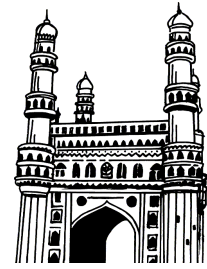


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**FINANCIAL MARKETS
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FINANCIAL MARKETS AND SERVICES

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UNIT - I

FINANCIAL MARKETS:

Indian Securities Market – An Overview , Introduction, Market segments, Primary market, Secondary market, products and participants, Derivatives market, reforms, research, corporate and government securities market; , Money Market, Debt Market, Derivative Market, Government Securities Market

FINANCIAL SERVICES:

Concept and meaning. Classification – Traditional and Modern activities; Fund-based and non-fund based activities. Financial Engineering – Need for financial innovation; Model for new product development; new financial products and services. Current scenario and challenges to the financial services sector in India.

UNIT – II

MERCHANT BANKING:

Concept and evolution of merchant banking (MB) in India. SEBI (MB) Regulations, 1992. Functions of MBs – underwriter, banker, broker, registrar, debenture trustee and portfolio manager. MBs' activities and SEBI guidelines related to issue management.

UNIT – III

LEASING AND HIRE-PURCHASING:

- (a) Leasing concept and classification. Financial rationale. Evolution of leasing industry in India. Product profile. Legal, tax and accounting aspects of leasing in India. Funding and regulatory aspects of leasing in India. Financial evaluation of leasing – break-even lease rental. Gross yield based pricing. IRR based pricing. Negotiating lease rental. Assessment of lease related risks. Lease vs. buy decisions.
- (b) Hire-purchase concept and characteristics. Legal and tax framework. Mathematics of hire purchase. Financial evaluation of hire-purchase deals.

UNIT – IV

INSURANCE:

Definition and basic characteristics of insurance. Requirements of an insurable risk. Types of insurance. Benefits and Costs of insurance to society. Fundamental legal principles of insurance. Functions of insurer. IRDA and recent trends in insurance sector in India.

UNIT – V

OTHER FINANCIAL SERVICES:

- (a) Factoring and bill discounting concept, process and forms. Functions of a factor. Legal aspects of factoring and bill discounting. Financial evaluation of factorial services – cost of factoring – decision analysis for factor services. Factoring scenario in India.
- (b) Credit rating concept and utility. Credit rating agencies in India and their performance. Financial dimensions of crediting rating methodology. Types of ratings and symbols.

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- 1. What is Financial Markets? State the features and classification of financial markets.**

Ans : (June-19)

Refer Unit-I, Q.No. 1.

- 2. Discuss an overview of Indian securities market.**

Ans : (Aug.-18)

Refer Unit-I, Q.No. 4.

- 3. State the products and participants in primary market.**

Ans : (Aug.-17)

Refer Unit-I, Q.No. 7.

- 4. Explain the functions of money market in India.**

Ans : (Imp.)

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- 5. Describe the objectives of money market.**

Ans : (Imp.)

Refer Unit-I, Q.No. 25.

- 6. Explain fund based and non-fund based financial services.**

Ans : (Nov.-20, June-19, Aug.-18)

Refer Unit-I, Q.No. 31.

- 7. Discuss the financial model for a new product development.**

Ans : (Imp.)

Refer Unit-I, Q.No. 34.

- 8. Outline the new financial products and services.**

Ans : (Nov.-20, Aug.-18)

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- 9. Critically analyse the present position of the financial service sector in India and state the challenges it has to face in the years to come.**

Ans : (Aug.-17)

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1. Discuss the evolution of merchant banking in India.

Ans : (Aug.-21, June-18, Aug.-17, Imp.)

Refer Unit-II, Q.No. 2.

2. Discuss the service provided by the merchant banker.

Ans : (June-18)

Refer Unit-II, Q.No. 5.

3. Explain the functions of merchant banking in India.

Ans : (Aug.-21, Aug.-18, Imp.)

Refer Unit-II, Q.No. 7.

4. How merchant banker acts as brokers to the issue?

Ans : (Nov.-20)

Refer Unit-II, Q.No. 9.

5. Explain the role of merchant banker as registrar to an issue.

Ans : (Imp.)

Refer Unit-II, Q.No. 11.

6. Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee.

Ans : (Imp.)

Refer Unit-II, Q.No. 12.

7. Explain the role of the merchant banker in issue management.

Ans : (Aug.-18, Aug.-17, Imp.)

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8. Describe the SEBI Guidelines in issue management.

Ans : (Aug.-21, Imp.)

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1. Discuss the various types of lease rentals.

Ans : (Aug.-18, June-18)

Refer Unit-III, Q.No. 3.

2. Discuss the benefits of leasing.

Ans : (Aug.-21, June-18)

Refer Unit-III, Q.No. 8.

3. Discuss the procedure and steps involved in the financial evaluation of leasing.

Ans : (Aug.-18)

Refer Unit-III, Q.No. 17.

4. Differences between Lease vs. Buy Decisions.

Ans : (Nov.-20)

Refer Unit-III, Q.No. 23.

5. Explain the concept of Hire purchase and its characteristics.

Ans : (Aug.-21, June-19, Aug.-17)

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6. State the merits and demerits of Hire Purchasing.

Ans : (Imp.)

Refer Unit-III, Q.No. 26.

7. Explain the various methods of interest calculation and reporting in hire purchase.

Ans : (Imp.)

Refer Unit-III, Q.No. 27.

8. State the differences between leasing and hire purchase.

Ans : (Aug.-21, Aug.-18)

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1. Explain the concept of insurance and its basic characteristics.

Ans : (Aug.-21, Nov.-20, June-19)

Refer Unit-IV, Q.No. 1.

2. Explain different types of Insurance.

Ans : (Nov.-20, June-18)

Refer Unit-IV, Q.No. 6.

3. What are the benefits and costs of insurance to society?

Ans : (June-19, Aug.-18)

Refer Unit-IV, Q.No. 12.

4. Briefly explain the fundamental legal principles of insurance.

Ans : (Nov.-20, June-18)

Refer Unit-IV, Q.No. 13.

5. Explain the functions of IRDA.

Ans : (Aug.-18)

Refer Unit-IV, Q.No. 19.

6. Discuss the regulations of IRDA regarding claim settlement.

Ans : (Imp.)

Refer Unit-IV, Q.No. 20.

7. State the recent Trends in Insurance Sector in India.

Ans : (June-19, Aug.-17)

Refer Unit-IV, Q.No. 21.

UNIT - V

1. Define factoring. Explain the features of factoring.

Ans : (Nov.-20, June-19, June-18)

Refer Unit-V, Q.No.1.

2. Explain different types of factoring.

Ans : (June-19, Aug.-18)

Refer Unit-V, Q.No. 4.

3. Discuss the financial evaluation of factorial services.

Ans : (Nov.-20, Aug.-17)

Refer Unit-V, Q.No. 10.

4. Discuss the emerging trends in Factoring.

Ans : (Aug.-21, June-18)

Refer Unit-V, Q.No. 11.

5. What are the advantages and disadvantages of Credit Rating ?

Ans : (June-19, June-18)

Refer Unit-V, Q.No. 22.

6. What are the Financial Dimensions of Crediting Rating Methodology.

Ans : (Nov.-20)

Refer Unit-V, Q.No. 26.

7. Explain the various symbols of credit rating.

Ans : (Imp.)

Refer Unit-V, Q.No. 27.

UNIT I

FINANCIAL MARKETS:

Indian Securities Market – An Overview , Introduction, Market segments, Primary market, Secondary market, products and participants, Derivatives market, reforms, research, corporate and government securities market; , Money Market, Debt Market, Derivative Market, Government Securities Market

FINANCIAL SERVICES:

Concept and meaning. Classification – Traditional and Modern activities; Fund-based and non-fund based activities. Financial Engineering – Need for financial innovation; Model for new product development; new financial products and services. Current scenario and challenges to the financial services sector in India.

1.1 FINANCIAL MARKETS

Q1. What is Financial Markets? State the features and classification of financial markets.

Ans : (June-19)

Financial markets are never perfect. In allocating credit, they can make two mistakes: funding low-yielding projects and failing to fund high-yielding ones. In the early stages of development, the governments of developing countries fearing that the costs of failing to fund good projects were likely to be high, intervened to direct credit. Perhaps that assessment was sound at the time, but experience has since revealed too many errors of the first kind funding low-yielding projects. With time, economies have become more complex, information flows have improved, and financial managers have become more skilled. In most countries, errors can be minimized by leaving more decisions to a diverse and competitive financial system that responds to market signals. The primary role of the government then shifts to making market signals more meaningful and, in particular, to preventing its own actions from distorting them.

Features

Some of the features of financial markets are,

1. There are large number of transactions which occur in the financial market and they involve transfer of resources from one market to another.
2. There can be immediate arbitrage between different instruments and markets.

3. It is a place where investment decisions and risk are taken on behalf of the investors by the financial intermediaries.
4. There are many parts of the financial markets where investments can be made by the investors.
5. Financial markets are sensitive to the changing conditions or environment.
6. Financial markets can influence the behaviours of non-financial markets. Functions.

Classification

The classification of financial markets in India are:

1. Unorganised Markets

In these markets there are a number of money lenders, indigenous bankers, traders etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganised sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

2. Organised Markets

In the organised markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrument-alisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organised markets can be further classified into two. They are :

(i) Capital market

(ii) Money market

(i) Capital Market: The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year.

(ii) Money Market: Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four.

Q2. What are the functions of financial market.

Ans : (June-19)

1. Price Determination

The financial market performs the function of price discovery of the different financial instruments which are traded between the buyers and the sellers on the financial market. The prices at which the financial instruments trade in the financial market are determined by the market forces i.e., demand and supply in the market.

So the financial market provides the vehicle by which the prices are set for both financial assets which are issued newly and for the existing stock of the financial assets.

2. Liquidity

The liquidity function of the financial market

provides an opportunity for the investors to sell their financial instruments at its fair value prevailing in the market at any time during the working hours of the market.

In case there is no liquidity function of the financial market, then the investor forcefully have to hold the financial securities or the financial instrument until the conditions arise in the market to sell those assets or the issuer of the security is obligated contractually to pay for the same i.e., at the time of maturity in debt instrument or at the time of the liquidation of the company in case of the equity instrument is until the company is either voluntarily or involuntarily liquidated.

Thus, in the financial market investors can sell their securities readily and convert them into cash thereby providing the liquidity.

3. Risk sharing

Financial market performs the function of the risk-sharing as the person who is undertaking the investments are different from the persons who are investing their fund in those investments.

With the help of the financial market, the risk is transferred from the person who undertakes the investments to those persons who provide the funds for making those investments.

Q3. What is a financial instruments? State the characteristic features of financial instruments.

Ans : (June-18)

Meaning

A financial instrument is a monetary contract between two parties, which can be traded and settled. The contract represents an asset to one party (the buyer) and a financial liability to the other party (the seller).

An asset class refers to the form that a financial instrument takes, such as commodities, shares, bonds, derivatives or forex. Financial instruments can be separated according to asset class and can

be further divided by whether they are complex or non-complex.

Characteristic

The characteristics/attributes to be possessed by financial instruments are as follows:

1. Liquidity

A financial instrument can be converted into cash easily by the holder when there is a requirement of cash. The financial instrument will be attractive when the the financial instrument holder is capable to convert it into cash to satisfy the cash requirements.

2. Productivity

The financial instrument should be capable to gain returns greater than the cost incurred due to investment in such financial instruments.

3. Real Positive Rate of interest

Real positive rate of interest denotes not just higher returns from the financial instruments but returns greater than the rate of inflation within the specified time. It is an actual rate of return which can be expected from the instrument after taking into account tax charges.

4. Transaction Cost

The financial instrument holder will incur costs by holding any financial instrument. If transaction costs involved are less than the returns from financial instrument then such financial instrument is considered as be attractive.

1.1.1 Indian Securities Market – An Overview, Introduction

Q4. Define Security Market. Explain its organization and structure.

(OR)

Discuss an overview of Indian securities market.

Ans :

(Aug.-18)

Meaning

The securities market refers to the market for equity debt and derivatives. The debt market is further classified into three types i.e., the government securities market, the corporate debt market and the money market. The derivatives markets are also further classified into two types namely the options market and the futures market.

Securities market is the market which influences the modern life greatly. The terms “Dalai Street”, “the gilt edged market” and “the Nifty”, are indefinite on unclear to understand but still they are being used by the people to refer the sensex or the securities market.

Examples of securities market at work are i.e., the activities which takes place under securities market are as follows, “Sensex falls by 400 points with in a day after a turbulent day’s trading. The Reserve Bank of India has decreased the repo rate by 30 basics points”. “The Government of India increases 2500 crore rupees by issuing bonds with a maturity period of 15 years”.

Organization and Structure of Security Market

Securities markets are broadly classified into two types as follows,

1. Primary market (New Issue Market) and
2. Secondary market (Stock Exchange).

1. Primary Market (New Issue Market)

The market where in new securities are being issued in lieu of each from an investor is called as primary market. Investment bankers are mostly being used as the instrument of activities. New issue of securities which takes place in the primary market are the new sales of treasury bills or IBM stock or North Carolina bonds. The issuers of these securities are basically the U.S. government, IBM and the state of North Carolina. Common stock sales of a publicly traded company are called as “seasoned new issues”.

In India, Equity market is also called as primary market which functions as per the guidelines of SEBI (Securities Exchange Board of India). There

are three different ways by which a company can raise its equity capital in the primary market. They are,

- (i) Public issue
- (ii) Rights issue
- (iii) Preferential allotment
- (iv) Global investment banking and
- (v) Private placement.

(i) Public Issue

Public issue is the sale of securities to the public at large and is governed and controlled by the provisions of the companies Act 1956.

In U.S, public issues of stocks as well as bonds are managed by Investment bankers who acts as underwriters. Investment bankers acts as intermediaries between issuers and investors. For instance, issuer sell securities to the investment bankers who further resell them to the investors. Thus, investment bankers underwrite the new issues by purchasing the securities from the issuer and assuming the risk of reselling the securities to the investors.

(ii) Rights Issue

Rights issue is an official invitation given by the company to its shareholders regarding the subscription for the purchase of further shares issued by a company. A 'right' represents an option or a choice that has to be made by a shareholder for the purchase of securities at a predetermined price. A limited company after obtaining the approval from its articles of association can issue new shares (either equity or preference).

(iii) Preferential Allotment

Preferential Allotment means an issue of an equity by a listed company to the selected investors at a price which may or may not be in accordance with the prevailing market price especially in the Indian Capital Market.

(iv) Global Investment Banking

Initially, selling new securities was restricted only in the domestic markets but presently the scenario has been changed due to globalization. Globalization helps the companies to raise new capital from different countries across the globe. A new concept has been introduced as "global equity offering" in the investment banking.

(v) Private Placements

Recently, many corporations have started introducing the "private placement" where in the new securities issues such as debt securities are being directly sold to the financial institution like Life Insurance Companies. As registration is necessary for these private placements, this results in time and money saving.

2. Secondary Market (Stock Exchange)

A secondary market is the market in which the remaining or the existing securities are traded between the investors. Secondary market helps the investors by providing them a mechanism for trading the existing securities. In this market, securities are resold when investors consider these securities as attractive opportunities. Secondary market is the place where common and preferred stock, warranty, bonds and puts and calls are traded among the investors.

(i) New York Stock Exchange (NYSE)

It is one of the oldest and most famous secondary market in the United States. The NYSE is a not-for-profit organization which has member firms who own seats and only these member firms can buy and sell securities on the trading floor. NYSE outlines certain lending requirements which the firms must fulfill for listing their securities at the NYSE.

(ii) American Stock Exchange (AMEX)

AMEX is the second national organised exchange whose procedures are similar to the procedures of NYSE. Compared to NYSE,

AMEX is smaller whose membership is limited only upto 807 regular members. The listing requirements of AMEX are less complicated when compared to NYSE. Presently, AMEX trades nearly 135 NASDAQ-listed stocks.

(iii) The NASDAQ Stock Market

The NASDAQ stock market is a competitive dealer market which consists of network of dealers or market makers who creates market and are ready to buy and sell securities at specified prices. In this market, dealers are involved in the transaction and acts as an intermediary.

The actively traded stocks which are not traded at the NYSE or AMEX are a part of NASDAQ stock market (NASDAQ). NASDAQ was initially introduced by the NASD (The National Association of Security Dealers) which is a self-governing body of brokers and dealers. Presently, NASDAQ is a privately owned corporation by its shareholders.

(iv) Over-the-Counter Stocks

Over-the-counter securities means the securities which are not listed and traded at an organised exchange. They are usually traded over the counter markets. It does not denote a particular place or floor where dealers assemble and transact foreign currencies. Rather, it is a network of banks, brokers and dealers spread across the various financial centres of the world. Over-the-counter market relies more on communication network.

(v) Electronic Communications Networks (ECNs)

Conventional form of Trading equity securities through agency auction markets have been replaced by fully computerized NASDAQ market. Modern changes in

Electronic Communication Networks (ECN's) have a clear impact on the functioning of the conventional markets like NASDAQ and NYSE.

An ECN is a computerized trading network for institutions and large traders. Electronic Communication network matches the buying and selling orders obtained from the subscribers and customers. After matching these orders, they can be transferred to brokerage firms for the trading of securities.

In India securities are traded in NSE, BSE etc.

(vi) National Stock Exchange (NSE)

The National Stock Exchange was started in November 1992. Its initial capital outlay was ` 25 crores which was subscribed by the Industrial Development Bank of India (IDBI) and co-subscribed by other lending institutions such as GIC, LIC other insurance companies, banks, financial institutions including the SBI capital market Ltd, Stock Holding Corporations Ltd, Infrastructure Leasing and Financial Services Ltd and International Securities Consultancy of Hongkong. NSE has an automated, electronic and screen based system of trading.

(vii) Bombay Stock Exchange (BSE)

Bombay Stock Exchange (BSE) is an ancient stock exchange in India. It is regarded as the most important part of the economy which reveals the economic conditions. Basically BSE was operating in Mumbai alone but with the help of Bombay Online Trading System (BOLT), its operations extended to 275 cities by March 2000. The number of trade workstations were also increased to 3803. There was an increase in its daily turnover from ` 11 crores during 1979-1980 to ` 4,587 crores in the year 2000-2001.

1.2 MARKET SEGMENTS

Q5. What is Capital Market? Describe the segments of the capital market in India.

Ans : (June-18)

Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions.

Capital markets help channelise surplus funds from savers to institutions which then invest them into productive use. Generally, this market trades mostly in long-term securities.

- (i) Primary market and
- (ii) Secondary market.

1.2.1 Primary Market / New Issue Market

Q6. What is Primary Market? Explain the functions of new issue market.

Ans :

Meaning

Primary market provides an opportunity to the issuers of securities, both Government and corporations, to raise resources to meet their requirements of investment. Securities, in the form of equity or debt, can be issued in domestic / international markets at face value, discount or premium.

The primary market issuance is done either through public issues or private placement. Under Companies Act, 1956, an issue is referred as *public* if it results in allotment of securities to 50 investors or more. However, when the issuer makes an issue of securities to a select group of persons not exceeding 49 and which is neither a rights issue nor a public issue it is called a private placement.

Functions

New issue market basically aims at providing adequate monetary resources to the companies from the investors. With the help of such resources, a private or partnership ltd company can be transformed into a public ltd company. At the same time with the help of these resources, the existing

public ltd companies can effectively expand and diversify their operations. The important functions of new issue market are as follows,

- (i) Origination
- (ii) Underwriting
- (iii) Distribution

(i) Origination

Origination basically includes the activities which facilitates the issuers of shares in decision making process with respect to price, size, time, terms and conditions, methods and so on. Investigation, review analysis, authenticating and other consultative services constitutes origination.

(ii) Underwriting

Underwriting is one of the key function of new issue market. Basically in the process of underwriting, an underwriter gives an assurance to the issuer of shares about the successful subscription of all the shares. The subscription may be done either by the investors or through the underwriter himself or by both.

(iii) Distribution

The act of selling securities to the specific investors is known as "Distribution" in new issue market. Distribution is carried out by brokers, agents, sub-brokers and dealers whose main task is to sell securities to the interested investors.

1.2.1.1 Products and Participants

Q7. Explain the products and participants in primary market.

(OR)

State the products and participants in primary market.

Ans : (Aug.-17)

A) Products

The primary market deals with the issue of new instruments by the corporate sector such as,

1. Equity Shares

Equity shares represent ownership position in a company. Equity holders are owners of the company and elect the board of directors and enjoy voting right. Equity shareholders control the operations of the firm. Equity shareholders have a claim on remaining assets which are leftover after meeting the claims of creditors and preference shareholder in event of liquidation. Equity share capital is also called as risk capital, because if the company is not performing well, the holders of the equity shares are sufferers and if the company is doing well they will reap the benefits.

2. Preference Shares

Preference shares are those which enjoy some extra benefits when compare to other types of shares. The preference shareholders are given due preference while giving dividends. Upon liquidation of the company, the preference shareholders are given preference. Preference shareholders are not participated in the affairs of management because they do not have voting rights. But the management give preference to all preference shareholders while giving benefits.

3. Debentures

Debenture is a document which either creates a debt or acknowledges it and any document which fulfills either of these conditions is a debenture. The debenture is issued by the company and is in the form of a certificate of indebtedness. It usually specifies the date of redemption. It also provides for the repayment of principal and interest at specified date of the given dates. It generally creates a charge in the undertaking or undertakings of the company.

B) Participants

There are many players in the new issue market. The important of them cate the following:

1. Merchant Bankers
2. Registrars
3. Collecting and co-ordinating bankers
4. Underwriters and brokers

1. Merchant Bankers

They are the issue managers, lead managers, co-managers and are responsible to the company and SEBI. Their functions and working are described in a separate chapter.

2. Registrars to the Issue

Registrars are an important category of intermediaries who undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue. Registrars have a major- role, next to merchant bankers, in respect of servicing of investors.

The role of Registrar in the pre-issue, during the currency of issue, pre-allotment, allotment and post-allotment are described below:

Role of Registrar in Pre-issue

- i) Suggest draft application form to the merchant bankers.
- ii) Help in identifying the collection centres. The choice of collection centre and of collecting banker is critical to the success of the issue.
- iii) Assist in opening collection accounts with banks and lay down procedure for operation of these accounts.
- iv) Send instructions to collecting branches, for collection of application along with cheques, drafts, stock invest separately and remittance of funds.
- v) Workout modalities to receive the collection figures on a regular basis until the subscription list is closed.

During the Currency of Issue

- i) Receive the collection figures every day.
- ii) Tabulate and classify the collection data on the basis of the standard proforma of slabs of shares applied for.
- iii) Keep the merchant bankers and the company informed of the progress of total subscriptions.
- iv) Inform the stock exchange about the closure of issue.

Pre-Allotment Work

- i) Get all application forms from the collecting bankers and sort out valid and invalid application forms.
- ii) The valid applications are to be categorised and grouped as cash, draft and stock invest applications.
- iii) Reclassify the valid applications eligible for allotment.
- iv) Prepare the list with inverted numbers and then approach the regional stock exchange for finalising the basis of allotment, in the event of over subscription.
- v) Finalise the allotment as per the basis approved by the stock exchange.
- vi) Tally the final list approved for allotment and rejections with the inhouse control numbers and correct mistakes, if any.

3. Collecting and Co-ordinating Bankers

Collecting bankers collect the subscriptions in cash, cheques, stockinvest etc.

Co-ordinating bankers collect information on subscriptions and co-ordinate the collection work. They monitor the work and inform it to the registrars and merchant bankers.

Collecting banker and co-ordinating banker may be the same bank or different banks.

4. Underwriters and Brokers

The functions and role of underwriters are explained separately.

Brokers along with the net work of sub-brokers market the new issues. They send their own circulars and applications to the clients and do follow up work to market the securities.

5. Printers

Advertising agencies and mailing agencies are other organizations involved in the new issue market operations.

Q8. Explain the role of SEBI in primary market.

Ans :

The following points highlights the role of SEBI in primary-securities markets,

1. The capital issues does not need any permission from any authority to make an issue and price it.
2. SEBI increased the standards of disclosure of the public issues and therefore, has improved transparency.'
3. At the draft stage itself the offer document is made public.
4. Public should be offered with more than 20% of equity (issued).
5. Book building requirement was initiated for the issues above 100 crore.
6. SEBI evaluates the draff prospectus to assure disclosure sufficiency.
7. Portfolio managers and bankers to an issue must be registered with the SEBI.

8. The companies holding with or without three years track record are promoted by a company holding five years track record. Thereafter they can price the issues and list the shares on a stock exchange.

1.2.2 Secondary Market

Q9. What is Secondary Market? Explain the functions of stock exchange.

Ans :

Secondary market refers to a market where securities are traded after being initially offered to public in the primary market and/or listed on the stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity market serves as a monitoring and control conduit by facilitating value-enhancing control activities, enabling implementation of incentive- based management contracts, and aggregating information (via price discovery) that guides management decisions.

Functions

(i) Liquidity and Marketability of Securities

Stock exchanges provide liquidity to securities since securities can be converted into cash at any time according to the discretion of the investor by selling them at the listed prices. They facilitate buying and selling of securities at listed prices by providing continuous marketability to the investors in respect of securities they hold or intend to hold. Thus, they create a ready outlet for dealing in securities.

(ii) Safety of Funds

Stock exchanges ensure safety of funds invested because they have to function under strict rules and regulations and the bye-laws are meant to ensure safety of investible funds. Over-trading, illegitimate speculation etc. are prevented through carefully designed set of rules. This would strengthen the investor's confidence and promote larger investment.

(iii) Supply of Long Term Funds

The securities traded in the stock market are negotiable and transferable in character and as such they can be transferred with minimum of formalities from one hand to another. So, when a security is transacted, one investor is substituted by another, but the company is assured of long term availability of funds.

(iv) Flow of Capital to Profitable Ventures

The profitability and popularity of companies are reflected in stock prices. The prices quoted indicate the relative profitability and performance of companies. Funds tend to be attracted towards securities of profitable companies and this facilitates the flow of capital into profitable channels. In the words of Husband and Dockeray "Stock exchanges function like a traffic signal, indicating a green light when certain fields offer the necessary inducement to attract capital and blazing a red light when the outlook for new investment is not attractive".

(v) Motivation for Improved Performance

The performance of a company is reflected on the prices quoted in the stock market. These prices are more visible in the eyes of the public. Stock market provides room for this price quotation for those securities listed by it. This public exposure makes a company

conscious of its status in the market and it acts as a motivation to improve its performance further.

(vi) Promotion of Investment

Stock exchanges mobilise the savings of the public and promote investment through capital formation. But for these stock exchanges, surplus funds available with individuals and institutions would not have gone for productive and remunerative ventures.

(vii) Reflection of Business Cycle

The changing business conditions in the economy are immediately reflected on the stock exchanges. Booms and depressions can be identified through the dealings on the stock exchanges and suitable monetary and fiscal policies can be taken by the government. Thus a stock market portrays the prevailing economic situation instantly to all concerned so that suitable actions can be taken.

(viii) Marketing of New Issues

If the new issues are listed, they are readily acceptable to the public, since, listing presupposes their evaluation by concerned stock exchange authorities. Costs of underwriting such issues would be less. Public response to such new issues would be relatively high. Thus, a stock market helps in the marketing of new issues also.

(ix) Miscellaneous Services

Stock exchange supplies securities of different kinds with different maturities and yields. It enables the investors to diversify their risks by a wider portfolio of investment. It also inculcates saving habits among the community and paves the way for capital formation. It guides the investors in choosing securities by supplying the daily quotation of listed securities and by disclosing the trends of dealings on the stock exchange. It enables companies and the Government to raise resources by providing a ready market for their securities.

1.2.2.1 Products and Participants

Q10. What are the products of secondary market?

Ans :

Products of Secondary Market

Secondary market deals in following products,

1. Equity Shares

Equity shares represent ownership position in a company. Equity holders are owners of the company and elect the board of directors and enjoy voting right. Equity shareholders control the operations of the firm. Equity shareholders have a claim on remaining assets which are leftover after meeting the claims of creditors and preference shareholder in event of liquidation. Equity share capital is also called as risk capital, because if the company is not performing well, the holders of the equity shares are sufferers and if the company is doing well they will reap the benefits.

2. Bonds

A bond is a marketable, legal contract that promises to pay who ever owns it at a predetermined rate of interest for a defined period and then repay the principal at the specific date of maturity.

3. Debentures

Debenture is a document which either creates a debt or acknowledges it and any document which fulfills either of these conditions is a debenture. The debenture is issued by the company and is in the form of a certificate of indebtedness. It usually specifies the date of redemption. It also provides for the repayment of principal and interest at specified date of the given dates. It generally creates a charge in the undertaking or undertakings of the company.

4. Commercial Papers (CPs)

It is a short term instrument of raising funds by corporate. It is a sort of unsecured promissory note sold by the issuer to the investor. The maturity of the commercial

papers is flexible. Usually, borrowers and lenders adopt the maturity of commercial papers rated needs. Highly rated corporate which can obtain funds at a cost lesser than the cost of borrowing from banks are particularly interested in issuing CPs.

5. Government Securities (G-secs)

The G-secs market is the oldest and largest component of the Indian debt market in terms of market capitalization, trading volumes and outstanding securities. The G-secs market plays a crucial role in the Indian economy as it provides the benchmark for determining the level of interest rates through the yields on the government securities which are traded as the risk free rate of return in any economy.

Q11. Who are the participants of secondary market?

Ans :

1. Stock Exchange

A stock exchange is defined as “an association organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities”.

Securities Contract Regulation Act, 1956

2. Depositories

Depository is an organization which keeps investors securities in an electronic form by changing physical securities into electronic form with the help of dematerialization process. The investor needs to open a depository account called as demat a/c with any of the depository participants in order to use the services offered by the depository.

Depository mainly aims at removing paper ownership and reducing the paperwork in the process of trading and transfer of securities. The depository performs its functions with the help of network of depository participants (DPs) who communicates with the clearing members and investors. The various functions

performed by depository are, keeping custody of investor's securities facilitating the surrender and withdrawal of securities, crediting accounts i.e., disusing dividend, rights issue and performs many other value added services like IPOs national savings certificates, Stock Lending and Borrowing (SLB).

3. Registrar to an Issue and Share Transfer Agent

The company or its registrar and transfer agent (R&T) contains complete information about the physical share holding along with the suitable/linked data to deal with transfer of related operations. The depository participant sends the share certificates which are given for dematerialization to the company or its R&T agent in order to accomplish the dematerialization process.

4. Clearing Corporation

The Depository Trust and Clearing Corporation (DTCC) with the help of its subsidiaries offers clearance, settlement and information services for equities, corporate and municipal bonds, money-market instrument, government and mortgage backed securities and over-the-counter derivatives. DTCC has insurance transactions, relating funds and carries with their distribution networks.

Q12. Explain the role of SEBI in secondary market.

Ans :

1. In stock exchange corporate membership is permitted, promoted, preferred and encouraged. The articles of association of stock exchange is amended in order to increase its membership.

2. The client and its own account are to be separated by the brokers.
3. The individual brokers can avail 3% capital adequacy while the corporate can avail 6% capital adequacy.
4. The concept of dual registration of the stock brokers with the SEBI and the stock exchanges was initiated and both the brokers and the subbrokers were brought into the regulatory fold for the first time.
5. If any person of stock exchange violates any of the , provisions of the SEBI Act then SEBI can directly take panel action against them.
6. The transaction price and the brokerage should be disclosed separately and compulsorily by the stock brokers in the contract notes issued by them to their clients.
7. The brokers book, audit with the SEBI has become essential.

Q13. Compare and contrast primary market and secondary market.

Ans :

S.No.	Nature	Primary Market (New Issue Market)	Secondary Market (Stock Exchange)
1.	Meaning	Primary market is a market where new securities are issued in the market for the first time, either by existing company or new company.	Secondary market is a market where already issued, existing securities are traded on stock exchanges.
2.	Regulatory Authority	Activities in primary market is governed by SEBI and Companies Act.	It is regulated by bye-laws of stock exchanges and SEBI.
3.	Price determination	When securities are issued for first time in primary market, the price of securities is determined by company itself.	Prices of securities is determined by demand and supply forces in the stock exchange.
4.	Price fluctuation	Price of securities is fixed.	Price of securities keep fluctuating because of demand and supply forces.
5.	Involvement of Companies	Companies are directly involved as shares are sold by company directly to public.	There is no involvement of companies.
6.	Type of Company	All types of companies can issue new shares whether listed or unlisted.	In secondary market, shares of only listed companies are bought and sold.
7.	Geographical location	There is no fixed geographical location for new issue market. The issuing companies may have offices at different locations.	The location of a stock exchange is fixed at a specific place. E.g. NSE is situated in Mumbai.
8.	Buying and selling between	The securities are sold by companies and bought by public. So buying and selling is done between company and public.	Buying and selling is done among investors only.
9.	Intermediaries	Major intermediaries in primary market are, registrar to the issue, merchant bankers, under writers, collection banks, debenture trustees, portfolio managers etc.	Main intermediaries in secondary market are Brokers, sub-brokers, jobbers etc.
10.	Financing to companies	Through primary market funds are raised for financing companies for their expansion and diversification.	No fund is raised for company. Only buying and selling of securities is done among investors.

1.3 DERIVATIVES MARKET

Q14. Define Derivative. State the characteristics of Derivative.

Ans :

Meaning

A derivative is a contract between two parties which derives its value/price from an underlying asset. The most common types of derivatives are futures, options, forwards and swaps.

Description: It is a financial instrument which derives its value/price from the underlying assets. Originally, underlying corpus is first created which can consist of one security or a combination of different securities. The value of the underlying asset is bound to change as the value of the underlying assets keep changing continuously.

Generally stocks, bonds, currency, commodities and interest rates form the underlying asset.

Features

- Derivative are of three kinds future or forward contract, options and swaps and underlying assets can be foreign exchange, equity, commodities markets or financial bearing assets.
- As all transactions in derivatives takes place in future specific dates it is easier to short sell then doing the same in cash markets because an individual can take of markets and take the position accordingly because one has more time in derivatives.
- Since derivatives have standardized terms due to which it has low counterparty risk, also transactions costs are low in derivative market and hence they tend to be more liquid and one can take large positions in derivative markets quite easily.
- When value of underlying assets change then value of derivatives also changes and hence one can construct portfolio which is needed by one and that too without having the underlying asset. So for example if one want to buy some stock and short the market then he can buy the future of a stock and at the same time short sell the market without having to buy or sell the underlying assets.
- Derivatives have the characteristic of Leverage or Gearing. With a small initial outlay of funds (a small percentage of the entire contract value) one can deal big volumes.
- Pricing and trading in derivatives are complex and a thorough understanding of the price behaviour and product structure of the underlying is an essential pre-requisite before one can venture into dealing in these products.
- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.

1.3.1 Reforms, Research

Q15. Explain the growth and development of derivatives in Indian market. State the reasons for the growth reforms of derivative market.

Ans :

Derivatives trading is not a new concept as it existed from the era where the people were carrying out trading activities with one another. Forward contracts were exercised from the 12th century, when the merchants entered into the contracts for the trading of commodities agreed upon the specified prices. However, the motives behind the entry of derivatives contract was different from the modern motives as the pre-arrangement was made only to reduce the wide fluctuations in prices, inhibiting the marketing of a commodity soon after its harvest.

From the last two decades, the derivatives market has undergone dramatic growth which can be clearly understood through following research data. Which is given in the form of tabulated results,

Product Years	Interest rate swaps and options	Currency futures and options	Interest rate futures and options	Stock index futures and options	Currency swaps and options	Other instruments	Total
1995	16515	154	8618	511	1197	-	26995
1996	23894	171	9257	591	1560	-	35473
1997	27211	161	11221	1021	1824	-	41438
1998	44259	81	12643	1208	5948	30110	94249
1999	53316	59	11669	1793	4751	30134	101722
2000	58244	96	12626	1580	5532	31423	109501
2004	75125	2016	27892	5217	9012	32981	152243

Table: Trends of the Global Derivatives Industry in terms of the Outstanding contracts (in \$ Billion)

The Bank of International Settlements (BIS) has disclosed that by the end of December 2000, the estimated size of derivatives market was found to be around US\$109.5 trillions, whereas, the OTC markets witnessed the outstanding contracts having a notional value of US\$95.2 trillions during the same period, which constituted an increase of about 7.9% from December 1999. Rapid expansion of interest rate contracts and bond markets have paved the path for the further growth of derivatives market in December 2000. There was an increase in the amount of outstanding contracts of the stock exchanges from US\$13.5 trillion to US\$14.3 trillion.

Reasons

- 1 The situation of the financial markets witnessing the increased volatility in the prices of the underlying assets.
- 2 Increased coordination and integration between the domestic markets and the foreign markets dealing with derivatives.
- 3 Reduced transaction cost and introduction of an improved and advanced communication facilities making an entire trading process, a prompt and convenient process.
- 4 Formulation of various risk management strategies by making use of advanced and more sophisticated risk management tools.
- 5 Optimally designing the risk return parameters for a wide variety of assets leading to higher generation of risk, reduced risk and transaction costs by introducing innovative derivative instruments.

Reforms

Some of the important recent reforms took place in derivative market are,

- (i) All OTC derivatives are considered under framework of reporting and all client transactions accordingly reported to trade repositories.
- (ii) IRS contracts have been standardised previously and attempts were made to standardize interest rate swaps and foreign exchange derivatives.
- (iii) Clearing corporation of India Ltd. establish public dissemination system in order to disclose price and volume information on inter bank OTC foreign exchange derivatives. Due to this transparency

and flexibility of OTC derivatives markets has improved.

- (iv) CCIL gas was authorized to provide central counterparty based clearing for all IRS trades. CCPs clearing of forex forwards are mandatory.
- (v) Financial Benchmarks India Pvt. Ltd. was established under recommendations of committee on Financial Benchmarks. It has been promoted combinedly by Fixed Income Money Market and Derivative Association of India, Foreign Exchange Dealers Association of India and Indian Banks Association. It has inaugurated FBIL overnight Mumbai Inter Bank Offer Rate on July 22, 2015.

Q16. Explain different types of derivatives.

Ans :

Derivatives are of two types: financial and commodities.

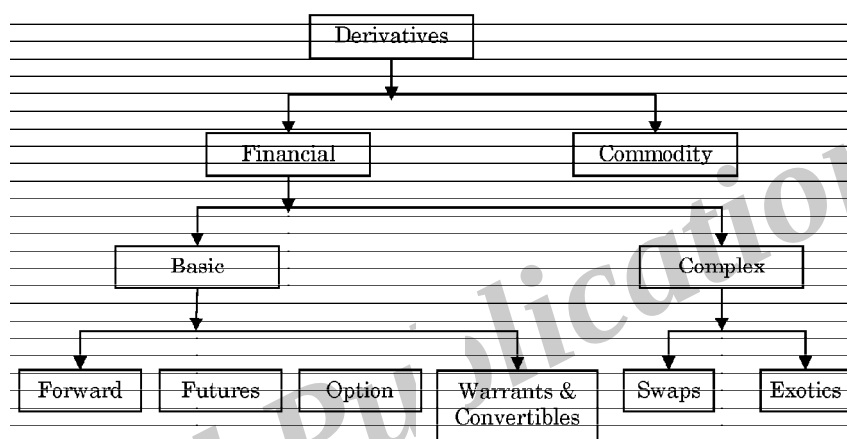


Fig.: Classification of Derivatives

One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivative, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soyabeans, crude oil, natural gas, gold, silver, copper and so on. In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard and there are no quality issues whereas in commodity derivative, the quality may be the underlying matter. However, despite the distinction between these two from structure and functioning point of view, both are almost similar in nature.

The most commonly used derivatives contracts are forwards, futures and options.

1. Forwards

A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

2. Futures

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts.

3. Options

Options are of two types - call and put. Call give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Put give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

4. Swaps

Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

- **Interest rate swaps:** These entail swapping only the interest related cash flows between the parties in the same currency.
- **Currency swaps:** These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.

5. Warrants

Options generally have lives of upto one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

6. LEAPS

The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of upto three years.

7. Baskets

Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average or a basket of assets. Equity index options are a form of basket options.

8. Swaptions

Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

Q17. What are the functions of derivatives?

Ans :

The following functions are performed by derivative markets:

1. Discovery of price

Prices in an organised derivatives market reflect the perception of market participants about the future and lead the prices of underlying assets to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices.

2. Risk transfer

The derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them.

3. Linked to cash markets

Derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

4. Check on speculation

Speculation traders shift to a more controlled environment of the derivatives market. In the absence of an organised derivatives market, speculators trade in the underlying cash markets. Managing, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets.

5. Encourages entrepreneurship

An important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. Derivatives have a history of attracting many bright, creative, well-educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense.

6. Increases savings and investments

Derivatives markets help increase savings and investment in the long run. The transfer of risk enables market participants to expand their volume of activity.

Q18. State the advantages and disadvantages of derivatives.

Ans :

Advantages**1. Help in Discovery of Price**

Prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus, derivatives help in discovery of future as well as current prices.

2. Helps to Transfer Risks

The derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them.

3. Higher Trading Volumes

Derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

4. Control Market Activities

Speculative trades shift to a more controlled environment of derivatives market. In the

absence of an organized derivatives market, speculators trade in the underlying cash markets. Managing, monitoring and surveillance of the activities of various participants become extremely difficult in these kinds of mixed markets.

5. Acts as Catalyst

An important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. The derivatives have a history of attracting many bright, creative, well-educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense.

In a nutshell, derivatives markets help to increase savings and investment in the long-run. Transfer of risk enables market participants to expand their volume of activity.

Disadvantages**1. Speculative and Gambling Motives**

One of most important arguments against the derivatives is that they promote speculative activities in the market. It is witnessed from the financial markets throughout the world that the trading volume of derivatives have increased in multiples of the value of the underlying assets and hardly one to two per cent derivatives are settled by the actual delivery of the underlying assets. As such speculation has become the primary purpose of the birth, existence and growth of derivatives. Sometimes, these speculative buying and selling by professionals and amateurs adversely affect the genuine producers and distributors.

2. Increase in Risk

The derivatives are supposed to be efficient tool of risk management in the market. In fact this is also one-sided argument. It has been observed that the derivatives market especially OTC markets, as particularly customized, privately managed and negotiated and thus, they are highly risky.

Derivatives used by the banks have not resulted in the reduction in risk and rather these have risen of new types of risk. They are powerful leveraged mechanism used to create risk.

3. Instability of Financial System

It is argued that derivatives have increased risk not only for their users but also for the whole financial system. The fears of micro and macro financial crisis have caused to the unchecked growth of derivatives which have turned many market players into big losers. The malpractices, desperate behavior and fraud by the users of derivatives have threatened the stability of the financial markets and the financial system.

4. Price Instability

Some experts argue in favour of the derivatives that their major contribution is toward price stability and price discovery in the market whereas some others have doubt about this. Rather they argue that derivatives have caused wild fluctuations in asset prices and moreover, they have widened the range of such fluctuations in the prices. The derivatives may be helpful in price stabilization only if there existed a properly organized, competitive and well-regulated market. Further, the traders behave and function in professional manner and follow standard code of conduct. Unfortunately, all these are not so frequently practiced in the market and hence, the derivatives sometimes cause to price instability rather than stability.

5. Displacement Effect

There is another doubt about the growth of the derivatives that they will reduce the volipie of the business in the primary or new issue market specifically for the new and small corporate units. It is apprehension that most of investors will divert to the derivatives markets, raising fresh capital by such units will be difficult and hence, this will create displacement effect in the financial market. However, it is not so strong argument because there is no such rigid segmentation of investors and investors behave rationally in the market.

6. Increased Regulatory Burden

Derivatives create instability in the financial system as a result; there will be more burdens on the government or regulatory authorities to control the activities of the traders in financial derivatives.

1.4 DEBT MARKET

1.4.1 Corporate and Government Securities Market

Q19. What are Corporate Securities Market?

Ans :

The corporate securities basically deals with which are issued by corporate companies. It includes

1. Primary Market is also known as new issues market.
2. Secondary Market is also known as stock exchange.

Q20. What is a government security? Explain different types of government securities.

Ans :

Meaning

A government security is a bond or other type of debt obligation that is issued by a government with a promise of repayment upon the security's maturity date. Government securities are usually considered low-risk investments because they are backed by the taxing power of a government. In fact, investment in U.S. treasury securities is probably the safest investment that can be made.

Types

There are several types of government securities offered by the Reserve Bank of India. Let's look at the given below:

1. Treasury Bills

Treasury bills, also called T-bills, are short term government securities with a maturity period of less than one year issued by the central government of India.

Treasury bills are short term instruments and issued three different types:

- (i) 91 days
- (ii) 182 days
- (iii) 364 days

Several financial instruments pay interest to you on your investment; treasury bills do not pay interest because they are also called zero-coupon securities.

These securities do not pay any interest; instead, they are issued at a discount rate and redeemed at face value on the date of the maturity.

For example a 91 day T-bill with a face value of Rs. 200 may be issued at Rs.196, with a discount of RS. 4 and redeemed at face value of Rs. 200.

However, RBI performs weekly auctions to issue treasury bills.

2. Cash Management Bills (CMBs)

Cash management bills are new securities introduced in the Indian financial market. The government of India and the Reserve Bank of India introduced this security in the year 2010.

Cash management bills are similar to treasury bills because they are short term securities issued when required.

However, one primary difference between both of these is its maturity period. CMBs are issued for less than 91 days of a maturity period which makes these securities an ultra-short investment option.

Generally, the government of India use these securities to fulfil temporary cash flow requirements.

3. Dated Government Securities

Dated Government securities are a unique type of securities because they either have fixed or a floating rate of interest also called the coupon rate.

They are issued at face value at the time of issuance and remains constant till redemption.

Unlike treasury and cash management bills, government securities are recognized as long-term market instruments because they provide a wide range of tenure starting from 5 years up to 40 years.

The investors investing in dated government securities are called primary dealers. There are nine different types of dated government securities issued by the Government of India given below:

- (i) Capital Indexed Bonds
- (ii) Special Securities
- (iii) 75% Savings (Taxable) Bonds, 2018
- (iv) Bonds with Call/Put Options
- (v) Floating Rate Bonds
- (vi) Fixed Rate Bonds
- (vii) Special Securities
- (viii) Inflation Indexed Bonds
- (ix) STRIPS

4. State Development Loans

State development loans are dated government securities issued by the State government to meet their budget requirements.

The issue is auctioned once every two weeks with the help of the Negotiated Dealing System.

SDL support the same repayment method and features a variety of investment tenures. But when it comes to rates, SDL is a little higher compared to dated government securities.

The major difference between dated government securities and state development loans is that G-Securities are issued by the central government while SDL is issued by the state government of India.

5. Treasury Inflation-Protected Securities (TIPS)

Treasury Inflation-Protected Securities (TIPS) are available based on five, 10 or 30 year term periods. These securities deliver interest payments to all users every six months.

TIPS are similar to conventional treasury bonds, but it comes with one major difference. The same principle is issued during the entire term of the bond in a standard treasury bond.

However, the par value of TIPS will increase gradually to match up with the Consumer Price Index (CPI) to keep the bond's principle on track with inflation.

If inflation increases during the year, there will be an increase in the security value during that year. It means you will have a bond that maintains its value throughout life instead of a bond that's worthless after maturity.

6. Zero-Coupon Bonds

Zero-coupon bonds are generally issued at a discount to face value and redeemed at par. These bonds were issued on January 19th 1994.

The securities do not carry any coupon or interest rate as the tenure is fixed for the security. In the end, the security is redeemed at face value on its maturity date.

7. Capital Indexed Bonds

In these securities, the interest comes in a fixed percentage over the wholesale price index, which offers investors an effective hedge against inflation.

The capital indexed bonds were floated on a tap basis on December 29th 1997.

8. Floating Rate Bonds

Floating rate bonds does not come with a fixed coupon rate. They were first issued in September 1995 as floating rate bonds are issued by the government.

1.5 MONEY MARKET

Q21. Define Money market.

(OR)

What is Money market ?

Ans :

Meaning

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short term funds. As the name implies, it does not actually deal in cash or money. But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government papers drawn for a short period not exceeding one year. These short term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

The money market does not refer to a particular place where short-term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short-term funds. The transactions between borrowers, lenders and middlemen take place through telephone, telegraph, mail and agents. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location.

For example, the London money market operates from Lambard street and the New York money market operates from Wall street. But, they attract funds from all over the world to be lent to borrowers from all over the globe. Similarly, the Mumbai money market is the centre for short-term loanable funds of not only Mumbai, but also the whole of India.

