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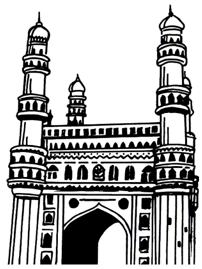

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UNIT I	**INTRODUCTION TO FINANCIAL SERVICES** **Financial Services:** Meaning and Classification **Fund Based Services:** Leasing – Hire Purchase – Factoring – Forfaiting – Bill Discounting – Housing Finance – Insurance Services – Venture Capital – Banking Services – Mutual Fund Services **Fee Based Services:** Corporate Advisory Services – Stock Broking – Custodial Services – Credit Rating – New Financial Products and Services: Merchant Banking – Loan Syndication – Securitization

1.1 Financial Services

1.1.1 Meaning

Q1. What do you mean by financial services?

(OR)

What are Financial Services.

Ans : **(May-18, May-15)**

Introduction.

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilization and allocation of savings.

Thus, it includes all activities involved in the transformation of savings into investment. Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organizations that deal with the management of money. These organizations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.

Meaning

Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

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

Q2. What are the characteristics of financial services?

(OR)

State the nature of financial services.

(OR)

Explain the Peculiarities of Financial services.

Ans : **(May-15, Imp.)**

From the following characteristics of financial services, we can understand their nature:

1. Intangibility

Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

2. Inseparability

Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect under standing between the financial service institutions and its customers.

3. Perishability

Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

4. Variability

In order to cater a variety of financial and related needs of different customers in different areas, financial service organizations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers.The service institutions differentiate their services to develop their individual identity.

5. Dominance of human element

Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled personnel to market the quality financial products.

6. Information based

Financial service industry is an information based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

Q3. What are the Objectives of Financial Services.

Ans :

(i) Fund raising

Financial services help to raise the required funds from a host of investors, individuals, institution and corporate. For this purpose, various instruments of finance are used.

(ii) Funds deployment

An array of financial services is available in the financial markets which help the players to ensure an effective deployment of funds raised. Services such as bill discounting, parking of short-term funds in the money market, credit rating &securitization of debts are provided by financial services firms in order to ensure efficient management of funds.

(iii) Specialized services

The financial service sector provides specialized services such as credit rating, venture capital financing, lease financing, mutual funds, credit cards, housing finance, etc. besides banking and insurance. Institutions and agencies such as stock exchanges, non-banking finance companies, subsidiaries of financial institutions, banks & insurance companies also provide these services.

(iv) Regulation

There are agencies that are involved in the regulation of the financial services activities. In India, agencies such as the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and the Department of Banking and Insurance of the Government of India, regulate the functioning of the financial service institutions.

(v) Economic growth

Financial services contribute, in good measure, to speeding up the process of economic growth & development.

Q4. Explain the importance of financial services.

Ans :

The successful functioning of any financial system depends upon the range of financial services offered by financial service organizations. The importance of financial services may be understood from the following points:

1. Economic growth

The financial service industry mobilizes the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. Promotion of savings

The financial service industry mobilizes the savings of the people by providing transformation services. It provides liability, asset and size transformation service by providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. Capital formation

Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. Creation of employment opportunities

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

5. Contribution to GNP

Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

6. Provision of liquidity

The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

1.1.2 Classification

Q5. State the classification of financial services.

Ans : **(May-15)**

The financial intermediaries in India can be traditionally classified into two:

(i) Capital market intermediaries and

(ii) Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

1.2 Scope of Financial Services

Q6. Explain traditional and modern activities of financial services.

Ans : **(May-18, Imp.)**

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.

(a) Fund-based Activities

Following services are categorized as fund-based activities,

(i) Investment in or underwriting of shares, debentures, bonds etc., of primary markets.

(ii) Investment and underwriting of secondary market securities.

(iii) Activities related to money market instruments like commercial papers, certificates of deposits, treasury bills etc.

(iv) Dealing in equipment leasing, hire-purchase, venture capital, seed capital etc.

(v) Activities related to foreign exchange markets.

(b) 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

The modern services offered by financial intermediaries include the following,

(i) Project advisory services from the time of preparation of project report till the approval of the project and raising of the funds.

(ii) Deciding on the need for mergers and acquisitions and planning and helping for its smooth execution.

(iii) Providing assistance to corporate customers in capital restructuring.

(iv) Playing the role of a trustee to the debenture holders.

(v) Advising for changes in management structure and style for achieving better results.

