIG or to reflect heightened industry risk following the turmoil in the global financial markets.

Exposure of foreign insurers

(in million)

Company	Kind of exposure	Amount
Allianz	To Lehman Brothers	€ 400
BNP Paribas	To Lehman Brothers	€ 400
Prudential Financial Inc	To AIG	$ 195
	To Lehman Brothers in fixed income securities	$ 207
Aviva Plc	To Lehman Brothers in senior debt, money market exposure and credit default swaps.	£ 270
	To AIG in senior debt, subordinated debt and equity.	£ 148
Sun Life	To Lehman Brothers in Bond securities and debt instruments.	$ 349

Foreign companies such as Allianz, Prudential Financial Inc, AXA, AEGON, Sun Life Financial, Aviva, BNP Paribas, Fortis and ING have all reported some kind of exposure to either Lehman Brothers or AIG or both.

So far, the ratings of AIG and its subsidiaries and Fortis' Asian subsidiary have been downgraded.

All these companies are stake holders in Indian insurance companies and hold about 26 per cent stake each.

But, according to analysts, this is unlikely to affect the credit ratings of these insurance companies at least in the short term.

Strong Parentage

"Most of these companies have strong parents and their ratings are unlikely to be revised in the near term," said Mr Subroto Ray, Head Corporate Sector Ratings, ICRA.

"In the short-term, these relatively new insurance companies are well capitalised, well managed and have good solvency margins, much more than the requirements specified by the IRDA. All the foreign partners have already brought in capital commensurate with their equity stake," said Mr Rajesh Mokashi, Executive Director, Care Ratings.

But this situation could change in the long term if the foreign partners are unable to bring in more capital for fuelling the expansion plans of companies.

"In the long term, if the foreign partner is unable to bring in the required capital, the Indian partner always has the option to buy him out or look for another partner. Besides, the insurance companies even have the option of listing themselves on the bourses to raise funds," Mr Mokashi added.

The global financial crisis could lead to a change in the foreign ownership of many domestic insurance companies, said Mr Ashu Dutt, MD, Asia Financial Services Practice, Northbridge Capital.

As India and China are considered among the fastest growing markets in the world, other companies would be keen on entering the sector and would look for tie-ups with companies here.

Contd...

Notes

"Even if the Government raises the cap on foreign direct investment to 49 per cent from the existing 26 per cent, the foreign partners might decide not to raise their stake due to their inability to bring in the requisite amount of capital. It could even lead to the foreign partners selling off their stakes to other European entities that have escaped unscathed in the current crisis," said Mr Dutt.

Question

Why companies go for credit rating? Discuss

Source: http://www.thehindubusinessline.in

17.4 Summary

- A credit rating estimates the credit worthiness of an individual, corporation, or even a country.
- It is an evaluation made by credit bureaus of a borrower's overall credit history.
- Credit ratings are calculated from financial history and current assets and liabilities.
- A Credit Rating Agency (CRA) is a company that assigns credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves.
- In some cases, the service providers of the underlying debt are also given ratings.
- In most cases, the issuers of securities are companies, special purpose entities, state and local governments, non-profit organizations, or national governments issuing debt-like securities (i.e., bonds) that can be traded on a secondary market.
- A credit rating for an issuer takes into consideration the issuer's credit worthiness (i.e., its ability to pay back a loan), and affects the interest rate applied to the particular security being issued.
- The credit rating agencies are regulated by the Securities and Exchange Board of India.
- The main credit rating organizations in India are CRISIL, CARE, DCR India and ONICRA.

17.5 Keywords

Rating: An opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

Securitisation: Securitization involves pooling assets together and turning them into a tradable security. In the case of loans it is pooling the receivables from a loan and then selling them to a third party.

17.6 Self Assessment

Fill in the blanks:

1. A credit rating for an issuer takes into consideration the issuer's .....
2. CARE's Credit Rating is an opinion on the relative ..... and ..... of an issuer to make timely payments on specific debt or related obligations over the life of the instrument.

Notes

3. Credit rating agencies are registered and regulated by the .....
4. The Board may appoint one or more persons as inspecting officers, to undertake inspection of the books of account, ... and ..... of the credit rating agencies.
5. The order of suspension or cancellation of certificate of registration is published by the Board in at least ..... daily newspapers.
6. The period of validity of certificate of registration shall be ..... years.
7. A renewal application has to be made not less than ..... months before expiry of the period of the validity of the certificate.
8. If, after considering an application, ... is of the opinion that a certificate should not be granted or renewed, as the case may be, it may, after giving the applicant a reasonable opportunity of being heard, ... the application.
9. Every credit rating agency has to abide by the ..... contained in the Third Schedule.
10. An applicant whose application for the grant of a certificate has been ....., shall not undertake any rating activity.
11. The application for renewal made under sub-regulation is to be accompanied by a ..... fee as specified in the second schedule.
12. The Board may, in order to ..... the interests of investors, issue directions with regard to the transfer of records.
13. Every credit rating agency has to, during the lifetime of securities rated by it continuously ..... the rating of such securities.
14. Provided that if owing to ....., a rating has been based on the best available information, the credit rating agency shall disclose to the investors the fact that the rating is so based.
15. Every credit rating agency has to frame appropriate ..... and systems for monitoring the trading of securities by its employees in the securities of its clients.

17.7 Review Questions

1. What do you think is the advantage for an economy to have multiple credit rating agencies?
2. What are the limitations of multiple credit rating agencies?
3. Do you think that SEBI itself is unable to handle the rating issue of the credit companies and that is why it registers credit rating agencies under it?
4. Evaluate the working of:
   (a) CRISIL
   (b) CARE
   (c) DCR India
   (d) ONICRA

   as credit rating agencies in India.
5. Critically evaluate the contribution of credit rating system in Indian economy.
6. What are the suggestions that you would give to various credit rating agencies operating in India for further improvement and why?

Notes

7. Comment on the fallacies of credit rating agencies in the current subprime crisis that has caused a great turmoil in the realty sector. What are your suggestions about the way in which the credit rating agencies should revamp their methodology?
8. Recently, Fitch has projected that NPA in Indian banking will rise by 10% by 2010. What will be the likely impact of the same in the Indian Banking sector?
9. In 2007, India secured investment grade rating from global agency Standard and Poor's for the first time in 14 years. What did it mean for the industry?
10. "India's credit rating is facing growing pressure because of the widening fiscal deficit and the country's increasing dependence on foreign capital inflow, global rating agency Moody's (May 28, 2009)." Comment.
11. According to Standard & Poor's 2009 Asia Pacific Mid Year Market Outlook, the Indian economy has bottomed out and is set for positive growth in 2010. Justify with reasons.

Answers: Self Assessment

1.	credit worthiness	2.	ability, willingness
3.	Securities and Exchange Board of India	4.	records, documents
5.	two	6.	three
7.	three	8.	SEBI, reject
9.	Code of Conduct	10.	rejected
11.	renewal	12.	protect
13.	monitor	14.	lack of co-operation
15.	procedures		

17.8 Further Readings


Book

Michael K. Ong, *Credit Ratings: Methodologies, Rationale and Default Risk*, Risk Books.


Online links

www.indianembassy.org

www.onicra.com

www.sebi.com

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