Definitions

- (i) **According to Geottery Crowther**, "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money".
- (ii) **According to RBI** defines the money market as, "a market for short term financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market".

Q22. Explain the features of money market.**(OR)****Describe the features of money market.****Ans :****1. Existence of Unorganized Money Market**

This is one of the major defects of Indian money market. It does not distinguish between short term and long term finance, and also between the purposes of finance. Since it is outside the control and supervision of RBI, it limits the RBI's control of over money market.

2. Lack of Integration

The Indian money market is broadly divided into two sectors, the organized money market and the unorganized market. The organized market constitutes several institutions such as RBI, State Bank of India, commercial banks, cooperative banks and financial institutions. RBI as an apex body regulates their working. The unregulated sector is not homogenous in itself. It constitutes indigenous bankers, loan companies, money lenders, etc. There is no uniformity in their practices and there is multiplicity of functionaries.

3. Multiplicity in Interest Rates

There exists too many rates of interest in the Indian money market such as the borrowing rate of government, deposits and lending rates of cooperative and commercial banks, lending rates of financial institutions, etc. This

is due to lack of mobility of funds from one section of the money market to another. The rates differ for funds of same durations lent by different institutions.

4. Inadequate Funds

Generally there is shortage of funds in Indian money market on account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy, etc. However, the banking development particularly branch expansion, has improved the mobilization of funds to some extent in the recent years.

5. Seasonal Stringency of Money

The seasonal stringency of money and high rate of interest during the busy season (November to June) is a striking feature of Indian money market. There are wide fluctuations in the interest rates from one season to another. RBI has been taking various measures to avoid such fluctuations in the money market by adding money into the money market during the busy season and withdrawing the funds during the slack season.

6. Absence of Bill Market

A well organized bill market is necessary for linking up various credit agencies effectively to RBI. The bill market is not yet developed on account of many factors such as the practice of banks keeping a large amount of cash for liquidity purposes, preference for borrowing rather than discounting bills, dependence of indigenous bankers on one another, widespread practice of using cash credit, high stamp duty on usance bill, etc.

7. Inadequate Credit Instruments

The Indian money market did not have adequate short term paper instruments till 1985-86. There were only call money and bill markets. Moreover there were no specialist

dealers and brokers dealing in the money market. After 1985-86, RBI has introduced new credit instruments such as 182-day treasury bills, 364-day treasury bills, CDs and CPs. These instruments are still in underdeveloped state in India. The above defects of Indian money market clearly indicate that it is relatively less developed and has yet to acquire sufficient depth and width. Thus, it cannot be compared with developed money markets such as London and New York money markets.

Q23. Explain the functions of money market.

(OR)

Describe the functions of money market.

(OR)

What are the functions of money market.

(OR)

Explain the functions of money market in India.

Ans :

(Imp.)

The money market contributes to the economic stability and development of a country by providing short-term liquidity to governments, commercial banks, and other large organizations. Investors with excess money that they do not need can invest it in the money market and earn interest.

Here are the main functions of the money market:

1. Financing Trade

The money market provides financing to local and international traders who are in urgent need of short-term funds. It provides a facility to discount bills of exchange, and this provides immediate financing to pay for goods and services. International traders benefit from the acceptance houses and discount markets. The money market also makes funds available for other units of the economy such as agriculture and small-scale industries.

2. Central Bank Policies

The central bank is responsible for guiding the monetary policy of a country and taking measures to ensure a healthy financial system. Through the money market, the central bank can perform its policy-making function efficiently. For example, the short-term interest rates in the money market represent the prevailing conditions in the banking industry and can guide the central bank in developing an appropriate interest rate policy. Also, the integrated money markets help the central bank to influence the sub-markets and implement its monetary policy objectives.

3. Growth of Industries

The money market provides an easy avenue where businesses can obtain short-term loans to finance their working capital needs. Due to the large volume of transactions, businesses may experience cash shortages related to buying raw materials, paying employees, or meeting other short-term expenses. Through commercial paper and finance bills, they can easily borrow money on a short-term basis. Although the money market does not provide long-term loans, it influences the capital market and can also help businesses obtain long-term financing. The capital market benchmarks its interest rates based on the prevailing interest rate in the money market.

4. Commercial Banks Self-Sufficiency

The money market provides commercial banks with a ready market where they can invest their excess reserves and earn interest while maintaining liquidity. The short-term investments such as bills of exchange can easily be converted to cash to support customer withdrawals. Also, when faced with liquidity problems, they can borrow from the money market on a short-term basis as an alternative to borrowing from the central bank. The advantage of this is that the money market may charge lower interest rates on short-term loans than the central bank typically does.

Q24. Explain the importance of money market.

Ans :

A developed money market plays an important role in the financial system of a country by supplying short-term funds adequately and quickly to trade and industry. The money market is an integral part of a country's economy. Therefore, a developed money market is highly indispensable for the rapid development of the economy. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

(i) Development of Trade and Industry

Money market is an important source of financing trade and industry. The money market, through discounting operations and commercial papers, finances the short-term working capital requirements of trade and industry and facilitates the development of industry and trade both - national and international.

(ii) Development of Capital Market

The short-term rates of interest and the conditions that prevail in the money market influence the long-term interest as well as the resource mobilisation in capital market. Hence, the development of capital market depends upon the existence of a developed money market.

(iii) Smooth Functioning of Commercial Banks

The money market provides the commercial banks with facilities for temporarily employing their surplus funds in easily realisable assets. The banks can get back the funds quickly, in times of need, by resorting to the money market. The commercial banks gain immensely by economizing on their cash balances in hand and at the same time meeting the demand for large withdrawal of their depositors. It also enables commercial banks to meet their statutory requirements of cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR) by utilizing the money market mechanism.

(iv) Effective Central Bank Control

A developed money market helps the effective functioning of a central bank. It facilitates effective implementation of the monetary policy of a central bank. The central bank, through the money market, pumps new money into the economy in slump and siphons it off in boom. The central bank, thus, regulates the flow of money so as to promote economic growth with stability.

(v) Formulation of Suitable Monetary Policy

Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the Government in formulating and revising the monetary policy then and there depending upon the monetary conditions prevailing in the market.

(vi) Non-inflationary source of Finance to Government

A developed money market helps the Government to raise short-term funds through the treasury bills floated in the market. In the absence of a developed money market, the Government would be forced to print and issue more money or borrow from the central bank. Both ways would lead to an increase in prices and the consequent inflationary trend in the economy.

Q25. Explain the objectives of money market.

(OR)

Describe the objectives of money market.

Ans : **(Imp.)**

The following are the important objectives of a money market:

- (i) To provide a parking place to employ short-term surplus funds.

- (ii) To provide room for overcoming short-term deficits.
- (iii) To enable the Central Bank to influence and regulate liquidity in the economy through its intervention in this market.
- (iv) To provide a reasonable access to user of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

Q26. State the defects of money market.

Ans :

The following are the defects of Indian money market,

1. Existence of Unorganized Market

One of the main defect of the Indian money market is the presence of indigenous bankers who do not differentiate between the short-term finance or long-term finance. Similarly, NBFC's (Non-Banking Financial Companies) raises funds from public but are not under the control and regulation of RBI. The indigenous bankers and NBFC's carry out their operations outside the organized market. The control and supervision of RBI is limited in unorganized sector.

2. Lack of Integration

The other significant drawback of money market is lack of integration. The Indian money market is divided into different heads which not have any cordial relationship with each other. The various heads in money market such as, SBI and its subsidiaries, foreign exchange banks, Urban Cooperative Banks and Indigenous Bankers restricts themselves in their respective business and are independent in their respective fields. The Indian banks and foreign banks presently does not have friendly relations with each other. After enacting the Banking Regulation Act 1949, the banks are becoming slowly united with each other.

3. Presence of Several Interest Rates

The other drawback of Indian money market is the presence of several interest rates such

as government rate for borrowing, lending and deposit rates of commercial banks and cooperative banks, lending rates of DFHI's and so on. The reason behind the presence of several interest rates is immobility of funds from one area to another area.

4. Seasonal Stringency of Money

Another defect of Indian money market is the seasonal stringency of money within an year. The period from November to June was considered as busy season, as funds were significantly needed to and for transferring the crops from villages to cities and towns and high interest rates was charged under this season. The period from July to October is considered as slack-season or off-season in which the banks have excess funds and low-interest rates were charged during this season. For this reason, more fluctuations exists in the interest rates within a year.

5. Non-existence of Bill Market

One more defect of Indian money market is the absence of commercial bill market or discount market especially for short-term commercial bills. This absence is due to some historical disasters like bank practices storing huge amount of cash for liquidity purposes, improper drafting of bazar hundi, lack of warehousing facilities for strong agricultural products etc.

6. Highly Sensitive Call Money Market

The funds borrowed in call money market are based on the call money rates which are market determined and there are wide fluctuations in these rates. RBI made efforts to reduce these fluctuations in the call-money-rates which was continued to be highly volatile.

7. Non-existence of Well-organized Banking System

Well developed banking system in India is still lacking. This is the main defect of the Indian money market. Before nationalization of banks (1969), branch banking was very slow in India. There are very less banks and were focussing themselves in large cities and mandi towns.

Q27. Explain the structure of Indian money market.

(OR)

What are the functions of organized money market ?

(OR)

Explain the various sectors of money market in detail.

Ans :

(Imp.)

The main components of Indian money market are :

1. Unorganized banking sector,
2. Organized banking sector
3. Sub markets

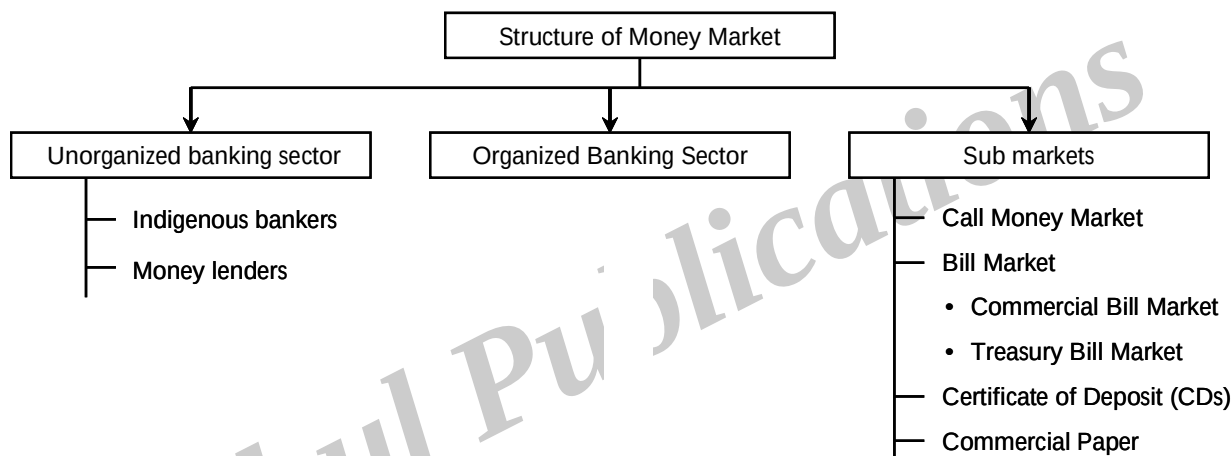


Fig.: Structure of money market

1. Unorganized banking sector

It consists of indigenous bankers and moneylenders in all the country who pursue banking business on traditional lines.

(i) Indigenous bankers

The Indian Central Banking Enquiry Committee defined Indigenous banks as “an individual or private firm receiving deposits and dealing in hundies or lending money”.

They accept deposits on current accounts and fixed deposits. They lend money to small farmers and traders. Along with this they deal in hundies. They charge exorbitant rate of interest on loans. Certain communities such as Marwaris, Bengalese, Gujarathies, Chettiars and Kallida Kurichi Brahmins do indigenous banking business in India. The main limitation of indigenous bankers is that they follow conservative practices and are not governed by Reserve Bank of India.

(ii) Money lenders

Money lenders constitutes one of the components of the organized money market of our country. Money lenders are those persons who do not accept deposits from public, but merely lend their own funds. They lend money mainly for consumption and other domestic purposes.

They are mainly two categories of money lenders

(a) Professional money lenders: They are those persons whose main business is to lend money. It may be of two types.

- **Resident money lenders :** Maharaja, Sahukars, Seths or Banias.
- **Itinerant money lenders:** Pathans, Kabulis and Qustwalas.

(b) Non-professional money lenders: These are those persons who combine money lending with other activities.

Defects

- (i) Their resources are limited to meet the requirement of the rural people.
- (ii) They charge high rate of interest.
- (iii) They grant loans for consumption and unproductive purposes.
- (iv) They provides loans against crops. In this way they compel the consumers to supply the crops to them.

2. Organized Banking Sector

It consists of Reserve Bank of India, the State Bank of India and its seven subsidiaries, 19 nationalized banks, the other joint stock banks including commercial banks, co-operative banks, regional Rural Banks, special institutions like LIC, UTI, IDBI, SFCs, NABARD, Exim bank etc. DFHI, non-banking companies and quasi Government bodies and large companies which supply funds in the money market through banks. Reserve Bank of India (RBI) is the central bank and monetary authority of our country. So RBI is the leader of Indian money market.

3. Sub markets

It consists of call money market and bill market. Bill market consists of commercial bill market and Treasury bills market, certificates of deposits, and commercial papers.

(i) Call Money Market

Call money market consists of overnight financing and money needed at short notice for periods upto 14 days. It is meant to balance the short-term needs of the banks. Call money markets exist in all developed money markets, in fact, it is the most sensitive part of the financial system. In India, the call money market is centered in Mumbai.

In 1998, DFIT was setup which operated in both markets. Other institutions like IDBI, GIC, NABARD participate in the call money market.

(ii) Bill Market

(a) Commercial Bill Market: Commercial bill market is the secondary market, which deals with trade bills or commercial bills. Commercial bills are the credit instruments which helps the business organizations and banking organizations. The commercial bill legally aims at repaying the seller in case of late payments by the purchaser. Usually, commercial bills emerge from local transactions.

(b) Treasury Bill Market: Treasury bill market is mainly concerned with the treasury bills. The treasury bills are referred as the short term liability of the central government in India. These bills are offered for settling the temporary deficits faced by the government. In India, the treasury bill market is still developing. Only the RBI is the primary holder of the treasury bills.

Non-banking financial intermediaries such as LIC, UTI and corporate firms do not hold treasury bills. At present the following types of treasury bills are issued,

- (i) 14 days intermediate treasury bills
- (ii) 91 days treasury bills
- (iii) 364 days treasury bills.

(iii) Certificate of Deposit (CDs)

A certificate of deposit is a type of certificate given by the bank to its depositors for a particular time period. These certificates are same like conventional term deposits but with the only difference that they are to be negotiated and trade in short-term money market.

(iv) Commercial Paper

It is a short-term instrument of raising funds by corporate. It is a sort of unsecured promissory note sold by the issuer to the investor, the maturity of the CPs is flexible. Usually, borrowers and lenders adopt the maturity of CPs to their needs. Highly rated corporate which can obtain funds at a cost lesser than the cost of borrowing from banks are particularly interested in issuing CPs.

1.6 FINANCIAL SERVICES**1.6.1 Concept and Meaning**

Q28. Explain the meaning and features of financial services.

(OR)

What do you mean by financial services?

Ans : **(June-19)**

Meaning

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

The 'financial service' can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial service sector is a key area and it is very vital for industrial developments. A well developed financial service industry is absolutely necessary to mobilise the

savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

Features

Financial services have certain basic features as stated below:

(i) Customer-oriented

Like any other service industry financial service industry is also a customer-oriented one. That customer is the king and his requirements must be satisfied in full should be the basic tenet of any financial service industry. It calls for designing innovative financial products suitable to varied risk-return requirements of customers. Above all, there should be timely delivery of services.

(ii) Intangibility

Financial services are intangible and therefore, they cannot be standardised or reproduced in the same form. Hence, there is a need to have a track record of integrity, reputation, good corporate image and timely delivery of services.

(iii) Simultaneous performance

Yet another feature is that both production and supply of financial services have to be performed simultaneously. Therefore, both suppliers of services and consumers should have a good rapport, clear-cut perception and effective communication.

(iv) Dominance of human element

Financial services are dominated by human element and thus, they are people-intensive. It calls for competent and skilled personnel to market the quality financial products. But, quality cannot be homogenised since it varies with time, place and customer-to-customer.

(v) Perishability

Financial services are immediately consumed and hence inventories cannot be created. There is a greater need for balancing demand and supply properly. In other words, marketing and operations should be closely interlinked.

Q29. Explain the Importance of Financial Services.**Ans :** (June-19)

Financial services cater to the requirements of both individual and corporate customers. In fact, the successful functioning of any financial system depends upon the range of financial services offered by vendors of services. Financial services can be defined to include not only the provision of a financial service but also the sale of a financial product or both. The importance of financial services can be realised from the following:

(i) Economic growth

The financial service industry mobilises the savings of the people and channels them into productive investment by providing various services to the people. In fact, the economic development of a nation depends upon these savings and investment.

(ii) Promotion of savings

The financial service industry promotes savings in the country by providing transformation services. It provides liability, asset and size transformation service by providing large loans on the basis of numerous small deposits. It also provides maturity transformation services by offering short-term claim to savers on their liquid deposit and providing long-term loans to borrowers.

(iii) Capital formation

The financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth. It is the principal mobiliser, of surplus funds to finance productive activities and thus, it promotes capital accumulation.

(iv) Provision of liquidity

The financial service industry promotes liquidity in the system by allocating and reallocating savings and investment into various avenues of economic activity. It

facilitates easy conversion of financial assets into liquid cash at the discretion of the holder of such assets.

(v) Financial intermediation

The financial service industry facilitates the function of intermediation between savers and investors by providing a means and a medium of exchange and by undertaking innumerable services.

(vi) Contribution to GNP

The contribution of financial services to GNP has been going on increasing year-after-year in almost all countries in recent times.

(vii) Creation of employment opportunities

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

1.6.2 Classification – Traditional and Modern Activities**Q30. Explain the classification of financial services.****Ans :**

Financial services can be classified into traditional and modern activities. Traditional activities include capital market intermediaries (term lending institutions and investing institutions) and money market intermediaries (commercial banks, co-operative banks and other short term financing companies). Traditional activities are further classified into fund-based and non-fund-based activities.

1. Traditional Activities

Financial intermediaries have been providing a wide range of services to both capital and money market. It can be grouped into,

- (a) Fund-based activities
- (b) Non-fund-based activities.

2. Modern Activities

1.6.2.1 Fund-based and Non-fund based Activities**Q31. Explain traditional and modern activities of financial services.****(OR)****Discuss the types of fund based and Non-fund based activities.****(OR)****Explain fund based and non-fund based financial services.****Ans : (Nov.-20, June-19, Aug.-18)**

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

1. Traditional activities
2. Modern activities

1. Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

- (i) Fund based activities and
- (ii) Non-fund based activities

(i) Fund based activities

The traditional services which come under fund based activities are the following :

- (i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)
- (ii) Dealing in secondary market activities.
- (iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
- (iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.
- (v) Dealing in foreign exchange market activities.

(ii) Non-fund based activities

Non-fund-based activities or fee-based activities refer to services beyond financing. In the recent times, individual and corporate customers expects much more than mere finance from financial service companies.

- (i) Capital issues management. This involves management of pre-issue and post issue activities of capital issues following the guidelines of SEBI. Hence, it involves activities that help promoters in marketing their issues.
- (ii) Making arrangements for the placement of capital and debt instruments with investment institutions.
- (iii) Funding of financing project costs and working capital needs of clients through the funds provided by financial institutions.
- (iv) Providing assistance in obtaining government clearance and fulfilling other legal requirements.

2. Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

- (i) Reorienting project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.
- (ii) Planning for mergers and acquisitions and assisting for their smooth carry out.
- (iii) Guiding corporate customers in capital restructuring.
- (iv) Acting as Trustees to the debenture-holders.
- (v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

- (vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.
- (vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.
- (viii) Hedging of risks due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.
- (ix) Managing the portfolio of large Public Sector Corporations.
- (x) Undertaking risk management services like insurance services, buy-back options etc.
- (xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.
- (xii) Guiding the clients in the minimisation of the cost of debt and in the determination of the optimum debt-equity mix.
- (xiii) Undertaking services relating to the capital market such as:
 - (a) Clearing services,
 - (b) Registration and transfers,
 - (c) Safe-custody of securities,
 - (d) Collection of income on securities.
- (xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

1.7 FINANCIAL ENGINEERING - NEED FOR FINANCIAL INNOVATION

Q32. What is Financial Engineering? Explain its need for Financial Innovation.

(OR)

Discuss the need for Financial Innovation.

Ans :

(Nov.-20, Aug.-17)

Meaning

“Financial Engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance”.

Need

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain marketplace. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons.

(i) Low profitability

The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition

The entry of many financial intermediaries in the financial sector market has led to severe competition among themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic liberalisation

Reform of the financial sector constitutes the most important component of India's programme towards economic liberalisation. The recent economic liberalisation measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

(iv) Improved communication technology

The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer service

Nowadays, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations, thus, help them in soliciting new business.

(vi) Global impact

Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

(vii) Investor awareness

With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land, etc., to financial assets like shares, debentures, mutual funds, etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

Q33. What are the problems in financial engineering.

Ans :

The various issues or problems involved in financial engineering was seriously analysed after the beginning of financial crisis in 2007. Some of those issues or problems are as follows,

1. Complex Market Situation

In the present globalized and financially integrated market situation, various markets are interconnected with each other and requires quick responses from the marketers. Therefore to meet the markets demand and supply, marketers are customizing their financial products which may leads to a new breed of exposure i.e., exposure to complexity. Such a complexity in market structure and payoffs, made difficult for the marketers to comprehend the payoffs and exposure for other states in the world. As a result regulators and supervisors of markets are facing difficulties to determine the issues in markets and take necessary action for minimizing financial instability.

2. Lack of Appropriate Information

Every investor require detail information about the financial products, and the payoff which he may receive while investing in a specific state or market. However, lack of appropriate information about the market situation may not provide good results from the investment contracts.

3. Liquidity

Financial products are always be at a risk of liquidity in the market. They are exposed at liquidity risk even due to a minor crisis situation in the market. This may deteriorate asset value and increased liquidity premium. As a result, the benefits of customized financial product offsets for risk management.

4. Securitization

Securitization is considered as one of the major issue which leads to financial crisis in the markets. It is the process in which various

intermediaries are involved with various levels of competing interest. As a result of remoteness, trust of the participants of market may get lost and can leads to crisis situation.

5. Operational and Reporting Risk

Customized financial products requires effective documentation and monitoring due to which a sound risk-monitoring infrastructure also become essential. The investors, who are invested in structured financial products, may not be able to monitor such product and also mitigate operational risk. Addition to this, a structured product also involve reporting risk in which investor have to compute fair value of product and maintain proper accounting treatment in respect to gains and losses.

6. Transparency

Lack of transparency in financial production innovation is also highlighted in the financial crisis of 2007. Process of innovation involves less transparency because investors receive competitive market edge from their new financial products.

1.8 MODEL FOR NEW PRODUCT DEVELOPMENT

Q34. Discuss the financial model for a new product development.

Ans :

The financial model for a new product involves many features, some of them are funds flow, direction, exposure and timing. Basically, finance has very less understanding relating to technical, marketing or sales aspects of the transaction. In the view of accountant, a new product development program can be represented in best way which is accepted by accounting.

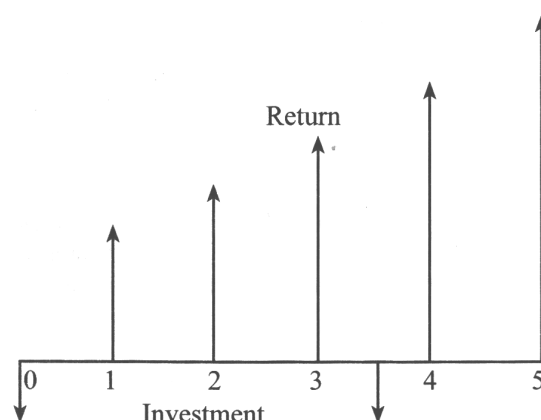


Fig.: Finance Model of Product Development

The basic model of financial analysis involves an initial investment in development which yield future profits at increasing rate in following time periods. In order to update the product or to respond to competitive action, additional investment is required. The initial and subsequent allocation of funds are compensate by the returned revenue.

From financial perspective, the quality of the investment is influenced by value of revenue, time to revenue generation and initial investment.

The mechanics of financial analysis for a new product are clear and direct as they comprise of investment, revenue and profit within a specified time period. It is one of the complicated task to ascertain expectations of company and minimum acceptable performance of a program.

1.9 NEW FINANCIAL PRODUCTS AND SERVICES

Q35. What are the new financial products and services?

(OR)

Outline the new financial products and services.

Ans :

(Nov.-20, Aug.-18)

(i) Merchant Banking

A merchant banker is a financial intermediary helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities

such as management of customers securities, portfolio management, project counselling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) Loan Syndication

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

(iii) Leasing

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

(iv) Mutual Funds

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

(v) Factoring

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

(vi) Forfaiting

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

(vii) Venture Capital

A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is

given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services

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

(ix) Corporate Advisory Services

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

(x) Securitisation

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

always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) Derivative Security

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

(xii) New Products in Forex Market

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

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

genuine business transactions. It can be extended to other transactions like interest payments.

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

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

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

(xiii) Letter of Credit(LOC)

It is an innovative funding mechanism for the import of goods and services on deferred

payment terms. LOC is an arrangement of a financing institution/bank of one country with another institution/bank/agent to support the export of goods and services so as to enable the importers to import on deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

1.10 CURRENT SCENARIO AND CHALLENGES TO THE FINANCIAL SERVICES SECTOR IN INDIA

Q36. Critically analyse the present position of the financial service sector in India and state the challenges it has to face in the years to come.

(OR)

What are the emerging challenges to the financial service sector in India?

Ans : **(Aug.-17)**

Present Scenario

(i) Conservatism to dynamism

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment

and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our country. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. The aggregate funds raised by the industries in the primary markets have gone from Rs. 61 billion in 1991-92 to Rs. 126 billion in 1993-94. The number of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 7000 in 1993. Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating

There is every possibility of introducing Equity Grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, Equity

Grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, Grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

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

- (i) Credit Rating Information Services of India Ltd. (CRISIL)
- (ii) Credit Analysis and Research Ltd. (CARE) and
- (iii) Investment Information and Credit Rating Agency (ICRA).
- (iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India).

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalization

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

(v) Process of Liberalisation

Realising all these factors, the Government, of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issuer from pricing issues by the Controller of capital issues. The interest rates have been deregulated. The private

sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatised. The Finance Act, 1992 has brought into effect large scale amendments in the tax structure of long-term capital gains. The Finance Act, 1994 has given a further boost by lowering the lock-in period from 3 years to 1 year, in order to get the entitlement as a long-term capital asset. The Securities Exchange Board of India has liberalised many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

Challenges

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

(i) Lack of qualified personnel

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

(ii) Lack of investor awareness

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

(iii) Lack of transparency

The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.

(iv) Lack of specialisation

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

(v) Lack of recent data

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

(vi) Lack of efficient risk management system

With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the

financial intermediaries as in the West, they would not be in a position to fulfil the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

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

Q37. Explain the role of financial services in economic development.

Ans : (June-18)

1. Help Businesses to Grow

Financial services help in the development of businesses by giving them the required financial assistance, guaranteeing losses, etc. The loans issued by companies are used for buying fixed assets and/or investing in other fundraising sources.

2. Capital Growth

Both working and fixed capital growth are led by financial services system in an economy by promoting the issue of debentures, shares, short-term loans, etc.

3. Promotes Entrepreneurship Growth

Financial services are also available for entrepreneurs looking for funding and investors for their business. Banks do not easily give loans to new entrepreneurs, but other players in the market specialize in this field. Angel investors, Venture capitals, loan services, counselling services, etc. assist play a key role in the growth of entrepreneurship in India.

4. Infrastructure Development

Investment in infrastructure companies will promote more involvement of private sector companies in this sector.

5. Healthy Competition

A vast and expanded financial service sector and market gives the choice of investing their

money in the investors' hands. Better the services, more the customers for a service and the company. This ensures competition among the firms which benefits the investors—the public and businesses of a country.

6. Promote Free and Easy Trade

Availability of choices to investors and the public ensures trade without barriers, mediation by trusted banks and companies. It also helps in the development of domestic and foreign trade of goods and services.

7. Networking of Finance

The financial service sector is not one single company or bank. Rather, it is a network of companies working together for different matters of money. Consider a person has surplus money. He saves some amount in a bank and invests the remaining in the stocks market. He gets high returns on the stocks and earns a profit. He now decides to buy a car and gets its insurance done.

In this situation, we saw how the person is connected to different segments of the market. The companies he dealt with must be connected with other service providers like the ones we discussed above. Role Of Financial Services In Economic Development.

Moral of this story was that a vast interconnected network of financial services ensures continuous flow of capital or what we call as liquidity in the market.

8. Easy Credit and Loan availability

Credits and loans are also the wheels of this financial system. Borrowing and lending capital and repaying it with interest is an age-old method of capital trade.

But due to problems in less income, high demand for money in the market, there is a huge imbalance between loans and their repayment. In India, many companies and individuals are unable to pay back the loans and outstanding credit dues. This causes the downfall of the economy and building up of leverages and debts. This sector has to be regulated with more attention to the type of buyer.

Short Question and Answers

1. Fund based activities.

Ans :

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

1. Traditional activities
2. Modern activities

1. Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

- (i) Fund based activities and
- (ii) Non-fund based activities

(i) Fund based activities

The traditional services which come under fund based activities are the following :

- (i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)
- (ii) Dealing in secondary market activities.
- (iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
- (iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.
- (v) Dealing in foreign exchange market activities.

(ii) Non-fund based activities

Non-fund-based activities or fee-based activities refer to services beyond financing. In the recent times, individual and corporate customers expects much more than mere finance from financial service companies.

- (i) Capital issues management. This involves management of pre-issue and post issue activities of capital issues following the guidelines of SEBI. Hence, it involves activities that help promoters in marketing their issues.
- (ii) Making arrangements for the placement of capital and debt instruments with investment institutions.
- (iii) Funding of financing project costs and working capital needs of clients through the funds provided by financial institutions.
- (iv) Providing assistance in obtaining government clearance and fulfilling other legal requirements.

2. What are the functions of financial market?

Ans :

1. Price Determination

The financial market performs the function of price discovery of the different financial instruments which are traded between the buyers and the sellers on the financial market. The prices at which the financial instruments trade in the financial market are determined by the market forces i.e., demand and supply in the market.

So the financial market provides the vehicle by which the prices are set for both financial assets which are issued newly and for the existing stock of the financial assets.

2. Liquidity

The liquidity function of the financial market provides an opportunity for the investors to sell their financial instruments at its fair value prevailing in the market at any time during the working hours of the market.

In case there is no liquidity function of the financial market, then the investor

forcefully have to hold the financial securities or the financial instrument until the conditions arise in the market to sell those assets or the issuer of the security is obligated contractually to pay for the same i.e., at the time of maturity in debt instrument or at the time of the liquidation of the company in case of the equity instrument is until the company is either voluntarily or involuntarily liquidated.

Thus, in the financial market investors can sell their securities readily and convert them into cash thereby providing the liquidity.

3. Risk sharing

Financial market performs the function of the risk-sharing as the person who is undertaking the investments are different from the persons who are investing their fund in those investments.

With the help of the financial market, the risk is transferred from the person who undertakes the investments to those persons who provide the funds for making those investments.

3. State the characteristic features of financial instruments.

Ans :

Characteristic

The characteristics/attributes to be possessed by financial instruments are as follows:

(i) Liquidity

A financial instrument can be converted into cash easily by the holder when there is a requirement of cash. The financial instrument will be attractive when the the financial instrument holder is capable to convert it into cash to satisfy the cash requirements.

(ii) Productivity

The financial instrument should be capable to gain returns greater than the cost incurred due to investment in such financial instruments.

(ii) Real Positive Rate of interest

Real positive rate of interest denotes not just higher returns from the financial instruments but returns greater than the rate of inflation within the specified time. It is an actual rate of return which can be expected from the instrument after taking into account tax charges.

(iv) Transaction Cost

The financial instrument holder will incur costs by holding any financial instrument. If transaction costs involved are less than the returns from financial instrument then such financial instrument is considered as be attractive.

4. Discuss the need for Financial Innovation.

Ans :

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain marketplace. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons.

(i) Low profitability

The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition

The entry of many financial intermediaries in the financial sector market has led to severe competition among themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic liberalisation

Reform of the financial sector constitutes the most important component of India's

programme towards economic liberalisation. The recent economic liberalisation measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

(iv) Improved communication technology

The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer service

Nowadays, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations, thus, help them in soliciting new business.

(vi) Global impact

Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

5. What is Financial Markets?

Ans :

Financial markets are never perfect. In allocating credit, they can make two mistakes: funding low-yielding projects and failing to fund high-yielding ones. In the early stages of development, the governments of developing countries fearing that the costs of failing to fund

good projects were likely to be high, intervened to direct credit. Perhaps that assessment was sound at the time, but experience has since revealed too many errors of the first kind funding low-yielding projects. With time, economies have become more complex, information flows have improved, and financial managers have become more skilled. In most countries, errors can be minimized by leaving more decisions to a diverse and competitive financial system that responds to market signals. The primary role of the government then shifts to making market signals more meaningful and, in particular, to preventing its own actions from distorting them.

6. Define Security Market.

Ans :

The securities market refers to the market for equity debt and derivatives. The debt market is further classified into three types i.e., the government securities market, the corporate debt market and the money market. The derivatives markets are also further classified into two types namely the options market and the futures market.

Securities market is the market which influences the modern life greatly. The terms "Dalai Street", "the gilt edged market" and "the Nifty", are indefinite on unclear to understand but still they are being used by the people to refer the sensex or the securities market.

Examples of securities market at work are i.e., the activities which takes place under securities market are as follows, "Sensex falls by 400 points with in a day after a turbulent day's trading. The Reserve Bank of India has decreased the repo rate by 30 basics points". "The Government of India increases 2500 crore rupees by issuing bonds with a maturity period of 15 years".

7. What is Primary Market?

Ans :

Primary market provides an opportunity to the issuers of securities, both Government and corporations, to raise resources to meet their requirements of investment. Securities, in the form of equity or debt, can be issued in domestic / international markets at face value, discount or premium.

The primary market issuance is done either through public issues or private placement. Under Companies Act, 1956, an issue is referred as *public* if it results in allotment of securities to 50 investors or more. However, when the issuer makes an issue of securities to a select group of persons not exceeding 49 and which is neither a rights issue nor a public issue it is called a private placement.

8. What is Secondary Market?

Ans :

Secondary market refers to a market where securities are traded after being initially offered to public in the primary market and/or listed on the stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity market serves as a monitoring and control conduit by facilitating value-enhancing control activities, enabling implementation of incentive- based management contracts, and aggregating information (via price discovery) that guides management decisions.

9. Define Derivative.

Ans :

A derivative is a contract between two parties which derives its value/price from an underlying asset. The most common types of derivatives are futures, options, forwards and swaps.

Description: It is a financial instrument which derives its value/price from the underlying assets. Originally, underlying corpus is first created which can consist of one security or a combination of different securities. The value of the underlying asset is bound to change as the value of the underlying assets keep changing continuously.

Generally stocks, bonds, currency, commodities and interest rates form the underlying asset.

10. Define Money market.

Ans :

Meaning

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short term funds. As the name implies, it does not actually deal in cash or money. But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government papers drawn for a short period not exceeding one year. These short term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

The money market does not refer to a particular place where short-term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short-term funds. The transactions between borrowers, lenders and middlemen take place through telephone, telegraph, mail and agents. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location.

For example, the London money market operates from Lambard street and the New York money market operates from Wall street. But, they attract funds from all over the world to be lent to borrowers from all over the globe. Similarly, the Mumbai money market is the centre for short-term loanable funds of not only Mumbai, but also the whole of India.

Definitions

- (i) **According to Geottery Crowther**, "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money".

- (ii) **According to RBI** defines the money market as, “a market for short term financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market”.
-

11. Explain the objectives of money market.

Ans :

The following are the important objectives of a money market:

- (i) To provide a parking place to employ short-term surplus funds.
 - (ii) To provide room for overcoming short-term deficits.
 - (iii) To enable the Central Bank to influence and regulate liquidity in the economy through its intervention in this market.
 - (iv) To provide a reasonable access to user of short-term funds to meet their requirements quickly, adequately and at reasonable costs.
-

12. Financial Services.

Ans :

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

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

13. What is Financial Engineering?

Ans :

Meaning

“Financial Engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance”.

Choose the Correct Answers

1. _____ is a set of complex or closely connected or intermixed institutions, agents, practices, markets claims etc. In an economy. [c]
(a) Financial intermediary (b) Financial company
(c) Financial system (d) None of these
2. Bonds, bearer debenture, government securities are the example for _____. [b]
(a) Non marketable asset (b) Marketable asset
(c) Primary asset (d) Secondary asset
3. _____ is a money assets consist of coins and currency notes and created money. [a]
(a) Cash asset (b) Stock asset
(c) Debt asset (d) Primary asset
4. Market for short term funds usually for one year is called _____. [b]
(a) Capital market (b) Money market
(c) Primary market (d) Secondary market
5. _____ is a place where foreign moneys are bought and sold. [c]
(a) Money market (b) Financial mortgage market
(c) FOREX market (d) Capital market
6. Those persons who do not accept deposit from the public, but merely lend their own funds. [d]
(a) Bankers (b) Borrowers
(c) Agents (d) Money lenders
7. Banking regulation act was passed in _____. [b]
(a) 1939 (b) 1949
(c) 1945 (d) 1935
8. To facilitate multiple rediscounting and reduce paper movements RBI introduce [a]
(a) DUPN (b) SUPN
(c) CURN (d) DURN
9. RBI issue _____ day treasury bills in 1977 [a]
(a) 14 (b) 40
(c) 344 (d) 91

10. Money market instruments consist of _____. [d]
(a) CD's (b) CP's
(c) MMMFS (d) All of these
11. In MMMFS the second and third 'M' consist of _____. [b]
(a) Money market (b) Market mutual
(c) Mutual market (d) Money mutual
12. SEBI was established in _____. [b]
(a) 4th April 1982 (b) 4th April 1992
(c) 4th June 1992 (d) 4th June 1993
13. The markets which generally confined to the stock exchanges. [b]
(a) Primary market (b) Secondary market
(c) Tertiary market (d) All of these
14. Government securities market also called _____. [b]
(a) Industrial securities (b) Guilt edged securities
(c) MM securities (d) Capital securities
15. Long term loan market includes _____. [d]
(a) Term loan market (b) Mortgage market
(c) Financial guarantee market (d) All of these
16. BSE's online trading system is called _____. [c]
(a) COLT (b) DOLT
(c) BOLT (d) ROLT
17. _____ pool resources from those who save and allocate them to various investment opportunities [a]
(a) Mutual funds (b) LIC
(c) Banks (d) RBI

Fill in the blanks

1. In _____ dealings of financial claims take place and prices are set depending upon the demand of the funds and their requirements by the investors.
2. _____ have been providing a wide range of services to both capital and money market.
3. A money market instrument issued by government at discount and redeemed at par is known as _____.
4. Debt instruments that allow investors to shift between two different types of securities is _____.
5. Market for extremely short period loans (1-14) days is considered as _____.
6. _____ is a debt instrument that aids in managing periodic interest rates.
7. _____ is an act of creating and popularizing new financial instruments as well as new financial technologies, institutions and markets.
8. The bonds that can be encashed anytime after 18 months of the issue date is _____.
9. _____ is a centre for dealings mainly of a short-term character in monetary assets.
10. Primary market is also known as _____.

ANSWERS

1. Financial markets
2. Financial intermediaries
3. Treasury bill
4. Flip-flop notes
5. Call money market
6. Floating rate notes
7. Financial innovation
8. Easy exit bond
9. Money Market
10. New Issue Market.

UNIT II

MERCHANT BANKING:

Concept and evolution of merchant banking (MB) in India. SEBI (MB) Regulations, 1992. Functions of MBs – underwriter, banker, broker, registrar, debenture trustee and portfolio manager. MBs' activities and SEBI guidelines related to issue management.

2.1 MERCHANT BANKING

2.1.1 Concept

Q1. What is Merchant Banking?

(OR)

Define merchant banking.

Ans : (Nov.-20, June-19, June-18, Imp.)

Meaning

Merchant Banking is defined differently in different countries. Though there is no universal definition for merchant banking functions and services offered by a merchant banker. It is also called as investment banking.

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So merchant banking may be defined as, 'an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

2.1.2 Evolution of Merchant Banking (MB) in India.

Q2. Give an overview of the evolution of merchant banking.

(OR)

Discuss the evolution of merchant banking in India.

Ans : (Aug.-21, June-18, Aug.-17, Imp.)

Though it is non-banking financial activity but resembles banking function, originated in Europe. The Dutch and Scottish merchants started financing foreign by accepting bills.

The concept was developed in London. When the merchants started floating bonds in London Money Markets to aid government of under-developed countries. The funds were raised for the long-term needs of the developing economies. Later, merchants moved to domestic business through syndication of short-term and long-term finance. With time, the scope of merchant bankers extended to underwriting of new issues, serving as registrars and share transfer agents, debenture trustees, portfolio managers etc. They also undertook specific functions like negotiating agents for mergers and takeover. The growing concept of merchant banking gained prominence in America and other countries also. Euro dollar and other innovative instruments were introduced and new financial centers were established in Singapore, Hong Kong, Dubai etc.

Merchant Banking in India

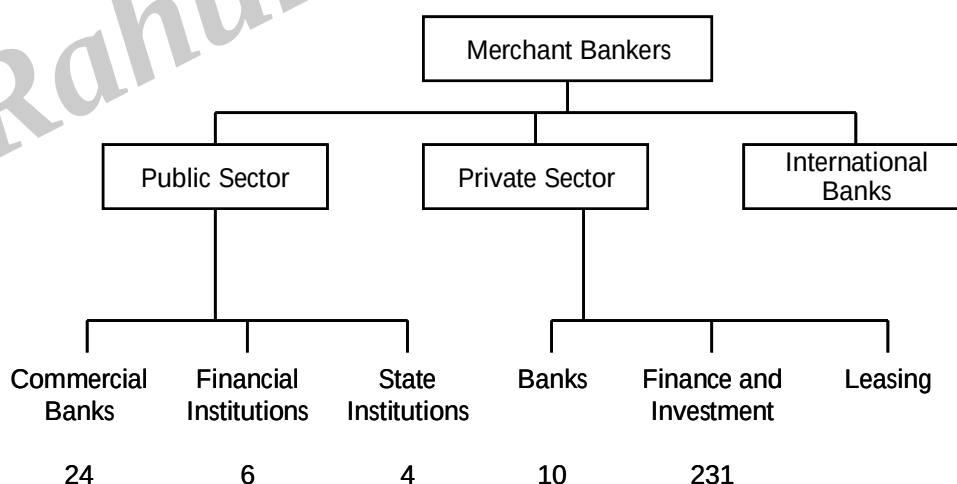
Specialized merchant banking services originated in India in 1969, when the ANZ Grindlays bank set-up the merchant banking division. It started with the management of public issues and selected consultancy services for corporate enterprises. Foreign banks like National Grindlays Bank and the City Bank felt the need for the merchant banking services due to the rapid growth of the issues in primary market. In 1972, the institution to set-up merchant banking institutions, Eventually SBI become the first Indian commercial bank to following year, ICICI was the first financial institution to offer Merchant Banking services have set-up Merchant Banking division in 1972. Thus, the early seventies mark the growth of merchant banking in India. At the outset, commercial banks, broker firms and financial institutions were offering merchant banking services in addition to the traditional services.

In the mid-eighties, amendments in Banking Regulation Act, were made to encourage commercial banks to offer wider variety of financial services through their subsidiaries. By late eighties 33 merchant banks were operating including, Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO Bank. Initially these players dealt with new capital issues management only.

In 1992, reforms were made in the capital markets and Indian economy was deregulated. SEBI was conferred statutory powers, Capital Issues Control Act was enacted and office of the controller of Capital Issues was abolished. All these reforms contributed to the improvement in efficiency and regulation of capital markets resulting in greater need for merchant banking. Merchant bankers assumed greater responsibility towards the investors in both legal and moral aspects.

Considering the growing needs of the markets, nationalized banks opened up subsidiaries companies to operate as merchant banks.

By the end of 1992, there were 115 merchant banks. The number increased to 501 in just two years (some merchant banks collaborated to expand their services to overseas). Besides, we now have global merchant bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Iardie Fleming etc.



Merchant Banking is a combination of Banking and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee. It helps a businessman to start a business. It helps to raise (collect) finance. It helps to expand and modernize the business. It helps in restructuring of a business. It helps to revive sick business units. It also helps companies to register, buy and sell shares at the stock exchange.

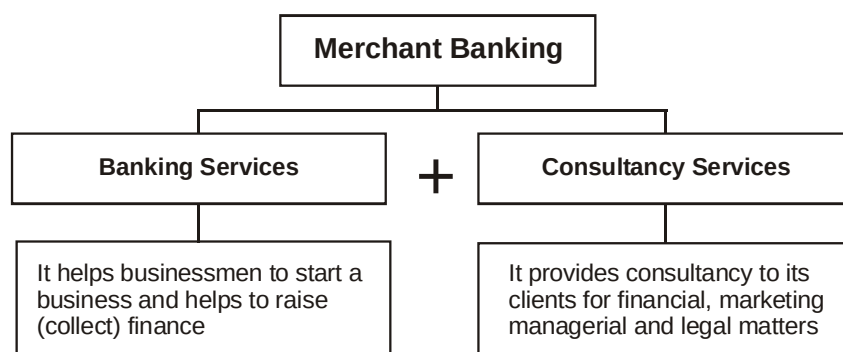


Fig.: Merchant Banking act as Financial Engineer for a Business

In short, merchant banking provides a wide range of services for starting until running a business. It acts as Financial Engineer for a business.

Merchant banking was first started in India in 1967 by Grindlays Bank. It has made rapid progress since 1970.

Q3. Explain the Scope for Merchant Banking in India.

Ans :

There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

(a) Growth of New Issues Market

The growth of new issue market is unprecedented since 1990-91. The amount of annual average of capital issues by non-government public companies was only about 90 crores in the 70s, the same rose to over Rs. 1,000 crores in the 80s and further to Rs. 12,700 crores in the first four years of 1990's.

(b) Entry of Foreign Investor

An outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly tap foreign capital through euro issues. Within two years to March 1994, the total inflow of foreign capital through these routes reached to about \$5 billion.

(c) Changing Policy of Financial Institutions

With the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would required the expert services of merchant bankers for project appraisal, financial management. The policy of decentralization and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by merchant bankers.

(d) Development of Debt Market

The concept of debt market has set to work through National Stock Exchange and the Over the Counter Exchange of India. Experts feel that of the estimated capital issues of Rs. 40,000 crores in 1994-95, a good portion may be raised through debt instruments. The development of debt market will offer tremendous opportunity to Merchant Bankers.

(e) Corporate Restructuring

As a result of liberalization and globalization the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning this has led to corporate restructuring including mergers, acquisitions, splits, and financial restructuring. This offers good opportunity to merchant bankers to extend the areas of their operations.

(f) Disinvestment

The government raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 1993-94. The government proposes to shift the present method of periodic sale of public sector shares to round the year off loading of shares directly on the stock exchange from the year 1995-96. The government will sell the shares of identified public sector at any time during the year when they get a good price above minimum stipulated level. This is likely to provide good business of merchant bankers in future.

(g) Innovations in Financial Instruments

The Indian capital market has witnessed innovations in the introduction of financial instruments such as non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, etc. This has further extended the role of merchant bankers as market makers for these instruments.

Q4. What are the Problems of Merchant Bankers ?

Ans :

- (a) SEBI guidelines have authorized merchant bankers to undertake issue related activities only with an exception of portfolio management. These guidelines have made the merchant bankers either to restrict their

activities or think of separating these activities from the present one and float new subsidiary and enlarge the scope of its activities.