(vi) Planning for joint-ventures and financial collaboration with suitable domestic or global partners through the preparation of joint venture agreement.

(vii) Offering rehabilitating measures for sick units and facilitating the implementation of those measures.

(viii) Hedging of risks which arises due to exchange rate risk, interest rate risk, economic and political risk by using swaps, forwards etc.

(ix) Assisting in portfolio management for large-scale units of public sector.

(x) Providing risk management services like insurance and buy-back options.

(xi) Guiding clients in selecting sources of finance with respect to the funds required, cost of acquiring funds, lending period etc.

(xii) Providing assistance in minimization of cost of debt and deciding on the optimum debt-equity mix.

(xiii) Undertaking capital market services such as clearing services, registration and transfers, safe-custody of securities, collection of income on securities etc.

(xiv) Promoting credit rating agencies with an objective of helping companies going public by issuing debt instruments.

1.2.1 Fund Based Services

1.2.1.1 Leasing – Hire Purchase – Factoring – Forfaiting – Bill Discounting – Housing Finance – Insurance Services – Venture Capital – Banking Services – Mutual Fund Services

Q7. Define fund based services. Explain briefly about various fund based services.

(OR)

Explain briefly about asset based services.

Ans : **(May-15, Imp.)**

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

A. Asset/Fund Based Services

1. Equipment leasing/Lease financing

A lease is an agreement under which a firm acquires a right to make use of a capital asset like machinery etc. on payment of an agreed fee called lease rentals. The person (or the company) which acquires the right is known as lessee. He does not get the ownership of the asset. He acquires only the right to use the asset. The person (or the company) who gives the right is known as lessor.

2. Hire purchase and consumer credit

Hire purchase is an alternative to leasing. Hire purchase is a transaction where goods are purchased and sold on the condition that payment is made in installments. The buyer gets only possession of goods. He does not get ownership. He gets ownership only after the payment of the last instalment. If the buyer fails to pay any instalment, the seller can repossess the goods. Each instalment includes interest also.

3. Bill discounting

Discounting of bill is an attractive fund based financial service provided by the finance companies. In the case of time bill (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer's account. Thus, the bank purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In short, discounting of bill means giving loans on the basis of the security of a bill of exchange.

4. Venture capital

Venture capital simply refers to capital which is available for financing the new business ventures. It involves lending finance to the growing companies. It is the investment in a highly risky project with the objective of earning a high rate of return. In short, venture capital means long term risk capital in the form of equity finance.

5. Housing finance

Housing finance simply refers to providing finance for house building. It emerged as a fund based financial service in India with the establishment of National Housing Bank (NHB) by the RBI in 1988. It is an apex housing finance institution in the country. Till now, a number of specialized financial institutions/companies have entered in the filed of housing finance. Some of the institutions are HDFC, LIC Housing Finance, Citi Home, Ind Bank Housing etc

6. Insurance services

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 risk is 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.

According to Mc Gill, "Insurance is a process in which uncertainties are made certain". In the words of 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.

7. Factoring

Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in respect of account receivables. The factor undertakes the responsibility of collecting the account receivables. The financial institution (factor) undertakes the risk. For this type of service as well as for the interest, the factor charges a fee for the intervening period. This fee or charge is called factorage.

8. Forfaiting

Forfaiting is a form of financing of receivables relating to international trade. It is a non-recourse purchase by a banker or any other financial institution of receivables arising from export of goods and services. The exporter surrenders his right to the forfaiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a technique that helps the exporter sells his goods on credit and yet receives the cash well before the due date. In short, forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter. The exporter need not bother about collection of export bill. He can just concentrate on export trade.

9. Mutual fund

Mutual funds are financial intermediaries which mobilize savings from the people and invest them in a mix of corporate and government securities. The mutual fund operators actively manage this portfolio of securities and earn income through dividend, interest and capital gains. The incomes are eventually passed on to mutual fund shareholders.

Q8. What are the functions of Venture Capital.

Ans :

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

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.
3. Venture capital is available only for commercialization of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.
5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.
7. Venture capital is not just injection of money but also an input needed to set-up the firm, design its marketing strategy and organize and manage it.
8. Investment is usually made in small and medium scale enterprises.

Q9. Explain the scope of Venture Capital.

Ans :

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) Development of an Idea Seed Finance

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

(2) Implementation Stage Start up Finance

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

(3) Fledging Stage Additional Fiance

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

(4) Establishment Stage Establishment Finance

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

Before investing in small, new or young hitech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems.