- (b) Non-co-operation of the issuing companies in timely allotment of securities and refund of application money is another problem of merchant bankers. The guidelines have put the responsibility on the merchant bankers. They have to seek the co-operation of the issuing company to shoulder the responsibility.
- (c) SEBI guidelines stipulate a minimum net worth of Rs. 1 crore for authorization of merchant bankers. Small but professional and specialized merchant bankers who do not have a net worth of Rs. 1 crore may have to close down their business. The entry is denied to young, specialized professionals into merchant banking business.

Q5. Explain the various Services of Merchant Banks.

(OR)

Discuss the service provided by the merchant banker.

Ans :

(June-18)

To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering multifarious services. The merchant bankers also advise the investors of the incentives available in the form of tax reliefs and other statutory obligations.

The services of merchant bankers are as follows :

(a) Corporate Counselling

It covers the entire field of merchant banking activities viz. project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, etc. the scope of corporate counselling is limited to giving suggestions and opinion to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to

ensure better performance, maintain steady growth and create better image among investors.

(b) Project Counselling

It includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. It also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

(c) Loan Syndication

It refers to assistance rendered by merchant banks 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 commercial banks. Merchant banks help clients approach financial institutions for term loans. The decision as to which financial institution should be approached depends on industry, location of the unit and size of the project cost.

(d) 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 intermediary whose main job is to transfer capital from those. The issue function may be broadly divided into

- Pre-Issue
- Post-Issue

In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

(e) Underwriting of Public Issue

It is a guarantee given by the underwriter that in the event of under subscription the amount underwritten, would be subscribed by him. It is insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

(f) 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 are free to appoint one or more agencies as managers to the issue. SEBI guidelines insist that all issues should be managed by at least one authorized merchant banker.

(g) Portfolio Management

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the Government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

(h) Advisory Service Relating to Mergers and Takeovers

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over 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 offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies.

(i) Off Shore Finance

The merchant bankers help their clients in the following areas involving foreign currency :

- Long-term foreign currency loans
- Joint venture abroad
- Financing exports and imports and
- Foreign collaboration arrangements
- The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

(j) Non-Resident Investment

The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities selection of securities, investment management etc. they also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

2.2 SEBI (MB) REGULATIONS, 1992

Q6. Describe the regulations of merchant banker under SEBI Act, 1992.

Ans : (Imp.)

Registration

It is mandatory for the merchant bankers to register (under SEBI Merchant Banking Regulation Act 1992). As per 1990 guidelines of SEBI, following is the criteria for authorization to merchant bankers to carry out business.

- Professional qualification in finance law or business.
- Adequate infrastructure.

- Employment of atleast two experienced merchant bankers.
- Capital adequacy.

As per the 1992, guidelines. Merchant Bankers into four categories.

1. Merchant bankers carrying on issue management activities belonged to category I. It included activities like preparation of prospectus, tie up financiers, determining the financial structure, final allotment of securities, underwriting consultant to an issue, portfolio management etc.
2. The second category constituted merchant bankers playing the role of advisors, consultants, co-managers, underwriters to an issue etc.
3. The third category merchant bankers could act as underwriter advisor or consultant to an issue.
4. Merchant bankers of fourth category were authorized to act only as advisory or consultants. We see that only category I merchant bankers were authorised to act as lead managers. This classification was however valid only upto 1997. Now, only category I merchant bankers are required to be registered by SEBI.

Grant of Certificate

Based on the above criteria, SEBI grants a certificate of registration to the corporate bodies other than a non-banking financial corporate, or merchant bankers registered by the RBI to act as primary or satellite dealer to carry on merchant banking.

Capital Adequacy

Based on the classification, the minimum networth requirement for each of the four categories was Rs. 1 crore, Rs. 50 lakhs, Rs. 20 lakhs and 0 respectively.

SEBI is authorised to collect a fee for original registration, annual fee, as well as the fee of renewal. With effect from 1999, merchant bankers

have to pay a renewal fee Rs. 2.5 lakhs every three years from the fourth year of initial registration, least the registration may be suspended.

Restriction on Business

Merchant bankers are not allowed to carry on funds asset-based (like leasing hire purchasing) business etc. Besides, banks and financial institutions in public sector, however, Merchant banks registered with RBI as primary satellite dealers can carry on business other than that in the securities market.

Number of Lead Managers

SEBI requires all public issues to be managed by atleast one merchant banker acting as lead manager. The minimum number of lead managers depends on the size of the issue. Generally a maximum of two lead managers are appointed as lead managers for issues less than Rs. 50 crores. For issues exceeding 100 crores, 200 crores maximum of four lead managers can be associated. With the approval of SEBI the number may be raised to five or more for an issue size of 200-400 crores and above.

Responsibilities of Lead Managers

Merchant bankers should submit to the SEBI in case of greater than one lead manager the specific responsibilities of each lead manager before the issue. General responsibilities include the following.

- Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relation to issues. Particularly, the agreement should consider disclosure, allotment and refund, preparation and maintenance of books of accounts and half-yearly reports.
- The agreement details has to be submitted with the SEBI atleast 30 days prior to the opening issues of the subscription.
- No lead managers can manage an issue of its associate companies.
- Leader merchant bankers should not associate with merchant bankers who are not registered with the SEBI.

- Lead managers of category one merchant bankers ought to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakhs whichever is less. If he fails, associate merchant banker should underwrite the equal amount by intimating it to the SEBI. Under capital adequacy requirement, merchant bankers are excepted to submit half-yearly unaudited financial results for SEBI to monitor capital adequacy.

Due Diligence Certificate

The lead manager is also responsible for verifying the contents of prospectus or letter of offer of an issue. According to SEBI, every lead manager has to submit a due diligence certificate at least 15 days before the issue. He should verify that,

- (a) The prospectus or the offer letter confirm the document relevant to the issue.
- (b) All legal requirements have been complied with.
- (c) The disclosures are adequate for an investor to make an investment decision and that they are true and fair.

Submission of Documents

Lead manager should submit issue particulars, prospectus, other literature for investors and shareholders and other legal documents and prospectus should be submitted with the prescribed fee atleast two weeks before the date of filing with the registrar of companies or regional stock exchanges.

Acquisition of Shares

SEBI prohibits merchant bankers from acquiring securities of any company using unpublished, price sensitive information obtained during the professional services as merchant banker. If any securities are acquired of the issuing company he is serving the merchant banker should submit full particulars to the SEBI within 15 days of the date of transactions.

Disclosures

A merchant banker is required to disclose the following information to the SEBI when needed.

- (a) His responsibilities related to the issue management.
- (b) Any change in previously submitted information.
- (c) Names of the companies whose issue to has manage or associated with.
- (d) Particulars regarding the breach of capital adequacy requirements.
- (e) Particulars of his activities as manager. Underwriting, consultants etc.

Code of Conduct

Merchant bankers are required to follow the code of conduct prescribed by the SEBI. He should make all efforts to protect investors interest. He should render high quality of service all the time and exercise due diligence, and independent professional judgment. He should act in ethical manner and make no discrimination in client except in commercial conditions. The bankers should fulfill all the obligation and adhere to the code of conduct with high degree of fairness.

Inspection

SEBI is entitled to inspect a merchant bankers books of accounts, records and documents in order to ensure that all the provisions of the regulations are duly complied with. The objective may also be to investigate complaints received from investors or others, merchant bankers should obligate and furnish the required documents for inspection and assist the inspecting authority.

However, merchant banker is allowed reasonable time after the notice of inspection before the inspection takes place. The merchant bankers is also given an opportunity to explain after the inspection report is submitted. The SEBI may then advise the concerned merchant banker to take measure and comply with the SEBI rules and regulations.

Regulations as to Default

SEBI is empowered to suspend or cancel the registration of the merchant banker who violates the regulations of SEBI. The penalty of suspension may be granted in the following cases.

- (i) Violation of provisions of the SEBI act.
- (ii) Failure to furnish or faulty submission of required information.
- (iii) Guilt of misconduct or indulgence in price ragging or manipulation of activities.
- (iv) Violation of conditions of registration.

The registration may be cancelled under the following conditions,

- (i) Deliberate manipulation of activities affecting investors interest or price rigging.
- (ii) Deterioration of financial position of the merchant banker.
- (iii) Guilt of fraud or a criminal offence and
- (iv) Repeated defaults leading to suspensions.

An aggrieved merchant banker can however appeal to the union government the order of SEBI.

SEBI gives penalty points for default by merchant bankers based on different types of defaults like general, minor, major and serious. Accordingly penalty is imposed.

2.3 FUNCTIONS OF MBs

Q7. Explain the functions of merchant banker.

(OR)

Describe the functions of merchant banker.

(OR)

Explain the functions of merchant banking in India.

Ans : (Aug.-21, Aug.-18, Imp.)

The financial institutions in India could not meet the demand for long-term funds required by the ever expanding industry and trade. The corporate sector enterprises, therefore, meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering multifarious services. The merchant bankers also advise the investors of the incentives available in the form of tax reliefs and other statutory obligations.

The services of merchant bankers are described in detail in the following section.

(i) Corporate Counselling

Corporate counselling covers the entire field of merchant banking activities viz. project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit etc. The scope of corporate counselling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions. The projects are appraised, as to the location, technical, commercial and

financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

(iii) Loan Syndication

Loan syndication refers to assistance rendered by merchant banks 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 commercial banks.

(iv) 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 intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided into preissue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be co-ordinated.

(i) Public Issue through Prospectus

- (a) The most common method of public issue is through prospectus. In 1991-92, of new capital issues of Rs. 5750.8 crores, Rs. 1903.7 crores (33 per cent) was made through prospectus.
- (b) Offers for sale are offers through the intermediary of issue house or firm of stock broker. The company sells the entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value.
- (c) The direct sale of securities by a company to investors is called private placement. The investors include LIC, UTI, GIC, SFC etc.

To bring out a public issue, merchant bankers have to co-ordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the Companies Act and SEBI are furnished in the prospectus and get it vetted by reputed solicitor.

(ii) Marketing

After despatch of prospectus to SEBI, the merchant bankers arrange 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.

Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the press, radio, TV, investors conference etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

(iii) Pricing of Issues

The SEBI guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre issue management.

(iv) Post Issue Management

The post issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in post issue management. They receive the applications, verify them and submit the basis

of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the Board, the auditor/company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent within 70 days of the close of the issue.'

The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by co-ordinating the above activities.

(v) 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. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully under written. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5% of the issue or Rs. 2.5 lakh whichever is less. Banks/ Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

(vi) 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 are free to appoint one or more agencies as managers to the issue. SEBI guidelines insist that all issues should be managed by at least one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over Rs. 100 crores, upto a maximum of four merchant bankers could be associated as managers.

(vii) Portfolio Management

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely, a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Today the investor is very prudent. Every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard. They have to conduct regular market and economic surveys to know.

- (i) Monetary and fiscal policies of the government.
- (ii) Financial statements of various corporate sectors in which the investments have to be made by the investors.

(iii) Secondary market position, *i.e.*, how the share market is moving.

(iv) Changing pattern of the industry.

(v) The competition faced by the industry with similar type of industries.

(viii) Advisory Service Relating to Mergers and Takeovers

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over 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 offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

(ix) Off Shore Finance

The merchant bankers help their clients in the following areas involving foreign currency.

- (i) Long-term foreign currency loans
- (ii) Joint venture abroad
- (iii) Financing exports and imports and
- (iv) Foreign collaboration arrangements.

The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

(x) Non-Resident Investment

The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management etc. They also take care of the

operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

2.3.1 Underwriter

Q8. Define underwriters. Explain general obligations and responsibilities of underwriters.

(OR)

What is underwriting?

Ans : (Nov.-20, June-19, Imp.)

The important intermediary in the new issue/primary market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organisation is an important element of the primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. A statement to the effect that in the opinion of the lead manager, the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

1. Make all efforts to protect the interests of its clients.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).
4. Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
5. At all times render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
6. Not make any statement, either oral or written, which would misrepresent (a) the services that

the underwriter is capable of performing for its client, or has rendered to any other issuer company; (b) his underwriting commitment.

7. Avoid conflict of interest and make adequate disclosure of his interest.
8. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in the an equitable manner.
9. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as underwriter which would impair its ability to render fair, objective and unbiased services.
10. Not divulge to other issuer, press or any party any confidential information about its issuer company, which has come to its knowledge and deal in securities of any issuer company without making disclosure to the SEBI as required under these regulations and also to the Board directors of the issuer company.
11. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
12. Ensure that any change in registration status/ any penal action taken by SEBI or any material change in financial which may adversely affect the interests of clients/ investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/ investors.
13. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI. The underwriter should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.

2.3.2 Broker**Q9. How merchant banker acts as brokers to the issue?****Ans :** (Nov.-20)

A broker is a person engaged in the procurement of subscription to an issue from the investors. While appointment of brokers is not mandatory, managers to the issue and the brokers can together organize the first distribution of securities and procure the subscription directly from the investors. The stock exchange members of an issuing company are prohibited from acting as brokers to issue unless the stock exchange approves it. The approval is subjected to the conditions that the company fulfills the listing requirements, undertakers to list its securities on a recognized stock exchange, conforms to the stipulations laid in the letter of consent.

The merchant banker acting is lead manager maintains a list of brokers and the particulars of their performance. The companies consult the stock exchange and contacts active broker to obtain their consent to act as brokers to the issue. A copy of consent letter, the names, addresses of the brokers and other particulars like brokerage have to be filed with the prospectus.

Brokers are entitled to a brokerage of 1.5 percent. Mailing costs and causassing costs have to be borne by brokers. Brokerage is not payable if the bankers/ underwriters apply against their underwriting commitments or on the amounts devolving on them as underwriters due to the undescription of the issues.

Registrar to an Issue

A registrar collects investors and applications, keeps record of applications, application money and money paid to the securities seller, assists companies in determining the allotment basis, finalizing the allotment of securities and displacing documents in respect of issue of capital.

For a merchant banker to act as registrar to an issue, he must obtain a certificate of registration from the SEBI. For registration, SEBI divides registrars or share transfer agents in two categories.

- (i) Consists of persons acting as Registrar and Share Transfer agent.
- (ii) Consists of person acting either Registrar or Share Transfer.

Capital Adequacy

Earlier SEBI required registrars and share transfer agents to have a net worth of lakhs and 3 lakhs category I and II respectively. However, since November 1999, the capital adequacy requirement has been removed.

Fee

Since November 1999 registration fee for category I is raised to 50,000, with a renewal fee of Rs. 40,000 and Rs. 30,000 or category II and a renewal fee of 25,000.

Inspection

SEBI is empowered to inspect the books of accounts and other documents to ensure that records are properly maintained satisfying all the rules and regulation of the SEBI act and the Securities Exchange Regulation Act (SERA) and to investigate the complaints received against the issuing company. If the registrar fails to comply with the provisions of the SEBI Act, SEBI can suspend or cancel the registration of the registrar.

2.3.3 Banker**Q10. "Merchant banker acts as a bankers to an issue". Discuss.****Ans :** (Imp.)

Bankers to an issue perform the activities like acceptance of applications and the application money from the investors for issues of capital and refund of applications money.

Registration

For merchant bankers to function as a banker to issue, they should obtain a certificate of registration from SEBI. SEBI registers for bankers to an issue based on the following requirements.

- (i) Applicant has needed infrastructure.
- (ii) Applicant is not involved in any litigation related to the securities market.

- (iii) Applicant is a scheduled bank and
- (iv) Applicant seeks the certificate in the investors interest.

Fee

The annual fee for the registration in force since 1999 is Rs. 5 lakhs for the initial registration. The renewal fee, Rs. 2.5 lakhs is payable after the fourth year for every three years.

Responsibilities of Banker to an Issue

A banker to an issue should furnish the following particulars to the SEBI.

- (i) The number of issues for which he is acting as banker.
- (ii) The number of applications and details of application money received.
- (iii) Dates of forwarding investors applications to the issuing company and the dates and amount of refund to the investors.

A bankers to an issue should maintain books of account for atleast 3 years.

Bankers to an issue enters into an agreement with the issuing company that contains the particulars like number of collection centers. Submission of daily statements etc.

If there is any disciplinary action against a banker to an issue, he should immediately inform the SEBI.

Inspection

At the request of the SEBI, RBI inspects a banker to an issue to ensure that the books of accounts are properly maintained. The objective of an inspection could also be to investigate the complaints received against the banker.

Action in Case of Default

SEBI is vested with the power to suspend the registration of a banker to an issue under the following circumstances.

- (i) Violation of the SEBI act.
- (ii) Failure to furnish the required information or submission of false information.

- (iii) Failure to resolve investors complaints.
- (iv) Guilty of misconduct.
- (v) Failure to pay the prescribed fee.

SEBI may cancel the registration in case of repeated defaults resulting in suspension, deterioration of the financial position of the banker or if the banker is guilty of a criminal offence.

2.3.4 Registrar

Q11. Explain the role of merchant banker as registrar to an issue.

Ans : (Imp.)

The different activities which are performed by the registrar to an issue who generally acts as an intermediary in the primary market are collecting the application from the investors, maintaining a proper record of applications and money received from investors or paid to the seller of securities and helping the companies in ascertaining the basis of allotment of securities by consulting with stock exchanges, finalizing the allotment of securities and processing/despaching allotment letters, refunding order, certificates and other related documents with respect to the issue of capital. For performing their activities, the registrars to an issue must be registered with the SEBI which can even renew the certificate of registration. Such registrars are classified into two categories which are as follows,

(i) Category-I

It deals with performing the activities as a registrar to an issue and share transfer agent.

(ii) Category-II

It deals with performing the activities either as a registrar or as a share transfer agent.

SEBI grants registration by considering all the significant matters specifically the important infrastructure, past experience and capital adequacy. SEBI ensures that any related individual has not been provided registration and any director or partner or principal officer has not been accused for any offence including moral turpitude or has been recognized guilty of any economic offence.

Capital Adequacy and Fee

The capital adequacy requirement with respect to the net worth was Rs. 6 lakh and Rs. 3 lakh for category I and category II of registrars and share transfer agents. But since November, 1999, the capital adequacy requirements are inapplicable for a department/division of a body corporate which maintains the records of holders of securities issued by them and handle all the matters related with transfer/redemption of securities. The two categories of registrars and transfer agents need to pay an annual fee of Rs. 15,000 and Rs. 10,000 respectively for initial registration and renewal. But with effect from November, 1999, category-I has to pay a registration fee of Rs. 50,000 and a renewal fee of Rs. 40,000 after every 3 years and category-II is required to pay Rs. 30,000 and Rs. 25,000 respectively.

General Obligations and Responsibilities

Code of conduct for registrar to an issue and share transfer agents.

A registrar to an issue and share transfer agent must carry out the following activities,

1. They should keep high standards of integrity while carrying out their business.
2. They should fulfil all their obligations in an easy, ethical and in a professional way.
3. They should perform their activities with more efficiency, due care and should give independent professional judgement.
4. Before dematerialization of securities they should give proper care, caution and due diligence by confirming and examining that the securities to be dematerialized have been given listing permission by the stock exchange.
5. They should ensure that the enquiries from investors are properly managed, grievances of investors are redressed without any delay and the transfer of securities which are held in physical manner and confirmation of dematerialization / rematerialization requests

and distribution of corporate benefits and allotment of securities is done within the stipulated time under any law.

6. They should take proper measures for preventing misinterpretation and for assuring that the information given to the investors is not misleading.
7. They should not reject the dematerialization/rematerialization requests on any false basis.
8. They should avoid conflict of interest and make appropriate disclosure of its interest.
9. A mechanism must be adopted for resolving any conflict of interest situation which may occur while carrying out the business or if any conflict of interest occurs then appropriate measures should be taken for resolving them in an equitable manner.
10. They should make adequate disclosure to the client of its source or perspective areas of conflict of duties and interest which will weaken its potentiality to offer fair, objective and unbiased services.
11. They should not get involved in any unfair competition.
12. They should make attempts to give proper advice to the clients.
13. They should not reveal any confidential information regarding its clients to other clients, press or to any other person without the permission of the client or when it is needed to reveal the information under any law.
14. They should not make any distinction/differentiation among its clients, except on ethical and commercial basis.
15. They should inform to the clients about any change in registration status/any penal action taken by SEBI or any other material change in financials which may unfavourably influence the interest of clients/investors.
16. They should possess the needed knowledge and competency and should follow the provisions of the SEBI.

17. They should cooperate with SEBI whenever it is required.
18. They should not ignore or fail or refuse to submit any books, documents, correspondence and papers etc., to the SEBI or other agencies with which they are registered.
19. They should make sure that the SEBI is regularly informed regarding the actions, legal proceeding and so on which are started against it with respect to the material breach or non-compliance of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
20. They should take appropriate measures for assuming that there is a continuity in data and record-keeping is properly maintained.
21. They should make attempts to solve all the complaints made against it or with respect to the activities conducted by it quickly.
22. They should neither directly nor indirectly render any investment advice regarding any security in the publicly reachable media. If an employee of registrar to an issue and share, transfer agent discloses such advice then the registrar to an issue and share transfer agent must assure that it also discloses its own interest, the interests of his dependent family members and employer while offering such advice.
23. They should submit all the records/data and all relevant documents before one month from the date of termination of agreement.
24. They should make a relevant statement either oral or written to the clients regarding its qualifications or capability to offer services or regarding its achievement in relation to the services offered to other clients.
25. They should assure that they have a satisfactory internal regulatory process and adequate financial and operational competencies which examines losses existing from theft, fraud and any other dishonest acts, professional misconduct or omissions.
26. They should give freedom and power to its compliance officer for discharging its duties effectively.
27. They should create their own internal code of conduct for regulating its internal operations.
28. They should adopt good corporate policies and corporate governance.
29. They should employ or appoint a person who is suitable for carrying out the business.
30. They should be held liable for the acts or omissions of its employees and agents with respect to the conduct of its business.
31. A dealing in securities should not be done partly or instrumentally for developing a false market, price manipulation and generating of unpublished price sensitive information particularly about the securities which are listed and are to be listed in stock exchange to different persons or intermediaries.

Maintenance of Records

The registrars to an issue and share transfer agents need to keep a record of all the applications received from investors with regard to an issue, all rejected applications along with reasons, allotment basis of securities in consultation with the stock exchanges, terms and conditions of purchase of securities, allotment of securities, list of allottees and non-allottees, refund orders etc. Apart from this, they must also maintain a record of the list of holders of securities of corporates, names of transferers and transferees and the dates of transfer of securities. According to SEBI, the registrars and transfer agents have to file the books of accounts and records etc., and must be preserved by them for three years period.

Inspection

SEBI is entitled to perform the inspection of the books of accounts, other records and documents of the registrars and share transfer agents for assuring that they are kept in an appropriate manner and the provisions of the SEBI act, rules, regulations

and the provisions of the SCRA and the proper rules are followed. It also enquires about the complaints from investors/other registrars in the securities market or any matter related to their activities. The SEBI based on the inspection report can direct the respective party to take the measures which it considers to be suitable. A qualified and for can be appointed for examining the books of accounts and affairs of the registrars to an issue and share transfer agents.

Action in Default

A registrar or share transfer agent will be suspended or his registration will be cancelled if they fails to follow any condition relating to which registration is given or contravenes any of the provisions of the SEBI act/SCRA, rules/regulations and stock exchange bye-laws, rules and regulations.

The penalty for suspension is improved for the following,

- (i) The violation of the provisions of the SEBI act, rules/regulations.
- (ii) The fail ure to provide information on stipulated time or providing wrong/false information or not submitting the periodical information and not cooperating in any enquiry.
- (iii) An involvement in manipulation/price rigging/ cornering activities.
- (iv) A failure to solve the complaints of investors or provide a satisfactory reply to the SEBI in this behalf.
- (vi) A guilt for misconduct or unprofessional conduct.
- (vii) A failure to maintain better capital adequacy requirement or to pay the requirement or to pay the needed fee.
- (viii) A violation of the conditions of registration.

If there are any repeated defaults then the certificate of registration can be cancelled.

2.3.5 Debenture Trustee

Q12. Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee.

Ans : (Imp.)

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debenture holders. An issue means an offer of sale or purchase of securities by any body corporate/ other person/ group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons.

To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of ` 2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off)] as per the latest audited balance sheet can act as trustees.

While considering the application for registration, the SEBI takes into account

- (i) The necessary infrastructure like adequate office space, equipment and manpower to effectively discharge duties,
- (ii) Any past experience as a debenture trustee or employment of minimum two persons with experience in matters relevant to a debenture trustee,
- (iii) Any person directly/ indirectly connected with the applicant has not been granted registration by the SEBI under the SEBI Act,
- (iv) Employment of at least one person who possesses the professional qualification in law from a government recognised institution,

- (v) Any of its directors/principal officer (i.e. a secretary/manager/director of the body corporate or any person connected with the management/ administration of the body corporate upon whom the Board of Directors has served notice of its intention of treating him as its principal officer) is/has any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

The responsibilities and duties of a debenture trustee as discussed below.

Obligation before Appointment

A debenture trustee has to enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures. The agreement should, *inter alia*, contain (i) that the debenture trustee has agreed to act as the trustee* under the trust deed for securing an issue of debentures for the body corporate and (ii) the time limit within which the security for the debenture holders would be created.

However, a debenture trustee cannot act as trustee for any issue of debenture if (a) it is an associate [i.e. (i) who directly/ indirectly by himself or in combination with relatives exercises control in terms of Regulations 2(C) of the SEBI Substantial Acquisition of Shares and Takeover Regulations over the debenture trustee/the body corporate or (ii) in respect of whom the debenture trustee/body corporate directly/indirectly exercises control or (iii) whose director is also a director of the debentures trustee/body corporate], (b) it has lent and the loan is yet not fully repaid/is proposing to lend money to the body corporate.

Obligations

A debenture trustee should, among other matters, accept the trust deed containing matters specified below.

Contents of Trust Deed

Every debenture trustee should ensure that the trust deed executed between a body corporate and debenture trustee should, amongst other things, provide for the following matters, namely:

Preamble

This section should, *inter alia*, state the rights of the debenture holders and the manner in which these rights are vested in the trustee.

Description of Instruments

This section should, *inter alia*, state the purpose of raising finance through debenture issue, description of debentures as regards amount, tenure, interest/coupon rate, periodicity of payment, period for redemption, options available, terms of conversion/ redemption of the debentures in terms of the issue to the debenture holders, debt equity and debt service coverage ratio, if applicable.

1. To maintain register of debenture holders with address with record of subsequent transfers and changes of ownership.
2. To keep proper books of account open for inspection by the debenture trustee.
3. To furnish whatever required information to debenture trustee including copies of reports, balance sheets, profit and loss accounts and so on.
4. To keep charged property/security adequately insured and in proper condition.
5. To permit debenture trustee to enter and inspect the state and condition of charged assets.
6. To pay all taxes, cases, insurance premia with respect to charged property/security, on time.
7. To inform debenture trustee before declaring or distributing dividend.
8. To comply with all guidelines/directions issued by any regulatory authority, with respect to the instant debenture issue.
9. To create debenture redemption reserve as per the SEBI Disclosure and Investor Protection Guidelines, 2000 and the provisions of Companies Act and submit an auditor's certificate to the trustee.

10. To convert the debenture into equity in accordance with the terms of the issue, if applicable.
11. To inform debenture trustee about any change in nature and conduct of business by company before such change.

Q13. Explain the duties and code of conduct of a debenture trustee.

Ans :

Duties

The duties of the debenture trustees include the following:

1. (a) Call for period reports from the body corporate,
- (b) Take possession of trust property in accordance with the provisions of the trust deed, (ba) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption fund.
- (c) Enforce security in the interest of the debenture holders,
- (d) Do such acts as are necessary in the event the security becomes enforceable,
- (e) Carry out such acts as are necessary for the protection of the debenture holders and do all things necessary in order to resolve the grievances of the debenture holders,
- (f) Ascertain and satisfy itself that
 - (i) In case where allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificate has been despatched by the body corporate to the debenture holders within 30 days of the registration of the charge with the Registrar of Companies,

- (ii) Debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act.
- (iii) Interest warrants for interest due on debentures have been despatched to the debenture holders on/before the due dates.
- (iv) Debenture holders have been paid the money(ies) due to them on the date of the redemption of the debentures.

- (g) Ensure on a continuous basis that the property charged to the debentures is available and adequate at all times to discharge the interest and principal amount payable to them and that the property is free from any other encumbrances save and except those which are specifically agreed to by the debenture trustee,
- (h) Exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement/trust deed,
- (i) Take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trustee deed law comes to its notice.

Code of Conduct

A debenture trustee should:

1. Make all efforts to protect the interest of debenture holders.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.

5. Take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation and maintain record of the same.
6. Ensure that any change in registration status/ any penal action taken by the SEBI or any material change in financial position which may adversely affect the interests of clients/ debentureholder is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
7. Avoid conflict of interest and make adequate disclosure of its interest.
8. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as debenture trustee which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other trustees or debenture holders or is likely to place such other debenture trustees in a disadvantageous position while competing for or executing any assignment nor should it wean away the clients of another trustee on assurance of lower fees.
12. Not discriminate among its clients, except and save on ethical and commercial considerations.

2.3.6 Portfolio Managers

Q14. What do you mean by the term portfolio management in the context of merchant banking.

Ans :

(Nov.-20)

Portfolio managers are the persons who enter into a contract with clients and accordingly advise and undertake the management of portfolio of securities on behalf of the clients. Portfolio refers to the total holdings of securities of an investor.

Registration

Portfolio managers have to obtain certificate of registration from the SEBI to act as portfolio managers. SEBI grants the certificate after taking into account the infrastructure. Minimum of two experienced persons, capital adequacy and professional qualification of the applicant. The person should not have been convicted of any offence and not directly or indirectly connected with the applicant.

Fee

SEBI issues the registration certificate on receiving the registration fee. The fee has been raised from Rs. 2.5 lakhs for first two years and 1 lakh for the third year to Rs. 5 lakhs from November 1999. Renewal fee payable from fourth year for every three years is Rs. 2.5 lakhs.

General Responsibilities of portfolio manager

- Every portfolio manager is required to enter into an agreement with the client. The agreement should define the relationship with the client and their mutual rights and duties.
- The portfolio manager should manage the clients funds to meet the client's needs and objectives.
- The portfolio manager cannot take any direct or indirect advantage from the clients funds.
- The portfolio manager should ensure that the complaints received from clients are duly handled and proper action is taken in time.

- Portfolio managers should accept money for not less than one year. However, the client can withdraw money before the maturity period at his own risk, under certain circumstances. The portfolio fund can also renewed on the maturity in which case, it is deemed to be a fresh placement for minimum one year.
- The funds can be invested in money markets but not in bill discounting or badla financing. The funds should not be used for speculation.
- For each client the portfolio manager should buy and sell securities separately. If the securities are purchased in bulk to derive the economies of scale it should be allocated on a prorata basis to the clients.
- Any transaction between the portfolio manager and a client or between the clients should be at the market price.
- The portfolio manager is required to keep of account and maintain records and documents. At the end of an accounting period, the portfolio manager should submit a copy of Profit and Loss Account, balance sheet, audit report and statement of financial position to the SEBI. The books and documents should be preserved for at least five years.

Yearly Audits

The portfolio manager should maintain separate records and accounts for each client which have to be audited every year by a qualified auditor.

The auditor's certificate to the portfolio manager to certify that all accounts and records have properly been maintained and that the portfolio manager has done his duties properly, has to be submitted with SEBI.

The portfolio manager should submit a periodical report to the client. The report should contain details like value of the portfolio, value of each security in the portfolio, transactions incurred, benefits received on debentures, bonus share and rights shares, expense incurred, risk predicted etc.

Compliance Officer

The portfolio manager is required to appoint a compliance officer who would monitor the activities of the portfolio manager and ensure compliance with SEBI rules and regulations and that the investors' grievances are redressed. Any non-compliance is immediately reported to the SEBI.

Inspection

SEBI has the right to inspect the books of accounts, records and other documents of the portfolio manager. The inspection is carried on to ensure that the books are properly maintained and the provisions of the SEBI are complied with. Another objective is to investigate the complaints received by SEBI.

Action in Default

SEBI is empowered to suspend the registration if the portfolio manager fails to furnish the required information or submit false information, fails to resolve investors' complaints, is guilty of misconduct or indulges in price rigging, fails to maintain capital adequacy or violates any of the registration conditions.

The registration may be cancelled under these circumstances.

- Indulgence in deliberate manipulation and price rigging.
- Deterioration of the portfolio manager's financial position.
- Guilty of fraud or a criminal offence.
- Guilty of repeated "defaults resulting in suspension."

2.4 SEBI GUIDELINES RELATED TO ISSUE MANAGEMENT

Q15. Explain the role of the merchant banker in issue management.

Ans : (Aug.-18, Aug.-17, Imp.)

Issue management is the heart of merchant banking. Merchant bankers have always been identified as issue houses. Companies turn to

merchant bankers to raise funds for new projects or expand the existing ones. Merchant bankers issue management function can be divided into pre issue management and post issue management. For both, merchant bankers have to comply with the SEBI guidelines, and co-ordinate the activities of different agencies.

1. Pre-issue Management

Pre-issue management is divided into three types. They are,

- (i) Public issue through prospectus
- (ii) Marketing and Underwriting and
- (iii) Pricing of issues.

(i) Public Issue Through Prospectus

Public issue through prospectus is very common. Merchant bankers should ensure that the prospectus contains all the information needed to comply with companies Act. After drafting the prospectus that satisfies SEBI provisions it has to be vetted by reputed solicitors. Only after the clearance by SEBI, the prospectus is filed with the registrar of companies.

Along with the prospectus the copies of consent of experts, bankers, attorney, legal advisors, solicitors, bankers to the issue, brokers and underwriters are also submitted to the registrar of companies.

Merchant bankers also have to appoint brokers to issue from members of recognized stock exchanges, principle brokers and bankers to issue. Bankers to issue canvass subscription by undertaking wide publicity, and sending mails to clients. Principle brokers help the merchant bankers in devising a successful strategy for the public issue. They keep liaison between stock exchange and merchant bankers. They also offer canvass support and at times centralize mailing of prospectus,

applications forms and other publicity materials. The bankers to the issues accept applications and the subscription tenders and forward the same for registration. Bankers to issue are also entitled to a brokerage on shares allotted, against the applications forwarded by them.

(ii) Marketing and Underwriting

Once the prospectus is filed with the SEBI, merchant bankers have to arrange for a meeting with the company representatives and advertising agents and finalize the data of opening and closing the issue, registration of the prospecting, advertising campaign and data of board meeting.

The advertising or publicity campaign involves publicity material and brochures, prospectus, advertisements etc. Merchant bankers choose the advertising media, keeping in mind the size of the issue, issuer's reputation and location of the company. It also involves conducting conference for a cross-section of investors, explaining the size and importance of the project.

Merchant bankers have to ensure that the statements are accurate, the size of the application form conform to the prescribed standards of the stock exchange and that the publicity material reaches the intermediaries on time. The stock exchange should receive the material at least 21 days before the issue.

(iii) Pricing of Issues

As per SEBI guidelines 1992 companies can consult merchant bankers and price their issues freely in the capital markets. Any listed companies or new companies with five year track record and unlisted company opting for public issues with two and half years of profitability can freely price its issue. The premium

should not be too low as it results in over subscription. The premium should therefore consider the net asset value, profit margin, market price and future prospectus of the company. The premium should be mentioned in the prospectus.

2. Post-issue Management

Post-issue management involves collection of application form from bankers. Statements of amount received, assessing applications devising allotment procedures and finally mailing letters of allotment and refund orders.

In the post-issue management, registrars play a vital role and works together with the bankers to issue. They obtain and sort application and submit the basis of allotment to the stock exchange. Management bankers aids in these activities. On the approval of the basis of allotment it is certified by the auditors. Applications have to wait for 90 to 180 days for the completion of this process.

Q16. Describe the SEBI Guidelines in issue management.

Ans : (Aug.-21, Imp.)

Pre-issue obligations under SEBI regulations 1992 are as follows,

1. Lead merchant bankers should exercise due diligence.
2. The merchant bankers should be satisfied about all the aspects of the issue.
3. The merchant bankers liability continues even after the issue process is finalized.
4. The merchant banker should pay the prescribed fee.
5. The merchant banker should submit the MOU, Due diligence certificates signed by the company secretaries and Chartered Accountant promoters group and an undertaking that the securities transactions will be reported to the stock exchanges with 24 hours.
6. The lead merchant bankers should undertake a minimum underwriting of lesser of 5% of the total underwriting or Rs. 25 lakhs. A statement of the same shall be incorporated with the prospectus.
7. Merchant bankers associated as a promoter with the issue company cannot lead manager the issue. Lead merchant bankers holding the securities of the listed company can lead-managed the issue. The lead merchant bankers appoint one advisor and co-managers, the number not exceeding the number of lead merchant bankers. He should also appoint other intermediates and ensure that they are registered with the board.
8. The lead merchant banker shall file the offer document with the board and the copies with the proposed exchanges. The copies of the offer document should also be made public, charging an appropriate sum for each copy.
9. The lead merchant banker should ensure that the public issues material is dispatched to the stock exchanges, brokers, underwriter and bankers to the issue in advance.
10. The lead manager shall after 21 days of the date of making offer document public, file a statement of list of complaints received and a statement describing the proposed amendments if any with the board.
11. SEBI requires a minimum of four collection centers one in the metropolitan cities of India. Further there should be collection centers in the regions where the registered office of the company is situated it stock exchanges are located in that region. Lead merchant bankers can be consulted for appointing authorised collection agents. Lead merchant bankers should ensure that selected agents are eligible in all aspects for the purpose.
12. Lead merchant banker shall also ensure that the rights issue are advertised in atleast one English National Daily, one Hindi National

- and one regional language papers. The advertisement with date of completion of despatch of offer letters shall be given atleast 7 days before the data of opening of the issue.
13. SEBI also requires issuing company to appoint a compliance officer and inform and particular of the appointment to the board. The compliance officer shall mediate the company and the board regarding compliance of the rules and regulations.
 14. The lead merchant bankers shall also ensure that the abridged prospectus is distributed along with the application forms. The abridged prospectus shall not contain detail that are extraneous to the contents of prospectus.
 15. Lastly, the lead manager has to ensure that the issuing company entered into agreement with the depositories. Investors should be given an opportunity to obtain allotment of securities in dematerialized form through the depositories.
- Post-issue Obligation**
- Post-issue obligation of lead managers involve the following,
1. Lead merchant bankers should ensure that the post- issue monitoring reports are submitted within the stipulated time and in the formats specified in schedule XVI.
 2. The lead manager shall look into the post-issue activities like allotment and refund and ensure that the investor grievances redressal is properly addressing the grievances.
 3. The post-issue lead managers shall co-ordinate with intermediaries after the closure of the issue so as to monitor the flow of applications, processing of the applications etc. The performance of the intermediaries should be reported to the board.
 4. The lead merchant banker shall ensure that the stock-investment compliance of RBI act is duly met with.
 5. The lead merchant bankers shall ensure that the issue is fully subscribed before announcing the closure of the issue if it is closed the earliest data.
 6. The post-issue lead manager shall ensure that the bankers to the issue releases the money received against the issue only after obtaining the listing permission, from all the proposed stock exchanges.
 7. The post-issue lead merchant bankers shall ensure that the advertisements of the issue is released in the popular national daily news papers of english, hindi and the regional language within 10 days from the date of completion of the issue. They shall also ensure that the issuing company or its agents do not advertise stating the over subscription of the issue or the investors response while the issue is not yet completed.
 8. The lead merchant bankers shall ensure that the basis of allotment finalises in compliance with the SEBI guidelines.
 9. The lead merchant banker shall ensure that the (applicants are paid interest if the despatch delays) allotment letter and other such documents are despatched by registered post.
 10. The post-issue lead merchant bankers is liable for post-issue activities untill the subscribers have received the share certificates or the applications money is refunded.
 11. Within two weeks from the date of allotment, the lead merchant bankers shall file a certificate to the Board to certify that the stock invests have been realized.

Short Question and Answers

1. Explain the functions of merchant banker.

Ans :

(i) Corporate Counselling

Corporate counselling covers the entire field of merchant banking activities viz. project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit etc. The scope of corporate counselling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions. The projects are appraised, as to the location, technical, commercial and financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

(iii) Loan Syndication

Loan syndication refers to assistance rendered by merchant banks 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 commercial banks.

(iv) 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 intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided into pre-issue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be co-ordinated.

2. Portfolio Managers

Ans :

Portfolio managers are the persons who enter into a contract with clients and accordingly advise and undertake the management of portfolio of securities on behalf of the clients. Portfolio refers to the total holdings of securities of an investor.

Registration

Portfolio managers have to obtain certificate of registration from the SEBI to act as portfolio managers. SEBI grants the certificate after taking into account the infrastructure. Minimum of two experienced persons, capital adequacy and professional qualification of the applicant. The person should not have been convicted of any offence and not directly or indirectly connected with the applicant.

Fee

SEBI issues the registration certificate on receiving the registration fee. The fee has been raised from Rs. 2.5 lakhs for first two years and 1 lakh for the third year to Rs. 5 lakhs from November 1999. Renewal fee payable from fourth year for every three years is Rs. 2.5 lakhs.

3. What is underwriting?*Ans :*

The important intermediary in the new issue/primary market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organisation is an important element of the primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. A statement to the effect that in the opinion of the lead manager, the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

- (i) Make all efforts to protect the interests of its clients.
- (ii) Maintain high standards of integrity, dignity and fairness in the conduct of its business.
- (iii) Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).
- (iv) Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.

4. State the objectives of merchant banking.*Ans :*

The objectives of merchant banking are as follows :

- (i) To establish secondary market for bills and provide discounting or re-discounting of bills.
- (ii) To assist business communities on various aspects like guiding in managing and encouraging underwriting, helping in securities and so on. Apart from this merchant banking helps in carrying out start-up activities.
- (iii) To help in organizing resources of the business organizations.

- (iv) To help in project formulation and development.
- (v) To help in capital formulation in the economy.
- (vi) To help in global exchange transaction.
- (vii) To encourage the venture capital technology funds.
- (viii) To help in modernization and diversification of business organizations which thereby speed up the activities in the economy.

5. Broker*Ans :*

A broker is a person engaged in the procurement of subscription to an issue from the investors. While appointment of brokers is not mandatory, managers to the issue and the brokers can together organize the first distribution of securities and procure the subscription directly from the investors. The stock exchange members of an issuing company are prohibited from acting as brokers to issue unless the stock exchange approves it. The approval is subjected to the conditions that the company fulfills the listing requirements, undertakers to list its securities on a recognized stock exchange, conforms to the stipulations laid in the letter of consent.

The merchant banker acting as lead manager maintains a list of brokers and the particulars of their performance. The companies consult the stock exchange and contact active broker to obtain their consent to act as brokers to the issue. A copy of consent letter, the names, addresses of the brokers and other particulars like brokerage have to be filed with the prospectus.

6. Define merchant banking.*Ans :*

Merchant Banking is defined differently in different countries. Though there is no universal definition for merchant banking functions and services offered by a merchant banker. It is also called as investment banking.

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So merchant banking may be defined

as, 'an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

7. Loan Syndication

Ans :

It refers to assistance rendered by merchant banks 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 commercial banks. Merchant banks help clients approach financial institutions for term loans. The decision as to which financial institution should be approached depends on industry, location of the unit and size of the project cost.

8. Issue Management

Ans :

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 intermediary whose main job is to transfer capital from those. The issue function may be broadly divided into

- Pre-Issue
- Post-Issue

In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

9. Registrar

Ans :

The different activities which are performed by the registrar to an issue who generally acts as an intermediary in the primary market are collecting the application from the investors, maintaining a

proper record of applications and money received from investors or paid to the seller of securities and helping the companies in ascertaining the basis of allotment of securities by consulting with stock exchanges, finalizing the allotment of securities and processing/despaching allotment letters, refunding order, certificates and other related documents with respect to the issue of capital. For performing their activities, the registrars to an issue must be registered with the SEBI which can even renew the certificate of registration. Such registrars are classified into two categories which are as follows,

(i) Category-I

It deals with performing the activities as a registrar to an issue and share transfer agent.

(ii) Category-II

It deals with performing the activities either as a registrar or as a share transfer agent.

10. Who is a Debenture Trustee ?

Ans :

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debenture holders. An issue means an offer of sale or purchase of securities by any body corporate/ other person/ group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons.

To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of ` 2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off)] as per the latest audited balance sheet can act as trustees.

Choose the Correct Answers

1. A merchant bank is a financial institution conducting money market activities and which of the following? [d]
(a) Lending (b) Underwriting and financial advice
(c) Investment service (d) All of the above
2. Formal merchant banking activity in India was originated in which of the following years? [b]
(a) 1978 (b) 1969
(c) 1769 (d) 1987
3. In India, merchant-banking activity was originated with the merchant banking division set up by which of the following? [a]
(a) Grind lays bank (b) Barclays bank
(c) Yes bank (d) None of the above
4. State Bank of India started merchant banking in which of the following years? [c]
(a) 1974 (b) 1978
(c) 1973 (d) 1980
5. The early growth of merchant banking in the country is assigned to the which of the following? [a]
(a) Foreign Exchange Regulation Act, 1973
(b) Securities Contracts Act
(c) Income-tax Act
(d) FEMA
6. Which of the following problems is needed to be resolved under issue management? [d]
(a) Problems with staff (b) Technical failures
(c) Material shortages (d) All of the above
7. Which of the following defines "issue" in Risk and Issue management? [a]
(a) Something that has happened or a current problems
(b) Something that hasn't happened yet but has some probability of occurring
(c) Potential future problems
(d) None of the above
8. Which of the following is the management of securities of the corporate sector offered to the public on a regular basis? [b]
(a) Corporate Issues Management (b) Public Issues Management
(c) Securities Issues Management (d) Private Issues Management

9. Which of the following helps in monitoring the status of all issue in issue management process? [c]
- (a) Issue manager (b) Issue recorder
(c) Issue register (d) Issue tracker
10. Which of the following is the function of Issue log? [d]
- (a) Keeps a record of all issues within a project
(b) Minimize the impact that issues have on your project
(c) Track the actions taken to resolve issues
(d) All of the above

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Fill in the blanks

1. _____ refers to the total holding of securities of an investor.
2. The marketing of corporate securities by offering them to the public is known as _____.
3. Portfolio managers have to obtain certificate of registration from the _____ to act as portfolio managers.
4. It is mandatory for the merchant bankers to register under _____ act.
5. According to SEBI, every lead manager has to submit a due diligence certificate at least _____ days before the issue.
6. At the request of the SEBI, _____ inspects a banker to an issue to ensure that the books of accounts are properly maintained.
7. A _____ is a person engaged in the procurement of subscription to an issue from the investors.
8. _____ are the persons who enter into a contract with clients and accordingly advise and undertake the management of portfolio of securities on behalf of the clients.
9. _____ deals in new securities i.e., securities which were not previously offered to the investors.
10. _____ is a service rendered by the merchant bankers for the procurement of term loans for the projects.

ANSWERS

1. Portfolio
2. Issue management
3. SEBI
4. SEBI Merchant Banking Regulation Act, 1992
5. 15 days
6. RBI
7. Broker
8. Portfolio managers
9. New issue market
10. Loan syndication.

UNIT III

LEASING AND HIRE-PURCHASING:

- (a) Leasing concept and classification. Financial rationale. Evolution of leasing industry in India. Product profile. Legal, tax and accounting aspects of leasing in India. Funding and regulatory aspects of leasing in India. Financial evaluation of leasing – break-even lease rental. Gross yield based pricing. IRR based pricing. Negotiating lease rental. Assessment of lease related risks. Lease vs. buy decisions.
- (b) Hire-purchase concept and characteristics. Legal and tax framework. Mathematics of hire purchase. Financial evaluation of hire-purchase deals.

3.1 LEASING CONCEPT

Q1. Define Leasing. Explain the characteristics of leasing.

(OR)

What is a Lease Agreement ? State the features of Leasing.

(OR)

What is Leasing ? Describe the features of leasing.

Ans : **(June-19, June-18)**

Meaning

Leasing has emerged as a new source of financing capital assets. It is a financing concept. It is an arrangement between two parties, the leasing company or lessor and the user or lessee. The lessor arranges to buy capital equipment for the use of the lessee for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to mutual convenience of both the parties. The lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitions

A Lease is Defined as follows:

- i) **According to Dictionary of Business and Management**, 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'
- ii) **According to James C. Van Horne** 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'
- iii) **According to Equipment Leasing Association of UK** 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

Characteristics

The following are the characteristics of a lease:

1. **The Parties:** Lease agreement involves two parties i.e., the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for periodical rental payment for an agreed period (pre-determined) of time.
2. **The Asset:** Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery, building, and so on. In leasing the ownership of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lesser where as it use is being transferred to the lesser.
3. **The Term:** The term of lease agreement is known as lease period. It considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Quite a few times the lease period is being divided into primary lease period and secondary lease period.
4. **The Lease Rentals:** Lease rentals forms the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up such cost i.e., interest on the less or's investment, any repairs and maintenance costs which forms the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease

Q2. Explain the Essential Elements of Leasing.

(OR)

Describe the various elements of lease financing.

Ans :

(Imp.)

1. **Parties to the Contract:** There are essen-tially two parties to a contract of lease financing, namely, the owner and the user, called the lessor and the lessee respectively. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial institutions. Sometimes there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous.
2. **Asset:** The asset, property or equipment to be leased is the subject-matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft and so on. The asset must, however, be of the lessee's choice suitable for his business needs.
3. **Ownership Separated from User:** The essence of a lease financing contract is that during the lease-tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.
4. **Term of Lease:** The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e., financial lease) or a period shorter than the useful life of the asset (i.e., operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further specific period.

5. **Lease Rentals:** The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the to rest on the investment, repairs and so forth-borne by the lessor and servicing charges over the lease period.
6. **Modes of Terminating Lease:** The lease is terminated at the end of the lease period and various courses are possible, namely,
- The lease is renewed on a perpetual basis or for a definite period or
 - The asset reverts to the lessor or
 - The asset reverts to the lessor and the lessor sells it to a third party or
 - The lessor sells the asset to the lessee.

The parties may mutually agree to and choose, any of the aforesaid alternatives at the beginning of the lease term.

3.1.1 Classification

Q3. Explain the classification of leasing.

(OR)

Explain the various kinds of leases.

(OR)

Explain the different types of leasing.

(OR)

What are the various types of leasing.

(OR)

Discuss the various types of lease rentals.

Ans :

(Aug.-18, June-18)

The lease is broadly classified into three types:

1. Financial lease
2. Operating lease
3. Other types of lease

1. **Financial Lease:** The financial lease, usually covers the complete economic life of the asset. During the lease period the lessor receives the lease rental in order to not only recover the full cost of the asset, but also the reasonable return on the funds which are being to buy the asset. Infact finance lease in also known as capital lease.

Finance lease is generally noncancellable in nature and the lesser provides for the proper asset maintenance. The asset would be returned to the lesser (or) managed as per the lease contract at the end of the period. Lease rental is usually considered as a payment for the usage of the asset only and a responsibility of repairing and maintaining the asset usually lies with the lessee.

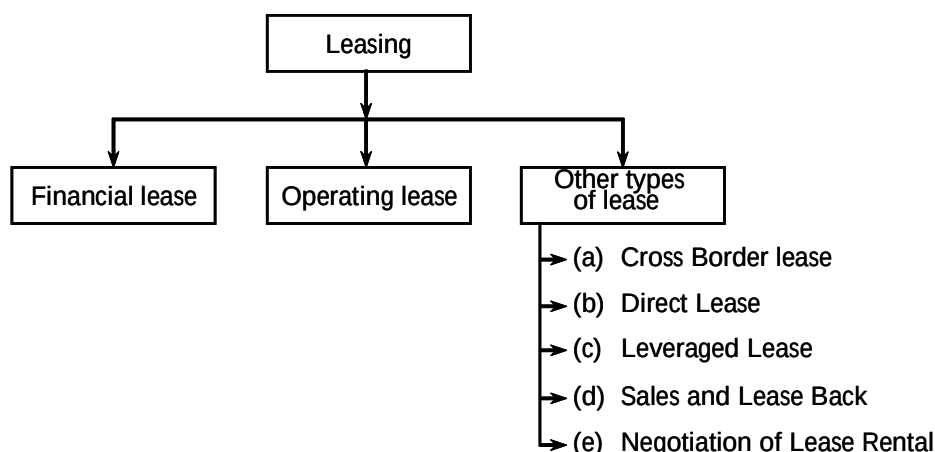


Fig.: Classification of Leasing

2. **Operating Lease:** An operating lease is an agreement where in the lessee obtains the use of an asset on a periodical basis. It is a lease arrangement for a period which is usually shorter than the life of an asset. An asset may be leased by the lesser to the different lessees one after the other. During the lease period the lease rental payable by one lessee is insufficient to completely cover the asset cost plus return. Therefore the present value of lease payment is usually lower than the actual price of the asset.

3. Other types of lease

- (a) **Cross Border lease:** A cross border lease refers to the situation when a lessor leases an equipment to a lessee who does not come under the jurisdiction of the lessors territory. The important reasons behind the recourse to cross border leasing is that in greater number of cases like the operation which provides finance to an international commercial transaction, where the user not only procures 100% financing, but also includes the finance which includes a longer time period than government export credit. Under the cross border lease on the basis of the circumstances in the international capital market the attitude of the parties changes.
- (b) **Direct Lease:** Direct lease is one of the type of finance lease where in lessor purchases the asset and transfers it to the lessee. Under the lease agreement, a manufacturer can also act as lessor and deliver the assets to the lesser.
- (c) **Leveraged Lease:** When the lessor borrows a part of the purchase price from any leading institution then such a lease is known as leveraged lease. Under this lease, with the help of assets and the lease rentals the loan is being secured. The lessee (or) the lessor directly repay the loan out of the lease rentals.

In this leveraged lease the lender finances the as-set. Initially the lease rentals are distributed for payment to the lender in order to satisfy the debt obligation and any surplus and the remaining amount would be sent back to the lessor.

For costly assets the leveraged lease may be more useful.

- (d) **Sales and Lease Back:** Under sale and lease back the lessee is already con-sidered as the owner of the asset. In this type of lease agreement, lessee sells the asset to the lessor, who further a leases back the asset to the owner i.e., the lessee.

The lessee not only retains the use of the asset, but also receives the funds from the sale of the asset to the lessor. This lease is usually opted by those firms having fixed assets, but shortage of funds. This agreement helps greatly the lessee as they can create the funds to enhance- the liquidity position.

(e) Negotiation of Lease Rental

The degree of acceptable level of rentals is represented by the break even rental of the lessor and the lessee. The lower limit is fixed by the break even lease rental of the lessor whereas the upper limit is fixed by the break even lease rental of the lessee.

The real rental needs to be negotiated within the range. A rental within the range for both the lessor and the lessee would refer to a positive benefit of leasing. The range between the break even lease rental for both the lessor and the lessee shows the bargaining power for the negotiation of the actual lease rental for a lease proposal.

Q4. What are the differences between Financial Lease and Operating Lease.

(OR)

Compare and contrast Financial Lease and Operating Lease.

(OR)

Distinguish between Financial Lease and Operating Lease.

Ans :

(June-19)

Sl. No.	Financial Lease	Sl. No.	Operating Lease
1.	A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment.	1.	An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period.
2.	It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2.	Operating lease provides for maintenance expenses and taxes of the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3.	Leasing company assumes risk of obsolescence.
4.	Contract period ranges from medium to long term.	4.	Contract period ranges from intermediate to short-term.
5.	Contracts are usually non cancellable.	5.	Contracts are usually cancellable either by the lessor or by the lessee.
6.	Air crafts, land and building heavy machinery are leased.	6.	Computers, office equipments, automobiles, truck etc. are leased.
7.	The lease involves a financial commitment similar to a loan by a leasing company. It places the lessee in a position of borrow.	7.	The financial commitment is restricted to regular rental payment. The rentals find a place in the P & L A/c of the lessee.
8.	The lessor fulfills financial function.	8.	The lessor fulfills service function.

3.2 FINANCIAL RATIONALE

Q5. Discuss about Rationality in leasing system.

Ans :

A leasing company intends to recover the full or at least a major part of the outlay on a leased asset. The lessor needs to be assured that the lessee is in a position to meet the rentals payable during the primary lease period and when they fall due.

In the event of premature termination of lease, before the end of the lease period, the lessor will require the outstanding capital cost of the equipment to be paid in lumpsum. In the absence of insurance cover, the lumpsum terminal payment has to be found by the lessee.

A financial lease is akin to a medium term loan secured on the equipment. From the credit worthiness viewpoint, the leasing companies need to make the same enquiries and obtain the same information regarding the credit standing of the lessee as banks do for loan applications. Credit appraisal is necessarily a subjective assessment of the solvency of a potential lessee.

Leasing companies place particular emphasis on a lessee's future viability. The lessors take into account, the nature of the lessee's business, quality of management, future prospects, the financial position, value of the equipment etc. Although, financial institutions regard one form of medium term finance as more risky than another, a financial lease has the same degree of credit risk.

Leasing companies can improve their credit position in the same way as other financial institutions. They can take additional security, such as guarantees, floating charges and cash deposits. They can require a higher initial rental to be paid. The reasons for increased risk in financial leasing are as follows.

- 1. Inherent Risks of Ownership:** As an owner, a lessor may be liable for claims from third parties for losses arising out of the use of the leased asset. In some situations, both the owner and the user are legally responsible.

- 2. Default Claims:** The law applying to a claim for repayment of a loan following a default by a borrower is more certain than the corresponding claim by a financial lessor for recovery of the unamortised cost of equipment.

- 3. Collateral:** A lessor is financing the acquisition of an individual item and may be unable to enjoy the benefit of additional security in the same way as a lender who also provides comprehensive banking services to a customer.

- 4. Interest and Tax Assumptions:** For leases without variation clauses, there is a risk that an adverse change in interest rates or taxation is more detrimental to the lessor's return than the element, included in the rental to compensate the lessor for assuming these risks.

For leases with interest or tax variation clauses, a change may result in higher rentals, which increase the lessor's overall exposure. On the other hand, leasing may reduce the level of risk, in the following way,

- (i) Asset Recovery :** It may be easier for a lessor as a owner to repossess leased equipment following a default by the lessee than it would for a mortgage agreement.

- (ii) Productive Investment :** A lessor is leasing an income producing asset, hence he is less likely to be propping up a lame duck than a lender.

Thus, a lessor's risk is less than that of a lender providing a loan.

Q6. Explain the steps involved in Leasing. (OR)

Outline the process of leasing.

Ans : (Imp.)

Leasing is a financial arrangement between the two parties which provides an opportunity to a lessor to avail the benefits of using an asset without owning or purchasing it.

Process

The process of leasing involves the following steps:

1. **Lease Selection:** In a lease transaction, the first step is to select an asset which has to be taken on lease. The lessee select an asset after considering various requirements like lease payments, duration of leasing period, its terms and conditions and so on. After finalizing the nature and type of asset, the lessee then approaches the leasing company or the lease broking company with the objective of finalizing the lease deal. A lease agreement is negotiated broadly.
 2. **Order and Delivery:** Depending on the selection made by the lessee, the lessor places an order with the manufacture of the asset which is to be leased. The asset must be delivered by the manufacturer to the concerned site of a lessee. After the receipt of the asset, the lessee is required to issue an acceptance notice to the lessor.
 3. **Lease Contract:** A lease agreement is signed by both the parties after deciding the terms of the lease contract. Generally, leases are full payout with different terms and conditions. Usually, lease period ranges between 3 to 5 years.
 4. **Lease Period:** During lease period, the lessee make regular payment of lease on which both the parties have to agree. The lessee ensures the lessor by run on the leased asset would be properly maintained.
In addition, the lessee must get warranties and after- sales services from the lessor. The lessee may either renews or terminates the leasing contract at the end of the lease period. The lessee is not provided with the purchase option in the lease agreement itself.
- Q7. Explain the factors affecting growth of Indian Leasing.**
- Ans :**
- The following factors have been responsible for the growth of Indian leasing, in no particular order:
1. **No Entry Barriers:** Any one could float a leasing entity, and even an existing company not in leasing business can write a lease purely for tax shelters.
 2. **Buoyant Growth in Capital Expenditure by Companies:** The post- liberalization era saw a spate of new ventures and fresh investments by existing ventures. Though primarily funded by the capital markets, these ventures relied upon leasing as a source of additional or stand-by funding. Most leasing companies, who were also merchant bankers, would have funded their clients who hired them for issue management services.
 3. **Fast Growth in Car Market:** Needless to state with facts, the growth in car leasing volume has been the highest over these years - the spurt in car sales with the entry of several new models was funded largely by leasing plans.
 4. **Tax Motivations:** India continues to have unclear distinction between a lease that will qualify for tax purposes, and one which would not. In retrospect, this is being realized as an unfortunate legislative mistake, but the absence of any clear rules to distinguish between true leases and financing transactions, and no bars placed on deduction of lease tax breaks against non-leasing income, propelled tax-motivated lease transactions. There was a growing market in sale and leaseback transactions, which, if tested on principles of technical perfection or financial prudence, would appear to be a shame on everyone's face.
 5. **Optimistic Capital Markets:** Data would establish a clear connection between bullish stock markets and the growth in both number of leasing entities and lease volumes. Year 1994-1995 saw the peak of primary market activity where a company, even if a new entrant in business, could price itself on unexplainable premium and walk out with pride.
 6. **Access to Public Deposits:** Most leasing companies in India have relied, some heavily, on retail public funds in the form of deposits. Most of these deposits were raised for a one year tenure, and on premise of high rates of interest, at times even more than the regulated rate (which was lifted in 1996 to be reintroduced in 1998).

7. **Generally Go-Go Business Environment:** At the backdrop of all this was a general euphoria created by liberalization and the economic policies of Dr. Manmohan Singh.

Q8. Explain the advantages and disadvantages of Leasing.

(OR)

What are the merits of leasing for a lessee and lessor.

(OR)

What are the benefits of leasing.

(OR)

What are the merits and demerits of leasing finance.

(OR)

Describe the merits and demerits of leasing.

(OR)

Discuss the benefits of leasing.

Ans :

(Aug.-21, June-18)

Advantages

1. To the lessee

- (i) It is a simple agreement, free from cumbersome procedures therefore, it saves time and effort.
- (ii) It helps in financing of capital goods like land, building, machinery etc. with small initial investment.
- (iii) It acts as an additional source of finance and helps the lessee to expand his business operations
- (iv) It is a cheaper source of finance than other alternatives
- (v) A lease agreement allows for flexibility in rental payments and negotiation of agreement terms at the convenience of the lessee
- (vi) The lessee receives tax benefits
- (vii) Risk of Obsolescence of asset is avoided as the lessee has the option to replace the asset with the latest one.

2. To the Lessor

- (i) The lessor is fully secure as in case of default by lessee, the lessor can take back the asset as the ownership lies with him
- (ii) The lessor can lease assets with high depreciation rate and enjoy tax benefits by way of depreciation
- (iii) It is a highly profitable business, the lessor usually pays less interest on borrowings than what he charges from the lessee as premium
- (iv) The ultimate return on initial investment is very high.

Disadvantages

The disadvantages of the lease to the lessee and to the lessor are as follows:

1. To the Lessee

- i) **High Cost** : The lease rentals include a margin for the lessor as also the cost of risk of obsolescence. It is, thus, regarded as a form of financing at higher cost.
- ii) **Loss of Moratorium Period** : The lease rentals do not take care of the gestation period. It usually takes a long-time before the asset generates funds to pay it back. The term loan provides certain suspension period in repayments for that reason. But no such moratorium is permitted under lease arrangements.
- iii) **Risk of being Deprived of the Use of Asset** : The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.
- iv) **No Alteration or Change in Asset** : As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase, the buyer can modify or alter the asset to increase its utility.
- v) **Loss of Ownership Incentives** : There are certain advantages of owning the assets, such as depreciation and investment allowance. In case of lease, the lessee is not entitled to such benefits.
- vi) **Penalties on Termination of Lease** : The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.
- vii) **Loss of Salvage Value of the Asset** : An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realize the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

2. To the Lessor

- i) **High Risk of Obsolescence** : The lessor has to bear the risk of obsolescence especially in the present era of rapid technology developments.
- ii) **Competitive Market** : As a number of leasing companies have emerged in recent years in India, the lessor has to face a tough competition from Indian as well as foreign companies. Due to this competition, the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.
- iii) **Price-Level Changes** : In spite of the increase in prices of assets due to inflation, the lessor gets only fixed rentals based on previous costs.
- iv) **Management of Cash Flows** : The success of a leasing business depends to a large extent upon efficient use of cash flows which are very difficult to manage because of unexpected market fluctuations.
- v) **Increased Cost due to Loss of User Benefits** :
The lessor is not entitled to certain benefits available to buyers who are actual users of the assets such as concession in sales tax, duties, etc. This increases the cost of the asset and compels the lessor to charge higher lease rentals.
- vi) **Long-term Investment** : It usually takes a long-time to recover the cost of the lessor in the capital outlays through lease rentals. Thus, lease rentals received may not represent actual realized profits because of inherent risks involved. Payment of dividends out of present earnings may ultimately result into payment out of capital.

Q9. What are the basic principles of lending.

Ans :

- (i) **Liquidity:** Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice.
- (ii) **Safety:** The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.
- (iii) **Diversity:** In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimizing risk of the investment portfolio of a bank.
- (iv) **Stability:** Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest its funds in the shares of reputed companies where the possibility of decline in their prices is remote.

Q10. Explain the main clauses in lease agreement.

Ans :

Main Elements of Leasing

The essential features of a leasing contract are as follows:

- a) **A Valid Contract of Leasing:** A leasing arrangement is undertaken by entering into a valid contract between the lessor and the lessee. Both the parties must be competent to contract. The lessor must have clear and undisputed title to the assets to be leased. The agreement must satisfy the essentials of a valid contract as per the Indian Contract Act.
- b) **Delivery of Goods:** The movable property, generally termed as 'goods' must be delivered by the lessor to the lessee. Delivery of the goods may be either actual delivery or constructive delivery. In the former case physical possession of the goods is handed over to the lessee, but in the latter case, there is no change in the physical possession, but some instruction or direction is given to the possessor of the goods to hold the same on behalf of the lessee rather than the lessor.
- c) **Purpose:** Goods are delivered to the lessee with the specific purpose of using them for his specified lawful activity throughout the lease period.
- d) **Consideration:** The lessee undertakes to pay to lessor regularly lease rental, as consideration for the use of the goods.
- e) **Return of the Goods:** The goods must be returned to the lessor exactly in the same form, after the lease period is over.
- f) **Ownership:** The lessor, after handing over possession of the leased asset, remains owner of the asset throughout the lease period and even thereafter.

- g) Methodology:** The prospective lessee identifies the equipment to be leased and its supplier and enters into a lease arrangement with a leasing company. He furnishes certain particulars, such as his name, address, details about his business, name and address of the guarantor, if any, description of the equipment (model, make, size, specification etc.), the name and address of the supplier and the price quoted by the supplier, place of installation, duration of the lease, etc.

The lessor examines the lease proposal and evaluates the credit-worthiness of the applicant, his past performance in the business and his capacity to pay the periodical rentals, taking into account the profitability and projected cash flows of his business and his reputation, etc.

3.3 EVOLUTION OF LEASING INDUSTRY IN INDIA

Q11. Give a brief overview of Evolution of Leasing Industry in India.

Ans :

The of leasing dates back to 200 BC when Sumerians leased goods Romans had developed a full body law relating to lease for movable and immovable property. However the modern concept of leasing appeared for the first time in 1877 when the Bell Telephone Company began renting telephones in the U.S.A. In 1832, Cottrell and Leonard leased academic caps, gowns and hoods. Subsequently, during 1930s the Railway Industry used leasing service for its rolling stock needs. In the post war period, the American Air Lines leased their jet engines for most of the new air crafts. This development ignited immediate popularity for the lease and generated growth of leasing industry.

Since World War II the use of leasing has been greatly expanded and is constantly used for new products and new industries. In May 1952, Henry Scholfeld set up a separate Corporation in the USA to handle lease transaction. He founded the US Leasing Corporation with a capital of \$20,000. Since 1963, commercial banks have been allowed

to engage themselves in direct leasing. In the early 1960s leasing entered the United Kingdom following its successful and rapid development in the USA.

The concept of financial leasing was pioneered in India during 1973. The First Company was setup by the Chidambaram group in 1973 in Madras. The company undertook leasing of industrial equipment as its main activity. The Twentieth century Leasing Company Limited was established in 1979. By 1981, four finance companies joined the fray. The performance of First Leasing Company Limited and the Twentieth Century Leasing Company Limited motivated others to enter the leasing industry. In 1980's financial institutions made entry into leasing business. Industrial Credit and Investment Corporation was the first all India financial institution to offer leasing in 1983. Entry of commercial banks into leasing was facilitated by an amendment of Banking Regulation Act, 1949. State Bank of India was the first commercial bank to set up a leasing subsidiary, SBI capital market, in October 1986. Can Bank Financial Services Ltd., BOB Financial Service Ltd., and PNB Financial Services Limited followed suit. Industrial Finance Corporation's Merchant Banking division started financing leasing companies as well as equipment leasing and financial services. There was thus virtual explosion in the number of leasing companies rising to about 400 companies in 1990.

In the subsequent years, the adverse trends in capital market and other factors led to a situation where apart from the institutional lessors, there were hardly 20 to 25 private leasing companies who were active in the field. The total volume of leasing business transacted by both private and public sector leasing companies was Rs. 5000 crores in 1993 and it is expected to cross Rs. 10,000 crores by March 1995.

3.4 PRODUCT PROFILE

Q12. Write about Product Profile.

Ans :

The product profile of the lease structures in India can be understood from the characteristic features of lease structures in India. The various characteristics features of lease structures in India are,

1. In case of lease agreements, ownership is not transferred to lessee, so lease transactions are categorized as hire purchase transactions from the tax perspective.
2. Majority of the agreements are found to be of direct lease type. Sale and lease back transactions are found less.
3. Operating lease is not much popular in Indian lease structure due to the absence of resale market for already used equipments.
4. Lease rentals are decided in such a way that the complete investment cost is recovered in the primary period itself. A reasonable amount of lease rent is charged during the secondary period. The various factors considered while deciding lease rent are, tax, depreciation etc.
5. Usually, equipment leases are for maximum ` 100 lakhs capital investment because majority of the people taking lease consider leasing as stand by finance for procuring non-productive assets (like, air conditions) and for meeting unexpected capital expenses).
6. Equipment leasing includes leasing of variety of equipments ranging from plant and machinery, office computers, other equipment to vehicles.
7. Usually, lease rent is paid in monthly installments.

3.5 LEGAL, TAX AND ACCOUNTING ASPECTS OF LEASING IN INDIA

Q13. Describe the legal aspect of leasing.

Ans :

As there is no separate statute for equipment leasing in India, the provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well. Section 148 of the Indian Contract Act defines bailment as :

“The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person

delivering the goods is called the ‘bailor’ and the person to whom they are delivered is called the bailee .

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the kessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

1. The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.
2. The lessee has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

Q14. Briefly explain the tax aspects of leasing.

Ans :

The tax aspects of leasing relating to both income tax and sale tax,

Income Tax Considerations

Leasing being a finance device holds tax implications and provides tax advantages to both the lessor and the lessee. The key variables of leasing are the scope for tax avoidance, reduction/deferment of tax liability and sharing tax savings at the time of heavy tax incidence. In short, leasing offers an adequate suitable method for transferring the tax incentives benefits from the purchase-owner to the lessor of the asset/equipment.

1. **For Lessor:** The main reason which attracts the lessor for leasing is the reduction of depreciation from his taxable income. The following are the most appropriate provisions which are applicable to the calculation of the income of lessor, the tax rates and so on:

(a) Parability of Lease Rentals :

According to the provisions of the Income-tax Act 1961, the calculation of taxable income of an assessee includes calculation under different heads of income which are summed up and then reduced by few deductions. Various set of provisions regulates the calculation of taxable income under each head.

The income from lease rentals is taxable under the head profits and gains of business and profession especially in case if the leasing forms the business/main activity of the assessee. While in other cases, the income from lease is taxed as income from other sources.

(b) Deductibility of Expenses : At the time of calculating the income of lessor from leasing, few expenses are regarded as a deduction in order to assess the taxable income. These include the following:

- (i) Depreciation.
- (ii) Rent, rates, taxes, repairs, and insurance of the leased asset where such expenditure is incurred by the lessor.
- (iii) The amortization of few preliminary expenses like expenditure for preparation of project report, feasibility report, and market survey, legal charges for drafting printing of memorandum of association and articles of association, registration expenses, public issue expenses instead of debentures and loans, which are subjected to a maximum of 2.5 percent of cost of the project/capital used which is permitted in 10 equal instalment.
- (iv) Interest on borrowed capital.
- (v) Bad debts.
- (vi) All the expenses borne in developing trade/ business.

(vii) Entertainment expenses related to specified limits.

(viii) The travel expenditures according to specified limits.

2. For Lessee: The income tax specifications for the lessees are as follows:

- (i) Allowability of lessee rentals
- (ii) Deduction of incidental expenses
- (iii) Tax planning.

(i) Allowability of Lessee Rentals : The Income Tax Act allows lease rentals as a normal business expenditure of the lessee for the purpose of assessment, but on the condition that the expense is not of capital nature, and not a personal expense and that it is associated either completely and exclusively to business purposes of the assessee.

(ii) Deductibility of Incidental Expenses : Usually the lessee is supposed to incur all the expenses related with the leased asset like the repairs and maintenance, insurance, finance charge and so on. The Income Tax Act considers these incidental expenses as deductions from the taxable income of the lessee. Suppose if, in case lessee is needed to bear certain expenses on installation of the equipment, then these expenses can also be claimed as a revenue expense that have taken place during the year but cannot be capitalized because the ownership of the asset is not given to the lessee.

(iii) Tax Planning : Leasing allows tax planning both for the lessor as well as for the lessee and tries to save/avoid taxes. The important device of saving taxes is the depreciation, deduction in the calculation of the taxable income of a lessor. The leasing transaction provides scope for the lessee for tax planning by deducting the lease rentals. Usually there

are two methods through which lessee can use leasing as a tax planning instrument:

1. Flexible structuring of lease rentals and
2. Transfer of unabsorbed capital allowance to the lessor.

Implications of Income Tax on Leasing

The income-tax provisions which are usually applicable to leasing transactions holds significant implications for financial analysis for both the lessors and lessees. Basically the lessee is initially entitled to tax shield on the lease rentals as a business expenditure. But the lessee would be ineligible for tax shield related with depreciation. The implication is that the tax shield on lease rental shows a cash inflow and even that on depreciation as cash outflow in ascertaining the lease-related cash flows of the lessee.

On the other hand, for the lessor the above implication is totally opposite i.e., the tax shield on depreciation forms a cash inflow and the tax liability on lease rentals as cash outflow. Both for the lessor and lessee the ultimately the net salvage value of an equipment is considered as a post-tax cash flow.

Sales Tax Aspects

The legislative structure controlling levy of sales tax includes the Central Sales Tax Act, 1957 (CST) enacted by the Government of India and Sales Tax Acts of the different states. Usually, the CST basically focuses on levying and collecting the sales tax on the inter-state sale of goods only. A lease includes three key elements from sales tax perspective as follows:

- (a) The procurement of an asset by a lessor with an aim of leasing it to a lessee.
- (b) The right to transfer the use of an asset to a lessee for a particular period of time inclusive of renewal, for cash, deferred payment and other valuable considerations.
- (c) The sale of asset during the expiry of the lease.

A lease transaction mainly attracts at the following three stages:

- (a) The procurement of equipment by a lessor.
- (b) The right to transfer the use of the equipment for a lease rental to a lessee.
- (c) The sale of asset by the lessor during the end of the lease period.

3.6 FUNDING AND REGULATORY ASPECTS OF LEASING IN INDIA

Q15. Write about the funding aspects of leasing.

Ans : (Aug.-17)

The quantity of funds required for development and the growth of leasing business is considerably large. Leasing companies have several sources of funding. The main financial sources are owned funds and borrowed funds. Owned funds consist of share capital and retained earnings. Borrowed funds consist of deposits, debentures, bank borrowings, institutional borrowings, commercial papers, funds from insurance companies, pension funds, mutual funds, etc. Some of these sources are also open to corporates in general. Some important funding sources of leasing companies are public deposits, bank borrowing and institutional borrowings from development/public financial institutions.

1. Deposits

Leasing company has a major source of finance from deposits. Provisions of the NBFC's directions of RBI, 1977, controls the provisions relating to the acceptance and repayment of deposits, their minimum and maximum maturity periods, the rate of interest etc.

2. Bank Borrowing

Bank borrowings taken from leasing companies are in the form of cash credit facility. RBI stipulations regulate the terms and conditions of cash credits.

3. Maximum Limit

The maximum borrowing from all the sources, (deposits, debentures/bonds) shouldn't exceed 10 times the "net owned funds". Net owned funds = Paid up capital + Free reserves - Accumulated balance of loss.

4. Provisions of Facility

Expected flow of lease until receivables have to be considered prior to financial assistance by bank. It is extended on a circular basis where these companies are allowed to avail the facility of liquidation on lease transaction or reduction in the liability of lease finance.

Q16. Explain the Regulatory mechanism for leasing system in India.

Ans : (Aug.-17)

In India, equipment lease financing does not have an exclusive-legislative or regulatory framework for controlling the mechanism. The relevant provisions of various allied legislations comprises the legislative framework of lease transactions. The lease agreements provide various of obligations on lessee which may not form an implied obligations under the legislative framework. The regulatory framework of lease financing in India is provided by legislative framework and the lease agreements.

The contract act, the vehicles act, the stamp Act and the RBI NBFCs directions under the RBI act. Forms the basis for the establishment of legislative framework of leasing.

Contract Act

The provisions of law of contract is applicable to all types of contracts which also includes leasing and hire purchase. There are certain provisions which are specifically designed for leasing transactions. The main features of such provisions of the law of contracts i.e., general and special are as follows:

General Provisions

The general provisions of contract act as follows:

Contract

It is an agreement which is enforceable by law. Some of the essential elements of a valid contract are:

1. Every contract has a legal obligation made through an offer and acceptance which shows the interest of offerer and offeree to enter into an agreement.

2. A contract must have a lawful consideration i.e., each of the parties to the agreement must give/get something.
3. Contract must be made between competent parties i.e., of 18 years of age and of sound mind.
4. The parties involved in contract must give free consent which must be free from coercion, fraud, mistake, etc.
5. The agreement must not be void if so it cannot be legally enforced.

Discharge of Contracts

There are different ways to discharge a contract, some of them includes:

1. By performance
2. By frustration
3. By mutual agreement
4. By operation of law and
5. By remission.

Remedies for a Breach of Contract

If a contract is not performed then it leads to a "Breach of contract". When any party of a contract is failed to fulfill his obligations, then the other party has a right to terminate the contract, on account of breach by the first party. The outcome of breach of contract must be borne by the party whose actions have created the breach of contract with whose action the other party has suffered. The following are the remedies for an aggrieved party.

1. Damages/compensation
2. Specific performance
3. Suit for injunction
4. Suit for quantum merit.

Indemnity and Guarantee

The provisions relating to indemnity and guarantee involved in the contract act are essential for leasing and hire-purchase contracts.

Indemnity

Indian contract Act defines contract of indemnity as "A contract by which are party promises to save the other from loss caused to him

by the conduct of the promisor himself, or by the conduct of any other person is called a contract of indemnity" The person who promises to make good the loss is called the indemnifier (promisor) and the person whose loss is to be made good is called the indemnified or indemnity-holder (promisee). A contract of indemnity is really a class of contingent contracts.

Guarantee

Definition of contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default.

The person who gives the guarantee is called the surety and the person in respect of whose default the guarantee is given is called the principal debtor and the person to whom the guarantee is given is called the creditor.

A Guarantee may be oral or written, express or implied and may also be inferred from the course of conduct of the parties concerned.

Special Provisions

The provisions of the law of contract which are related to bailment are particularly applicable to even leasing contracts/transactions. In fact, a leasing agreement is a form of bailment agreement. Whereas, the hire-purchase agreement is a combination of bailment and sales agreement.

Leasing as a Bailment Agreement

Both leasing and bailment agreement possess similar elements. They are :

1. In bailment agreement, there are two parties i.e., a bailor, an individual who is entitled to deliver the goods to a bailee for use, like wise, in leasing transactions, the role of a bailor is same as that of a lessor while the lessee plays the same role as that of a bailor.
2. There is a transfer of goods which may be actual or constructive, between the bailor (lessor) and the bailee (lessee). However, the ownership remains to continue with the bailor (lessor).
3. In bailment agreement, goods are transferred for specific purpose whereas, in lease agreement, lessee is allowed to use the asset during lease period by the lessor.

4. In both the agreements, goods are returned back to the bailor (lessor) or disposed off as per his directions.

Liabilities of Lessee (Bailee)

The liabilities of a lessee are same as that of bailee. These are:

1. A lessee must take care of goods leased to him similarly, as an ordinary person takes care of his own goods.
2. The lessee must not use the leased goods for any other purpose other than the provisions mentioned in lease agreement and must not indulged into any unauthorized activities relating to the goods.
3. The lessee must return back the goods as soon as the lease time is over or if the purpose of the leased goods has been accomplished.
4. The lessee need to protect the lessors's title against any adverse claim.
5. The lessee must pay the lease rentals as mentioned in the lease agreement.
6. Some lease agreement require a lessee to insure or repair goods as per the provisions of the lease contract. However, if agreement does not specify any provision relating under to the repair then lessee is under no obligation to do the same.

Liabilities of the Lessor (Bailor)

The obligations of a lessor/bailor are as follows:

1. It is the responsibility of lessor to make sure that goods and necessary documents are delivered to lessee so as to use the goods lawfully.
2. During lease agreement, the lessee is allowed to use the goods only for economic purpose.
3. The lessor must see that goods are in a good operating condition for the purpose with which lessee takes them.
4. The lessor must disclose all the defects or faults of goods which are in his knowledge to the lessee.

3.7 FINANCIAL EVALUATION OF LEASING

3.7.1 Break-even Lease Rental

Q17. Discuss the procedure and steps involved in the financial evaluation of leasing.

Ans : (Aug.-18)

The evaluation framework is being explained from the perspective of both the lessees and the lessors.

A) Lessee's Perspective

The finance lease can effectively transfer the risk and rewards related with the ownership of an equipment from the lessor to the lessee. Lease can be assessed either in the form of an investment decision or as a financing alternative.

A lease can be assessed either as an investment decision or as a financing alternative provided that the investment decision is being already made a firm (lessee) need to assess whether it will purchase the asset or obtain it on lease basis. As the lease rental payments are same as the payments of interest on debt, leasing is treated as an important alternative for borrowing. Therefore, the evaluation of lease from the lessee's point of view includes a selection between debt financing and lease financing. The decision criterion which is being used in the Net Present Value of leasing [NPV(L)]/Net Advantage of Leasing (NAL); discount rate is used i.e., the marginal cost of capital for all cashflows except the lease payments and pre-tax cost of debt for lease payments. The interest tax shield value is being added as foregone cash flow in the calculation of NPV (L)/ NAL. It can be represented symbolically as:

$$NPV(L) / NAL = \text{Investment Cost}$$

- (-) Less present value of lease payment (discounted by K_d)
- (+) Plus present value of tax shield on lease payment (discounted by K_c)
- (-) Less management Fee
- (+) Plus present value of tax shield on management fee (discounted by K_c)
- (-) Minus present value of depreciation shield (discounted by K_c)

(-) Minus present value of interest shield (discounted by K_c)

(-) Minus present value of residual / salvage value (discounted by K_c)

Where,

K_c = Post-tax marginal cost of capital

K_d = Post-tax cost of long-term debt

If the NAL/NPV (L) is positive, then it is better to use the leasing alternative or else borrowing alternative would be a better option.

An alternative approach is being used in order to ascertain the present values of the cash outflows after taxes in leasing and the borrowing alternatives. The decision-criterion is to choose an alternative with the lower present value of cash outflows.

Break-even Lease Rental (BELR)

The break-even lease rental (BLER) is the rental wherein the lessee is not concerned about the lease financing, borrowing and buying. NAL is zero in BELR and it shows the maximum level of rental which the lessee would be desiring to pay. The lease proposal would be accepted if increase the BELR is more than the actual lease rental otherwise the proposal would be rejected.

B) Lessor's Viewpoint

From the lessor's point of view, the least evaluation basically aims at determining as to whether to accept a lease proposal or to select from the alternative proposals. The discounted cash flow technique which is based on the lessor's cash flows is being used as one of the appraisal techniques for evaluating the lessee. The lease-related cash flow includes:

- (a) The outflows in terms of the initial investment/ acquisition cost of the asset at the inception of the lease; income-tax on lease payments, sales-tax on lease transaction, if any; lease administration expenses like rental collection charges, expenses on suits for recovery and other direct costs.
- (b) The inflows like lease rentals, management fee, tax shield on depreciation, residual value and security deposit, if any and so on.

From the perspective of a lessor, lease evaluation covers the following aspects like break even rental for the lessor, negotiation and fixation of lease rentals. These break-even lease rental indicates the minimum (floor) lease rental which are acceptable in nature. At this level of rental, the NAL/ NPV (L) is zero and discount rate to calculate the NAL is the marginal over-all cost of funds to the lessor.

Negotiation of Lease Rentals

The break-even rentals of both the lessor and the lessee indicates the range of acceptable level of rentals. The lower limit is set by the break-even lease rental of the lessor whereas the upper limit of the range is set by the break-even rental of the lessee. A rental that exists within the range results into a positive NAL / NPV (L) for both the lessor and the lessee. The difference that exists between break-even lease rental for the lessor and the lessee shows the area for bargaining for the purpose of negotiation of the actual lease rental for a lease proposal.

Structuring of Lease Rentals

The lease rentals are structured in such a way that they are being made suitable for the lessors and the lessees. From the lessee, point of view the structure of the lease rental must take place along with the operational cash flow pattern. The synchronization dimensions existing between the lease rental and the pattern of cash flows of the lessee are periodicity of rentals. The lease rentals make sure that lessor gets an expected return.

Q18. Explain the process underlying calculations of break-even lease Rental.

Ans :

The break-even lease rental can be computed from both lessors and lessees viewpoint.

1. Lessees Perspective

The break-even lease rental is the rental at which the lessee is indifferent between lease financing and buying. At this level the maximum lease rental lies, a lessee would be willing to pay. If the break-even lease rental exceeds the actual lease rental, the lease proposal would be accepted otherwise rejected. The break even lease rental has a zero net advantage of lease.

The Net Advantage of Leasing (NAL) is computed as follows,

NAL = Investment cost

Less present value of lease payment

Plus present value of tax shield on lease payment

Less management fee

Plus present value of tax shield on manage-ment fee

Minus present value of depreciation shield

Minus present value of interest shield

Minus present value of residual value

2. Lessors Perspective

The break-even lease rental represents the minimum lease rental which can be accepted by the lessor.

The lease evaluation from the point of view of the lessor aims at ascertaining, whether to accept a lease proposal or to choose from alternative proposals. The appraisal method used is the discounted cash flow technique based on the lessors cash flows. The lease related cash flows from the lessors viewpoint consist of the following,

- (a) Outflows in terms of the initial acquisition cost of the asset at the inception of the lease, income tax on lease payments, sales tax on lease transaction (if any), lease administration expenses such as rental collection charges, expenses on suits for recovery etc.
- (b) Inflows such as lease rentals, management fee, tax shield on depreciation, residual value and security deposit (if any).

3.7.2 Gross Yield based Pricing

Q19. Write about Gross Yield Pricing ?

Ans :

To work out the gross rental yield, you need 2 key figures – the annual rental income and the property value.

- Annual rental income = weekly rent × 52
- Property value = could be purchase or market value, depending on whether you are looking at the current performance, or future prediction.

Once you've worked out the 2 figures above, the calculation is relatively simple:

Gross rental yield = (Annual rental income / Property value) × 100

For example, a property that was purchased for ₹ 390,000 and returns a weekly rent of ₹ 500 would have a current rental yield of 6.67%.

However, if the current market value of the property is ₹ 600,000, and the rental income remains the same, then the potential rental yield would be 4.33%.

It's important to understand that current or historical rental yields are not necessarily accurate indicators of future performance, especially in a heated property market where prices are soaring but rental prices are stalling.

Also, gross rental yield does not take into account any expenses associated with keeping the property. So, a property with high rental yield but also high expenses may actually result in a low net rental income.

3.7.3 IRR based Pricing - Negotiating Lease Rental

Q20. Write about IRR Based Pricing ?

Ans :

(Nov.-20)

The internal rate of return is also one of the capital budgeting technique that identifies the time value of money. This method is also known as yield method, discounted rate of return and trial and error yield method. It is that rate of return which equates the present value of cash inflows to the present value of cash outflows. The hit and trial method is used in internal rate of return method to discount the cash flows of the project as discount rate is not known. The internal rate of return is calculated with the help of the following formula.

$$C = \frac{A_1}{(1+r)^1} + \frac{A_2}{(1+r)^2} + \frac{A_3}{(1+r)^3} + \dots + \frac{A_n}{(1+r)^n}$$

Where,

C – Initial outlay at time zero

r – Rate of discount or internal rate of return

$A_1, A_2, \dots, A_n$ – Future net cash flows at different periods

n – Number of years.

Evaluation of Leasing by Using IRR Method

The Internal Rate of Return (IRR) method involves following steps,

1. Calculate the future cash inflows before depreciation but after tax.
2. Calculate fake payback period by dividing the initial investment by average cash flows.

Fake payback period

$$= \frac{\text{Initial investment}}{\text{Average cash flows}}$$

3. Identify the discounting factor from present value annuity table and calculate NPV with that percentage.

4. If NPV is positive take a higher rate and if NPV is negative take a lower rate and once again calculate NPV
5. After getting one positive NPV and one negative NPV, use interpolation to calculate actual IRR. Actual IRR can be calculated by using the following formula,

$$\text{Lower rate} + \frac{\text{Present value at lower rate} - \text{Cash outflow}}{\text{PV at lower rate} - \text{PV at higher rate}} \times \text{Difference in the Rates}$$

A particular project is accepted when IRR is more than cost of capital and if IRR of the project is less than cost of capital then it is rejected.

3.7.4 Assessment of Lease Related Risks

Q21. What are the various types of lease related risks? Explain the process involved in evaluating the lease or buy decisions.

Ans :

The various types of lease related risks may be categorized into two,

- I. Financial risks and
- II. Operational risks.

I. Financial Risks Financial risks comprises,

- (i) Funding risk
- (ii) Interest risk
- (iii) Currency risk
- (iv) Credit risk.

II. Operational Risks

Operational risks comprises risks related to,

- (i) Management
- (ii) Regulations
- (iii) Culture
- (iv) Board composition.

All these risks are assessed before taking lease or buy decisions.

Process involved in Lease or Buy Decision

Every time a firm requires an asset, it has to decide between the two mutually exclusive situations. First, should the asset be purchased or second, should the asset be acquired on a lease basis.

Even, if the firm has liquid resources with which it can purchase the asset, the use of these resources may be viewed as a form of borrowing, because the opportunity cost of the funds is atleast equal to the prevailing interest rate on borrowings. In case of lease financing, the lease rental are payable which are similar to payment of interest on borrowings which may be needed for raising the funds for buying the asset.

Therefore, a lease or buy decision is a financing decision, as it involves a choice between debt financing and lease financing. The firm should compare leasing to borrowing the amount of purchase price and then buying the asset. This is because, leasing creates such obligations for the firm, which are similar to those created by borrowing.

In the lease or buy decision, the choice depends upon the present value of the two series of after tax cash flows to the lessee.

To evaluate the lease-buy decision, the finance manager has to consider only the relevant cash flows i.e., only those cash flows that differ under the two alternatives. The after tax present value of the two options should be compared.

The evaluation should be done as follows:

1. Identification of Relevant Cash Flows

- Firstly, the cash flows emanating from the lease option as well as the buying option are to be identified. In case of lease, the firm receives benefits from using the assets, but has no claim on its residual value.
- The lessee has to make lease payments and has to meet the maintenance expenses. The lease payments and other expenses associated with the lease are tax deductible for the lessee. The lessee cannot claim depreciation as he is not the owner.
- On the other hand, if the asset is bought, the firm assumes all the risk and benefit associated with the asset. The firm also has to pay the interest on the funds borrowed to finance the asset.
- If the asset is bought, the firm can claim tax benefits associated with depreciation, maintenance expenses, interest, etc as these are tax deductible.
- The after tax cash flow emanating from the lease option are relatively easier to identify. The after tax cash flow of lease rental may be taken as equal to the difference between the lease rental and the tax benefit.
- However, the cash flows associated with borrowings are more difficult to obtain due to the need to identify both the interest and the depreciation associated with the asset.
- The cash flows associated with the buying option are :

- i) Interest payment, which is tax deductible.
- ii) Principal repayment of debt.
- iii) Tax shelter from depreciation.
- iv) Salvage value at the end of the assets life.

2. Analysis of Incremental Cash Flows

After identification of the after tax cash flows, they have to be analysed. The present value of the stream of after tax cash flows associated with each option is calculated.

There is a difference of opinion about the rate of discount being used to find out the present values.

One opinion is that the discount rate used to evaluate the cash flows should be the after tax cost of debt. The other opinion is that the weighted average cost of capital should be taken for discounting the cash flows.

Q22. What are the factors to be considered while deciding whether to buy an asset, lease it or take it on hire purchase?

Ans :

The factors that need to be considered for deciding whether to buy, lease or take an asset on hire purchase are as follows,

- (a) **Availability of Funds:** If the firm decides to purchase an asset, it requires a large amount to meet its cost, whereas in the case of leasing and hire purchase, it requires smaller amounts to be paid at regular intervals. Hence, buying involves a larger outlay of funds.
- (b) **Financial Evaluation:** Buying, leasing and hire purchase involve cash outlay. Hence, the firm needs to calculate the net advantage of one over the other. The firm has to select that option which gives the lowest cash outflow.
- (c) **Possession of Asset:** In all the three forms the asset can be obtained, but the ownership lies with the lessor in a leasing agreement. In the case of buying, the ownership is transferred to the owner at the time of agreement whereas in hire purchase the ownership is transferred to the hirer only after he pays the last installment.

- (d) **Cost of Borrowing:** If the asset has to be purchased by borrowing fund then, it involves an additional expenditure in the form of interest whereas in leasing only the lease rent has to be paid. In hire purchase, the installment includes the principal and interest.
- (e) **Depreciation:** The lessee under a lease agreement cannot claim depreciation, as he is not the owner of the asset. The buyer or the hirer in a hire purchase transaction can claim depreciation.
- (f) **Taxes:** In the case of leasing, the lease rent is a tax deductible expenditure, whereas in hire purchase, only the interest component of the hire purchase installment is a tax deductible expenditure.
- (g) **Salvage Value:** The lessee does not enjoy the residual salvage value, whereas the buyer and the hirer enjoy the salvage value.
- (h) **Risk:** The risk related to the asset lies with the lessor, as lessee is not the owner. Whereas the buyer and the hirer have to bear the risk associated with the asset.
- (i) **Maintenance:** In an operating lease, the lessee uses the asset but the maintenance expenditure is borne by the lessor. The hirer and buyer has to meet the maintenance cost of the asset.

3.7.5 Lease vs. Buy Decisions

Q23. Differences between Lease vs. Buy Decisions.

Ans :

(Nov.-20)

Sl.No.	Nature	Lease	Buy Decisions
1.	Capital	Initial capital requirement under leasing contracts is limited and monthly payments also account to a smaller amount.	Purchasing requires more capital (cash reserve or lender support) as you look to purchase the asset by paying its full value.
2.	Ownership	Under leasing, the lessee is not the owner of the asset. He just obtains the right to use the asset for a fixed term under pre-defined lease payments.	When you buy equipment, you are the ultimate owner and are responsible for its maintenance etc.
3.	Term	Leasing agreements are run usually for a fixed term and at the end of the term, the lessee is required to either purchase the asset or to return it to lessor. Most of lease contracts cannot be terminated before the end of the term.	Buying decision is not related to the term of the asset as the owner can use it till the end of its useful life. An asset that is bought can be replaced at any time.
4.	Risk and Rewards	Under operating lease, all the rewards associated with the asset remain with the lessor whereas most of the risks and rewards stay with the lessee under finance lease.	Given that the ownership lies with the purchaser, the buyer is responsible for all risks and rewards associated with the asset. Hence, buying an asset should be avoided in an industry or segment where there are frequent technological innovations.
5.	Tax Benefits	Under a lease contract, all the lease payments are fully tax deductible. This will include any lease rental payment plus the interest on any outstanding lease amount. Thus from a taxation perspective, leasing is much more beneficial	Purchasing an asset will bring you limited tax benefit. If the asset is funded using existing cash reserves, there is likely no tax benefit at all. For a debt funded asset purchase, the owner will be able to claim tax benefit on interest on such debt. Principal amount is not deductible though.