After assessing the viability of projects, the investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation.

All the above stages of finance involve varying degrees of risks and venture capital industry, only after analyzing such risks invest in one or more. Hence they specialize in one or more but rarely all.

1.2.2 Fee Based Services

1.2.2.1 Corporate Advisory Services – Stock Broking – Custodial Services – Credit Rating – Merchant Banking – Loan Syndication – Securitization

Q10. Define non-fund based services. Explain the various services of non-fund based services.

(OR)

Explain briefly about fee based services.

Ans : **(May-15, Imp.)**

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

(i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients project cost or his working capital requirements.

(iv) Assisting in the process of getting all Government and other clearances.

Non-Fund Based/Fee Based Financial Services

1. Merchant banking

Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined 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 securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

2. Credit rating

Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the credit worthiness of a company by an independent organization.

3. Stock broking

Now stock broking has emerged as a professional advisory service. Stock broker is a member of a recognized stock exchange. He buys, sells, or deals in shares/securities. It is compulsory for each stock broker to get himself/herself registered with SEBI in order to act as a broker. As a member of a stock exchange, he will have to abide by its rules, regulations and by laws.

4. Custodial services

In simple words, the services provided by a custodian are known as custodial services (custodian services). Custodian is an institution or a person who is handed over securities by the security owners for safe custody. Custodian is a caretaker of a public property or securities. Custodians are intermediaries between companies and clients (i.e. security holders) and institutions (financial institutions and mutual funds). There is an arrangement and agreement between custodian and real owners of securities or properties to act as custodians of those who hand over it. The duty of a custodian is to keep the securities or documents under safe custody. The work of custodian is very risky and costly in nature. For rendering these services, he gets a remuneration called custodial charges.

Thus custodial service is the service of keeping the securities safe for and on behalf of somebody else for a remuneration called custodial charges.

5. Loan syndication

Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. In a loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager.

A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

6. Securitization of debt

Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of securitization. Securitization is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitized.

Securitization is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non-marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments.

Securitization is different from factoring. Factoring involves transfer of debts without transforming debts into marketable securities. But securitization always involves transformation of illiquid assets into liquid assets that can be sold to investors.

7. Corporate Advisory Services

Financial intermediaries like banks have set up corporate advisory service branches to render services exclusively to their corporate customers. 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.

Q11. Explain the Nature of Credit Ratings.

Ans :

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 prerequisites. 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 over looked 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 predetermined 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 cooperation 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.

Q12. Explain Credit Rating agencies in India.

Ans :

The Indian capital market has witnessed a tremendous growth in the past few years. Companies are relying on capital markets for financing existing operations as well as for new projects rather than on institutions. As the number of company's borrowings directly from capital market increase, investors find that the company's size or name is no longer a sufficient assurance of the timely payment of interest and principal.

Default by large and well-known companies recently in payment of interest on fixed deposits or debentures have reinforced this belief among investors. They felt the need for an independent and credible agency, which judges the quality of debt obligations of different companies and assists individual and institutional investors in making investment decisions.

The Credit Rating Information Services of India Limited was set up in 1987. After this, Investment Information and Credit Rating Agency of India were promoted in 1991 and Credit Analysis and Research Limited were floated in 1993. The Reserve Bank of India has approved all the three credit rating agencies.

Credit Rating Agencies in India

There are five credit rating agencies in India. They are :

(a) Credit Rating Information Service Ltd. (CRISIL)

(b) Investment Information and Credit Rating Agency of India. (ICRA)

(c) Credit Analysis and Research (CARE)

(d) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

(e) Onida Individual Credit Rating Agency Ltd. (ONICRA)

(a) Credit Rating Information Service Ltd

It is the first credit agency, which was set up on January 1, 1988. It was started jointly by ICICI and UTI with an equity capital of Rs. 4 crores. The principal objective of CRISIL is to rate the debt obligations of Indian Companies. Its rating guides investors about the risk of timely payment of interest and principal on particular debt instrument.

Objectives of CRISIL

- To assist both individuals and institutional investors in making investors decisions in fixed income securities.
- To enable corporates to raise large amounts at fair cost from a wide spectrum of investors.
- To enable intermediaries in placing their debt instruments with investors by providing them with an effective marketing tool.