PROBLEMS

1. A Limited company is contemplating to have an access to a machine for a period of 5 years. The company can have the use of machine for the stipulated period through leasing arrangement or the requisite amount can be borrowed at 14% to buy the machine. The firm is in the 50% tax bracket.

In the case of leasing, the firm would be required to pay at the end-of-year lease rent of Rs.1,20,000 for 5 years. All maintenance, insurance and other costs are to be borne by the lessee.

In the case of purchase of the machine (which costs Rs.3,43,300), the firm would have 14% five-year loan to be paid in 5 equal annual instalments, each instalment becoming due at the end of each year. The machine would be depreciated on a straight line basis, with no salvage value.

Advise the company which option it should go for, assuming lease rents are paid (a) at the end of the year (b) in advance.

Sol :

The analysis is presented in Tables 1 to 3 (year-end lease rental payments) and Table 4 (advance lease payments).

Table 1: Present value of total lease payments

Year-end	Lease payment (L) after tax $L(1-0.5)$ (Rs.)	PV factor at after tax cost of debt 7% or 14% (1-0.5)	Total PV of Lease payments Col. (2) X Col. (3) (Rs.)
1	2	3	4
1-5	60,000	4.100	2,46,000

Table 2: Determination of the interest and Principal Components and Loan Instalment

Year-end	Loan instalment (Rs.)	Loan at the beginning of the year (Rs.)	Payment of Interest on loan (Col. 3 × 14%) (Rs.)	Principal re-payment (Col. 2- Col. 4) (Rs.)	Principal outstan- ding at the end of the year (Col. 3-Col. 5) (Rs.)
1	2	3	4	5	6
1.	1,00,000	3,43,300	48,062	51,938	2,91,362
2.	1,00,000	2,91,362	40,791	59,209	2,32,153
3.	1,00,000	2,32,153	32,501	67,499	1,64,654
4.	1,00,000	1,64,654	23,052	76,948	87,706
5.	1,00,000	87,706	12,294	87,706	—

* Determination of loan instalment:

$$\frac{\text{Amount of loan}}{\text{PV factor of annuity of 1 Re. for 5 years at 14\% rate of interest.}} = \frac{\text{Rs. 3,43,300}}{3.433} = \text{Rs. 1,00,000}$$

Table 3: Present Value of After-Tax Cash Outflows under Buying (Borrowing) alternative

Year-end	Loan instalment (Rs.)	Tax advantage on interest payment I(0.5) (Rs.)	Tax advantage on depreciation Rs. 68,660 (0.5) (Rs.)	Net Cash outflows (Col. 2-Col. 3+4) (Rs.)	PV factor at after-tax cost of debt 7% (Rs.)	PV of buying alternative (Rs.)
1	2	3	4	5	6	7
1.	1,00,000	24,031	34,330	41,639	0.935	38,932
2.	1,00,000	20,395	34,330	45,275	0.873	39,525
3.	1,00,000	16,250	34,330	49,420	0.816	40,327
4.	1,00,000	11,526	34,330	54,144	0.763	41,312
5.	1,00,000	6,147	34,330	59,523	0.713	42,440
					Total	2,02,536

Table 4: PV of Cash Outflows under Leasing Alternative, when Lease Rent is Paid in Advance

Year-end	Lease Payment (Rs.)	Tax Shield (Rs.)	Cash outflows after taxes (Rs.)	PV factor at 7% (Rs.)	Total PV (Rs.)
1	2	3	4	5	6
0	1,20,000	–	1,20,000	1,000	1,20,000
1-4	1,20,000	60,000	60,000	3,387	2,03,220
5	–	60,000	– 60,000	0.713	– 42,780
					2,80,440

The operational implication of advance payment for tax purposes is that it qualifies for tax shield only in the year for which payment applies. For instance, Rs. 1,20,000 payment at the beginning of the period ($t = 0$) represents a pre-paid expense and is not deductible for tax purposes until year 1. Similarly, the other 4 payments are not deductible until the following year. The schedule of cash flows under leasing alternative when the payment is made in advance is shown in Table 4.

2. ABC Ltd. is considering to acquire an additional computer to supplement its time sharing services. It has two options:

- i) To purchase the computer for Rs. 22,00,000, and
- ii) To lease the computer on an annual rental (payable at the end of the year) of Rs. 5,00,000 plus 10% of gross revenue from time sharing services. An amount of Rs. 6,00,000 is also payable at the end of year 3. The revenues from time sharing services are estimated at Rs. 22,50,000, Rs. 25,00,000 and Rs. 27,50,000 for 3 years. The computer has a salvage value of Rs.10,00,000 at the end of 3rd year.

Annual operating cost (excluding depreciation and lease rent) is estimated at Rs.2,00,000 per annum and an additional revenue expense of Rs. 2,00,000 is payable for training in the beginning of the 1st year (both these costs are to be borne by the lessee in case of lease). Funds for purchase are to be acquired at the rate of 16% and are repayable Rs. 5,00,000, Rs. 8,50,000 and Rs. 8,50,000 at the end of 3 years respectively. The firm pays tax at the rate of 50% and provides depreciation at straight line method.

Sol :

In this case, the firm has two options: To buy the computer out of borrowed funds or lease the computer. In case of buying option, the funds are to be acquired at the rate of 16%. Therefore, the after-tax cost of debt of the firm is 8% i.e., 16% (1-0.5). This 8% rate can be used to discount the future cash flows for the evaluation purpose as follows:

Evaluation of Lease Option

(Figures in Rs.)

Year	Rental	10% of Rev.	Total	Tax Shield	Net Outflow	PVF	PV
1	5,00,000	2,25,000	7,25,000	3,62,500	3,62,500	.926	3,35,675
2	5,00,000	2,50,000	7,50,000	3,75,000	3,75,000	.857	3,21,375
3	11,00,000	2,75,000	13,75,000	6,87,500	6,87,500	.794	5,45,875
Present value of outflows							12,02,925

Evaluation of Purchase Option

Year	Installment	Interest	Dep.	Expenses	Total	Tax Shield	Net CF
	(1)	(2)	(3)	(4)	(2+3+4)	@ 50%	
0	—	—	—	2,00,000	2,00,000	—	2,00,000
1	5,00,000	3,52,000	4,00,000	2,00,000	9,52,000	5,76,000	4,76,000
2	8,50,000	2,72,000	4,00,000	2,00,000	8,72,000	4,36,000	8,86,000
3	8,50,000	1,36,000	4,00,000	2,00,000	7,36,000	3,68,000	8,18,000

The net cash flows have been calculated as follows:

$$\text{Net CF} = (\text{Instalment} + \text{Interest} + \text{Expense} - \text{Tax Shield})$$

The tax shield for the first year has been calculated as follows : At the time of installation of the computer system, a revenue expense of Rs. 2,00,000 is incurred. This is, however, tax deductible at the end of year 1 and so the tax shield in respect of this expense of Rs. 2,00,000 (i.e. Rs.1,00,000) is available only at the end of the year 1. So, for the year 1, the total tax shield is (50% of Rs.9,52,000) + Rs.1,00,000 = Rs.5,76,000 and the cash outflows for the year 1 is (Rs.5,00,000 + 3,52,000 + 2,00,000 – 5,76,000) = Rs.4,76,000.

Calculation of Present Value

Year	NetCF	PVF	PV
0	Rs. -2,00,000	1.000	Rs. -2,00,000
1	-4,76,000	.926	-4,40,776
2	-8,86,000	.857	-7,59,302
3	-8,18,000	.794	-6,49,492
3	+10,00,000	.794	+7,94,000
Net Present Value			-12,55,570

Since the NPV of outflows is lower in case of lease (i.e. Rs.12,02,295) as compared to NPV of the purchase option (i.e. Rs.12,55,570), the firm should acquire the computer system on lease.

Working Notes: The depreciation has been calculated as per straight line method as follows:

$$\begin{aligned} \text{Annual Depreciation} &= (\text{Rs.22,00,000} - \text{Rs.10,00,000})/3 \\ &= \text{Rs.4,00,000.} \end{aligned}$$

The interest at the rate of 16% has been calculated on the outstanding balance of total purchase price of Rs.22,00,000.

3.8 HIRE-PURCHASE CONCEPT AND CHARACTERISTICS

Q24. Define Hire Purchase. Explain the features of hire purchase.

(OR)

What do you mean by Hire Purchase? Explain the features of Hire Purchase.

(OR)

Explain the concept of Hire purchase and its characteristics.

Ans : (Aug.-21, June-19, Aug.-17)

Introduction

The term 'hire purchase' originated in the United Kingdom and this is similar to rent-town system in the United States of America. Hire Purchase System is a method of purchasing the goods with an arrangement to make payment (of the purchase price) in installments over time. The purchaser is, therefore, leasing the goods and does not obtain the ownership of the goods until he pays the full amount of the contract. However, physical possession of goods is given by the seller to the buyer immediately after the finalization and signing of the agreement called, hire purchase agreement.

Hire purchase is a system for purchasing merchandise such as cars, furniture, etc., in which the buyer takes possession of the merchandise on payment of a deposit and completes the purchase by paying a series of regular installments while the seller retains the ownership of the merchandise until the final instalment is paid.

Definitions

- (i) Hire purchase system is also defined as a system by which a buyer pays for a thing in regular installments while enjoying the use of it. During the repayment period, ownership (i.e., title) of the item does not pass to the buyer. Upon the full payment of the amount/loan, the title passes to the buyer.
- (ii) Hire purchase system is a method of paying for something in which the buyer pays part of the cost immediately and then makes small regular payments until the debt is completely paid.
- (iii) Hire purchase system is a system of purchase wherein the seller gives the physical possession of the goods to the buyer immediately after

signing of the agreement on the condition that the purchase price should be paid by the buyer in a specific number of instalments and the ownership of the goods will be transferred after the receipt of all instalments.

Features

1. There is an agreement between the seller (called, hire seller or hire vendor) and the buyer (called, hire purchaser or hirer) and this agreement is called, hire purchase agreement.
2. Purchase price of the goods and services is paid in a number of agreed instalments (also called, hire). That means, purchase price is not paid in one lump sum either at the time of signing the agreement or at a future date. Instead, it is paid in a few instalments over a period of time.
3. As the purchase price is not paid in one lump sum at the time of time of purchase, it (i.e., hire purchase) is a kind of credit purchase.
4. Under the system of hire purchase, though the full amount is not paid at the time of purchasing (i.e., at the time of signing the agreement), the seller hands over the goods to the buyer on signing the agreement. In other words, the hire purchaser takes possession of the goods purchased on hire purchase basis. Therefore, the buyer is able to start using these goods for the intended purpose immediately after signing the agreement. And the hire purchaser has the right to use the goods purchased on hire purchase basis as the bailer.
5. However, the legal ownership of the goods (i.e., title to the goods) remains with the seller and it is passed on to the hire purchaser only after the receipt of all instalments including the last instalment as per the agreement. As a result, the hire vendor continues to be the owner of the goods till the receipt of last instalment from the hire purchaser.
6. As the title to the goods is not transferred from seller to buyer till the receipt of last instalment in accordance with the Provisions of the agreement, all earlier instalments paid (prior to the payment of last instalment) are considered as hire charges (till the payment

of last instalment). And the hire purchaser becomes the owner of the goods only after the payment of all instalments as per the Provisions of the agreement (i.e., after the payment of last instalment, the hire vendor transfers the ownership of the goods to hire purchaser).

7. As already stated, the legal ownership of the goods sold on hire purchase system is not transferred to the buyer by the seller until the receipt of last instalment from the buyer. Therefore, if the hire purchaser fails to pay any of the instalments, the hire vendor has the right to take back (i.e., repossess) the goods from the hire purchaser.
8. Similarly, the hire purchaser also has an option to terminate the agreement any time but before the payment of last instalment and return the goods to the seller (if he is not willing and/or not able to pay the remaining instalments).

3.8.1 Legal and Tax Framework

Q25. Explain the Legal and tax Framework for Hire Purchasing System.

Ans : (June-18, Aug.-17)

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 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.

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.

Essential Ingredients of a Sale

A contract of sale is constituted of following elements:

- i) **Two parties:** namely the buyer and the seller, both competent to contract to effectuate the sale.
- ii) **Goods:** The subject matter of the contract.
- iii) **Money consideration:** price of the goods.
- iv) **Transfer of ownership:** of the general property in goods from the seller to the buyer.
- v) **Essentials** of a valid contract under the Indian Contract Act.

Tax Framework for Hire Purchase System

The taxation aspects of hire-purchase transactions can be divided into three parts:

1. Income tax
2. Sales tax
3. Interest tax

1. Income Tax

Hire-Purchase, as a financing alternative, offers tax benefits both to the hire-vendor, (hire-purchase finance company) and the hire-purchaser (user of the asset).

a) Assessment of Hire-Purchaser (Hirer)

According to circular issued by the Central Board of Direct Taxes in 1943 and a number of court rulings, the hirer is entitled to the tax shield on depreciation calculated with reference to the cash purchase price and

b) The tax shield on the 'consideration for hire' (total charge for credit)

In other words, though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price. Similarly, he can claim deduction on account of 'consideration for hire' that is, finance charge. The finance charge is difference between the hire-purchase price and cash price. The amount of finance charge to be deducted each year is to be spread evenly over the term of the management.

c) Assessment of Owner (Hire Vendor)

The consideration for hire/ hire charge/ income received by the hire vendor is liable to tax under the head profits and gains of business and profession where hire purchase constitute the business of the assessee, otherwise as income from other sources. The hire incomes from the house property. Normal deduction (except depreciation) are allowed while computing the taxable income.

d) Tax planning in Hire-Purchase

The Hire-Purchase transaction can be used as a tax planning device in two ways:

- (i) First, the net income (finance income less interest on borrowings by the hire-vendor) can be inflated at the rear end of the transaction and thereby defer tax liability.
- (ii) Secondly, another possible area of tax planning is to use hire-purchase as a bridge between the lessor and the lessee. Instead of a direct lease an intermediate financier is introduced.

2. Sales Tax

The Salient Features of Sales Tax are as follows:

a) Higher purchase as Sale

Higher-purchase, though not sale in the true sense, is demand to be sale such transactions are liable to sales tax. The sales tax is payable once the goods are delivered by the owner (hire vendor) to the higher (hire purchaser) even if the transaction does not fructify in to a sale. There is no provision for the refund of sales tax on the unpaid installment. Full tax is payable irrespective of whether the owner gets the full price of the goods or not.

b) Delivery vs Transfer of property: Taxable Event

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. That is, a taxable event is the delivery of the goods and not transfers of the title of the goods. For the purpose of levying sales tax, a sale is deemed to take place only when the hirer exercises the option to purchase.

c) Taxable Quantum

The quantum of sales tax is related to the sales price. It must be determined to be the consideration for the transfer of the goods when the delivery of the goods takes place. The consideration for the sale of the goods is the total amount which is agreed to be paid before the transfer of the goods takes place in a hire purchase contract. In other words, sales tax is levied on the entire amount payable under the agreement by deeming it to be the sale price of the goods instead of reducing the amount by the hire charges assumed to be included and by depreciation in the value of the goods for the period when the goods were on hire.

d) States Entitled to Impose Tax

When a hire-purchase transaction is entered in the state where the goods are lying, the concerned state is entitled to impose sales-tax. In case where the contract of hire-

purchase is entered into one state and goods are in another state, the entitlement to tax vests with the state in which the goods are delivered by the hire-vendor to the hirer even though the goods may be transported/ transferred to a different states subsequently.

e) Rate of Tax

The rates 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 delivery of the goods to the hirer is applicable.

3. Interest-Tax

The hire-purchase finance companies, like other credit/finance companies, have to pay 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 @ 2 per cent. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income the Income-tax Act.

Q26. Explain the advantages and disadvantages of Hire Purchase System.

(OR)

Describe the advantages and disadvantages of Hire Purchasing.

(OR)

State the merits and demerits of Hire Purchasing.

Ans : **(Imp.)**

Advantages

Hire-purchase is a mode of financing wherein the price of goods that needs to be sold is paid on some future date in the form of lease installments/ lease rentals. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed with an option of purchasing them by paying the last installment.

The main advantages of hire purchase system are:

a) Advantages to Hire Purchaser

1. Use of Expensive Goods

In hire purchase system, people can fulfill their dream of owning luxurious and expensive goods such as cars, machineries, and so on.

2. Easy Payment

In this method, goods are paid in the form of monthly installments.

3. Encouragement to Savings

In leasing, as the payment of goods need to be made over a long period of time, it requires buyer to avoid other expenses in order to pay installments. As a result, it develops savings among them.

4. Facility of Free Repairs

In spite of buyer using the goods carefully if damage occurs then it is the responsibility of the owner to make arrangements for facilitating normal repairs free of cost till the termination of the lease contracts by paying last installment.

b) Advantages to Seller

1. Increase in Sales: People get attracted and are facilitated to valuable goods through the hire purchase financing which also increases the sales of valuable goods in the market.

2. Recovery of Instalment Easily: If purchaser makes default in the payment of instalment then hire vendor can take back his goods from the buyer without refunding amount received in past. In order to overcome this issue, the buyer himself makes the payment on time.

3. Established Good Relation between the Buyer and Seller

Good relationship is established between the buyer and seller due to regular transaction and it helps the seller to get the information about the goods. Defective goods must be removed.

4. Possibility of Sales of other Goods

When buyer visit the showroom to make payment of installment, other attractive goods can also be offered to him. In this manner, additional sales can be generated.

5. Facility to Get Capital at Lower Rate

Creditors provide capital to the seller at low rate with full confidence so as to recover instalment amount regularly from the buyer,

c) Advantages to Society**1. More Production**

In hire purchase transaction, there is a rise in sales which results in increase of production, employment and income.

2. Facilitate in Business

In hire purchase, payments are made in installments, which requires less capital in business. So business can be done easily.

3. Increase in Standard of Living

The hire purchase system facilitates the person to use the valuable goods which increases his standard of living.

Disadvantages

Some of the main disadvantages of hire purchase system are:

a) Disadvantages to Buyer

1. Costly: In a hire purchase transaction, a buyer has to pay additional charges which are usually more than the actual price of such goods. As the hire purchase price is an inclusive of interest on unpaid installments of the goods.

2. Risky for Hire Buyer: If the buyer is failed to pay the required installments then the seller will take back the goods sold by him on the basis of hire purchase even without paying back the amount paid by buyer in past.

3. Promotion of Wasteful Competition: It is easy to get possession of

expensive goods from hire purchase traders as a result people gets attracted towards luxurious live which is beyond their scope. This results in extravagance and wasteful competition among them.

4. No Right to Sale or Mortgage the Goods: In hire purchase, ownership is transferred after the payment of the last installment. During installments, if the buyer sells or mortgages the goods then the new party is devoid of getting a better title.

b) Disadvantages to Vendor

1. Large Capital: The business concerns involved in hire purchase transactions need to have large capital to finance their business as its considerable part of capital is held in the form of book-debts (debtors).

2. Difficulty in Repossession of Goods: Seller is entitled to take back the goods from the buyer in case of default in the payment of hire purchase installment. Because, seller has to face lot of difficulty in fulfilling the legal requirements.

3. More Expenses for Accounting: Hire purchase system has to bear more expenses if it involves the selling of goods to customer who are living in remote areas. As a result it creates problem of correspondence and also creates the problem of accounting.

4. Loss on Sale of Goods: Even though, seller can take back the goods let out on hire purchase on account of default payment instalment, he has to incur actual loss as goods taken back may not yield reasonable price on resale.

c) Disadvantage to Society

It is easy to get expensive things though hire purchase traders. People of medium and lower income group get attracted to luxury goods and even purchase unnecessary goods. They curtail other necessary expenses watch result.

3.8.2 Mathematics of Hire Purchase**Q27. Explain the various methods of interest calculation and reporting in hire purchase.***Ans :***(Imp.)**

The comparative evaluation between the leasing and hire purchase, computation of interest and division of the installment amount into the 'interest and principal' elements constitute the importance where, flat rate of interest is available. The interest amount is computed by applying the interest rate on the outstanding principal amount at the starting of every period. The principal amount is calculated as a difference between the installment amount per period and the interest amount per period. The methods used for calculating interest are as follows :

Methods of Interest Calculation

(In all these methods the annual payment is assumed at the end of the year)

- (a) Effective rate of interest or annual percentage rate method.
- (b) Sum-of-years digits method.
- (c) Straight-line method.

(a) Effective Rate of Interest (ERI)

Effective Rate of Interest (ERI), this method is a kind of the interest calculation method wherein effective rate of interest is ascertained with the help of the popular 'IRR' technique. It is also known as annual percentage rate method. Accordingly, effective rate of interest is that rate of interest which makes all PV's of future annual installment payments equal to the HP principal payable at the starting of the hire purchase contract. The HP principal payable is the excess amount of the cost of asset hire- purchased which is above the downpayment made. Steps involved in ascertaining the ERI is,

1. Determine HP principal = Cost of asset – Downpayment.
2. Determine total interest amount for the HP period = [HP principal × Flat rate of interest × HP period of years]:
3. Determine total HP amount = [Step 1 + Step 2]:
4. Determine annual installment amount = step 3 ÷ number of installments
5. Determine Effective rate of Interest (ERI)
Rate of interest: $\rightarrow$ PV of future annual installments = PV of HP principal amount payable
6. Determine annual interest amount = Total principal outstanding at the beginning × ERI

(b) Sum-of-years Digits Method

In this method, the annual amount of interest is ascertained as follows:

Annual amount of interest = $\left[\frac{\text{Number of years including the current year remained for HP period}}{\text{Total of all digits representing the period of HP}} \right] \times \text{Total amount of interest for HP period}$. Where,
Total interest amount for HP period = Total amount payable × flat rate of interest.

(c) Straight-line Method

In this method, the annual amount of interest is ascertained as an equated annual financial charge as follows:

Annual amount of interest = $\frac{\text{Total amount of Interest for HP period}}{\text{Number of HP periods}}$.

Method of Reporting

Both interest charged and the principal component must be disclosed separately in the books of the hirer and the hire vendor. The method used for reporting in hire purchase finance transactions are as follows:

Disclosure in Hirer Books

- (a) Both annual interest and depreciation charged need to be debited in P and L a/c every year, unless the loan is paid completely.
- (b) The principal component of outstanding hire purchase must be recorded in balance sheet as current liability of hire purchase outstanding within one year and as a secured loan of hire purchase outstanding for periods more than one year.

Disclosure in Hire Vendor Books

- (a) The cost of HP deal must be debited to P and L account.
- (b) The interest received every year from hirer contribute to finance income and must be credited to P and L account.

3.8.3 Financial Evaluation of Hire Purchase Deals

Q28. Explain the financial evaluation of a hire purchase transaction.

Ans :

The financial evaluation structure of a hire-purchase can be explain with the help of the assessment of financial lease from the perspectives of both the hirer and the finance company.

A) From the perspective of the hirer (Hire - Purchaser)

The tax treatment in hire-purchase is completely opposite to that of the tax treatment of lease financing. In lease financing, the lesser has the right to claim depreciation and other deductions related to the ownership of equipment which includes interest on the amount borrowed to purchase the asset, whereas, the lessee is entitled to enjoy full deductions of lease rentals. Contrasty in a hire-purchase transaction, the hirer is eligible to claim depreciation and the deduction for the finance charge component of hire installment. As both the hire-purchase and lease financing constitute the alternative modes of acquisition of assets, they are widely used by different firms. If the evaluation of hire purchase transaction from the perspective of hirer must be done in relation to leasing alternative.

Decision-criterion

In hire purchase transactions, decisions are made by considering the cost of hire purchase, cost of leasing. If hire purchase cost is less than leasing cost, then hirer prefers the hire-purchase alternative for acquiring the assets and vice-versa. If $H_c > W_c$ then leasing option is preferred.

Cost of Hire Purchase

The cost of hire-purchase to the hirer (CHP) includes the cost of hire purchase is calculated by deducting the sum of the present value of depreciation the present value of net salvage value obtained after discounting it with as appropriate cost of capital (K_e) from the aggregate value. This aggregate value is obtained as a sum of downpayment charges, service charges and the present value of hire purchase payments made after discounting them with an appropriate cost of debt.

Mathematically, it is represented by a formula:

Cost of hire purchase = Aggregate value – [PV of Depreciation $\times K_c$ + PV of net salvage $\times K_e$]

Whereas, Aggregate value = Down payment + Service charges + (PV of hire purchase payments $\times K_d$)

Cost of Leasing

The Cost of Leasing (COL) includes the following elements:

1. Lease management fee.
2. Plus present value of lease payments discounted K_d .
3. Less present value of tax shield on lease payments and lease management fee discounted by K_c .
4. Plus present value of interest tax shield on hire purchase discounted by K_c .

B) From the perspective of Finance Company (Hire-vendor)

Hire purchase and leasing are two different alternative investment decisions of a finance company financial intermediary/hire-vendor. Therefore, the decision of acquisition of assets depend on a comparative analysis of the net present values of the two alternatives i.e., hire- purchase and lease financing. An alternative which has higher net present value is selected and one which has lower net present value must rejected.

Net Present Value of Hire-purchase Plan [NPV(HPP)]

The NPV(HPP) includes:

1. Present value of hire-purchase installments.
2. Plus documentation and service fee.
3. Plus present value of tax shield on initial direct cost.
4. Minus loan amount
5. Minus initial cost
6. Minus present value of interest tax on finance income (interest).
7. Minus present value of income tax on finance income (interest) netted for interest tax.
8. Minus present value of income tax on documenta-tion and service fee.

Net Present Value of Lease Plan [NPV(LP)]

Following, elements are included in NPV(LP):

1. Present value of lease rentals
2. Add lease management fee.
3. Add present value of tax shield on initial direct costs and depreciation.
4. Add present value of net salvage value.
5. Less initial investment.
6. Less initial direct costs.
7. Less present valve of tax liability on lease rentals and lease management fee.

Q29. State the differences between leasing and hire purchase.

(OR)

Distinguish between lease and the purchases.

Ans :

(Aug.-21, Aug.-18)

Lease Financing Vs. Hire Purchase

Sl.No.	Nsature	Lease Financing	Hire Purchase
1.	Ownership of Asset	Lies with the lessor. Lessee has the right to use the equipment and does not have the option to purchase.	The hirer has the option to purchase the asset immediately after the last instalment is paid.
2.	Depreciation	Claimed as the expense in the books.	Allowed to the hirer.
3.	Rental Payments	Covers the cost of asset the principal and interest amount for the period of use.	Instalment is inclusive of
4.	Duration	Longer duration for bigger assets	Shorter duration and cheaper assets
5.	Tax Impact	Total lease payments are shown as an expense by the lessee	Hirer claims the depreciation on the asset as an expense.
6.	Repair and Maintenance	Responsibility of the lessee in the case of finance lease and of the lessor in case of operating lease	Responsibility lies with the hirer.
7.	Extent of financing	It is a complete financing option in which no down payments are required	Normally an amount of margin money is required to be paid upfront by the hirer.

Short Question & Answers

1. Define Leasing.

Ans :

Meaning

Leasing has emerged as a new source of financing capital assets. It is a financing concept. It is an arrangement between two parties, the leasing company or lessor and the user or lessee. The lessor arranges to buy capital equipment for the use of the lessee for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to mutual convenience of both the parties. The lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitions

A Lease is Defined as follows:

- i) **According to Dictionary of Business and Management**, 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'
- ii) **According to James C. Van Horne** 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'
- iii) **According to Equipment Leasing Association of UK** 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

2. Distinguish between Financial Lease and Operating Lease.

Ans :

Sl. No.	Financial Lease	Sl. No.	Operating Lease
1.	A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment.	1.	An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period.

2.	It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2.	Operating lease provides for maintenance expenses and taxes of the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3.	Leasing company assumes risk of obsolescence.
4.	Contract period ranges from medium to long term.	4.	Contract period ranges from intermediate to short-term.
5.	Contracts are usually non cancellable.	5.	Contracts are usually cancellable either by the lessor or by the lessee.
6.	Air crafts, land and building heavy machinery are leased.	6.	Computers, office equipments, automobiles, truck etc. are leased.
7.	The lease involves a financial commitment similar to a loan by a leasing company. It places the lessee in a position of borrow.	7.	The financial commitment is restricted to regular rental payment. The rentals find a place in the P & L A/c of the lessee.
8.	The lessor fulfills financial function.	8.	The lessor fulfills service function.

3. What are the various types of leasing.

Ans :

The lease is broadly classified into three types:

- i) Financial lease
- ii) Operating lease
- iii) Other types of lease

i) Financial Lease: The financial lease, usually covers the complete economic life of the asset. During the lease period the lessor receives the lease rental in order to not only recover the full cost of the asset, but also the reasonable return on the funds which are being to buy the asset. Infact finance lease is also known as capital lease.

ii) Operating Lease: An operating lease is an agreement where in the lessee obtains the use of an asset on a periodical basis. It is a lease arrangement for a period which is usually shorter than the life of an asset. An asset may be leased by the lesser to the different lessees one after the other. During the lease period the lease rental payable by one lessee is insufficient to completely cover the asset cost plus return. Therefore the present value of lease payment is usually lower than the actual price of the asset.

iii) Other types of lease

(a) Cross Border lease: A cross border lease refers to the situation when a lessor leases an equipment to a lessee who does not come under the jurisdiction of the lessors territory. The important reasons behind the recourse to cross border leasing is that in greater number of cases like the operation which provides finance to an international commercial transaction, where the user not only procures 100% financing, but also includes the finance which includes a longer time period than government export credit. Under the cross border lease on the basis of the circumstances in the international capital market the attitude of the parties changes.

(b) Direct Lease: Direct lease is one of the type of finance lease where in lessor purchases the asset and transfers it to the lessee. Under the lease agreement, a manufacturer can also act as lessor and deliver the assets to the lesser.

(c) Leveraged Lease: When the lessor borrows a part of the purchase price from any leading institution then such a lease is known as leveraged lease. Under this lease, with the help of assets and the lease rentals the loan is being secured. The lessee (or) the lessor directly repay the loan out of the lease rentals.

In this leveraged lease the lender finances the as-set. Initially the lease rentals are distributed for payment to the lender in order to satisfy the debt obligation and any surplus and the remaining amount would be sent back to the lessor.

For costly assets the leveraged lease may be more useful.

4. Break-even Lease Rental (BELR)

Ans :

The break-even lease rental (BLER) is the rental wherein the lessee is not concerned about the lease financing, borrowing and buying. NAL is zero in BELR and it shows the maximum level of rental which the lessee would be desiring to pay. The lease proposal would be accepted if increase the BELR is more than the actual lease rental otherwise the proposal would be rejected.

5. Explain the features of Hire Purchase.

Ans :

1. There is an agreement between the seller (called, hire seller or hire vendor) and the buyer (called, hire purchaser or hirer) and this agreement is called, hire purchase agreement.

2. Purchase price of the goods and services is paid in a number of agreed instalments (also called, hire). That means, purchase price is not paid in one lump sum either at the time of signing the agreement or at a future date. Instead, it is paid in a few instalments over a period of time.

3. As the purchase price is not paid in one lump sum at the time of time of purchase, it (i.e., hire purchase) is a kind of credit purchase.

4. Under the system of hire purchase, though the full amount is not paid at the time of purchasing (i.e., at the time of signing the agreement), the seller hands over the goods to the buyer on signing the agreement. In other words, the hire purchaser takes possession of the goods purchased on hire purchase basis. Therefore, the buyer is able to start using these goods for the intended purpose immediately after signing the agreement. And the hire purchaser has the right to use the goods purchased on hire purchase basis as the bailer.

5. However, the legal ownership of the goods (i.e., title to the goods) remains with the seller and it is passed on to the hire purchaser only after the receipt of all instalments including the last instalment as per the agreement. As a result, the hire vendor continues to be the owner of the goods till the receipt of last instalment from the hire purchaser.

6. Explain the Essential Elements of Leasing.

Ans :

- i) **Parties to the Contract:** There are essentially two parties to a contract of lease financing, namely, the owner and the user, called the lessor and the lessee respectively. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial institutions. Sometimes there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous.

ii) **Asset:** The asset, property or equipment to be leased is the subject-matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft and so on. The asset must, however, be of the lessee's choice suitable for his business needs.

iii) **Ownership Separated from User:** The essence of a lease financing contract is that during the lease-tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

7. Write about Product Profile.

Ans :

The product profile of the lease structures in India can be understood from the characteristic features of lease structures in India. The various characteristics features of lease structures in India are,

1. In case of lease agreements, ownership is not transferred to lessee, so lease transactions are categorized as hire purchase transactions from the tax perspective.
2. Majority of the agreements are found to be of direct lease type. Sale and lease back transactions are found less.
3. Operating lease is not much popular in Indian lease structure due to the absence of resale market for already used equipments.
4. Lease rentals are decided in such a way that the complete investment cost is recovered in the primary period itself. A reasonable amount of lease rent is charged during the secondary period. The various factors considered while deciding lease rent are, tax, depreciation etc.
5. Usually, equipment leases are for maximum ₹ 100 lakhs capital investment because majority of the people taking lease consider leasing as stand by finance for procuring non-productive assets (like, air conditions) and for meeting unexpected capital expenses).

8. Write about Gross Yield Pricing ?

Ans :

To work out the gross rental yield, you need 2 key figures – the annual rental income and the property value.

- Annual rental income = weekly rent × 52
- Property value = could be purchase or market value, depending on whether you are looking at the current performance, or future prediction.

Once you've worked out the 2 figures above, the calculation is relatively simple:

Gross rental yield = (Annual rental income / Property value) × 100

For example, a property that was purchased for ₹ 390,000 and returns a weekly rent of ₹ 500 would have a current rental yield of 6.67%.

However, if the current market value of the property is ₹ 600,000, and the rental income remains the same, then the potential rental yield would be 4.33%.

It's important to understand that current or historical rental yields are not necessarily accurate indicators of future performance, especially in a heated property market where prices are soaring but rental prices are stalling.

Also, gross rental yield does not take into account any expenses associated with keeping the property. So, a property with high rental yield but also high expenses may actually result in a low net rental income.

9. Write about IRR Based Pricing ?

Ans :

The internal rate of return is also one of the capital budgeting technique that identifies the time value of money. This method is also known as yield method, discounted rate of return and trial and error yield method. It is that rate of return which equates the present value of cash inflows to the present value of cash outflows. The hit and trial method is used in internal rate of return method to discount the cash flows of the project as discount rate is not known. The internal rate of return is calculated with the help of the following formula.

$$C = \frac{A_1}{(1+r)^1} + \frac{A_2}{(1+r)^2} + \frac{A_3}{(1+r)^3} + \dots + \frac{A_n}{(1+r)^n}$$

Where,

C – Initial outlay at time zero

r – Rate of discount or internal rate of return

$A_1, A_2, \dots, A_n$ – Future net cash flows at different periods

n – Number of years.

10. Define Hire Purchase.

Ans :

Introduction

The term 'hire purchase' originated in the United Kingdom and this is similar to rent-town system in the United States of America. Hire Purchase System is a method of purchasing the goods with an arrangement to make payment (of the purchase price) in installments over time. The purchaser is, therefore, leasing the goods and does not obtain the ownership of the goods until he pays the full amount of the contract. However, physical possession of goods is given by the seller to the buyer immediately after the finalization and signing of the agreement called, hire purchase agreement.

Hire purchase is a system for purchasing merchandise such as cars, furniture, etc., in which the buyer takes possession of the merchandise on payment of a deposit and completes the purchase by paying a series of regular installments while the seller retains the ownership of the merchandise until the final instalment is paid.

Definitions

- (i) Hire purchase system is also defined as a system by which a buyer pays for a thing in regular installments while enjoying the use of it. During the repayment period, ownership (i.e., title) of the item does not pass to the buyer. Upon the full payment of the amount/loan, the title passes to the buyer.
- (ii) Hire purchase system is a method of paying for something in which the buyer pays part of the cost immediately and then makes small regular payments until the debt is completely paid.

11. Effective Rate of Interest (ERI)

Ans :

Effective Rate of Interest (ERI), this method is a kind of the interest calculation method wherein effective rate of interest is ascertained with the help of the popular 'IRR' technique. It is also known as annual percentage rate method. Accordingly, effective rate of interest is that rate of interest which makes all PV's of future annual installment payments equal to the HP principal payable at the starting of the hire purchase contract. The HP principal payable is the excess amount of the cost of asset hire- purchased which is above the downpayment made. Steps involved in ascertaining the ERI is,

1. Determine HP principal = Cost of asset – Downpayment.
2. Determine total interest amount for the HP period = [HP principal x Flat rate of interest x HP period of years]:
3. Determine total HP amount = [Step 1 + Step 2]:
4. Determine annual installment amount = step 3 ÷ number of installments

5. Determine Effective rate of Interest (ERI)

Rate of interest: $\rightarrow$ PV of future annual installments = PV of HP principal amount payable

6. Determine annual interest amount = Total principal outstanding at the beginning $\times$ ERI

12. State the differences between leasing and hire purchase.

Ans :

Lease Financing Vs. Hire Purchase

Sl.No.	Nature	Lease Financing	Hire Purchase
1.	Ownership of Asset	Lies with the lessor. Lessee has the right to use the equipment and does not have the option to purchase.	The hirer has the option to purchase the asset immediately after the last instalment is paid.
2.	Depreciation	Claimed as the expense in the books.	Allowed to the hirer.
3.	Rental Payments	Covers the cost of asset the principal and interest amount for the period of use.	Instalment is inclusive of
4.	Duration	Longer duration for bigger assets	Shorter duration and cheaper assets
5.	Tax Impact	Total lease payments are shown as an expense by the lessee	Hirer claims the depreciation on the asset as an expense.
6.	Repair and Maintenance	Responsibility of the lessee in the case of finance lease and of the lessor in case of operating lease	Responsibility lies with the hirer.

Choose the Correct Answers

1. What is the maximum debt period permitted under factoring? [a]
(a) 150 days (b) 120 days
(c) 90 days (d) 60 days
2. What is the maximum grace period under factoring? [d]
(a) 150 days (b) 120 days
(c) 90 days (d) 60 days
3. Which out the following is not a service provided by factor in factoring? [b]
(a) Management of receivables (b) Production of Goods
(c) Collection of debt (d) Maintaining the sales ledger
4. The type of factoring in which the factor recovers the amount advanced from client in case of non payment by customer? [c]
(a) Bill Discounting (b) Non-Recourse Factoring
(c) Recourse factoring (d) Bill Collection
5. How many factors are there in International Factoring? [b]
(a) One (b) Two
(c) Three (d) Four
6. Which of the following are the different options available to the entrepreneurs for funding the business? [d]
(a) Venture Capital (b) Angel Financing
(c) Invoice Factoring (d) All of the Above
7. Which of the following clearly defines the Factoring business? [d]
(a) It is a type of debtor finance in which a business sells its accounts receivable .
(b) The receivables are sold to the third party (called a factor) at a discount.
(c) It is commonly referred to as accounts receivable factoring, invoice factoring.
(d) All of the Above
8. Factoring Business is also known as by which of the following names? [d]
(a) Accounts Receivable Factoring (b) Asset Based Lending
(c) Invoice Factoring (d) All of the Above
9. Which of the following civilization is considered to be the origin of Factoring? [b]
(a) Indus Valley Civilization (b) Mesopotamian culture
(c) Incas Civilization (d) Aztecs Civilization
10. For which of the following businesses Factoring services are most commonly used? [d]
(a) Haulage Business (b) Healthcare Industry
(c) Real Estate (d) All of the Above

Fill in the blanks

1. In _____ the ownership of asset is separated from economic use of an asset or equipment.
2. The consideration paid by the lessee as mentioned in the lease transaction is called as _____ .
3. In _____ the parties stays in different countries.
4. The rental at which the lessee becomes indifferent between lease financing and borrowing and buying is _____
5. Close end leasing is also known as _____.
6. A means of financing the price of goods to be sold on a future date is _____.
7. _____, and _____ are included in taxation aspects of hire-purchase transactions.
8. In _____, annual amount of interest is determined as an equated annual financial charge.
9. The rate of interest which is charged in HP as a percent of the original cash price of the asset is _____.
10. _____ is the balance amount which is by the hirer after making the down payment.

ANSWERS

1. Leasing
2. Lease rentals
3. International lease
4. Break-even Lease Rental (BELR)
5. Walk-away lease
6. Hire-purchase
7. Income tax, sales tax and interest tax
8. Straight-line method
9. Add-on rate of interest
10. Equated Monthly Installments (EMIs)

UNIT IV

INSURANCE:

Definition and basic characteristics of insurance. Requirements of an insurable risk. Types of insurance. Benefits and Costs of insurance to society. Fundamental legal principles of insurance. Functions of insurer. IRDA and recent trends in insurance sector in India.

4.1 INSURANCE

4.1.1 Definition and Basic Characteristics of Insurance

Q1. Define Insurance. Explain the basic characteristics of insurance.

(OR)

What is Insurance? State the basic characteristics of insurance.

(OR)

Explain the concept of insurance and its basic characteristics.

Ans : (Aug.-21, Nov.-20, June-19)

Meaning

Insurance is a contract between two parties. One party is the insured and the other party is the insurer. Insured is the person whose life or property is insured with the insurer. That is, the person whose risks are insured is called insured. Insurer is the insurance company to whom risk is transferred by the insured. That is, the person who insures the risk of insured is called insurer. Thus insurance is a contract between insurer and insured. It is a contract in which the insurance company undertakes to indemnify the insured on the happening of certain event for a payment of consideration. It is a contract between the insurer and insured under which the insurer undertakes to compensate the insured for the loss arising from the risk insured against. Some definitions of insurance are given below:

Definitions

- (i) **According to Gosh and Agarwal**, "insurance may be defined as a co-operative form of distributing a certain risk over a group of persons who are exposed to it"
- (ii) **According to Mc Gill**, "Insurance is a process in which uncertainties are made certain".
- (iii) **According to Jon Megi**, "Insurance is a plan wherein persons collectively share the losses of risks".

Thus, insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join themselves against such an event. The document which contains all the terms and conditions of insurance (i.e. the written contract) is called the 'insurance policy'. The amount for which the insurance policy is taken is called 'sum assured'.

The consideration in return for which the insurer agrees to make good the loss is known as 'insurance premium'. This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

Characteristics

Insurance follows important characteristics - These are follows

1. Sharing of risk

Insurance is a co-operative device to share the burden of risk, which may fall on happening of some unforeseen events, such as the death of head of family or on happening of marine perils or loss of by fire.

2. Co-operative device

Insurance is a co-operative form of distributing a certain risk over a group of persons who are exposed to it. A large number of persons share the losses arising from a particular risk

3. Large number of insured persons

The success of insurance business depends on the large number of persons Insured against similar risk. This will enable the insurer to spread the losses of risk among large number of persons, thus keeping the premium rate at the minimum.

4. Evaluation of risk

For the purpose of ascertaining the insurance premium, the volume of risk is evaluated, which forms the basis of insurance contract.

5. Payment of happening of specified event

On happening of specified event, the insurance company is bound to make payment to the insured. Happening of specified event is certain in life insurance, but in the case of fire, marine or accidental insurance, it is not necessary. In such cases, the insurer is not liable for payment of indemnity.

6. Transfer of risk

Insurance is a plan in which the insured transfers his risk on the insurer. This may be the reason that many persons observe, that insurance is a device to transfer some economic losses which would have been borne by the insured themselves.

7. Spreading of risk

Insurance is a plan which spreads the risk & losses of few people among a large number of people. John Magee writes, "Insurance is a plan by which large number of people associate themselves and transfer to the shoulders of all, risk attached to individuals".

8. Protection against risks

Insurance provides protection against risk involved in life, materials and property. It is a device to avoid or reduce risks.

9. Insurance is not charity

Charity pays without consideration but in the case of insurance, premium is paid by the insured to the insurer in consideration of future payment.

10. Insurance is not a gambling

Insurance is not a gambling. Gambling is illegal, which gives gain to one party and loss to other. Insurance is a valid contract to indemnify against losses. Moreover, insurable interest is present in insurance contracts; it has the element of investment also.

11. A contract

Insurance is a legal contract between the insurer and insured under which the insurer promises to compensate the insured financially within the scope of insurance policy, the insured promises to pay a fixed rate of premium to the insurer.

12. Social device

Insurance is a plan of social welfare and protection of interest of the people. Rieged and Miller observe "insurance is of social nature".

13. Based upon certain principle

Insurance is a contract based upon certain fundamental principles of insurance, which include utmost good faith, insurable interest, contribution, indemnity, causa proxima, subrogation etc., which are operating in the various fields of insurance.

14. Regulation under the law

The government of every country enacts the law governing insurance business so as to regulate and control its activities for the interest of the people. In India General Insurance Act 1972 and the Life Insurance Act 1956 are the major enactments in this direction.

15. Insurance is for pure risk only

Pure risks give only losses to the insured, and no profits. Examples of pure risks are accident, misfortune, death, fire, injury, etc., which are all the sided risks and the ultimate

results in loss. Insurance companies issue policies against pure risk only, not against speculative risks.

16. Based on mutual goodwill

Insurance is a contract based on good faith between the parties. Therefore, both the parties are bound to disclose the important facts affecting to the contract before each other. Utmost good faith is one of the important principles of insurance.

Q2. Explain the basic terms used in insurance.

Ans :

(i) Insured

The party or the individual who seeks protection against a specified task and entitled to receive payment from the insurer in the event of happening of stated event is known as insured. An insured is normally in insurance policy holder.

(ii) Insurer

The party who promises to pay indemnity the insured on the happening of contingency is known as insurer. The insurer is an insurance company.

(iii) Beneficiaries

The person or the party to whom the policy proceeds will be paid in the event of the death or happening of any contingency is called beneficiary.

(iv) Contract

An agreement binding at law between two or more parties is called contract.

(v) Premium

The amount which is paid to the insurer by the insured in consideration to insurance contract is known as premium. It may be paid on monthly, quarterly, half yearly, yearly or as agreed upon it is the price for an insurance policy.

(vi) Insured sum

The sum for which the risk is insured is called the insured sum, or the policy money or the

face value of the policy. This is the maximum liability of the insurer towards the insured.

(vii) Peril

A peril is an event that causes a personal or property loss by fire, windstorm, explosion, collision premature death, sickness, floods, dishonesty etc.

(viii) Hazard

Hazard is a condition that may create, increase or decrease the chances of loss from a given peril.

(ix) Exposure

An exposure is a measure of physical extent of the risk. An individual who owns a business house may be subjected to economic loss and individual loss because of his business and personal exposure.

(x) Cover note

An unstamped document issued by or on behalf of insurers as evidence of insurance pending issue of policy.

(xi) Damages

Monetary compensation award at law for a civil wrong or breach of contract.

(xii) Indemnity

Compensation for actual loss suffered is call indemnity.

(xiii) Reinsurance

Reinsurance is a method where by the original insurer transfer all or part of risk he has assumed to another company or companies with the object of reducing his own commitment to an reducing his own commitment to an amount that he can bear for his own account commensurate with his financial resources in the event of loss. It was originally confined to offers and acceptances on individual risk known as facultative reinsurance transactions.

(xiv) Double Insurance

Double insurance implies that subject matter is insured in two or more insurance companies (insurers) and the total sum

insured exceeds the actual value of subject matter. In other words, the same subject matter is insured in more than one insurer.

(xv) No claim bonus

The bonus is getting under the policy, if the claim is not reported during the policy period and after that the time renewal (in time) then as per the policy term no claim bonus is avail for the vehicle insurance policy and the rate of bonus is different in different general insurance companies, and the maximum rate should be up to 50' off as per the norms.

4.2 REQUIREMENTS OF AN INSURABLE RISK

Q3. What are the Requirements of an Insurable Risk?

Ans :

Ideally insurers issue insurance policies only for pure risks. But it should be noted that all pure risks aren't insurable. Before privately insuring a pure risk, the following requirements must be fulfilled.

Elements of an Insurable Risk

- 1. The loss must be due to chance:** Regular recurring losses such as shoplifting in a supermarket are built into the price and would not be insurable as it is not fortuitous.
- 2. The loss must be definite and measurable:** This means that there must be bills to establish "proof of loss," not just casual references.
- 3. The loss must be predictable,** meaning it must be of such a nature that its frequency and average severity can be readily determined to establish the required premium.
- 4. The loss cannot be catastrophic.** All individual losses are personal catastrophes. The reference here is to national or area disasters, such as floods, riots, wars, earthquakes, etc. These events will often have coverage amount limitations in the property and casualty insurance areas.
- 5. The loss exposures must be large.** To avoid adverse selection, there must be

enough exposure to losses for the frequency to be predictable and to be grouped for the purpose of establishing rates.

- 6. The loss exposures must be randomly selected.** Concentration of risks by area, age groups, occupations, economic status, etc., can lead to adverse selection. A prominent example of the failure to avoid concentrations of risks is demonstrated by the efforts of numerous home insurers to reduce their risks, after Hurricane Andrew and several other smaller hurricanes.

Q4. "Insurance is a perfect risk management tool". Do you feel so? Substantiate your answer with suitable examples.

Ans :

Insurance as a Risk Management Technique

Most of the firms use insurance as a risk management technique to negotiate the risks and losses associated with the business. Insurance is suitable for the firms in which the probability of loss exposure i.e., low with high extent of loss. While using insurance as a risk management tool, risk manager of a firm should consider the following important aspects,

1. Selection of insurance coverage
2. Selection of insurer
3. Terms of negotiation
4. Dissemination of information
5. Periodic review of program.

1. Insurance Coverage

Risk manager of the firm should determine the required coverage of insurance to compensate huge losses. For this he should have complete knowledge on the property and liability insurance policies. Before determining the appropriate coverage risk manager should first determine the size of deductible provisions that should be maintained for loss. Insurer will deduct this amount from the coverage at the time of recovery. Deductibles reduces the claims and expenses incurred in adjusting the claims and also enhance the premium savings. Mostly firms integrate the insurance tool with risk retention technique in order

to take effective decisions regarding the proportion of risk to be transferred to insurer.

Firms can also opt for excess insurance policies in which insurer will recover the losses exceeding the retention limit of the firm. In this firm should be financially strong to expand the maximum retention limit to retain the huge losses.

Example

A firm has fixed its maximum net line as ` 10,00,000/- for a unit of worth ` 40,00,000. Accidentally, if there occurs a total loss of unit, the firm could bear a loss of ` 10,00,000/- and the remaining loss will be paid by insurers i.e., ` 30,00,000.

2. Selection of Insurer

Risk manager should be very careful while selecting a competent insurer. He should consider the following key factors,

- (i) **Financial Strength of Insurer:** It can be determined by analysing the policy owners, surplus, underwriting and investment results, ability to meet liabilities for losses, types of insurance policies and quality of the management.

Risk manager also consider the rating given to the insurer by rating agencies as the rates are based on the financial strength of insurers.

- (ii) **Range of the Risk Management Services:** Risk manager should compare the range of these services provided by different insurers by analysing the information furnished by the agents/brokers.

- (iii) **Terms of their under writing policy.**

- (iv) **Prices of the Insurance Policies:** Minimum possible price of insurance product can be determined by analysing the prices of different insurers or he can also invite bids from different insurers and select the best and cheapest (reasonable price).

3. Negotiation Terms

The firm should agree upon the terms of the insurer's contract and should negotiate them. Both the parties insurer and insured firm should agree upon the terms, conditions, and contractual

provisions of insurance contract, if the negotiation terms are framed in "manuscript policy". Most of the times agents or brokers are also involved in the process of negotiation.

4. Dissemination of Information

The risk manager of insured firm should communicate the whole information to employees and other managers who are responsible for noticing the loss for claims regarding the coverage required records, risk management services offered by insurers. The firm should have complete knowledge about the provisions of the policy regarding notification of loss and prescribed forms to present the required documents for the proof of loss to insurers.

5. Periodic Review of Insurance Policy

It is necessary to review the insurance policy periodically in order to cope up with the changes in operations and structure of the firm. Risk manager should review the program by analysing the agent-broker relationship, coverages, quality of loss control services. He should also review the decisions whether to retain the risk or to transfer it to the insurer.

Q5. Explain the advantages and disadvantages of Insurance.

Ans :

Advantages

- Assures for financial compensation:** Insurance provides financial security to the insured. It gives guarantee of compensation against large financial losses in return of small premium.
- Reduction of risks:** Human beings are exposed to different kinds of financial risks, which may cause large financial losses. It is not possible to eliminate the risks but it can be forecasted and reduced by applying some precautionary measures. Insurance helps in reducing risks by suggesting for pre caution measures on one side and by sharing the losses to a group of person who has agreed to join the common pool.

3. **Encouragement to saving and investment:** In the insurance agreement, the insured has to pay a certain regular premium to the insurer in return to the compensation of the probable future loss or compensation at old age or compensation after his/her death. Insurance is thus a method of collecting saving from the parties willing to get secured from the financial risks. Hence, it encourages persons to make regular savings.
4. **Basis of credit:** An insured can easily get loan by pledging insurance policy as a security from the insurance company itself. Besides, financial institutions grant credit facilities on the pledge of the properties which are being insured.
5. **Maintains economic stability:** Financial risks and uncertainties pushes the entire economy into instability. It is a very bad sign to total business and social sectors. Insurance assures the compensation of the financial losses caused by the specified future events and considerably helps in maintaining economic stability.
6. **Promotes business activities:** Business sector is more risky sector. The chances of fire in the go down, loss of stocks by theft, explosion in the ship, train or plane etc. are more frequent in this sector. Insurance takes away these risks and promotes and develops business activities in consideration to a nominal charge i.e., premium.
7. **Provides employment opportunities:** As insurance has become business in the modern day business world, hundreds of entrepreneurs and thousands of employees have been engaging in this line. Hence, by establishing and developing insurance companies, it has provided employment opportunities to thousands of people as per their qualification and calibre.

Disadvantages

Besides a number of benefits, insurance has also some limitations.

- Insurance leads to negligence as the insured feels that he/she can be compensated for any loss or damage.

- Insurance companies do not make the compensation promptly on maturity of the policy or for the financial losses as the expectation of the insured.
- It may lead to the crimes in the society as the beneficiaries of the policy may be tempted to commit crimes to receive the insured amount.
- Although insurance encourages savings, it does not provide the facilities that are provided by bank.

4.3 TYPES OF INSURANCE

Q6. Explain different types of Insurance.

Ans : (Nov.-20, June-18)

Insurance is broadly classified into two types:

1. Life Insurance
2. General Insurance

(1) Life Insurance

Life insurance (or life assurance, especially in the Common wealth), is a contract between an insurance policy holder and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the benefit) in exchange for a premium, upon the death of an insured person (often the policy holder). Depending on the contract, other events such as terminal illness or critical illness can also trigger payment. The policy holder typically pays a premium, either regularly or as one lump sum. Other expenses (such as funeral expenses) can also be included in the benefits. Life policies are legal contracts and the terms of the contract describe the limitations of the insured events. Specific exclusions are often written into the contract to limit the liability of the insurer; common examples are claims relating to suicide, fraud, war, riot, and civil commotion.

Life-based contracts tend to fall into two major categories:

Protection policies

Designed to provide a benefit, typically a lump sum payment, in the event of specified event. A common form of a protection policy design is term insurance.

Investment policies

Where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms (in the U.S.) are whole life, universal life, and variable life policies.

Types

Types of Life Insurance Policies

1. Term Policy

In case of Term assurance plans, insurance company promises the insured for a nominal premium to pay the face value mentioned in the policy in case he is no longer alive during the term of the policy.

Term assurance policy has the following features:

- It provides a risk cover only for a prescribed period. Usually these policies are short-term plans and the term ranges from one year onwards. If the policyholder survives till the end of this period, the risk cover lapses and no insurance benefit payment is made to him.
- The amount of premium to be paid for these policies is lower than all other life insurance policies. As savings and reserves are not accumulated under this policy, it has no surrender value and loan or paid-up values are not allowed on these policies.
- This plan is most suitable for those who are initially unable to pay high premium
- When income is low as required for Whole Life or Endowment policies, but requires life cover for a high amount.

2. Whole Life Policy

This policy runs for the whole life of the assured. The sum assured becomes payable to the legal heir only after the death of the assured. The whole life policy can be of three types.

- (i) **Ordinary whole life policy:** In this case premium is payable periodically throughout the life of the assured.
- (ii) **Limited payment whole life policy:** In this case premium is payable for a specified period (Say 20 Years or 25 Years) Only.
- (iii) **Single Premium whole life policy:** In this type of policy the entire premium is payable in one single payment.

3. Endowment Life Policy

In this policy the insurer agrees to pay the assured or his nominees a specified sum of money on his death or on the maturity of the policy whichever is earlier. The premium for endowment policy is comparatively higher than that of the whole life policy. The premium is payable till the maturity of the policy or until the death of the assured whichever is earlier. It provides protection to the family against the untimely death of the assured.

4. Health insurance schemes

An individual is subject to uncertainty regarding his health. He may suffer from ailments, diseases, disability caused by stroke or accident, etc. For serious cases the person may have to be hospitalized and intensive medical care has to be provided which can be very expensive. It is here that medical insurance is helpful in reducing the financial burden. These days the vulnerability to lifestyle diseases such as heart, cancer, neurotic, and pollution based, etc., are on the increase. So it makes sense for an individual to go for medical insurance cover.

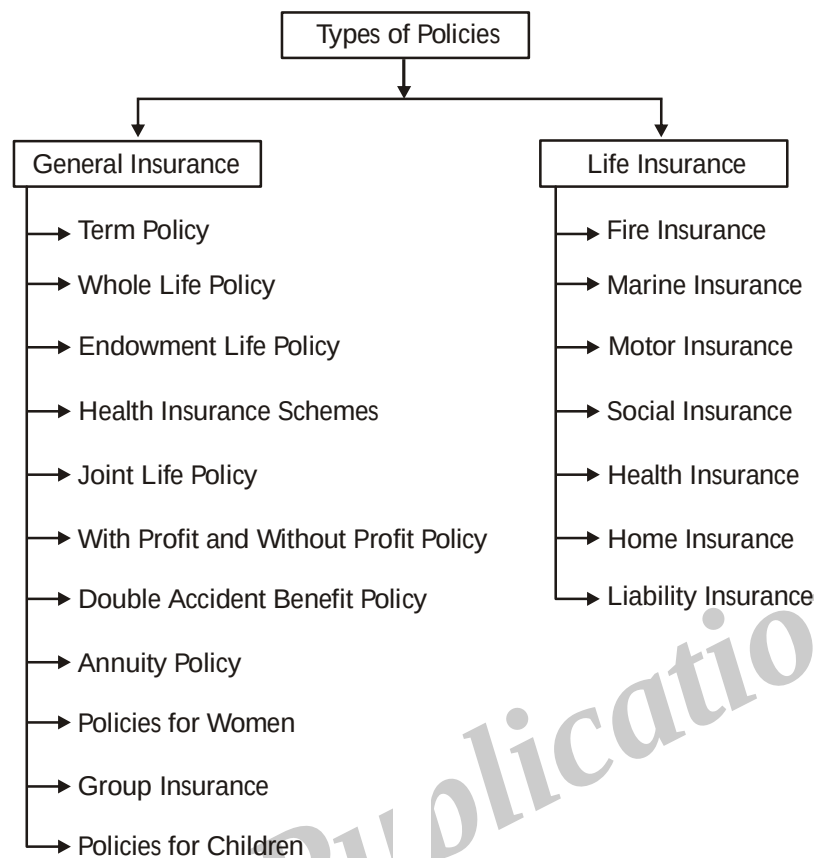


Fig.: Types of Insurance

5. Joint Life Policy

This policy is taken on the lives of two or more persons simultaneously. Under this policy the sum assured becomes payable on the death of any one of those who have taken the joint life policy. The sum assured will be paid to the survivor(s). For example, a joint life policy may be taken on the lives of husband and wife, sum assured will be payable to the survivor on the death of the spouse.

6. With Profit And Without Profit Policy

Under with profit policy the assured is paid, in addition to the sum assured, a share in the profits of the insurer in the form of bonus. Without profit policy is a policy under which the assured does not get any share in the profits earned by the insurer and gets only the sum assured on the maturity of the policy. With profit and without profit policies are also known as participating and non-participating policies respectively.

7. Double Accident Benefit Policy

This policy provides that if the insured person dies of any accident, his beneficiaries will get double the amount of the sum assured.

8. Annuity Policy

Under this policy, the sum assured is payable not in one lump sum payment but in monthly, quarterly and half-yearly or yearly installments after the assured attains a certain age. This policy is useful to those who want to have a regular income after the expiry of a certain period e.g. after retirement. Annuity is paid so long as the assured survives. In annuity policy medical check-up is not required. Annuity is paid so long as the assured survives.

9. Policies For Women

Women, now a days are free to take life assurance policies. However, some specially designed policies suit their needs in a unique manner; important policies for women are

- (A) Jeevan Sathi is also known a Life Partner plan where the husband and wife are covered under this endowment policy
- (B) Jeevan Sukanya

10. Group Insurance

Group life insurance is a plan of insurance under which the lives of many persons are covered under one life insurance policy. However, the insurance on each life is independent of that on the other lives. Usually, in group insurance, the employer secures a group policy for the benefit of his employees. Insurer provides coverage for many people under single contract.

11. Policies For Children

Policies for children are meant for the various needs of the children such as education, marriage, security of life etc. Some of the major children policies are:

- (i) Children's deferred assurances
- (ii) Marriage endowment and educational annuity plans.
- (iii) Children endowment policy

(2) General Insurance

It refers to insurance of products excluding life insurance. The companies which offers the non-life insurance must pay for losses or damages caused to the insured party.

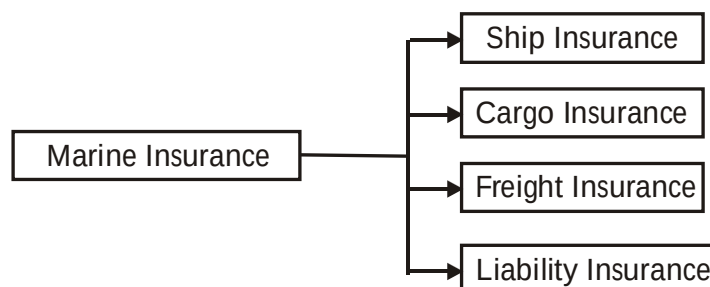
Types**1. Fire Insurance**

Fire insurance is property insurance that covers damage and losses caused by fire. It helps to cover the risk of loss of property caused by fire accidentally or unintentionally. A fire insurance policy covers the loss that the insurer may suffer due to destruction of or damage to property or goods, caused by fire, during a specified period and upto agreed amount.

Fire Insurance = Covers damage and losses caused by fire

2. Marine Insurance

Marine insurance covers the loss or damage of ships, cargo, terminals and any transport by which the property is transferred, acquired or held between the points of origin and the final destination. Marine insurance is an arrangement by which the insurance company agrees to indemnify the owner of the ship or cargo against risks involved in marine venture. It provides protection against loss of marine perils. Marine insurance involves ship insurance, cargo insurance, freight insurance and liability insurance. Hence, marine insurance protects from business losses incurred during water transport operations.



(i) Ship Insurance

It is also known as hull insurance. It is the insurance against loss caused by damage or destruction of ship to the owner. It is done to protect the ship owner and investment in ship.

(ii) Cargo Insurance

The goods sent through waterway is called as cargo. It covers physical damage or loss of goods while in transit by land, sea and air.

Cargo = Goods sent through waterway

(iii) Freight Insurance

The amount paid to the owner of ship to transfer the goods from one port to another is called freight. It provides protection to merchant vessels corporations. It stands for the chance of losing freight amount in case cargo is lost due to the ship meeting in an accident.

(iv) Marine Liability Insurance

It is that type of marine insurance where compensation is bought to provide any liability occurring on account of a ship crashing. One ship may collide with another ship. Goods of another ship may be lost. Marine insurance offers compensation of such liabilities.

3. Motor Insurance

Motor vehicle insurance, called automotive insurance, is a contract by which the insurer assumes the risk of any loss the owner of a vehicle may incur through damage to property or persons as the result of an accident. It is insurance for cars, motorcycles and other road vehicles. It provides financial protection against physical damage, theft of vehicle or bodily injury resulting from traffic collisions and against liability that could arise from incidents in a vehicle.

4. Social Insurance

It is a public insurance that provides protection against economic risks. Social insurance is considered to be a type of social security. Social insurance provides economic security to weaker sections of the society who are unable to pay the premium for an adequate insurance. Social insurance includes pension plans, disability benefits, unemployment benefits, sickness insurance, oldage insurance and so on.

Social Insurance = Economic security to weaker sections of society
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5. Health Insurance

Health insurance is generally known as medical insurance. In this insurance, a person or group of persons acquire health care coverage in advance by paying premium. Health insurance is insurance against the risk of incurring medical expenses among individuals.

6. Home Insurance

Home insurance is a type of property insurance that covers losses and damages to an individual's house and to assets in the home. It also provides liability coverage against accidents in the home or on the property. The policy usually covers interior damage, exterior damage, loss or damage of personal assets and injury that arises while on the property.

7. Liability Insurance

Liability insurance is also known as third party insurance. It is a part of the general insurance system of risk financing to protect the insured from the risk of liabilities imposed by lawsuits and similar

claims and protects the insured if the purchaser is sued for claims that come within the coverage of the insurance policy. Hence, liability insurance is designated to offer particular protection against third-party insurance claims i.e., payment is not typically made to the insured but rather to someone suffering loss who is not a party to the insurance contract.

Q7. Explain the importance of life insurance.

Ans :

1. Covers the Risk of Death

The risk of death is covered under the life insurance. In case of death, insurance company pays full sum assured, which would be several times larger than the total of the premiums paid.

2. Encourages Compulsory Savings

The element of protection and investment both are present in case of life insurance. In most of the life policies, elements of savings predominates. After taking insurance, if the premium is not paid the policy lapses. Thus, the insured is forced to go on paying premium. In other words, it encourages compulsory saving to pay premium.

3. Easy Settlement and Protection Against Creditors

In case nomination or assignment is made, a claim under life insurance can be settled in a simple way. The policy money becomes a kind of trust, which cannot be taken away by the creditors.

4. Provides Security and Safety

Under life insurance payment is made in case of death of insured or when the term of insurance expires. The loss to family of an insured at an premature death and payment for old age both are adequately provided by life insurance. In other words, security against premature death and old age sufferings both are provided by life insurance.

5. Eliminates Dependency

On the death of husband or father, the destruction of family needs no elaboration. The family suffers a lot. It brings down the standards of living and the suffering may go to any extent of begging from the relatives, neighbours or family friends. The economic freedom of family is totally lost. The life insurance is here to help the wife and children and it provides adequate amount at the time of sufferings.

6. Profitable Investment

Life insurance policies provide the best alternative of investment to individuals. There are better forms of investment in endowment policies, multipurpose policies, deferred annuities.

7. Facilitates Liquidity

Life insurance provides liquidity. If a policyholder is not in a position to pay the premium, he can surrender the policy for cash to meet his cash requirement in time.

8. Tax Relief

In India, insurance policies carry a special exemption from income-tax, wealth tax, gift tax and estate duty. The insured obtains significant reliefs in income tax and wealth tax by paying the insurance premium.

9. Loan Facility

The insured can also take a loan for a temporary period to meet his difficulty against policy. Sometimes, a life insurance policy is also acceptable as security for a commercial loan.

10. Helpful in Re-adjustment

The life insurance helps to accumulate adequate funds to make adjustment in standard of living, at the time of reduction in income due to loss of employment, disability, death retirement etc.

11. Helpful in Education

There are several life insurance policies, and annuities which are useful for education of the children irrespective of the death or survival of the family head.

12. Assist in Marriage

The life insurance can provide funds for the marriage of daughter if a appropriate policy is taken for this purpose. The daughter may remain unmarried in case of death of father due to inadequate provision for meeting the expenses of marriage.

13. Help in Family Requirement

After death, ritual ceremonies, payment of wealth tax and income tax, are certain requirements which decrease the amount of funds of the family member. Insurance comes to help for meeting these requirements.

Q8. What are the features of life insurance?

Ans :

1. Like other contracts of insurance, the life insurance contract is also the outcome of an offer made by the insured and its acceptance by the insurer. Usually, contract of life insurance is made in writing.
2. The insurance company agrees to pay a certain sum of money either on the death of the insured or on the maturity of the policy, whichever is earlier.
3. The insured is under obligation to pay periodically the amount of payment till the death of insured or expiry of the period of policy, whichever is earlier.
4. The contract of life insurance is not a contract of indemnity because the loss caused by the death cannot be calculated in money terms, nor is money any compensation for loss of one's life.
5. Insurable interest must be present in the person insured at the time when the policy is taken in case of life insurance, which may or may not be present at the time of insured's death.
6. Life insurance extends the hand of protection to those who are left support less and helps financially in case of death of the insured. It is also considered to be the best alternative for making savings.

7. Life insurance covers under scope certain other risks which are connected with the human life in addition to the risk of death. For example, in case of total and permanent disability or the living death, temporary disability and medical expenses, compulsory retirement or the economic death risks, etc., have also been covered under the purview of life insurance these days.
8. It relieves the insured from the sword of Damocles *i.e.* various risks and uncertainties which may occur before and after the death of the insured.

Q9. Explain the merits and demerits of life insurance.

Ans :

Merits

The following are the advantages of life insurance:

1. Life insurance policy as a security offers guaranteed payment as it is conducted by LIC which is a government undertaking.
2. The loan becomes self-liquidating in case of death of the borrower.
3. the banker is legally assigned with the policy and the assignment is registered with LIC.
4. If the premium is paid regularly, then the surrender value of a life insurance policy increases with time.
5. The banker can easily supervise the payments of premium.

Demerits

The following are the disadvantages of life insurance:

1. If the assured commits suicide in one year from the policy's date then the security becomes void and null due to the 'suicide clause' of LIC.

2. If the insured could not pay the premium on regular basis then the policy will be lapsed.
3. The assured person must make complete disclosure of all the facts to the insurer and if he hides any material fact then the insurance company can avoid the claim under the policy. That's why a contract of life insurance is a contract of utmost good faith (uberrimae fidei).
4. Most of the bankers do not advance loans against life policies due to unsatisfactory nature of law related to question of assignment.

Q10. Explain the merits and demerits of general insurance.

Ans :

Merits

The merits of general insurance are as follows:

1. Under general insurance policy, actual loss can be measured. Therefore, insured is paid with the amount equal to the extent of loss occurred.
2. It maintains reserve for unexpired risk.

Demerits

The demerits of general insurance are as follows:

1. General insurance is a short-term contract and its premium varies with the renewal of contract.
2. In general insurance, no such specification is made regarding surrender value or paid up value.

Q11. Compare and contrast life insurance and general insurance.

Ans :

S.No.	Nature	Life Insurance	General Insurance
1.	Contract	Life insurance is not a contingent contract.	General insurance is a contingent contract
2.	Objective	The objective of life insurance policy is to provide protection and encourage the investment of savings.	The objective of general insurance policy is to provide security against the risk.
3.	Period and Premium	Life insurance is a long-term contract and its premium remains fixed throughout the contract.	General insurance is a short-term contract and its premium varies with the renewal of contract.
4.	Indemnity	Under life insurance policy, actual loss occurred on the death of a person is not possible to measure. Because of this, an insured amount of policy is payable.	Under general insurance policy, actual loss can be measured. Therefore, insured is paid with the amount equal to the extent of loss occurred.
5.	Risk	In life insurance policy, risk associated with the life of the individual increases with the growing age of a person.	In general insurance policy, risk of loss increases with the passage of time.
6.	Amount of Claim	In life insurance policy, full amount of policy is paid either at the event of maturity or death whichever is earlier.	In general insurance policy, amount of policy is paid either to the extent of loss suffered by an individual or the sum assured by a party which ever is low.
7.	Surrender Value	It contains a specified amount of surrender value or paid up value.	In general insurance, no such specification is made regarding surrender value or paid up value.
8.	Reserve for Unexpired	It does not maintain any reserve for unexpired risk.	It maintains reserve for unexpired risk.

4.4 BENEFITS AND COSTS OF INSURANCE TO SOCIETY

Q12. Explain the benefits and costs of insurance to society.

(OR)

What are the benefits and costs of insurance to society?

Ans : (June-19, Aug.-18)

(A) Benefits of Insurance to Society

People live in society. Society is full of risks and uncertainty. Insurance is a social device providing financial compensation to those who suffer from misfortune. Such payment being made forms accumulated contribution of all parties participating in the scheme. Insurance provides stability in the society by necessary arrangement of security against loss from unexpected risks. Society becomes more peaceful and safe by insurance, which provides different benefits and financial security against losses from risks. The major benefits of insurance to society are given below.

- 1. Indemnification for Loss :** All members of society are facing different risks. If risks are insured, all losses occurred from unexpected risks are indemnified. Indemnification permits individuals and families to be restored to their former financial state after loss occurs. As a result, they can maintain their financial security.
- 2. Fewer Burdens to Society :** Because insureds are restored either in part or in whole after a loss occurs, they are less likely to apply for public assistance welfare benefits, or to seek financial assistance from relatives and friends. So other members of the society need not help the unlucky member even after suffering from loss. If the individual has not insured the risk, the relatives and friends should support him financially, when he becomes an unlucky victim from the risks.
- 3. Source of Investment Funds :** Insurance is a business of collection of funds and payment to insureds suffered from unexpected incidents. Hence, insurance industry accumulates funds as premium from

society and become an important source of funds for capital investment. Insurance companies collect premiums in advance of the loss and funds not needed to pay immediate losses can be loaned to business firms. Generally, insurance companies invest such funds typically in shipping centers, hospitals, factories, housing development etc. In this way, insurance industry creates capital fund and promotes economic development of a country.

- 4. Less worry and Fear :** Another benefit of insurance to society is that it decreases the worry and fear of members of society regarding the risk of accident and premature death. If family heads have adequate amounts of life insurance, they are less likely to worry about the financial security of their dependents in the event of premature death. Similarly, businessmen who are insured enjoy greater peace of mind because they know are covered if a loss occurs.
- 5. Prevention of loss :** When losses occur from risks, the insurer has to indemnify them financially. Since loss of insured is transferred to insurer in the insurance policy, the insurance company should bear the risks. It means occurrence of loss from the risks is the loss of the insurer, not of the insured. Hence, the prevention as well as now becomes the interest of the owner of the property as well as the insurance company. That is why, insurance companies are actively involved in numerous programs about loss-prevention. They employ a wide specialists in fire prevention, occupational safety engineers and specialists in fire prevention, occupational safety and health, and products liability. Some important loss prevention activities that insurers strongly support include the following programs.
 - (a) Prevention of Fire
 - (b) Prevention of boiler explosion
 - (c) Prevention of auto thefts
 - (d) Prevention of defective products
 - (e) Prevention of arson losses
 - (f) Reduction of road accident and death

- (g) Reduction of work related disabilities
- (h) Educational programs on loss prevention

(B) Costs of Insurance To Society

1. Cost of doing Business

Like any other business insurance companies also need resources like land, capital, labour and organization. The resources that are scarcely available to the society are consumed by insurance companies. The effect is that insureds have to pay for the insurance administration expenses in addition to the pure premium. 22% of the premium is accounted for sales and administration expenses of the insurer. Say, the cost to society is 100, then with insurance, the costs to society increase to 122.

However, this economic cost is justified if insurance can reduce the uncertainty of payment of a covered loss. Moreover, insurers provide jobs to millions and also conduct loss prevention activities.

2. Cost of Fraudulent and Inflated Claims

A major cost of insurance is that of indemnifying fraudulent and inflated claims. Consider the following fraudulent claims,

- Fake automobile accidents to collect insurance benefits.
- Fake slip and fall accidents.
- Dishonest and fake burglaries, theft reported to insurers.
- Fake health insurance claims.
- Policy owners fraudulently taking life insurance policies on dead relatives.

The payment of such fraudulent claims results in higher premiums to all insureds. The existence of insurance policy also allows some insureds to cause a deliberate loss in order to earn profits from such policies.

Inflated claims refer to the amount of claim exaggerated in an unintentional financial loss. Following are some of the examples of inflated claims,

- Legal representatives suing for high liability judgements above actual loss of the victims.
- Disabled insured exceeding the period of disability to collect disability income for long.
- Exaggerating the amount of loss due to theft and robbery.

Insurers paying such fraudulent and inflated claims, charge high premium from all the insureds. A direct effect of this on society is that the disposable income and consumption of goods and other services reduces.

4.5 FUNDAMENTAL LEGAL PRINCIPLES OF INSURANCE

Q13. Write the fundamental legal principles of insurance.

(OR)

Briefly explain the fundamental legal principles of insurance.

Ans : (Nov.-20, June-18)

1. Nature of contract

Nature of contract is a fundamental principle of insurance contract. An insurance contract comes into existence when one party makes an offer or proposal of a contract and the other party accepts the proposal.

A contract should be simple to be a valid contract. The person entering into a contract should enter with his free consent.

2. Principle of utmost good faith

Under this insurance contract both the parties should have faith over each other. As a client it is the duty of the insured to disclose all the facts to the insurance company. Any fraud or misrepresentation of facts can result into cancellation of the contract.

3. Principle of Insurable interest

Under this principle of insurance, the insured must have interest in the subject matter of the insurance. Absence of insurance makes

the contract null and void. If there is no insurable interest, an insurance company will not issue a policy.

An insurable interest must exist at the time of the purchase of the insurance. For example, a creditor has an insurable interest in the life of a debtor, A person is considered to have an unlimited interest in the life of their spouse etc.

4. Principle of indemnity

Indemnity means security or compensation against loss or damage. The principle of indemnity is such principle of insurance stating that an insured may not be compensated by the insurance company in an amount exceeding the insured's economic loss.

In type of insurance the insured would be compensation with the amount equivalent to the actual loss and not the amount exceeding the loss.

This is a regulatory principal. This principle is observed more strictly in property insurance than in life insurance.

The purpose of this principle is to set back the insured to the same financial position that existed before the loss or damage occurred.

5. Principal of subrogation

The principle of subrogation enables the insured to claim the amount from the third party responsible for the loss. It allows the insurer to pursue legal methods to recover the amount of loss, For example, if you get injured in a road accident, due to reckless driving of a third party, the insurance company will compensate your loss and will also sue the third party to recover the money paid as claim.

6. Double insurance

Double insurance denotes insurance of same subject matter with two different companies or with the same company under two different policies. Insurance is possible in case of indemnity contract like fire, marine and property insurance.

Double insurance policy is adopted where the financial position of the insurer is doubtful. The insured cannot recover more than the actual loss and cannot claim the whole amount from both the insurers.

7. Principle of proximate cause

Proximate cause literally means the 'nearest cause' or 'direct cause'. This principle is applicable when the loss is the result of two or more causes. The proximate cause means; the most dominant and most effective cause of loss is considered. This principle is applicable when there are series of causes of damage or loss.

4.6 FUNCTIONS OF INSURER

Q14. Discuss the various functions of Insurer.

(OR)

What are the Functions of Insurer?

Ans : (June-18)

1. Production

The main function of an insurer is to retain and secure the applicants in order to maintain the operational ability of the firm. Production function in an insurance firm is similar to that of sales/marketing in other sectors. As insurance is an intangible product, it is not possible to realise the sales before selling the policy. Insurance company have a production sales management department to manage the relations with agents and customers. They need to recruit, train and monitor the performance of sales executives/ agents. In addition to production sales department, insurance company also have market research departments in order to direct the production sales department in planning the capacity of market, advertising campaign, surveys (to determine customer preferences), purchasing capacity and estimating the future sales of the company.

2. Underwriting

The process of identifying and classification of the risks involved in the insurance policies

is termed as underwriting. Insurer should act as an underwriter to select the qualified applicants with minimum risk. Applicants with risk less than average standards can be offered the insurance policies. In property and liability insurance agents are provided with an underwriting authority whereas, in life insurance policy agents are mostly not provided with underwriting activities but they need to assess the risks associated with prior to their screening by actual underwriter?)

3. Investing and Financing Investing

Insurers will receive funds in the form of premium from the policy holders and he need to pay the total amount at the end of maturity period. Along with these funds, insurer also have paid-up capital, surplus loss reserves etc. Insurers should maintain an investment department in order to manage these funds and their investment using proper medium as the income from these investments constitute the profit of an insurer. The solvency of an insurer in case of life insurance policies is affected by the minimum guaranteed amount/returns on assets. Whereas, in case of property and liability insurance, the profit of the insurers to meet underwriting losses depends on the income/return on investments.

4. Accounting and Record Keeping

Insurer also acts as an accounting manager to assist the management in formulating the policies by recording, analysing, classifying and interpreting the financial data of the company. The accounting functions of an insurer are similar to those of other firms. Financial reports of insurance sector should follow separate accounting standards called Statutory Accounting Principles (SAP).

5. Miscellaneous Functions

The miscellaneous functions of an insurer includes,

- (i) **Legal Advisor:** Insurer acts as a legal advisor to guide the underwriter to frame the policies and endorsements according to the rules and regulations. It is necessary to maintain a legal advisor to resolve the disputes regarding the

claims and other legal issues associated with the policies.

- (ii) **Marketing Research:** Insurer acts as a marketing research manager in order to direct the production department in planning the market activities. The activities involved in market research are testing the performance of advertising campaign, understanding customer preferences and tastes, their purchasing capacities etc.

- (iii) **Engineering Services:** Insurer needs to perform the engineering activities in order to assist the rate making and underwriting activities.

Q15. State the types of insurer.

Ans :

(a) Classification Based on the Type of Insurance

Based on the type of insurance product, insurers are categorized into a three types,

(i) Life Insurers

Insurers who are engaged in selling life insurance policies are called life insurers. In addition to life insurance policies, life insurers also sell annuities and health insurance policies.

(ii) Property and Liability Insurance Companies

Insurers who are engaged in selling property and liability insurance are called property and liability insurers. They do not consider the health insurance contracts.

(iii) Health Insurers

Insurers associated with health insurance are called health insurers or speciality insurers. They emphasis more on one area of risk. Some groups of speciality risks are included in property and liability insurance.

(b) Classification based on the Place of Incorporation and License

Based on the place of incorporation, insurers are categorized into three types,

(i) Domestic Insurer

Domestic insurer is an insurer who has

incorporated the insurance company in their local state and under the law of that state.

(ii) Foreign Insurer

Insurer who has incorporated the company in another state and under the law of other state are called foreign insurer.

(iii) Aleign Insurer

Insurer of one country who has incorporated the company in other country is called aleign insurer.

Insurers are classified into two types based on the licensing status of an insurer.

(a) Licensed/admitted insurer

(b) Unlicensed/non-admitted insurer.

(a) Licensed Insurer: An insurer who has been granted licence for proceeding insurance operations in a particular state is called admitted insurer.

(b) Unlicensed Insurer: An insurer who has not been granted licence for proceeding insurance operations in a particular state is called unlicensed insurer

The licensed insurance agents should represent only licensed insurer.

(c) Classification based on Legal form of Ownership

Based on the legal form of ownership, insurers are classified into six types,

(i) Stock Insurers

The insurance companies in which the ownership is held by the stock holders are called stock insurers. Stock holders share the profits and losses of the stock insurers. The characteristics of stock insurers include,

- Stock insurers issue only non-assessable policies i.e., it does not require any additional premium to cover the losses and expenses, if the loss is exactly predictable.
- The additional expenses can be covered by stock holders.

➤ Stock insurers do not force the policy holders to maintain provisions for contingent liabilities.

➤ Stock holders only elect the board of directors to operate the company.

➤ Stock insurers will share the profits with stock holders in the form of dividends in case of surplus profits.

(ii) Mutual Insurers

The insurance companies in which the ownership is held by policy holders are called mutual insurers. Unlike stock insurers, in mutual insurance companies, policy holders select the board of directors to operate the mutual insurance company.

(iii) Reciprocals

Reciprocals are the private multiple line insurers which are not incorporated. Reciprocals consist of a group of individuals called "subscribers". Reciprocals are also called "interinsurance companies".

Reciprocals are of 2 types,

1. **Pure Reciprocals:** Pure reciprocals are the traditional reciprocals for which separate account should be maintained for each subscriber to credit the premium and profit share and to debit the shared assets and expenses.
2. **Modified Reciprocals:** Modified reciprocals are the modern reciprocals which are similar to advance premium mutual insurer except in having an administrator.

(iv) Lloyd's Association

Lloyd's associations provide a source of insurance contracts but does not include underwriting activities.

They are of two types,

1. Lloyd's of London
2. American Lloyd's

1. **Lloyd's of London:** Lloyd's of London are the professional insurers offering ocean marine insurance across the

world. They can take variety of risks associated with the insurance contracts.

2. **American Lloyd's :** American Lloyd's are similar to Lloyd's of London which consists of a group of private underwriters of America.

(v) **Health Expense Associations**

Health expense associations are associated with health insurance contracts and included two types of associations. They are,

1. **Blue Cross Association:** These are non-profit organizations associated with the advance payment of expenses incurred for hospital services. These associations are licensed under the law of the state.
2. **Blue Shield Plans:** These associations are also non-profit organizations associated with the advance payment of the, physician expenses, surgeon fees etc. These are licensed under the law of states and by the local physicians.

4.7 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Q16. Discuss about Insurance Regulatory and Development Authority.

Ans :

The Insurance Regulatory and Development Authority is the main organization or supervisory body that regulates the insurance sector in the country. It sets rules and regulations for the functioning of the insurance industry. Its sole purpose is to protect the interest of policyholders and to develop the industry on the whole.

The IRDA or IRDAI regularly issues advisories to insurance companies in case of changes to the rules and regulations.

Establishment

The Government of India was the regulator for the insurance industry until 2000. However, to institute a stand-alone apex body, the IRDA was established in 2000 following the recommendation of the Malhotra Committee report in 1999. In

August 2000, the IRDA began accepting applications for registrations through invites and allowed companies from other countries to invest up to 26% in the market.

The IRDA has outlined several rules and regulations under Section 114A of the Insurance Act, 1938. Regulations range from registration of insurance companies for operating in the country to protecting policyholder's interests. As of September 2020, there are 31 General Insurance companies and 24 Life Insurance companies who are registered with the IRDA.

Objectives

The main objective of the Insurance Regulatory and Development Authority of India is to enforce the provisions under the Insurance Act. The mission statement of the IRDA is:

1. To protect the interest and fair treatment of the policyholder.
2. To regulate the insurance industry in fairness and ensure the financial soundness of the industry.
3. To regularly frame regulations to ensure the industry operates without any ambiguity.

Q17. What are the features of IRDA ?

Ans :

The following are salient features of the IRDA Act (1999),

1. The insurance sector in India has been thrown open to the private sector. The second and third schedules of the act provide for removal of existing corporations (or companies) to carry out the business of life and general (non-life) insurance in India.
2. An Indian insurance company is a company registered under the Companies Act, 1956, in which foreign equity does not exceed 26 percent of the total equity shareholding, including the equity shareholding of NRIs, FIIs and OCBs.
3. After commencement of an insurance company, the Indian promoters can hold more than 26 percent of the total equity holding for a period of ten years, the balance

- shares being held by non-promoter Indian shareholders which will not include the equity of the foreign promoters and the shareholding of NRIs, FIIs and OCBs.
4. After the permissible period of ten years, excess equity above the prescribed level of 26 percent will be dis-invested as per a phased programme to be indicated by IRDA. The central government is empowered to extend the period of ten years in individual cases and also to provide for higher ceiling on share holding of Indian promoters in excess of which disinvestment will be required.
 5. On foreign promoters, the maximum of 26 percent will always be operational. They will thus be unable to hold any equity beyond this ceiling at any stage.
 6. The act gives statutory status for the Interim Insurance Regulatory Authority (IRA) set up by the central government through a resolution passed in January 1996.
 7. All the powers presently exercised under the Insurance Act, 1938, by the Controller of Insurance (Col) will be transferred to the IRDA.
 8. The IRDA act also provides for the appointment of Col by the central government when the regulatory authority is superseded.
 9. The minimum amount of paid-up equity capital is Rs. 100 crores in case of life insurance as well as general insurance and Rs. 200 crores in the case of reinsurance.
 10. Solvency margin (excess of assets over liabilities) is fixed at not less than Rs. 50 crores for life as well as general insurance, for reinsurance solvency margin is stipulated at not less than Rs. 100 crores in each case.
 11. Insurance companies will deposit Rs. 10 crores as security deposit before starting their business.
 12. In the non-life sector, IRDA would give preference to companies providing health insurance.
 13. Safeguards for policy holders' funds include specific provision prohibiting investment of policy holders' funds outside India and provision for investment of funds in accordance with policy directions of IRDA, including social and infrastructure investments.
 14. Every insurer shall provide life insurance or general insurance policies (including insurance for crops) to the persons residing in the rural sector, workers in the unorganised or informal sector or for economically vulnerable or backward classes of the society and other categories of persons as may be specified by regulations made by IRDA.
 15. Failure to fulfill the social obligations would attract a fine of Rs. 25 lakhs, in case the obligations are still not fulfilled, licence would be cancelled.
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- Q18. What are the duties and responsibilities of IRDA?**
- Ans :** **(Aug.-21, Imp.)**
- Under Section 14 of the IRDA Act, the authority's duty is to regulate, promote and to ensure an orderly growth of the insurance and the re-insurance business.
- Under sub-Section 1 of Section 14 of the IRDA Act, the authority has the following duties and responsibilities :
- 1. Registration**
Issuance of certificate of registration, or to renew, modify, withdraw, suspend or cancel such registration.
 - 2. Protection**
Protection of the interests of 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 in contracts of insurance.
 - 3. Qualification**
Specifying the requisite qualifications, code of conduct and practical training for insurance intermediaries and agents.

4. Code of Conduct

Specifying the code of conduct for surveyors and loss assessor.

5. Efficiency

Promoting efficiency in the conduct of the insurance business.

6. Professionalism

Promoting and regulating professional organizations connected with the insurance and re insurance business.

7. Fees

Levying fees and other charges for carrying out the objectives of this act.

8. Information

Calling for information from, undertaking inspection of, and conducting enquiries and investigations, including audit of the insurers, intermediaries, insurance intermediaries and other organizations connected with the insurance business.

9. Terms of Business

Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers for general insurance, business not so controlled and regulated by the Tariff Advisory Committee under Section 64U of the Insurance Act, 1938 (4 of 1938).

10. Books of Accounts

Specifying the form and the manner in which books of account shall be maintained, and statement of accounts shall be rendered by insurers and other insurance intermediaries.

11. Funds Investment

Regulating investment of funds by insurance companies.

12. Margin of Solvency

Regulating the maintenance of margin of solvency.

13. Adjudication

Adjudication of disputes between insurers and intermediaries or insurance intermediaries.

14. Supervising

Supervising the functioning of the Tariff Advisory Committee.

15. Premium Income

Specifying the percentage of the premium income going into finance schemes for promoting and regulating professional organizations pursuing assurance business.

16. Rural and Social Insurance

Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector.

17. Others

Exercising other powers as may be prescribed.

Q19. What are the functions of IRDA?

(OR)

Explain the functions of IRDA.

Ans : (Aug.-18)

The important functions of the IRDAI in the insurance industry in India:

1. Grant, renew, modify, suspend, cancel or withdraw registration certificates of the insurance company.
2. Protecting the interests of the policyholder in matters concerning the grant of policies, settlement of claims, nomination by policyholders, insurable interest, surrender value of the policy and other terms and conditions of the policy.
3. Specify code of conduct, qualifications and training for intermediary or insurance agents.
4. Specify code of conduct for loss assessors and surveyors.
5. Levying fees and charges for carrying out the provisions of the Act.

6. Undertaking inspection, calling for information, and investigations including an audit of insurance companies, intermediaries, and other organizations associated with the insurance business.
7. Regulate and control insurance rates, terms and conditions, advantages that may be offered by the insurance providers.

Q20. Discuss the regulations of IRDA regarding claim settlement.

Ans : (Imp.)

The regulations provided by IRDA relating to claim payment/settlement are as follows,

1. Insurance company must demand all requirements in case of death claim at one time rather in steps.
2. Within 30 days of receiving death claim papers, insurer must make decision whether to accept or reject a death claim.
3. Within six months all the required investigation must be completed.
4. An interest at 2% over bank rate is paid to claimant in case of any delay in claim settlement because to insurer.
5. On receipt of all the requirements, payment must be made within 7 days.
6. If there is any delay in claim from claimant then investigation must be done.

Circular Issued By IRDA for Health Insurance Claim Settlement

On 19th March 2021, IRDA issued a circular for health insurance claims settlement. It includes the following points,

1. It is essential that all insurers establish procedures to let policyholders get clear and transparent communication at various stages of claim processing. As specified in the within

referred circular dated 10.4.2019, all the insurers shall ensure putting in place systems to enable policyholders track the status of cashless requests/ claims filed with the Insurer/ TPA through the Website/Portal/App or any other authorized electronic means on an ongoing basis. The status shall cover from the time of receipt of request to the time of disposal of the claim along with the decision thereon.

2. Where claims are processed through TPAs, the insurers are permitted to let their respective Third Party Administrators operationalize the claim tracking mechanism. The policyholders shall be invariably notified in all the communications, the location to track the claim status.
3. Insurer shall ensure that the repudiation of the claim is not based on "presumptions and conjectures". As specified in the IRDAI (Health Insurance) Regulations, 2016, where a claim is denied or repudiated, the communication about the denial or the repudiation shall be made only by the Insurer by specifically stating the reasons for the denial or repudiation, while necessarily referring to the corresponding policy conditions. The insurer shall also furnish the grievance redressal procedures available with the Insurance Company and with the Insurance Ombudsman along with the detailed addresses of the respective offices. Claims shall be processed in a transparent, seamless and efficient manner within the prescribed timelines.
4. Insurer shall also ensure that the policyholder is provided with granular details of the payments made, amounts disallowed and the

reasons for the amount disallowed as specified in the within referred provisions of IRDAI (Third Party Administrators - Health Services) Regulations, 2016.

5. Insurers and TPAs, wherever applicable, are advised to ensure compliance of these instructions without fail.

This has the approval of the competent authority.

Circular Issued By IRDA for Covid-19 Pandemic situation

On 23rd March, 2020 IRDA issued a circular related to the Covid-19 Pandemic situation. It provide instructions to all the life insurers.

This has reference to various measures being taken by Central and State Governments including lockdown of certain states impacting the normal functioning of offices and the possible difficulties to policyholders in accessing various services including timely payment of premium, settlement of claims. In this regard the following directions are being issued under Section 34(1)(a) of the Insurance Act, 1938.

1. Functioning of Offices

Following points highlights the functioning of offices with Regard to Covid-19,

- (a) Safety and well-being of employees and policyholders is to be treated as top priority and necessary arrangements are to be made.
- (b) The instructions of the Central and State Governments and local authorities in this regard may be followed scrupulously.
- (c) Wherever the offices are not functioning fully/partially, the policyholders may be notified by SMS, E-mail and/or Press Release in addition to suitable display in

the branch office. Policyholders may also be informed about other alternate channels for payment of premiums, submission of claim and other service requests/requirements. The services of call centers wherever appropriate may be used.

- (d) The web site of Life Insurers shall be updated with all the information including list of offices not functioning and alternate arrangements for policyholder servicing, contact phone numbers, if any, for emergency needs.

2. Grace Period for payment of Premiums

For premiums due in the month of March 2020, the Grace Period shall stand extended by one more month in the areas where lockdown has been declared by state government.

3. Claim Payments with Regard to Covid-19

Following points highlights the Claim Payments with Regard to Covid-19,

- (a) Any claims received may be settled expeditiously. Life Insurers may consider developing quicker claim settlement process to suit the emerging situation in the affected areas.
- (b) Information to be provided in the respective websites about admissibility or otherwise of Covid-19 death claims, for all products covering the contracts already issued.
- (c) Specific Information, product wise, related to any health insurance contracts already issued, regarding admissibility or otherwise of Covid-19 claims to be provided in the website

4. Periodic Reports

A report every fortnight may be submitted to the Authority giving the details of offices fully/partially closed with duration and steps taken in this regard. Data in respect of claims related to Covid-19 may be maintained separately to be submitted to Authority as and when called for. This is issued with the approval of the competent authority.

Circular for All General and Health Insurers

On 23rd April, 2021 IRDA issued a circular for all general and health insurers (Except ATC and ECGC). It includes following points,

1. There are reports of certain network providers (hospitals) charging high rates and insisting on cash payments from the policyholders for providing treatment to COVID-19 infected patients despite having cashless arrangement with insurers.
2. In compliance with the provisions of Regulation 31 Of IRDAI (Health Insurance) Regulations, 2016, the Insurers, in case of "cashless claim" under a health insurance policy, are advised to ensure expeditious settlement of such claims on cashless basis in accordance to the Service Level Agreements (SLAs) entered with hospitals.
3. While reviewing cashless requests the insurers are also advised to ensure that the policyholders are charged as per the rates agreed to by network providers wherever applicable. Insurers are also advised to ensure that hospitals do not levy any additional charges for the same treatment other than those rates that are agreed with the insurers.
4. In order to ensure that all network providers extend cashless services to policyholders and to address any issues causing inconvenience to policyholders while availing cashless service, the Insurers are advised to put in place an effective communication channel with all the network providers for prompt resolution

of grievances of policyholders. Insurers are advised to report levying of excess charges or denial of cashless facility to the respective State governments for appropriate action.

5. All insurers are directed to ensure that the "reimbursement claims" under a health insurance policy shall be settled as per the terms and conditions of the respective policy contract expeditiously. Insurers are advised to issue suitable guidelines on this to all TPAs.
6. This has the approval of the competent authority.

4.8 RECENT TRENDS IN INSURANCE SECTOR IN INDIA

Q21. Discuss the recent Trends in Insurance Sector in India.

(OR)

State the recent Trends in Insurance Sector in India.

Ans : (June-19, Aug.-17)

1. Increased Usage of Internet of Things

Insurers are increasingly using internet of things for many reasons such as identification of risk or customer requirements etc. Low cost of sensors, increased data processing power and advanced methods of communication enable the increased use of internet of thing.

2. Acquiring Big Data

Insurers are using big data from different sources such as social media and gathering insights. These sources enable faster claims processing and fraud detection.

3. Using Aerial and Digital Imagery

For quick claims processing, insurers are using aerial and digital imagery for assessing losses and damages of lands or properties.

4. Shift from Auto-insurance to Usage-based Insurance

Advanced technologies like GPS, G-force tracking, accelerometers etc., in smartphones, telematics systems in cars or vehicles and other value-added services which are built for customer safety, influence the insurers to shift from auto-insurance to usage-based insurance. With the help of these technologies insurers can improve their claim handling capabilities and can carryout better customer segmentation.

5. Applying Gamification Processes

Insurers are using gamification processes to deal with the complex processes, to improve internal training and to enhance consumer engagement and loyalty.

6. Non-traditional Firms Entering into the Insurance Industry

Non-traditional firms can improve their huge customer base, capital availability, and data processing power by entering into the insurance industry in the form of partnerships, joint ventures, alliances or acquisitions.

7. Concept of Peer-to-Peer Insurance

The concept of peer-to-peer insurance reduces the cost of insurance and makes the uninsured people to buy the insurance policy. The insurance companies may face a tough competition if this model is adopted by majority of firms.

8. Focus on m-Health Application

The m-Health application is very effective which controls and improves the customers health and reduces their spendings on health care. Therefore, the insurers are emphasizing on m-Health apps which enables them to understand customer's risk profile.

Short Question and Answers

1. General Insurance.

Ans :

It refers to insurance of products excluding life insurance. The companies which offers the non-life insurance must pay for losses or damages caused to the insured party.

2. Explain the basic characteristics of insurance.

Ans :

Insurance follows important characteristics - These are follows

(i) Sharing of risk

Insurance is a co-operative device to share the burden of risk, which may fall on happening of some unforeseen events, such as the death of head of family or on happening of marine perils or loss of by fire.

(ii) Co-operative device

Insurance is a co-operative form of distributing a certain risk over a group of persons who are exposed to it. A large number of persons share the losses arising from a particular risk

(iii) Large number of insured persons

The success of insurance business depends on the large number of persons Insured against similar risk. This will enable the insurer to spread the losses of risk among large number of persons, thus keeping the premium rate at the minimum.

(iv) Evaluation of risk

For the purpose of ascertaining the insurance premium, the volume of risk is evaluated, which forms the basis of insurance contract.

(v) Payment of happening of specified event

On happening of specified event, the insurance company is bound to make payment to the insured. Happening of

specified event is certain in life insurance, but in the case of fire, marine or accidental insurance, it is not necessary. In such cases, the insurer is not liable for payment of indemnity.

(vi) Transfer of risk

Insurance is a plan in which the insured transfers his risk on the insurer. This may be the reason that many persons observe, that insurance is a device to transfer some economic losses would have been borne by the insured themselves.

3. What are the Functions of Insurer?

Ans :

(i) Production

The main function of an insurer is to retain and secure the applicants in order to maintain the operational ability of the firm. Production function in an insurance firm is similar to that of sales/marketing in other sectors. As insurance is an intangible product, it is not possible to realise the sales before selling the policy. Insurance company have a production sales management department to manage the relations with agents and customers. They need to recruit, train and monitor the performance of sales executives/agents. In addition to production sales department, insurance company also have market research departments in order to direct the production sales department in planning the capacity of market, advertising campaign, surveys (to determine customer preferences), purchasing capacity and estimating the future sales of the company.

(ii) Underwriting

The process of identifying and classification of the risks involved in the insurance policies is termed as underwriting. Insurer should act as an underwriter to select the qualified applicants with minimum risk. Applicants with

risk less than average standards can be offered the insurance policies. In property and liability insurance agents are provided with an underwriting authority whereas, in life insurance policy agents are mostly not provided with underwriting activities but they need to assess the risks associated with prior to their screening by actual underwriter?)

(iii) Investing and Financing Investing

Insurers will receive funds in the form of premium from the policy holders and he need to pay the total amount at the end of maturity period. Along with these funds, insurer also have paid-up capital, surplus loss reserves etc. Insurers should maintain an investment department in order to manage these funds and their investment using proper medium as the income from these investments constitute the profit of an insurer. The solvency of an insurer in case of life insurance policies is affected by the minimum guaranteed amount/returns on assets. Whereas, in case of property and liability insurance, the profit of the insurers to meet underwriting losses depends on the income/return on investments.

(iv) Accounting and Record Keeping

Insurer also acts as an accounting manager to assist the management in formulating the policies by recording, analysing, classifying and interpreting the financial data of the company. The accounting functions of an insurer are similar to those of other firms. Financial reports of insurance sector should follow separate accounting standards called Statutory Accounting Principles (SAP).

4. Types of Insurance.

Ans :

Insurance is broadly classified into two types:

1. Life Insurance
2. General Insurance

1. Life Insurance

Life insurance (or life assurance, especially in the Common wealth), is a contract between

an insurance policy holder and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the benefit) in exchange for a premium, upon the death of an insured person (often the policy holder). Depending on the contract, other events such as terminal illness or critical illness can also trigger payment. The policy holder typically pays a premium, either regularly or as one lump sum. Other expenses (such as funeral expenses) can also be included in the benefits. Life policies are legal contracts and the terms of the contract describe the limitations of the insured events. Specific exclusions are often written into the contract to limit the liability of the insurer; common examples are claims relating to suicide, fraud, war, riot, and civil commotion.

2. General Insurance

It refers to insurance of products excluding life insurance. The companies which offers the non-life insurance must pay for losses or damages caused to the insured party.

5. Reinsurance.

Ans :

Reinsurance is a method where by the original insurer transfer all or part of risk he has assumed to another company or companies with the object of reducing his own commitment to an reducing his own commitment to an amount that he can bear for his own account commensurate with his financial resources in the event of loss. It was originally confined to offers and acceptances on individual risk known as facultative reinsurance transactions.

6. Disadvantages of Insurance.

Ans :

Besides a number of benefits, insurance has also some limitations.

- Insurance leads to negligence as the insured feels that he/she can be compensated for any loss or damage.

- Insurance companies do not make the compensation promptly on maturity of the policy or for the financial losses as the expectation of the insured.
- It may lead to the crimes in the society as the beneficiaries of the policy may be tempted to commit crimes to receive the insured amount.

7. Principle of indemnity.

Ans :

Indemnity means security or compensation against loss or damage. The principle of indemnity is such principle of insurance stating that an insured may not be compensated by the insurance company in an amount exceeding the insured's economic loss.

In type of insurance the insured would be compensation with the amount equivalent to the actual loss and not the amount exceeding the loss.

This is a regulatory principal. This principle is observed more strictly in property insurance than in life insurance.

The purpose of this principle is to set back the insured to the same financial position that existed before the loss or damage occurred.

8. Principal of subrogation.

Ans :

The principle of subrogation enables the insured to claim the amount from the third party responsible for the loss. It allows the insurer to pursue legal methods to recover the amount of loss. For example, if you get injured in a road accident, due to reckless driving of a third party, the insurance company will compensate your loss and will also sue the third party to recover the money paid as claim.

9. Principle of Insurable interest.

Ans :

Under this principle of insurance, the insured must have interest in the subject matter of the insurance. Absence of insurance makes the contract null and void. If there is no insurable interest, an insurance company will not issue a policy.

An insurable interest must exist at the time of the purchase of the insurance. For example, a creditor has an insurable interest in the life of a debtor, A person is considered to have an unlimited interest in the life of their spouse etc.

10. Insurance regulatory and development authority.

Ans :

The Insurance Regulatory and Development Authority is the main organization or supervisory body that regulates the insurance sector in the country. It sets rules and regulations for the functioning of the insurance industry. Its sole purpose is to protect the interest of policyholders and to develop the industry on the whole.

The IRDA or IRDAI regularly issues advisories to insurance companies in case of changes to the rules and regulations.

Establishment

The Government of India was the regulator for the insurance industry until 2000. However, to institute a stand-alone apex body, the IRDA was established in 2000 following the recommendation of the Malhotra Committee report in 1999. In August 2000, the IRDA began accepting applications for registrations through invites and allowed companies from other countries to invest up to 26% in the market.

The IRDA has outlined several rules and regulations under Section 114A of the Insurance

Act, 1938. Regulations range from registration of insurance companies for operating in the country to protecting policyholder's interests. As of September 2020, there are 31 General Insurance companies and 24 Life Insurance companies who are registered with the IRDA.

11. What are the functions of IRDA?

Ans :

The important functions of the IRDAI in the insurance industry in India:

1. Grant, renew, modify, suspend, cancel or withdraw registration certificates of the insurance company.
2. Protecting the interests of the policyholder in matters concerning the grant of policies, settlement of claims, nomination by policyholders, insurable interest, surrender value of the policy and other terms and conditions of the policy.
3. Specify code of conduct, qualifications and training for intermediary or insurance agents.
4. Specify code of conduct for loss assessors and surveyors.

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Choose the Correct Answers

1. Which one of the following does not belong to the main products of life insurance? [d]
(a) Term (b) Whole life
(c) Endowment (d) Personal accident insurance
2. Which one of the following does not belong to the major general insurance private sector companies in India? [b]
(a) Reliance General Insurance (b) The Oriental Insurance Company
(c) Bajaj Allianz General Insurance (d) Royal Sundaram Alliance Insurance
3. When was Life Insurance sector nationalised? [c]
(a) 1947 (b) 1951
(c) 1956 (d) 1959
4. provide the benefit to insured to claim from the insurer any loss incurred due to the negligence of third party. [c]
(a) Principle of utmost good faith (b) Principle of contribution
(c) Principle of subrogation (d) Principle of indemnity
5. The amendments made by IRDA in which of the following acts, [c]
(a) GIC Act, 1972 (b) LIC Act, 1956
(c) Both (a) and (b) (d) MRTTP Act
6. The main purpose of is to prevent gambling and minimize the moral hazard. [c]
(a) Subrogation (b) Utmost good faith
(c) Insurable interest (d) Proximate cause
7. The facts that should not be disclosed by insured are, [d]
(a) Facts that minimize the risk (b) Facts relating to public knowledge
(c) Facts waived by insurer (d) All the above
8. "A contract that pledges payment of an agreed upon amount to the person (or his/her nominee) on the happening of an event covered against" is technically known as [b]
(a) Death coverage (b) Life insurance
(c) Savings for future (d) Provident fund

9. The insurance companies collect a fixed amount from its customers at a fixed interval of time. What is it called? [c]
- (a) Instalment (b) Contribution
(c) Premium (d) EMI
10. Different types of life insurance claims are [d]
- (a) Death claim (b) Maturity claim
(c) Survival Benefit (d) All the above

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Fill in the blanks

1. LIC stand for _____.
2. PLI stand for _____.
3. ULIPs stand for _____.
4. Example of LIC plan _____.
5. Type of Health insurance _____.
6. _____ is the pooling of fortuitous losses by the transfer of risk of insured to insurer.
7. The process of identification and classification of the risks involved in insurance program is called _____.
8. The price paid by the policy holder for the insurance policy is referred as _____.
9. The insurance that pays death benefits to the beneficiaries after the death of the insured is known as _____.
10. IRDA plays a role of a _____ for the insurance industry in India.

ANSWERS

1. Life Insurance Corporation
2. Postal Life Insurance
3. Unit linked policy
4. Money Back policy
5. Group Health Insurance
6. Insurance
7. Underwriting
8. Premium
9. Life insurance
10. Regulator

UNIT V

OTHER FINANCIAL SERVICES:

- (a) Factoring and bill discounting concept, process and forms. Functions of a factor. Legal aspects of factoring and bill discounting. Financial evaluation of factorial services – cost of factoring – decision analysis for factor services. Factoring scenario in India.
- (b) Credit rating concept and utility. Credit rating agencies in India and their performance. Financial dimensions of crediting rating methodology. Types of ratings and symbols.

5.1 FACTORING

5.1.1 Concept

Q1. Define factoring. Explain the features of factoring.

(OR)

What is factoring?

Ans : (Nov.-20, June-19, June-18)

Meaning

Factoring is a fund-based financial service which provides resources to finance receivables and facilitates the collection of receivables. Factoring is defined as a method of financing whereby a company sells its trade debts at a discount to a financial institution. It is a continuous arrangement between a financial institution and a company which sells goods and services to trade customers on credit.

Definition

According to Robert W. Johnson, Factoring is a service involving the purchase by a financial organization, called a factor of receivables owned to manufacturers and distributors by their customers with the factor assuming full credit and collection responsibilities.

Factoring means an arrangement between a factor and his client which includes at least two of the following services :

- (a) Finance
- (b) Maintenance of accounts
- (c) Collection of debts
- (d) Protection against credit risk

Features

The features of Factoring & Discounting include :

1. Improved Cash Flow

A better cash flow helps to save time and money, leads to greater profits and increases confidence in future planning.

2. Flexibility

Factoring/Discounting is one of the most flexible forms of finance available to business, as the available funds increase with the value of the credit-approved invoices.

3. Costs

Factors/Discounters usually charge a service fee plus interest on funds utilized. The fees depend on volume of sales and the level of services that are provided.

4. Collections

With its professionalism and weight in the marketplace, a Factor can often collect debts more quickly and effectively than a small independent business.

5. Credit Management

The Factor/Discounter can provide the business with regular, up-to-date information on the status of its sales ledger and the performance fits trade debtors.

6. Credit Protection

The Factor/Discounter undertakes credit checks on the business's debtors and may set a rate for credit protection under a non-

recourse arrangement. The Factor/Discounter will pay the business, regardless of whether the invoice has been paid.

7. Credit Assessment

A Factor/Discounter has access to credit reference databases that many businesses may not be able to afford. A Factor / Discounter can advise the business on the credit-worthiness of current and potential debtors.

Q2. What are the objectives of factoring?

Ans :

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realization of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

5.1.2 Process

Q3. Explain the Working Mechanism of Factoring.

(OR)

Explain the process of factoring.

Ans :

A schematic representation of factoring mechanism describing the interaction between the different parties and flow of information between them is explained below:

1. The Buyer

- (a) The terms of purchasing the material with the seller are negotiated by the buyer.

- (b) For making payment to the factor on due date the buyer receives the delivery of goods with invoice and Instructions by the seller.

- (c) The buyer makes payment to factor on time or gets extension of time or in case of default it is influenced by the legal process of factor.

2. The Seller

- (a) A seller enters into a Memorandum of Understanding (MOU) with the buyer in the form of letter which is exchanged between them or an agreement entered into between them.

- (b) The seller sells goods to the buyer according to the MOU.

- (c) The seller performs different activities such as delivers copies of invoice, delivery challan, MOU and gives instructions for making payment to factor which given to buyer.

- (d) The seller for selling the receivables from the buyer to him receives 80 percent or more payment in advance from the factor.

- (e) After deducting the factors service charges etc., the seller receives balance payment from the factor.

3. The Factor

- (a) For the purpose of rendering the factor services, the factor enters into an agreement.

- (b) After receiving the copies of sale documents a payment of 80 percent of the price of the debt, is made to the seller.

- (c) The factor receives payment from the buyer mostly on due dates and after making usual deductions the money is transferred to the seller.

- (d) The factor also assures that the following conditions must be met for influencing the factoring arrangements.

- (i) The documents which are drawn by the seller such as invoice, bills or other documents must include a clause that these payments existing from the transaction are referred to or specified in, must be factored.

- (ii) The seller must ensure in writing to the factor that all the payments existing from these bills are free from any encumbrances, charge, lien, pledge, hypothecation or mortgage or right of set-off or counter-claim from others and so on.
- (iii) The seller who is in favour of the factor must execute an assignment deed to allow him to recover the payment on time or after default.

5.1.3 Forms

Q4. What are the types of factoring?

(OR)

Explain the classification of factoring.

(OR)

Explain different types of factoring.

Ans : (June-19, Aug.-18)

(i) Recourse and Non-recourse Factoring

In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor.

On the other hand, in non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

(ii) Disclosed and Undisclosed Factoring

The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.

Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

(iii) Domestic and Export Factoring

When the three parties to factoring, i.e. customer, client, and factor, reside in the same

country, then this is called as domestic factoring.

Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

(iv) Advance and Maturity Factoring

In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

5.1.4 Functions of a Factor

Q5. Explain the functions of Factoring.

Ans :

A factor performs the following functions :

(a) Administration of Sales Ledger

The factor maintains the client's sales ledgers. On transacting a sales deal, an invoice is sent by the client to the customer and a copy of the same is sent to the factor. The ledger is maintained under the open-term method. The customer's account clearly reflects the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables, receipts of payments from the customers and other useful information.

(b) Provision of Collection Facility

The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection and enables him to concentrate on other important functional areas of his business. This also enables the client to reduce the cost of collection by way of savings in manpower, time and efforts.

(c) Financing Trade Debts

The factor purchases the book debts of his client at a price and the debts are assigned in favour of the factor that is usually willing to grant advance to the extent of 80-85 % of the assigned debts. The balance 15-20 % is retained as a factor reserve.

(d) Credit Control and Credit Protection

This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to purchase all trade debts of the customer without recourse. There are two important benefits to the client. They are,

- (i) Factoring relieves the client of the collection work
- (ii) With access to extensive information available on the financial standing and credit rating of individual customers and their track record of payments

Thus the factor is able to advise the client on the credit worthiness of potential customers leading to better credit control.

(e) Advisory Services

These services are spin-offs of the close relationship between a factor and a client. By virtue of their specialized knowledge and experience in finance and credit dealings and access to extensive credit information, factors can provide a variety of incidental advisory services to their clients.

(f) Cost of Services

The factors provide the various services at a charge. The charge for collection and sales ledger administration is in the form of a commission expressed as a percent of the value of debt purchased. It is collected in advance.

Q6. Explain the advantages and disadvantages of Factoring.

Ans :

Advantages**1. Financial Service**

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash upto 80% immediately as soon as the credit sales are over. The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus he can avail of cash discount facilities also.

2. Collection Service

Collection of debts in a problematic area for many concerns. Delay in collection process often leads to delay in production and supplies. This collection work is completely taken up by the factoring organization, leaving the client to concentrate on production along. The cost of collection is also cut down as a result of the professional expertise of a factor.

3. Credit Risk Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realization of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

4. Provision of Expertise Sales Ledger Management Service

Administration of sales ledger is the factor's responsibility. It is the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Factoring offers an excellent credit control for the client.

5. Consultancy Services

Factors helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters.

Disadvantages**1. The Stigma**

The most common thing small business owners don't know about factoring, Napolitano says, is that their customers are notified when a factor takes the receivables over. "The customers are no longer paying you, they're paying the factoring company," he says. That may alert them to your cash flow trouble.

2. Less Control

Once you accept cash for your receivables, you give up a measure of control. For example, the factoring company could deny your ability to do business with a particular customer because of its poor credit history or rating, says Napolitano.

3. The Cost

While it may be necessary to have immediate access to cash, it will come at higher price than loans. Factoring companies usually keep between 1% and 4% of a receivable as their fee. Additionally, Napolitano says, they charge interest on the cash advance, typically at prime rate plus 2%. That all can add up to more than 30% in annual interest.

5.1.5 Legal Aspects of Factoring**Q7. Explain the Legal Aspects of Factoring.**

Ans :

There is no codified legal framework to regulate factoring services in India. The legal relationship between a factor and a client is largely determined by the terms of the factoring contract entered into before the factoring process starts. Some of the legal obligations of the factoring contract are :

1. The client gives an undertaking to sell and the factor agrees to purchase receivables subject to terms and conditions mentioned in the agreements.

2. The client warrants that the receivables are valid, enforceable, undisputed and recoverable.
3. The client agrees to serve notices of assignments in the prescribed form to all those customers whose receivables have been factored.
4. The factor acquires the power of attorney to assign the debts further and to draw negotiable instruments in respect of such debts.
5. The timeframe for the agreement and the mode of termination are specified in the agreement.
6. The legal status of a factor is that of an assignee.
7. The factoring agreement will set out in detail how the firm is to be paid.
8. The customer whose account has been factored and has been notified of the assignment is under legal obligation to remit the amount directly to the factor failing which he will not be discharge from his obligations to pay the factor even if he pays directly to the client unless the client remits the amount to the factor.
9. Warrants : Warrants to be required are :
 - (a) The firm should disclose any material facts that it knows might affect the factor's decisions to approve a debt.
 - (b) It will have to warrant that the invoices sent for factoring represent a proper debt for goods supplied.
10. The factor's power to inspect the firm's books and accounts and the period of the factoring arrangement is usually laid down in the agreement.
11. The factor needs to act quickly to recover money due on an invoice. A customer with money outstanding to the factor may be difficulty and any delays in acting could see the money gone forever. The agreement must provide for the factor to act swiftly in his own name, whenever necessary.

12. Before factoring a receivable, the factor will require a letter of disclaimer from the bank which has been financing the book debts through bank finance to the effect that from the date of the letter the bank will not create a charge against receivables.

5.2 FINANCIAL EVALUATION OF FACTORING

Q8. Explain the cost benefit analysis. Describe the methods of evaluation used in factoring.

Ans :

For using factoring as a feasible source of short-term financing it is necessary to take into consideration the relative costs and benefits involved in the factoring option. Factoring as an option of financing is assessed in the following manner.

Principles of Factoring

The following are the principles which assists in evaluating the factoring as an option of financing,

- Factoring advance is ascertained based on the average level of receivables factored.
- Factoring advance is the average level of receivables factored less the factoring commission, reserve maintained by the factor and the interest or discount charged on factoring.
- The receivables associated with costs and benefits are computed based on the Average Collection Period (ACP) on an annual basis.

Methods of Evaluation

The methods which are for evaluating the effectiveness of factoring finance are as follows,

- Next benefit method and
- Effective rate of interest method.

1. Next Benefit Method

Factoring is treated as a feasible short-term financing option, if the expected benefits are more than the expected costs. In this method, the desirability of factoring is ascertained based on the net benefit occurring from it.

Net benefit = Expected benefits > Expected costs

The following are some of the expected benefits of factoring,

- Cash discount earned on the credit payments made by the customers.
- Interest which avoided on non-factoring funds.
- Bad debt losses which are avoided on credit sales.
- The cost of credit administration which is avoided.
- The contribution on incremental sales.

The following are some of the expected costs of factoring,

- Factoring commission
- Factoring discount/interest
- Interest on own funds which are invested in receivables.

2. Effective Rate of Interest Method

In this method, the decision relating to factoring is made based on the effective rate of interest which is incurred due to factoring by the firm.

5.2.1 Cost of Factoring

Q9. Discuss the Cost of Factoring.

Ans : **(Aug.-17)**

The cost of factoring comprises of two aspects namely finance charges and service fees. Since the factor provides 80 per cent of the invoice as credit, he levies finance charges. This charge is normally the same interest rates which are in vogue in the banking system. Factoring is a cheap source because the interest is charged only on the amount actually provided to the client as repayment of his supplies. Apart from this financial charge, a service charge is also levied. This service fees is charged in proportion to the gross value of the invoice factored based on sales volume, number of invoices, work involved in collections, etc. Generally, the factor charges a service fee on the total turnover of the bills. It is around 1 per cent. If the bills get paid earlier, service

charges could be reduced depending upon the volume of work involved.

Pricing of factoring services

While pricing factoring services, the following components should be taken into account:

- (i) Factoring fees or administrative charges.
- (ii) Discount charges.

Factoring fees

This is charged mainly as administrative expenses for providing various services to the clients namely:

- (i) Sales ledger administration.
- (ii) Credit control administration.
- (iii) Bad debts administration.

This fees is normally computed with reference to the projected sales turnover of the client during the next twelve months. It is always quoted as a per cent of projected sales turnover. Generally, this charge varies between 1 per cent and 2.5 per cent of the projected turnover. In fact, the quantum of levy actually depends on several factors as given below:

- (a) Reputation of the client as well as the debtors.
- (b) Nature of the industry to which the client belongs.
- (c) Volume of sales per annum.
- (d) Terms of sales.
- (e) Average invoice value.
- (f) Security available to the factor.
- (g) Type of factoring service offered.
- (h) Profit margin.

Usually, a minimum handling /administrative charge is stipulated to which a certain per cent of the projected turnover is added.

Discount charges

For providing instant credit to the client by way of prepayment, some charges have to be levied and they are called discount charges. This charge is normally linked with the base rate.

5.2.2 Decision Analysis for Factor Services

Q10. Explain Decision Analysis for Factor Services.

(OR)

Discuss the financial evaluation of factorial services.

Ans : (Nov.-20, Aug.-17)

As factoring is a financial service, it involves different implications from the firm's perspective. Some of the implications of factoring are as follows,

1. Impact on the Balance Sheet

The impact of factoring on the balance sheet of the client and its implications can be understood with the help of following points,

(a) Off-balance Sheet Finance

In recourse factoring, as the debts of the client are purchased by the factor the finance offered by him is off the balance sheet and is entered in the balance sheet as a contingent liability. But in nonrecourse factoring, it is not entered in the financial statements of the borrower.

(b) Reduction of Current Liabilities

The bank borrowings are liquidated from the factoring proceeds and the remaining balance can be used by the client for paying off other current liabilities such as trade creditors for goods and services, creditors and expenses, loan installments, payable, statutory liabilities and provisions.

(c) Improvement in Current Ratio

The factoring transaction which is usually off balance sheet removes from the asset side the receivables factored to the level of the prepayment made which reduces, the current liabilities on liabilities side. This results in a desirable improvement in the current ratio.

2. Impact of Factoring in Improving the Financial Discipline

(a) Higher Credit Standing

The cash flow which is increased by the factoring helps the client to meet his liability quickly when required. The factor's acceptance of the client's receivables denotes the quality of receivables. In nonrecourse factoring, the factor assumes the credit risk and relieves the client from the problem of bad debts significantly. This also helps him to minimize his bad debts reserve.

(b) Improved Efficiency

For the purpose of increasing the cash flow, it is necessary for the firm to assure that key information is transferred for decision making and the delays and wastage of man-hours are eliminated. But, this process needs advanced infrastructures for high level specialization in credit control and for administering the sales - ledger. The small and medium - sized units have the chances of facing the resource constraint in this area. The factoring is developed for placing such units on the similar efficiency level in the areas of credit control and sales ledger administration.

(c) More time for Planning the Production

For any business, it is very essential to allot a specific part of management time to credit control. For this purpose, large companies can afford to have special departments, but small size units cannot afford it. The factor is responsible for controlling the solving problems involved in controlling the credit, administering the sales ledger and collecting the debt. Hence, the client can focus on the functional areas of the business such as planning, purchase, production, marketing and finance.

(d) Reduction of Cost and Expenses

As the client does not have any special administrative framework for focusing on the credit control, he can obtain the advantage of reduced overheads by saving the manpower, time and efforts. Factoring facilitates uniform and reliable cash flow, so

the clients have several opportunities to reduce expenses such as taking the payment of supplier and quantity discounts, ordering for materials at the right time and at the right place, avoiding any disturbances in the process of production etc.

(e) Additional Source

The supplier usually receives an extra source of funding the receivable which eliminates the uncertainty involved in the collection cycle. The funds from a factor is considered as an additional source of finance for the client outside the range of normal bank credit.

The different advantages of factoring usually involves costs. The evaluation framework of factoring depends on the relative costs and the benefits related with the two main alternatives to receivables management. These alternatives are,

- (a) In-house management by the firm itself.
- (b) Factoring service, either recourse or nonrecourse.

The over relevant costs and benefits related with these alternatives are as follows,

1. Costs Associated with In-house Management

- (i) Cash Discount
- (ii) Cost of funds invested in receivables
- (iii) Bad Debts
- (iv) Lost contribution on foregone sales and
- (v) Avoidable costs of sales ledger administration and credit monitoring.

2. Costs Associated with Recourse and Non Recourse Factoring

- (i) Factoring Commission
- (ii) Discount charge and
- (iii) Cost of long term funds invested in receivables.

3. Benefits Associated with Recourse Factoring

These are the costs related with the in-house management alternative along with the exception of bad debt loss.

4. Benefits Associated with Non Recourse Factoring

It includes the above mentioned benefits plus the bad debts losses associated with the in-house management of receivables.

- (ii) The banks may set up separate subsidiaries or invest in factoring companies jointly with other banks.
- (iii) A factoring subsidiary or a joint venture factoring company may undertake the factoring business. But, they should not finance other factoring companies.
- (iv) The banks can invest in the shares of factoring companies not exceeding 10 per cent of the paid-up capital and reserves of the bank concerned.

But, recently in February 1994, the RBI has permitted all banks to enter into factoring business departmentally. Perhaps, this step would have been taken with a view of giving further impetus to the factoring system. Since factoring requires special skills and infrastructure, the RBI has further stipulated that:

- (i) Factoring activities should be treated on par with loans and advances and should accordingly be given risk weight of 100 per cent for calculation of capital to risk asset ratio.
- (ii) A bank's exposure shall not exceed 25 per cent of the bank's capital funds to an individual borrower and 50 per cent to a group of borrowers. Factoring would also be covered within the above exposure ceiling along with equipment leasing and hire purchase finance.
- (iii) Factoring services should be provided only in respect of those invoices which represent genuine trade transactions.

In India, the factoring service was first started by the State Bank of India in association with the Small Industries Development Bank of India, Union Bank of India, State Bank of Saurashtra and State Bank of Indore. The pioneering factoring company founded by the SBI is called 'SBI-Factors and Commercial Services Pvt. Ltd., (SBI-FACS)'. It was started in July 1991 with a subscribed capital of ₹ 25 crore. It has been allotted the Western Zone composing of Maharashtra, Gujarat, Goa, Madhya Pradesh, The Union Territories of Dadra and Nagar Haveli, Daman and Diu. Similarly, the RBI has allotted the Southern Region to the Canara Bank, the Northern Region to the Punjab National Bank

5.3 FACTORING SCENARIO IN INDIA**Q11. What is the Factoring Scenario in India?**

(OR)

Discuss briefly the Factoring Scenario in India.

(OR)

Discuss the emerging trends in Factoring.

Ans : **(Aug.-21, June-18)**

In India, the idea of providing factoring services was first thought of by the Vaghul Working Group. It had recommended that banks and private non-banking financial companies should be encouraged to provide factoring services with a view to helping the industrialists and traders to tide over their financial crunch arising out of delays in the realization of their book debts. The RBI subsequently constituted a study group in January 1988 under the chairmanship of Mr. C.S. Kalyanasundaram, former Managing Director of the SBI, to examine the feasibility of starting factoring services. On the recommendation of the committee, the Banking Regulations Act was amended in July 1990 with a view of enabling commercial banks to take up factoring services by forming separate subsidiaries.

In the public interest and in the interest of banking policy, the RBI is of the view that:

- (i) The banks should not directly undertake the business of factoring.

and the Eastern Region to the Allahabad Bank for providing necessary factoring services to the clients of those regions. This zonal restriction has been removed by the RBI in 1993. In South, Canara Bank has already established Can Factors Ltd. Now, these two factoring companies can operate in the centres outside their given zones. Besides the above, some non-banking companies also have made a bid for entering into factoring services. Thus, factoring service has got a very bright future in India due to its superiority over other forms of financing.

Regulation of Factors (Assignment of Receivables) Bill 2011

The Government is in the process of enacting the above bill which seeks to provide for and regulate the assignment of receivables by making provisions for registration and rights and obligations of parties. The bill empowers the RBI to issue directions, call for information from the factors and prohibit financial institutions from undertaking business if the factor fails to comply with the directions given by the RBI. The bill also provides for the establishments of a central registry which would maintain details regarding all transactions carried out by factors. It makes registration of all factor transactions mandatory. Besides, factors would be entitled to take legal resource for recovering assigned debt and receivables from buyers of goods and services.

Q12. State the RBI Guidelines in factoring.

Ans :

The banking regulation Act 1949 was amended for allowing the commercial banks to start the factoring business. This amendment was made mainly because of the recommendations of the Kalyansundaram group. In July 1990 RBI issued guidelines in the interest of banking policy and public interest to develop a statutory structure which allows the banks to conduct such business. These guidelines are as follows,

- (i) The banks presently can neither directly nor departmentally conduct the factoring business. The banks can invest in factoring companies with the prior permission of the RBI. Within the stipulated limits, but they cannot act as promoters of these companies. The banks are allowed to establish separate

subsidiaries or invest in factoring companies along with other banks which would need the prior permission of the RBI. But such banks are presently allowed to conduct factoring departmentally.

- (ii) A factoring subsidiary/joint venture factoring company must not get involved in the financing of other companies or other factoring companies.
- (iii) The banks investment in the shares of factoring companies (including its factoring subsidiary) must not be more than the aggregate 10 percent of the paid up capital and reserves of the bank.

Organizational Profile

Initially, RBI examined the growth of factoring services on a zonal or regional basis which covered the whole nation with more than one bank focussing in one zone. It even selected to receive factoring services by the subsidiaries of nationalized banks. More than one bank can collaboratively carry out its operations in a region constituting a subsidiary.

On the basis of the regions RBI identified banks for sponsoring subsidiaries and offers factoring services to the clients in the specified regions. These banks are as follows,

- (a) For western region - State Bank of India
- (b) For the south zone - Canara Bank
- (c) For the northern region - Punjab National Bank and
- (d) For the eastern zone - Allahabad Bank.

But only State Bank of India and Canara Bank sponsors factoring services.

5.4 BILL DISCOUNTING

5.4.1 Concept

Q13. What is Bill Discounting? Explain its characteristics.

Ans :

Meaning

When goods are sold on credit, the receivables or book debts are created. The supplier

or seller of goods draws a bill of exchange on the buyer or debtor for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months. Sometimes it is drawn for 9 months. After drawing the bill, the seller hands over the bill to the buyer. The buyer accepts the same. This means he binds himself liable to pay the amount on the maturity of the bill. After accepting the bill, the buyer (drawee) gives the same to the seller (drawer). Now the bill is with the drawer. He has three alternatives. One is to retain the bill till the due date and present the bill to the drawee and receive the amount of the bill. This will affect the working capital position of the creditor. This is because he does not get immediate payment. The second alternative is to endorse the bill to any creditors to settle the business obligation. The third or last alternative is to discount the bill with his banker. This means he need not wait till the due date. If he is in need of money, he can discount the bill with his banker. The banker deducts certain amount as discount charges from the amount of the bill and balance is credited in the customer's (drawer's or holders) account. Thus the bank provides immediate cash by discounting trade bills. In other words, the banker advances money on the security of bill of exchange. On the due date, the banker presents the bill to the drawee and receives payment. If the drawee does not make payment, the drawer has to make payment to the banker. Here the bank is the financier. It renders financial service. In short, discounting is a financial service

Characteristics

The different steps which are involved in the discounting and purchasing of commercial bills of exchange are as follows,

1. Examination of Bill

Generally, the nature of the bill and the transaction is verified by the banker. The banker then assures that the customer has supplied all the needed documents along with the bill.

2. Crediting Customer Account

Once the authenticity of the bill is verified, the banker offers a credit limit either on regular or on a specific basis. The customers account is credited with the net amount of

the bill and the discount amount is the income earned by the bank on discounting/purchasing. The bank takes the amount of bill as advance.

3. Control Over Accounts

A completely separate register is kept for recording the amount availed by each customer in order to assure that the customers does not borrow more than the sanctioned limit.

Separate columns are made for displaying the names of customers, limits sanctioned, bills discounted, bills collected, loans granted and loans repaid. This helps in knowing the limit utilized by the customer easily.

4. Sending Bills for Collection

The bill along with the documents which are duly stamped by the banker is sent to the branch of a banker for formally introducing the bill for acceptance or payment as per the instructions that are accompanied along with the bill.

5. Action Taken by the Branch

The collecting banker after receiving the payment remits the payment to the banker which was sent the bill for collection.

6. Dishonour

In case of dishonor the drawer of the bill receives the dishonor advice. It will be more suitable for the collecting banker to obtain the bill which is protested for dishonor. The collecting banker or the branch of bank for such purpose keeps a separate register in which the particulars like date on which the bills are to be presented, the party to whom it is to be presented and so on are recorded. The banker then introduces them for acceptance or payment as needed. The customer account is debited by the banker with the amount of the bill and also the charges incurred because of dishonour of the bill. But this bill must not be purchased at the time at which it is presented again. The banker may however agree to accept it for collection.

5.4.2 Process

Q14. Explain the process of bill discounting.

Ans :

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5.4.3 Forms

Q15. What are the different types of bills discounting?

Ans :

There are various types of bills. They can be classified on the basis of when they are due for payment, whether the documents of title of goods accompany such bills or not, the type of activity they finance, etc. Some of these bills are,

(i) Demand Bill

This is payable immediately "at sight" or "on presentment" to the drawee. A bill on which no time of payment or "due date" is specified is also termed as a demand bill.

(ii) Usance Bill

This is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.

(iii) Documentary Bills

These are the B/Es that are accompanied by documents that confirm that a trade has taken place between the buyer and the seller of goods. These documents include the invoices and other documents of title such as railway receipts, lorry receipts and bills of lading issued by custom officials. Documentary bills can be further classified as,

1. Documents against acceptance (D/A) bills and
2. Documents against payment (D/P) bills.

1. D/A Bills

In this case, the documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee. This means the documentary bill becomes a clean bill after delivery of the documents.

2. D/P Bills

In case a bill is a "documents against payment" bill and has been accepted by the drawee, the documents of title will be held by the bank or the finance company till the maturity of the B/E.

(iv) Clean Bills

These bills are not accompanied by any documents that show that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills are higher than the rate charged on documentary bills.

(v) Creation of a B/E

Suppose a seller sells goods or merchandise to a buyer. In most cases, the seller would like to be paid immediately but the buyer would like to pay only after some time, that is, the buyer would wish to purchase on credit.

Maturity on the buyer. The seller has now assumed the role of a creditor, and is called the drawer of the bill. The buyer, who is the debtor is called the drawee. The seller then sends the bill to the buyer who acknowledges his reasonability for the payment of the amount on the terms mentioned on the bill by writing his acceptance on the bill.

The acceptor could be the buyer himself or any third party willing to take on the credit risk of the buyer.

(vi) Discounting of a B/E

The seller, who is the holder of an accepted B/E has two options.

- (i) Hold on to the B/E till maturity and then take the payment from the buyer.
- (ii) Discount the B/E with a discounting agency, Option (2) is by far more attractive to the seller.

The seller can take over the accepted B/E to a discounting agency (bank, NBFC, company, high net worth individual) and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E.

5.4.4 Legal Aspects

Q16. What are the legal aspects of bill discounting ?

Ans :

Bill discounting has been developed as a financial service due to emergence of a fully grown bill market. The Reserve Bank of India (RBI) has set up many committees for the development of commercial bills market and also for analyzing the system of bank financing. Some of the important committees include :

- (i) Dehejia committee, 1969
- (ii) Tandon committee, 1974
- (iii) Chore committee, 1980
- (iv) Vaghul committee, 1985

Legal aspects of bill discounting can be studied under two schemes headed by RBI.

Q17. What are the parties involved in bill discounting ?

Ans :

The parties who are involved in bill discounting are as follows,

1. Drawer

The drawer is a person who sells the bill at a rate of discount to due bank when the money is needed before the maturity of bill.

2. Bank

The bank accepts the bill at a specific rate of interest or discount from drawer for certain number of days.

3. Acceptor

The acceptor is the person to whom the bank presents the bill for availing the cash payment. The acceptor is also known as drawer. In commercial bill financing, there are two systems of bills i.e., the drawer bill system and the drawee bill system.

1. Drawer Bills System

The characteristics of 'drawer bills system' are as follows,

- (i) The sellers of goods draws the bills on the buyers of the goods.
- (ii) For the drawee of the bills the bills are discounted or purchased.
- (iii) The banker basically takes into account the credit of the drawer of the bill, at the time of discounting or purchasing these bills.

Drawer bills system is very popular in India.

2. Drawee Bills System

The characteristics of drawee bill system are as follows,

- (i) At the instance of the buyer the drawer the banker accepts the bill drawn by the seller.
- (ii) The banker provides support based on the strength of the creditworthiness of the buyer.

Drawee bill system is classified into the types which are as follows,

(a) Acceptance Credit System

In this system, the banker of the buyer accepts the bill of exchange which is made for the goods purchased - by the drawee. This type of bill can be drawn on the buyer or on the banker. The banker wants the borrower to show the goods which are purchased under the acceptance credit in periodical stock statements that are submitted to the banker.

(b) Bill Discounting System

In this system, a bill is directly drawn on buyers bank by the seller. The buyers bank then discounts the bill and the proceeds are sent to the seller. The buyers banker will show the bills as "bill discounted".

In both the systems, the record of bills is maintained by the banker (both accepted and still outstanding bills). This is to make sure that the advance which is sanctioned with not cross the credit limit.

Q18. Compare and contrast Bills Discounting and Factoring.

Ans :

S.No.	Basis	Bill discounting	Factoring
1.	Meaning	Bill discounting means to trade bill before it becomes due for payment at par value.	Factoring means to sell its book debt to the financial transaction to the factoring company at a discount.
2.	Existence	Bill discounting comes under the Negotiable instrument act, 1881.	There is no such specific law for factoring.

3.	Settlement of finance	In bill discounting, the bill is discounted and paid when the transaction takes place.	In factoring, the financier gives a maximum amount as an advance when a transaction takes place the remaining amount at the time of settlement.
4.	Parties involved	In bill discounting there is a drawer, drawee, and a payee.	In factoring, there is a factoring company, debtor and a customer.
5.	Fees	A financier charges fees in the form of discounting charges or interest.	Financier gets fees in the form of interest for the financial services and commission for extra services facilitate.

5.5 CREDIT RATING CONCEPT AND UTILITY

Q19. Define credit rating. Explain the nature of credit rating.

Ans :

Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

Definitions

- (i) "A corporate credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted."
- (ii) "Credit rating is an unbiased and independent opinions as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

A credit rating does not create a fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationships. Credit rating in India is done for a specific debt security and not for a company as a whole. No rating agency tells that it is an indicator of the financial status of the company. All that a rating agency claims is that the rating symbols indicate the capacity of the company to honour the terms of contract of a debt instrument.

Nature

1. Rating is based on information

Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information are important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.

2. Many factors affect rating

Rating does not come out of a predetermined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The rating Committee, which assigns the final rating, consists of specialized financial and credit analysts. Rating agencies also ensure that the rating process is free from any possible clash of interest.

3. Rating by more than one agency

In the well developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a debt issue, may be rated 'AA+' by one agency and 'AA' or 'AA-' by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a 'BBB'.

4. Monitoring the already rated issues

A rating is an opinion given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them as part of their investor service. The rating agencies should put issues under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.

5. Publication of ratings

In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.

6. Right of appeal against assigned rating

Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision. Unless the rating agency had overlooked critical information at the first stage chances of the rating being changed on appeal are rare.

7. Rating of rating agencies

Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.

8. Rating is for instrument and not for the issuer Company

The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly if maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees. In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as the risk profile changes for longer maturities.

9. Rating not applicable to equity shares

By definition, credit rating is an opinion on the issuers capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.

10. Credit vs. Financial analysis

Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the rating is normally done at the request of and with the active co-operation Of the issuer. The rating agency has access to unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies.

Necessary adjustments are made to the published accounts for the purpose of analysis. rating is carried out by specialized professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.

11. Time taken in rating process

The rating process is a fairly detailed exercise. It involves, among other things analysis of published financial information, visits to the issuers offices and works, 'intensive discussion with the senior executives of issuers, discussions with auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time, a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than on long-term fundamentals. Rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results. Issuers are always advised to. Approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

Q20. Explain the utility of credit rating.

Ans : (June-19, Aug.-18)

1. Based on credit rating, decisions are made regarding the organization debt or equity.
2. It is used by organizations when they take loan from the banks or various financial institution.
3. The organizations use credit rating as an organization with good credit rating can easily acquire funds from capital markets in the form of issue of equity shares or from debt market in the form of bonds.
4. It is used to evaluate the efficiency of operations and top management is carrying out the business of an organization.
5. It has regulatory importance because if an organization is going for initial public offering

then it is mandatory for it to obtain credit rating before doing so. By this, the investors will get to know regarding the organization prior to applying for the initial public offering.

6. It is used in deciding the capital needs.
7. It is useful to classify or identify assets in the context of entitled investments or allowed asset concentrations.
8. It is used in assessing the credit risk connected with assets purchased as a part of securitization offering or a covered bond offering.

Q21. Explain the functions of credit rating agency.

Ans :

A credit rating agency serves following functions:

1. Provides unbiased opinion

An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:

- (i) It has no vested interest in an issue unlike brokers, financial intermediaries.
- (ii) Its own reputation is at stake.

2. Provides quality and dependable information

A credit rating agency is in a position to provide quality information on credit risk which is more authenticate and reliable because:

- (i) It has highly trained and professional staff who has better ability to assess risk.
- (ii) It has access to a lot of information which may not be publicly available.

3. Provides information at low cost

Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

4. Provide easy to understand information

Rating agencies first of all gather information, then analyze the same. At last these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

5. Provide basis for investment

An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

6. Healthy discipline on corporate borrowers

Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/discipline on corporate.

7. Formation of public policy

Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional portfolio.

Q22. What are the advantages and disadvantages of Credit Rating ?

Ans : (June-19, June-18)

Advantages**(i) Low Cost Information**

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information are done by a specialized agency which a group of investors can trust.

(ii) Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

(iii) Independent Investment Decision

For rated instruments, investors need not depend upon the advice of the financial intermediaries. As the rating symbol suggests the credit worthiness of the instrument and indicated the degree of risk involved in it, the investors can make direct investment decisions.

(iv) Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditable and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

Disadvantages

Credit rating suffers from the following limitations

(i) Non-disclosure of significant information

Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of such significant information may put investors at a loss.

(ii) Static study

Rating is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk indicativeness of rating.

(iii) Rating is no certificate of soundness

Rating grades by the rating agencies are only an opinion about the capability of the company to meet its interest obligations. Rating symbols do not pinpoint towards

quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

(iv) Rating may be biased

Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.

(v) Rating under unfavorable conditions

Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hampers the company's interest.

(vi) Difference in rating grades

Same instrument may be rated differently by the two rating agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

Q23. Explain the classifications of credit rating.

Ans :

Credit rating is classified into four major types which are as follows,

1. Bond Rating

Bond rating deals with grading of bonds or securities which are issued by a company, government or semi-government institution. It denotes the possibilities of payment on the maturity of the bond. In other words, it ascertains whether the level of risk involved is more or less.

2. Equity Rating

The rating of shares which are traded in capital market are called as equity rating.

3. Commercial Paper Rating

A company is statutorily bound to avail rating level from a rating agency before issuing commercial paper. It is known as commercial paper rating. In India, the rating of commercial papers issued by corporate bodies is compulsory.

4. Sovereign Rating

Sovereign rating is related with the payment of the credit of the government of a country.

Q24. Explain the Purpose of Credit Rating.

Ans :

Credit rating is applicable to various purposes such as,

1. Long-term/medium-term debt obligations like debentures, bonds, preference shares or project finance debt are treated as long-term and debts that are ranging from 1 to 3 years like fixed deposits are treated as medium-term,
2. Short-term debt obligations which are for a period of one year or less than one year and includes money market instruments like commercial paper, credit notes, cash certificates etc.
3. Credit rating is applicable to equity grading and assessment, structured obligations, municipal bonds, mutual fund schemes, plantation schemes, real estate projects, infrastructure-related debts, ADR, GDR issues, bank securities, etc.

5.6 CREDIT RATING AGENCIES IN INDIA AND THEIR PERFORMANCE

Q25. Write a note on credit rating agencies in India and their performance.

(OR)

Critically Evaluate the Performance of Credit rating in India.

Ans :

(Aug.-21)

The important credit rating agencies in India are :

- A) CRISIL
- B) ICRA
- C) CARE

(A) CRISIL

It is the first credit rating agency in India which was jointly promoted by ICICI and UT1. It has pioneered the concept of credit rating in the country.

(i) Rating Services

The principal objective of CRISIL is to rate debt obligations of Indian companies. It now rates rupee-denominated credit instruments both long term and short term, namely debentures, deposits, structured obligations, preference shares and commercial papers.

(ii) Information Services

Though the primary business of CRISIL is credit rating, it has diversified into information services as a thrust area for future. The extensive compilation and analysis of data for rating business is also used to provide information services to the corporate clients.

The main information product is the CRISIL Card. It has also launched the CRISIL-500 equity index a market value weighted composite index of 500 companies.

(iii) Advisory Services

A thrust area in the context of the emerging financial scenario is the provision of the advisory services by the CRISIL to the Government, banks, financial institutions and so on.

It utilizes its information base and expertise in credit rating to provide counselling on aspects such as privatization of public sector undertakings, debt securitization, credit evolution system and so on.

(iv) Performance of CRISIL

During 1994-95, CRISIL rated 379 instruments covering a debt volume of Rs. 34544 crores.

The cumulative number of instruments rated by CRISIL since its inception in January 1988,

till the end of March 1995 has been 1305 and the value of instruments covered has been Rs. 78151 crores.

The CRISIL has published CRISIL bond yield tables to provide handy reference to investors for determining yield-to-maturity on a debenture, given the price of debenture, its coupon rate and its maturity period.

During the year 1990-91 CRISIL started a quarterly publication called CRISIL Rating Scan containing rating reports on companies whose instruments have been rated by CRISIL during the quarter and which are using the rating.

These rating reports contain details of rating instruments, rationale for rating assigned, brief details of the business of the borrower and the key issues involved in the rating. CRISIL Rating Scan also includes details of rating in use, ratings reviewed during the quarter, the instruments which have been placed under 'rating watch' and rating symbols with definition.

"CRISIL CARD" service was developed by CRISIL during the year 1990-91.

The service provides details about a company such as business it is engaged in shareholding pattern, key management personnel, plant location, equity share record, analyzed profit and loss accounts and balance sheet for the last four years, account practices, key financial ratios, raw material consumption, major competitors, major lenders, excerpts from the Directors reports and events after the balance sheet date.

CRISIL has won international recognition. It is one of the four international companies shortlisted by the Asian Development Banks for being appointed as consultant for setting up a credit rating organization in Thailand. CRISIL has set up an information company in collaboration with Extel Financial Limited of the U.K. called Crisil Information Limited. Standard and Poor's Rating Services, a global rating agency from the USA, has formed strategic alliance with CRISIL for providing analytical and business development cooperation.

(B) ICRA

Investment Information and Credit Rating Agency of India (ICRA) has been promoted by the IFCI Ltd., as the main promoter to meet the requirements of the companies based in the north. The other shareholders of ICRA are SBI, UT1, PNB, LIC, GIC, etc. It started operations in 1991.

The primary objective of ICRA is to rate the credit instruments, to award a grade in consonance with the risk associated with them, to reflect their capability of timely servicing of debt.

ICRA has ventured into "Earning Prospects Risk Analysis" (EPRA), which focuses on equity rating. The main emphasis of EPRA is on grading the primary market at the instance of the issuer and assessment of the secondary market at the instance of the investor. ICRA also undertakes rating of LPG/ kerosene, dealers/banks etc. In addition to credit rating, it also provides two services, credit assessment and general assessment.

(i) Credit Assessment

It takes up assignments for credit assessment of companies who intend to use such assessment for obtaining specific line of assistance from commercial banks, financial institutions, factoring companies, etc.

(ii) General Assessment

It provides services of general assessment at the request of banks or any other potential users. This service is also likely to be useful for other non-banking nonfinancial agencies for the purpose of merger, joint venture, acquisition, collaboration, amalgamation and factoring of debts.

(iii) Performance of ICRA

During 1994-95 ICRA rated 212 debt instruments covering a debt volume of Rs. 5,343 crores. The cumulative number of instruments rated since its inception till March 1995 has been 485 covering a total debt volume of Rs. 17638 crores.

(C) CARE

The CARE Ltd is one of the credit rating and information services company which is promoted by the Industrial Development Bank of India (IDBI) along with financial institutions, public/private sector banks and private finance companies. CARE started its credit rating functions in October 1993 and provides a wide range of products and services relating to credit information and equity research. CARE is very careful and attentive in entering the new areas of business not like CRISIL and ICRA. Presently, it offers the following services:

1. Credit Rating

Credit rating of all types of debt instruments including both short-term and long-term instruments is performed by CARE.

2. Information Services

The main aim of the information services is to provide information relating to any company, industry or sector needed by a business enterprise. The value addition made by inclusive analysis helps the users of the service such as individuals, mutual funds, investment companies, residents or non-residents in making informed decisions relating to investments.

3. Equity Research

Equity research deals with an extensive study of the share, which are listed or ought to be listed in major stock exchanges and recognizing the potential winners and losers among them based on the fundamentals influencing the industry, market shares, management capabilities international competitiveness and other significant factors. CARE offers the equity research service with certain objectives which must be attained by the client.

4. Advisory Services

CARE offers advisory services in the following areas:

- Transactions of securitization
- Structuring of financial instruments

- Financing of infrastructure projects and
- Municipal finances.

5. Publications

CARE's publications consists of:

- Rating reckoner which provides an update on its accepted ratings and
- CAREVIEW which is a quarterly bulletin offering information on its ratings.

6. Other Services

CARE also offers many other rating services such as:

(i) CARE loan rating

(ii) Credit analysis rating and

(iii) Interest rate structural model.

(i) **CARE Loan Rating (CLR):** CARE loan ratings are the suggestions made on the ability and willingness of a borrower for making regular payments on the specific loan obligation throughout its life. The CLR emphasizes on providing a valuable input which helps in making the decisions in banks and DFIs. CLR directly addresses the needs by rating the loan and including the specific features of the loan in the analysis. There are many benefits which are obtained by using the CLR at it fulfills the needs of banks and institutions for the following purposes:

- Evaluating the creditworthiness of borrowers.
- Serving as a simple objective indicator for internal credit risk exposure guidelines.
- Ascertaining the premium to be charged.
- Monitoring the portfolio, and
- Making instant credit decisions.
- It is also helpful to the borrowers in,
- Obtaining a range of potential lenders.

- Obtaining more stable capital and
- Minimizing the cost of borrowing by developing risk-reward relationship.

(ii) Credit Analysis Rating (CAR):

Credit analysis ratings is basically meant for business entities which are planning to obtain or improve the credit facilities from banks/NBFCs/financial institutions and so on. It indicates the overall debt management capability of the entity. The evaluation shows the broad opinion of CARE on the entity's relative capability to make regular payments of interest and principal on its debt obligations. The basic features of the credit analysis rating are as follows,

- It is issuer specific and not instrument specific.
- It deals with the evaluation of credit quality that can be renewed on the request of the issuer, and
- Confidential ratings is done for the specific use of institutional investors/lenders and not for raising funds from public.

(iii) **Interest Rate Structure Model:** Due to the deregulation of the interest rates, the lending institutions (Banks/FIs) are free to charge interest rates on individual loans on the basis of their risk perception. A model must be developed to get an appropriate interest rate which takes into account both the quantitative and qualitative factors which are necessary. Interest Rate Structure Model (IRSM) is a software package which was developed by CARE to facilitate the determination of interest rate with the track record and credit risk of corporate borrowers.

5.7 FINANCIAL DIMENSIONS OF CREDITING RATING METHODOLOGY

Q26. What are the Financial Dimensions of Crediting Rating Methodology.

Ans : (Nov.-20)

The credit rating agencies are regulated by SEBI. The main elements of its regulatory framework are,

- (A) Registration
- (B) General obligations
- (C) Restrictions on the rating of securities
- (D) Procedure for inspection and investigation and
- (E) Action in case of default.

(A) Registration of Credit Rating Agencies

Registration with SEBI is mandatory to carry on the rating business. The application for the grant of certificate of registration should be made to SEBI in form A and accompanied by a non refundable fee of Rs. 25,000.

A Credit Rating Agency means a body corporate (As defined in section 2(7) of the Companies Act) engaged/ proposed to be engaged in the business of rating of securities offered by way of public/rights issues.

Rating is defined by SEBI regulations as an opinion regarding securities expressed in the form of standard symbols in any other standardized form, assigned by a credit rating agency and used by the issuer of such securities to comply with the requirement specified by these regulations.

Promoter of Credit Rating Agency

A Credit Rating Agency (CRA) can be promoted by a,

- (i) Public financial institution as defined in section 4-A of the Companies Act
- (ii) Scheduled bank
- (iii) Foreign bank operating in India with RBI approval

- (iv) Foreign credit rating agency, having atleast five years experience in rating securities and
- (v) Any company incorporated under the companies Act/body corporated, having continous network [i.e., paid up equity plus free reserves (Excluding reserves created out of revaluation) less accumulated losses and deferred expenditure including miscellaneous expenses not written off of a minimum of Rs. 100 crore as per its audited annual accounts for the previous five years prior to filling of the application with SEBI for registration.

Eligibility Criteria

The eligibility criteria for a rating agency are as specified below. The agency,

1. Is set up and registered as a company.
 2. Has specified in its memorandum of Association rating activity as one of its main objects.
 3. Has a minimum networth of Rs. 5 crore.
 4. Has adequate infrastructure.
 5. Soundness and general reputation of fairness and integrity in business transactions to the satisfaction of SEBI.
 6. Has in its employment persons with adequate professional and other relevant experience to the satisfaction of SEBI.
 7. Is in all respects a fit and proper person for the grant of the certificate;
 8. Application or its promoter(s), any director of the applicant or its promoter(s);
- (i) Is not involved in any legal proceedings connected with the securities market which may have an adverse impact on the interests of the investors.
 - (ii) Has not at any time in the past been convicted of any offence involving moral turpitude or any economic offence.

9. Applicant or any person directly or indirectly (i.e., an associate/subsidiary/interconnected or group company or a company under the same management) in the past has not been
 - (i) Refused by SEBI a certificate under these regulations or
 - (ii) Subjected to any proceedings against contravening SEBI Act.

Grant of Certificate of Registration

SEBI will grant to eligible applications a certificate of registration on the payment of a fee of Rs. 5,00,000, subject to the conditions specified below.

- (a) The CRA would comply with the provisions of the SEBI Act/Regulation and guidelines/circular and instructions issued by SEBI, from time to time on the subject of credit rating.
- (b)
 - (i) Where any information/particulars furnished to SEBI by (a) CRA (i) Is found to be false/misleading any material particular or (ii) Has undergone change subsequent to its furnishing at the time of application it would immediately inform SEBI in writing and
 - (ii) The certificate of registration is valid for three years renewable on payment of the renewal fee of Rs. 3,00,000 for another three years each time.

(B) General Obligations

The general obligations of CRA are as specified below.

(i) Code of Conduct

Every CRA should abide by the code of conduct specified below it should observe in the conduct of its business high standards of integrity and fairness in all its dealings with its clients.

Fulfil its obligations in an ethical manner, Render, high standards of service, exercise due diligence, ensure proper

care and exercise independent professional judgement. It should also, wherever necessary, disclose to the clients possible sources of conflict of duties and interests, while providing unbiased services.

(ii) Monitoring of Ratings

The CRA should continuously monitor the rating of securities rated by it during its lifetime. It should disseminate the earlier ratings promptly through press releases and websites, and in the case of securities issued by listed companies, provide such information simultaneously to the respective regional stock exchange and to all the stock exchanges where the securities are listed.

(iii) Procedure for Review of Rating

The CRA should carry periodic reviews of all published ratings during its lifetime of the securities.

If its client does not cooperate so as to enable it to comply with its obligations relating to monitoring of ratings it should carry out the review on the basis of the best available information.

The CRA should disclose this fact to the investors. It cannot withdraw a rating so long as the obligations under the rated security are out standing, except where the company is wound up/merged/amalgamated with another company.

(iv) Disclosure of Rating Definitions and Rationale

The credit rating agency (a) Should make public the definitions of the concerned rating, along with the symbol and (b) Also state that the ratings do not constitute recommendations to buy, hold or sell any securities.

It should make available to the general public information relating to the rationale of the ratings, which should cover an analysis of the various factors justifying a favorable investment.

(v) Submission of Information to SEBI

When any information is called for by SEBI for the purpose of these regulations, including any report relating to its activities, the CRA must furnish such information (a) Within the specified period or (b) If no such period is specified, within a reasonable time. It should also at the close of each accounting period, furnish to SEBI copies of its balance-sheet and profit and loss account.

(vi) Maintenance of Books of Accounts and Records

Every CRA has to maintain, for a minimum period of five years, the following books of accounts, records and documents and intimate to SEBI the place where they are maintained.

- (a) A copy of its balance sheet, as on the end of each accounting period.
- (b) A copy of its profit and loss account for each accounting period.
- (c) A copy of the auditor's report on its accounts for each accounting period.
- (d) A copy of the agreement entered into, with each client.
- (e) Information supplied by each of the clients.
- (f) Correspondence with each client.
- (g) Ratings assigned to various securities, indicating upgrading and down gradation (If any) of the ratings so assigned.
- (h) Rating notes considered by the rating committee.
- (i) Record of decisions of the rating committee
- (j) Letter assigning rating
- (k) Particulars of fees charged for rating and such other records as SEBI may specify from time to time.

(vii) Confidentiality

The CRA should treat, as confidential, information supplied to it by the client and not disclose the same to any other person, except where such disclosure is required or permitted by or under any law for the time being in force.

(viii) Rating Process

The CRA should specify as,

1. The rating process, file a copy of the same with SEBI for the record
2. File any modifications or additions made therein from time to time
3. Follow a proper rating process
4. Have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating; all rating decisions, including the decisions regarding changes in rating, should be taken by the rating committee.
5. Exercise, due diligence in order to ensure that the rating given is fair and appropriate.
6. Disclose to the stock exchange concerned, through periodic releases and websites for general investors, the rating assigned to the securities of a client, including changes in rating, if any.

(C) Restrictions on Rating of Securities

The restrictions on rating by CRAs relating to securities issued by,

- (i) Promoters and
- (ii) Certain other persons.

Securities Issued by Certain Entities

The securities of any entity cannot be rated by a CRA if it is,

- (a) A borrower of its promoter or
- (b) A subsidiary of its promoter or

- (c) An associate (i.e., a person holding atleast 10 percent of the share capital) of its promoter when there are common chairman/directors/employees on the rating committee. The CRA should also not rate a security issued by its associate/subsidiary if the chairman/director/ its rating committee also hold similar position in such an entity.

(D) Procedure for Inspection/Investigation

SEBI is empowered to appoint inspecting officers to undertake inspection/investigation of the books of accounts/ records/documents of CRAs.

- (i) To ascertain whether they are being maintained properly
- (ii) To ascertain whether the provisions of the SEBI Act/these regulations are being complied with
- (iii) To investigate into complaints from investors/clients whose securities are rated by either on any matter having a bearing on the activities of the CRA and
- (iv) In the interest of the securities market/investors.

The inspection would ordinarily not go into an examination of the appropriateness of the assigned ratings on merit. In case of complaints of serious nature, however, appropriateness of the ratings also should be covered by the inspection to be carried out either by the officer of SEBI or independent experts with relevant experience or a combination of both.

(E) Action in Case of Default

The CRA which (a) Fails to comply with any condition subject to which certificates of registration had been granted or (b) Contravene the provisions of the SEBI Act/ are liable to suspension of their registration. Their registration is liable to be cancelled in case.

- 1. Of repeated defaults of the nature mentioned above.
- 2. They are guilty of fraud or have been convicted for any offence involving moral turpitude/an economic offence.
- 3. They are declared insolvent/wound up.

The order of suspension/registration would be published by SEBI in two daily news papers. Any CRA whose registration is suspended/cancelled has the right to appeal to the Securities Appellate Tribunal (SAT).

5.8 TYPES OF RATINGS AND SYMBOLS

Q27. Explain the various symbols of credit rating.

Ans :

(Imp.)

The important credit rating agencies in India are :

- 1. CRISIL
- 2. ICRA
- 3. CARE

1. CRISIL

CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries.

The following table shows the investment-wise rating symbols assigned by CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols

High Investment Grades		
AAA (Triple A)	:	Highest Safety
AA (Double A)	:	High Safety
Investment Grades		
A	:	Adequate Safety
BBB (Triple B)	:	Moderate Safety
Speculative Grades		
BB (Double B)	:	Inadequate Safety
B	:	High Risk
C	:	Substantial Risk
D	:	Default

Notes :

1. CRISIL may apply '+' (plus) or '-' (minus) sign for ratings from AA to C to reflect comparative standing within the category.
2. The contents within parenthesis are a guide to the pronunciation of the rating symbols.
3. Preference shares rating symbols are identical to debenture rating symbols except the letters 'pf' are prefixed to the rating symbols, e.g., pf AAA ("pf Triple A").

CRISIL Fixed Deposit Rating Symbols

Investment Grades		
FAAA (F-Triple A)	:	Highest Safety
FAA (F-Double A)	:	High Safety
FA	:	Adequate Safety
Speculative Grades		
FB	:	Inadequate Safety
FC	:	High Risk
FD	:	Default

Note:

- (1) CRISIL may apply '+' (plus) or '-' (minus) sign for ratings from FAAA to FC to indicate the relative position within the rating category.
- (2) The contents within parenthesis are a guide to the pronunciation of the rating symbols.

Credit Rating for Short Term Instruments**Rating Symbol****Indication**

(Each rating indicates that the degree of safety regarding timely payment on the instrument is shown against the symbol)

P ₋₁	:	Very Strong
P ₋₂	:	Strong
P ₋₃	:	Adequate
P ₋₄	:	Minimal
P ₋₅	:	Expected to be in default on maturity or in default

Note: CRISIL may apply “+” signs for ratings from PQ-1 to P-3 to reflect a comparatively higher standing within the category.

2. ICRA**IICRA RATING SCALE****Long term including Debentures****Bonds and Preference Shares**

LAAA	:	Highest Safety
LAA	:	High Safety
LA	:	Adequate Safety
LBBB	:	Moderate Safety
LBB	:	Inadequate Safety
LB	:	Risk Prone
LC	:	Substantial Risk
LD	:	Default, Extremely Speculative

Medium term including**Deposits Fixed**

MAAA	:	Highest Safety
MAA	:	High Safety
MA	:	Adequate Safety
MB	:	Inadequate Safety
MC	:	Risk Prone
MD	:	Default

Short term including Commercial Paper

A - 1	:	Highest Safety
A - 2	:	High Safety
A - 3	:	Adequate Safety
A - 4	:	Risk Prone
A - 5	:	Default

IICRA FIXED DEPOSIT RATING SYMBOLS	IICRA CREDIT ASSESSMENT SYMBOLS
MAAA Highest Safety	1. Very Strong Capacity
MAA +	2. MAA + High Safety
	3. Strong Capacity
MAA-	4.
MA +	5.
MA Adequate Safety	6. Adequate Capacity
MA-	7.
MB +	8.
MB Inadequate Safety	9. Inadequate Capacity
MB-	10.
MC+ High Risk	11. Poor Capacity
MC	12.
MC-	13.
MD Default	14. Default

3. CARE

Rating Services

CARE provides rating services to the following debt instruments.

- Debentures
- Certificate of Deposits
- Commercial paper
- Fixed Deposits.

CARE also undertakes Credit Analysis Rating of Companies for the use of bankers, other lenders and business enterprises.

SI. No.	Investment Grade For Long term debt instruments	CARE
1	Highest Safety	CARE AAA
2	High Safety	CARE AA
3	Adequate Safety	CARE A
4	Inadequate Safety	CARE BB
5	High Risk	CARE B

	For Medium term debt instruments	
1	Highest Safety	CARE AAA
2	High Safety	CARE AA
3	Adequate Safety	CARE A
4	Inadequate Safety	CARE BB
5	High Risk	CARE C
	For Short term debt instruments	
1	Highest Safety	PR1
2	High Safety	PR2
3	Adequate Safety	PR3
4	Inadequate Safety	PR4
5	High Risk	

Short Question & Answers

1. Non-recourse Factoring

Ans :

Non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

2. Explain Decision Analysis for Factor Services.

Ans :

As factoring is a financial service, it involves different implications from the firm's perspective. Some of the implications of factoring are as follows,

1. Impact on the Balance Sheet

The impact of factoring on the balance sheet of the client and its implications can be understood with the help of following points,

(a) Off-balance Sheet Finance

In recourse factoring, as the debts of the client are purchased by the factor the finance offered by him is off the balance sheet and is entered in the balance sheet as a contingent liability. But in nonrecourse factoring, it is not entered in the financial statements of the borrower.

(b) Reduction of Current Liabilities

The bank borrowings are liquidated from the factoring proceeds and the remaining balance can be used by the client for paying off other current liabilities such as trade creditors for goods and services, creditors and expenses, loan installments, payable, statutory liabilities and provisions.

(c) Improvement in Current Ratio

The factoring transaction which is usually off balance sheet removes from the asset side the receivables factored to the level of the prepayment made which reduces the current liabilities on liabilities side. This results in a desirable improvement in the current ratio.

2. Impact of Factoring in Improving the Financial Discipline

(a) Higher Credit Standing

The cash flow which is increased by the factoring helps the client to meet his liability quickly when required. The factor's acceptance of the client's receivables denotes the quality of receivables. In nonrecourse factoring, the factor assumes the credit risk and relieves the client from the problem of bad debts significantly. This also helps him to minimize his bad debts reserve.

(b) Improved Efficiency

For the purpose of increasing the cash flow, it is necessary for the firm to assure that key information is transferred for decision making and the delays and wastage of man-hours are eliminated. But, this process needs advanced infrastructures for high level specialization in credit control and for administering the sales - ledger. The small and medium - sized units have the chances of facing the resource constraint in this area. The factoring is developed for placing such units on the similar efficiency level in the areas of credit control and sales ledger administration.

3. Advantages of Credit Rating

Ans :

(i) Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information are done by a specialized agency which a group of investors can trust.

(ii) Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

(iii) Independent Investment Decision

For rated instruments, investors need not depend upon the advice of the financial interme-diaries. As the rating symbol suggests the credit worthiness of the instrument and indicated the degree of risk involved in it, the investors can make direct investment decisions.

(iv) Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditable and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

4. Discuss the Cost of Factoring.

Ans :

The cost of factoring comprises of two aspects namely finance charges and service fees. Since the factor provides 80 per cent of the invoice as credit, he levies finance charges. This charge is normally the same interest rates which are in vogue in the banking system. Factoring is a cheap source because the interest is charged only on the amount actually provided to the client as repayment of his supplies. Apart from this financial charge, a service charge is also levied. This service fees is charged in proportion to the gross value of the invoice factored based on sales volume, number of invoices, work involved in collections, etc. Generally, the factor charges a service fee on the total turnover of the bills. It is around 1 per cent. If the bills get paid earlier, service charges could be reduced depending upon the volume of work involved.

Pricing of factoring services

While pricing factoring services, the following components should be taken into account:

- (i) Factoring fees or administrative charges.
- (ii) Discount charges.

5. What are the objectives of factoring?

Ans :

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realization of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

6. Domestic and Export Factoring

Ans :

When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.

Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

7. Advance and Maturity Factoring

Ans :

In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

8. What is Bill Discounting?*Ans :***Meaning**

When goods are sold on credit, the receivables or book debts are created. The supplier or seller of goods draws a bill of exchange on the buyer or debtor for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months. Sometimes it is drawn for 9 months. After drawing the bill, the seller hands over the bill to the buyer. The buyer accepts the same. This means he binds himself liable to pay the amount on the maturity of the bill. After accepting the bill, the buyer (drawee) gives the same to the seller (drawer). Now the bill is with the drawer. He has three alternatives. One is to retain the bill till the due date and present the bill to the drawee and receive the amount of the bill. This will affect the working capital position of the creditor. This is because he does not get immediate payment. The second alternative is to endorse the bill to any creditors to settle the business obligation. The third or last alternative is to discount the bill with his banker. This means he need not wait till the due date. If he is in need of money, he can discount the bill with his banker.

9. Define credit rating*Ans :*

Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

Definitions

- (i) "A corporate credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted."

- (ii) "Credit rating is an unbiased and independent opinions as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

10. CRISIL*Ans :*

It is the first credit rating agency in India which was jointly promoted by ICICI and UT1. It has pioneered the concept of credit rating in the country.

➤ Rating Services

The principal objective of CRISIL is to rate debt obligations of Indian companies. It now rates rupee-denominated credit instruments both long term and short term, namely debentures, deposits, structured obligations, preference shares and commercial papers.

➤ Information Services

Though the primary business of CRISIL is credit rating, it has diversified into information services as a thrust area for future. The extensive compilation and analysis of data for rating business is also used to provide information services to the corporate clients. The main information product is the CRISIL Card. It has also launched the CRISIL-500 equity index a market value weighted composite index of 500 companies.

11. ICRA*Ans :*

Investment Information and Credit Rating Agency of India (ICRA) has been promoted by the IFCI Ltd., as the main promoter to meet the requirements of the companies based in the north. The other shareholders of ICRA are SBI, UT1, PNB, LIC, GIC, etc. It started operations in 1991.

The primary objective of ICRA is to rate the credit instruments, to award a grade in consonance with the risk associated with them, to reflect their capability of timely servicing of debt.

ICRA has ventured into "Earning Prospects Risk Analysis" (EPRA), which focuses on equity rating. The main emphasis of EPRA is on grading the primary market at the instance of the issuer and assessment of the secondary market at the instance of the investor. ICRA also undertakes rating of LPG/

kerosene, dealers/banks etc. In addition to credit rating, it also provides two services, credit assessment and general assessment.

12. Explain the features of factoring.

Ans :

The features of Factoring & Discounting include :

1. Improved Cash Flow

A better cash flow helps to save time and money, leads to greater profits and increases confidence in future planning.

2. Flexibility

Factoring/Discounting is one of the most flexible forms of finance available to business, as the available funds increase with the value of the credit-approved invoices.

3. Costs

Factors/Discounters usually charge a service fee plus interest on funds utilized. The fees depend on volume of sales and the level of services that are provided.

4. Collections

With its professionalism and weight in the marketplace, a Factor can often collect debts more quickly and effectively than a small independent business.

5. Credit Management

The Factor/Discounter can provide the business with regular, up-to-date information on the status of its sales ledger and the performance of its trade debtors.

6. Credit Protection

The Factor/Discounter undertakes credit checks on the business's debtors and may set a rate for credit protection under a non-recourse arrangement. The Factor/Discounter will pay the business, regardless of whether the invoice has been paid.

7. Credit Assessment

A Factor/Discounter has access to credit reference databases that many businesses may not be able to afford. A Factor /

Discounter can advise the business on the credit-worthiness of current and potential debtors.

13. AAA and BB in Credit Rating

Ans :

In the case of municipal and corporate bond funds, a fund company's literature, such as its fund prospectus and independent investment research reports, will report an "average credit quality" for the fund's portfolio as a whole.

Investment-grade issuer credit ratings are those rated above BBB- or Baa. The exact ratings depend on the credit rating agency. For Standard & Poor's, investment-grade credit ratings include:

- AAA
- AA+
- AA
- AA-

Companies with any credit rating in this category boast a high capacity to repay their loans; however, those awarded an AAA rating stand at the top of the heap and are deemed to have the highest capacity of all, to repay loans.

The next category down includes the following ratings:

- A+
- A
- A-

Companies with these ratings are considered to be stable entities with robust capacities for repaying their financial commitments. However, such companies may encounter challenges during deteriorating economic conditions.

The bottom tier of investment-grade credit ratings delivered by Standard and Poor's include:

- BBB+
- BBB
- BBB-

Companies with these ratings are widely considered to be "speculative grade" and are even more vulnerable to changing economic conditions than the prior group. Nevertheless, these companies largely demonstrate the ability to meet their debt payment obligations.

Choose the Correct Answers

1. What is the maximum debt period permitted under factoring? [a]
(a) 150 days (b) 120 days
(c) 90 days (d) 60 days
2. What is the maximum grace period under factoring? [d]
(a) 150 days (b) 120 days
(c) 90 days (d) 60 days
3. Which out the following is not a service provided by factor in factoring? [b]
(a) Management of receivables (b) Production of Goods
(c) Collection of debt (d) Maintaining the sales ledger
4. The type of factoring in which the factor recovers the amount advanced from client in case of non payment by customer? [c]
(a) Bill Discounting (b) Non-Recourse Factoring
(c) Recourse factoring (d) Bill Collection
5. How many factors are there in International Factoring? [b]
(a) One (b) Two
(c) Three (d) Four
6. Which of the following are the different options available to the entrepreneurs for funding the business? [d]
(a) Venture Capital (b) Angel Financing
(c) Invoice Factoring (d) All of the Above
7. Which of the following clearly defines the Factoring business? [d]
(a) It is a type of debtor finance in which a business sells its accounts receivable .
(b) The receivables are sold to the third party (called a factor) at a discount.
(c) It is commonly referred to as accounts receivable factoring, invoice factoring.
(d) All of the Above
8. Factoring Business is also known as by which of the following names? [d]
(a) Accounts Receivable Factoring (b) Asset Based Lending
(c) Invoice Factoring (d) All of the Above
9. Which of the following civilization is considered to be the origin of Factoring? [b]
(a) Indus Valley Civilization (b) Mesopotamian culture
(c) Incas Civilization (d) Aztecs Civilization
10. For which of the following businesses Factoring services are most commonly used? [d]
(a) Haulage Business (b) Healthcare Industry
(c) Real Estate (d) All of the Above

Fill in the blanks

1. _____ is a service rendered by the merchant bankers for the procurement of term loans for the projects.
2. The marketing of corporate securities by offering them to the public is known as _____.
3. _____ deals in new securities i.e., securities which were not previously offered to the investors.
4. The debenture trustee has to pay an initial registration fee of _____.
5. _____ refers to the total holdings of securities of an investor.
6. An independent opinion about the capability of the issuer to meet their financial obligation is _____.
7. The main objective of CRISIL is to rate _____ of Indian companies _____.
8. ICRA has ventured into _____ which focuses on equity rating.
9. _____ offers a wide range of products and services in the fields of credit information and equity research.
10. _____ are regulated by SEBI.

ANSWERS

1. Loan syndication
2. Issue management
3. New issue market
4. Lakhs
5. Portfolio
6. Credit rating
7. Debt obligations
8. Earning prospects risk analysis
9. CARE
10. Credit rating agencies.

FACULTY OF MANAGEMENT
M.B.A I Year I - Semester(CBCS) Examination
MODEL PAPER - I
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

[Short Answer Type]

Note: Answer **All** the Questions in not more than one page each

ANSWERS

- | | |
|---|--------------------|
| 1. Fund based activities. | (Unit-I, SQA-1) |
| 2. Define merchant banking. | (Unit-II, SQA-6) |
| 3. Define Hire Purchase. | (Unit-III, SQA-10) |
| 4. What are the Functions of Insurer? | (Unit-I, SQA-3) |
| 5. Explain Decision Analysis for Factor Services. | (Unit-I, SQA-2) |

PART - B (5 × 12 = 60 Marks)

[Essay Answer Type]

Note: Answer **All** the Questions by using internal choice in not exceeding four pages each

- | | |
|--|---------------------|
| 6. (a) Explain traditional and modern activities of financial services. | (Unit-I, Q.No.31) |
| OR | |
| (b) Explain the products and participants in primary market. | (Unit-I, Q.No.7) |
| 7. (a) Explain the various Services of Merchant Banks. | (Unit-II, Q.No.5) |
| OR | |
| (b) "Merchant banker acts as a bankers to an issue". Discuss. | (Unit-II, Q.No.10) |
| 8. (a) Explain the classification of leasing. | (Unit-III, Q.No.3) |
| OR | |
| (b) Discuss the procedure and steps involved in the financial evaluation of leasing. | (Unit-III, Q.No.17) |
| 9. (a) Define Insurance. Explain the basic characteristics of insurance. | (Unit-IV, Q.No.1) |
| OR | |
| (b) What are the functions of IRDA? | (Unit-IV, Q.No.19) |
| 10. (a) Explain the various symbols of credit rating. | (Unit-V, Q.No.27) |
| OR | |
| (b) What are the parties involved in bill discounting? | (Unit-V, Q.No.17) |

FACULTY OF MANAGEMENT
M.B.A I Year I - Semester(CBCS) Examination
MODEL PAPER - II
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

PART - A (5 × 4 = 20 Marks)**[Short Answer Type]****Note:** Answer **All** the Questions in not more than one page each**ANSWERS**

- | | |
|-----------------------------------|-------------------|
| 1. Define Security Market. | (Unit-I, SQA-6) |
| 2. What is underwriting? | (Unit-II, SQA-3) |
| 3. Define Leasing. | (Unit-III, SQA-1) |
| 4. Disadvantages of Insurance. | (Unit-IV, SQA-6) |
| 5. Advance and Maturity Factoring | (Unit-V, SQA-7) |

PART - B (5 × 12 = 60 Marks)**[Essay Answer Type]****Note:** Answer **All** the Questions by using internal choice in not exceeding four pages each

- | | |
|---|---------------------|
| 6. (a) Explain the structure of Indian money market. | (Unit-I, Q.No.27) |
| OR | |
| (b) What are the new financial products and services? | (Unit-I, Q.No.35) |
| 7. (a) Define underwriters. Explain general obligations and responsibilities of underwriters. | (Unit-II, Q.No.8) |
| OR | |
| (b) Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee. | (Unit-II, Q.No.12) |
| 8. (a) Explain the advantages and disadvantages of Leasing. | (Unit-III, Q.No.8) |
| OR | |
| (b) What are the various types of lease related risks? Explain the process involved in evaluating the lease or buy decisions. | (Unit-III, Q.No.21) |
| 9. (a) Explain different types of Insurance. | (Unit-IV, Q.No.6) |
| OR | |
| (b) Write the fundamental legal principles of insurance. | (Unit-IV, Q.No.13) |
| 10. (a) What are the types of factoring? | (Unit-V, Q.No.4) |
| OR | |
| (b) What are the advantages and disadvantages of Credit Rating ? | (Unit-V, Q.No.22) |

FACULTY OF MANAGEMENT
M.B.A I Year I - Semester(CBCS) Examination
MODEL PAPER - III
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

PART - A (5 × 4 = 20 Marks)**[Short Answer Type]****Note:** Answer **All** the Questions in not more than one page each**ANSWERS**

- | | |
|---|-------------------|
| 1. Financial Services. | (Unit-I, SQA-12) |
| 2. State the objectives of merchant banking. | (Unit-II, SQA-4) |
| 3. Break-even Lease Rental (BELR) | (Unit-III, SQA-4) |
| 4. Principle of indemnity. | (Unit-IV, SQA-7) |
| 5. Explain Decision Analysis for Factor Services. | (Unit-V, SQA-2) |

PART - B (5 × 12 = 60 Marks)**[Essay Answer Type]****Note:** Answer **All** the Questions by using internal choice in not exceeding four pages each

- | | |
|---|---------------------|
| 6. (a) Critically analyse the present position of the financial service sector in India and state the challenges it has to face in the years to come. | (Unit-I, Q.No.36) |
| OR | |
| (b) Define Security Market. Explain its organization and structure. | (Unit-I, Q.No.4) |
| 7. (a) Explain the functions of merchant banker. | (Unit-II, Q.No.7) |
| OR | |
| (b) Explain the role of merchant banker as registrar to an issue. | (Unit-II, Q.No.11) |
| 8. (a) Explain the Legal and tax Framework for Hire Purchasing System. | (Unit-III, Q.No.25) |
| OR | |
| (b) State the differences between leasing and hire purchase. | (Unit-III, Q.No.29) |
| 9. (a) Discuss the various functions of Insurer. | (Unit-IV, Q.No.14) |
| OR | |
| (b) Explain the advantages and disadvantages of Insurance. | (Unit-IV, Q.No.5) |
| 10. (a) Write a note on credit rating agencies in India and their performance. | (Unit-V, Q.No.25) |
| OR | |
| (b) Discuss briefly the Factoring Scenario in India. | (Unit-V, Q.No.11) |

FACULTY OF MANAGEMENT
MBA II - Semester (CBCS) Examinations
August - 2021
FINANCIAL MARKETS AND SERVICES

Time: 2 Hours

Max. Marks: 80

PART - A (4 × 5 = 20 Marks)

Answers

Note: Answer any four questions

- | | |
|---|--------------------|
| 1. What is Financial Engineering ? | (Unit-I, SQA-13) |
| 2. Distinguish between lease and Hire purchases | (Unit-III, SQA-12) |
| 3. State functions of Merchant Banker | (Unit-II, SQA-1) |
| 4. AAA and BB in Credit Rating | (Unit-V, SQA-13) |
| 5. Non-recourse factoring | (Unit-V, SQA-1) |

PART - B (4 × 15 = 60 Marks)

Note: Answer any four questions.

- | | |
|--|------------------------|
| 6. Discuss the recent trends in Financial services in India. | (Unit-I, Q.No. 37) |
| 7. Discuss the types of fund and non-fund based financial services in India. | (Unit-I, Q.No. 31) |
| 8. Explain the concept and evolution of Merchant Banking in India. | (Unit-II, Q.No. 1, 2) |
| 9. State the SEBI guidelines relating to issue Management. | (Unit-II, Q.No. 15) |
| 10. Discuss the benefits of leasing. | (Unit-III, Q.No. 8) |
| 11. Explain the Concept of Hire purchase and its characteristics. | (Unit-III, Q.No. 24) |
| 12. Explain the concept of Insurance and its basic Characteristics. | (Unit-IV, Q.No. 1) |
| 13. Write about IRDA and its role in regulating Insurance sector in India. | (Unit-IV, Q.No. 18) |
| 14. Discuss the emerging trends in factoring and state RBI guidelines. | (Unit-V, Q.No. 11, 12) |
| 15. Critically evaluate the performance of credit rating in India. | (Unit-V, Q.No. 25) |

FACULTY OF MANAGEMENT
M.B.A. II - Semester (CBCS) Examination
November - 2020
FINANCIAL MARKETS AND SERVICES

Time : 2 Hours]

[Max. Marks : 80

PART – A (4 × 5 = 20 Marks)**Note : Answer any Four questions****ANSWERS**

- | | |
|---|-------------------|
| 1. Fund based activities | (Unit-I, SQA-1) |
| 2. Portfolio manager | (Unit-II, SQA-2) |
| 3. Leasing | (Unit-III, SQA-1) |
| 4. Non Life Insurance | (Unit-IV, SQA-1) |
| 5. Decision analysis for factor services. | (Unit-V, SQA-2) |

PART – B (4 × 15 = 60 Marks)**Note: Answer any Four questions.**

- | | |
|--|------------------------|
| 6. What is financial engineering? Explain its need for financial innovation. | (Unit-I, Q.No. 32) |
| 7. What are the new financial products and services? | (Unit-I, Q.No. 35) |
| 8. What is merchant banking? Explain its functions. | (Unit-II, Q.No. 1, 7) |
| 9. Discuss : | |
| (i) Underwriter | (Unit-II, Q.No. 8) |
| (ii) Broker | (Unit-II, Q.No. 9) |
| (iii) Portfolio manager | (Unit-II, Q.No. 14) |
| 10. What is IPR based pricing ? Discuss its importance. | (Unit-III, Q.No. 20) |
| 11. Difference between lease Vs. buy decisions. | (Unit-III, Q.No. 23) |
| 12. What is Insurance? Write the fundamental legal principles of insurance. | (Unit-IV, Q.No. 1, 13) |
| 13. What is Insurances? Explain its types? | (Unit-IV, Q.No. 1, 6) |
| 14. What is factoring and bill discounting? | (Unit-V, Q.No. 1, 13) |
| 15. What are the financial dimensions of credit rating methodology? | (Unit-V, Q.No. 26) |

FACULTY OF MANAGEMENT
M.B.A. II - Semester (CBCS) Examination
May / June - 2019
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer all the questions from Part-A and Part-B.
Each question carries 4 marks in Part-A and 12 marks in Part-B.

PART - A (5 × 4 = 20 Marks)

ANSWERS

- | | |
|---|-------------------|
| 1. What are the functions of financial system? | (Unit-I, SQA-2) |
| 2. What is the role of underwriters in capital markets? | (Unit-II, SQA-3) |
| 3. Distinguish between operating lease and financial lease. | (Unit-III, SQA-2) |
| 4. What are the basic characteristics of insurance? | (Unit-IV, SQA-2) |
| 5. What are the advantages of credit rating? | (Unit-V, SQA-3) |

PART - B (5 × 12 = 60 Marks)

(Essay Answer Type)

- | | |
|--|----------------------------|
| 6. (a) Discuss the functions of a developed financial market. What are the types of financial markets? | (Unit-I, Q.No. 2, 1) |
| OR | |
| (b) What do you mean by financial services? Explain their scope and importance. | (Unit-I, Q.No. 28, 29, 31) |
| 7. (a) What is merchant banking? Explain the role and responsibilities of merchant bankers in India. | (Unit-II, Q.No. 1, 7) |
| OR | |
| (b) Explain the regulatory framework of merchant bankers in India. | (Unit-II, Q.No. 6) |
| 8. (a) What is leasing? Compare and contrast between operating lease and financial lease. | (Unit-III, Q.No. 1, 4) |
| OR | |
| (b) Describe the features of hire purchasing. | (Unit-III, Q.No. 24) |
| 9. (a) Explain the benefits and costs of insurance to the society. | (Unit-IV, Q.No. 12) |
| OR | |
| (b) Discuss the recent trends in Insurance Sector in India. | (Unit-IV, Q.No. 21) |
| 10. (a) What is factoring? What are the types of factoring. | (Unit-V, Q.No. 1, 4) |
| OR | |
| (b) Explain the utility of credit rating to issues and investors. | (Unit-V, Q.No. 18) |

FACULTY OF MANAGEMENT
M.B.A. II - Semester (CBCS) Examination
July / August - 2018
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer all the questions from Part-A and Part-B.
Each question carries 4 marks in Part-A and 12 marks in Part-B.

PART – A (5 × 4 = 20 Marks)

Note : Answer all the question in not more than one page each.

ANSWERS

- | | | |
|----|--|-------------------|
| 1. | Discuss fund based activities. | (Unit-I, SQA-1) |
| 2. | Explain the role of underwriter. | (Unit-II, SQA-3) |
| 3. | What is break-even rental? | (Unit-III, SQA-4) |
| 4. | State the function of insurer. | (Unit-IV, SQA-3) |
| 5. | Discuss the decision analysis for factor services. | (Unit-V, SQA-2) |

PART – B (5 × 12 = 60 Marks)

(Essay Answer Type)

Note : Answer all the questions by using internal choice.

- | | | |
|-----|--|-------------------------|
| 6. | (a) Discuss an overview of Indian securities market. | (Unit-I, Q.No. 4) |
| | OR | |
| | (b) What are the new products and services available in India? | (Unit-I, Q.No. 35) |
| 7. | (a) Explain the functions of merchant bankers. | (Unit-II, Q.No. 5) |
| | OR | |
| | (b) Discuss the SEBI guidelines relating to issue management. | (Unit-II, Q.No. 15) |
| 8. | (a) Explain the types of leasing. | (Unit-III, Q.No. 3) |
| | OR | |
| | (b) State the differences between leasing and hire purchase. | (Unit-III, Q.No. 29) |
| 9. | (a) What are the benefits and costs of insurance to society. | (Unit-IV, Q.No. 12) |
| | OR | |
| | (b) Explain the functions and role of IRDA. | (Unit-IV, Q.No. 14, 16) |
| 10. | (a) Discuss the types of factoring. | (Unit-V, Q.No. 4) |
| | OR | |
| | (b) Explain the utility of credit rating. | (Unit-V, Q.No. 20) |

FACULTY OF MANAGEMENT
M.B.A. II - Semester (CBCS) Examination
May / June - 2018
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer all the questions from Part-A and Part-B.
Each question carries 4 marks in Part-A and 12 marks in Part-B.

PART - A (5 × 4 = 20 Marks)

ANSWERS

- | | |
|---|-------------------|
| 1. What are the characteristic features of financial instruments? | (Unit-I, SQA-3) |
| 2. State the objectives of merchant banking. | (Unit-II, SQA-4) |
| 3. State various types of leasing. | (Unit-III, SQA-3) |
| 4. What are the functions of insurer? | (Unit-IV, SQA-3) |
| 5. What are the characteristics of factoring services? | (Unit-V, SQA-3) |

PART - B (5 × 12 = 60 Marks)

(Essay Answer Type)

- | | |
|---|-------------------------|
| 6. (a) What is capital market? Describe the segments of the capital market in India. | (Unit-I, Q.No. 5, 6, 8) |
| OR | |
| (b) Explain the role of financial services in economical development. | (Unit-I, Q.No. 37) |
| 7. (a) Who is a merchant banker? Discuss the services provided by a merchant banker. | (Unit-II, Q.No. 1, 5) |
| OR | |
| (b) Give an overview of the evolution of merchant banking. | (Unit-II, Q.No. 2) |
| 8. (a) What is meant by leasing? What are the advantages and limitations of leasing? | (Unit-III, Q.No. 1, 8) |
| OR | |
| (b) Explain the legal frame work of hire-purchase system. | (Unit-III, Q.No. 25) |
| 9. (a) Explain the various types of insurances along with their merits and demerits in India. | (Unit-IV, Q.No. 6, 9) |
| OR | |
| (b) Briefly explain the fundamental legal principles of insurance. | (Unit-IV, Q.No. 13) |
| 10. (a) What is factoring? Discuss briefly the factoring scenario in India? | (Unit-V, Q.No. 1, 11) |
| OR | |
| (b) Discuss the merits and demerits of credit rating. | (Unit-V, Q.No. 22) |

FACULTY OF MANAGEMENT
M.B.A. II - Semester (CBCS) Examination
July / August - 2017
FINANCIAL MARKETS AND SERVICES

Time : 3 Hours]

[Max. Marks : 80

Note : Answer all the questions from Part-A and Part-B.
Each question carries 4 marks in Part-A and 12 marks in Part-B.

PART – A (5 × 4 = 20 Marks)

ANSWERS

- | | |
|---|-------------------|
| 1. Discuss the need for financial innovation. | (Unit-I, SQA-4) |
| 2. What are the functions of a broker? | (Unit-II, SQA-5) |
| 3. Explain the features of hire purchase. | (Unit-III, SQA-5) |
| 4. State this types of insurances. | (Unit-IV, SQA-4) |
| 5. Discuss the cost of factoring. | (Unit-V, SQA-4) |

PART – B (5 × 12 = 60 Marks)
(Essay Answer Type)

- | | |
|---|--------------------------|
| 6. (a) State the products and participants in primary market. | (Unit-I, Q.No. 7) |
| OR | |
| (b) What are the emerging challenges to the financial services sector in India. | (Unit-I, Q.No. 36) |
| 7. (a) Explain the role of the merchant banker in issue management. | (Unit-II, Q.No. 15) |
| OR | |
| (b) Discuss the concept and evolution of merchant banking in India. | (Unit-II, Q.No. 2) |
| 8. (a) Explain the funding and regulatory aspects of leasing in India. | (Unit-III, Q.No. 15, 16) |
| OR | |
| (b) Discuss the legal and tax framework of hire purchase agreement. | (Unit-III, Q.No. 25) |
| 9. (a) Explain the fundamental principles of insurance. | (Unit-IV, Q.No. 13) |
| OR | |
| (b) State the recent trends in insurance sector in India. | (Unit-IV, Q.No. 21) |
| 10. (a) Discuss the financial evaluation of factorial services. | (Unit-V, Q.No. 8) |
| OR | |
| (b) Explain the various symbols of credit rating. | (Unit-V, Q.No. 27) |