(b) Investment Information and Credit Rating Agency of India (IICRA)

The IICRA was set up by Industrial Finance Corporation of India on 16th January, 1991. It is a public limited company with an authorized share capital of Rs. 101 crores. During 1994-95, IICRA rated 212 debt instruments covering a debt volume of Rs. 5343 crores. The cummulative number of instruments rated since its inception till March 1995 has been 485 covering a total debt volume of Rs. 17,638 crores.

(c) Credit Analysis and Research Limited (CARE)

The CARE was promoted in 1993 jointly with investment companies, banks and finance companies services offered by CARE are credit rating, information service, equity research, rating of paralled market of LPG and kerosene. Since its inception till the end of March 1995, CARE has rated 249 debt instruments covering a total debt volume of Rs. 9,729 crores.

(d) Duff and Phelps Credit Rating India Private Ltd. (DCR)

The Duffs and Phelps is a leading international credit rating agency. The J.M. Financial and Alliance Group in joint venture with Duffs and Phelps has now set-up DCR in India. Its main objective is to give credit rating to debt instruments. On special request it may undertake rating of companies and countries as well. The popular symbol employed by DCR is D1,D2,D3 etc depending upon the credit status.

(e) Onida Individual Credit Rating Agency Ltd

Almost all credit rating agencies established in India undertake credit analysis work of corporate bodies only. Unlike these agencies, the ONICRA Ltd. has taken up the individual borrowers. It has been sponsored by the Onida Finance Ltd. It does not rate the individual as such but the risk associated with entering into those credit transactions with that individual at a certain period. Thus, it helps the users of this rating to know risks associated with credit transactions while dealing with individuals. It is gaining popularity among financial institutions.

Q13. What are the Advantages and Disadvantages of Credit Ratings

Ans :

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, 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 :

1. 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.

2. 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.

3. Rating is no certificate of soundness

Rating grades by the rating agencies are only an opinion about the capability of the company to meets 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.

4. 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.

5. 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.

6. 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.

1.3 New Financial Products and Services

Q14. What are the services provided by financial institutions? Explain their relevance.

(OR)

Write a note on new financial products and services in India.

Ans : **(Imp.)**

1. Merchant Banking

Merchant bankers transfer funds from those who have it to those who need it. Merchant bankers serve corporate customers with different services like securities management for customers, portfolio management, project counselling and appraisal, underwriting shares and debentures, loan syndication, playing banker's role in order refunds, managing interest and dividend warrants etc.

2. Loan Syndication

Extending the concept of consortium financing, merchant bankers act as lead manager and offer syndicated loans. Corporate customers or government requires huge funds. Since banks cannot serve such customers individually, they join hands to share the credit risk and form a syndicate. Merchant banker, the lead manager, offers major part of the loan while other banks participate in lending according to their lending capacity.

3. Derivative Security

A security that is valued based on the values of other variables backing the security is called a derivative security. It is a risk management tool and covers the risk of price fluctuations. With derivative securities financial intermediaries allow breaking or risk into components like credit risk, exchange rate risk, interest rates risk etc. Forwards are examples of such derivatives offered in India.

4. Leasing

Leasing is another popular financial service being offered today. A lease agreement allows a company to use the leased capital assets like machinery, heavy equipments, land, mines, etc., by paying the fees called rental charges. While the ownership retains with the lessor, the lessee using the asset is to bear all the maintenance and repairing costs. In India, commercial banks are also allowed to provide leasing service through its subsidiaries.

5. Mutual Funds

Financial service institutions pool up savings of small investors to raise funds called mutual funds. Mutual funds are invested in diversified portfolio to spread risk. While it opens an investment channel to small investors, it reduces risks, improves liquidity and results in stable returns and better capital appreciation in the long run.

6. Factoring

Today, financial institutions offer a range of services through factoring. Factoring implies assuming credit risk in the collection of book debts for the clients. Financial intermediary acting as factor collects debts, provides credit information, monitors the clients' sales ledgers, and also offers finance against debts.

7. Letter of Credit (LOC)

This new service aids corporate customers in funding their imports. A financing company of home country make arrangements with the foreign financing company and enables the importers to import on deferred payment terms. The LOC is a way of temporary financing on certain terms and conditions for imports. It also forms a source of foreign exchange.

8. Forfeiting

Forfeiting refers to the discounting of an export bill. The exporter is offered hard cash. Financial intermediaries discount bill without any resource to the exporters. Thus, being protected from the risk of non - payment of debts, the exporter focuses on exports rather than on collection of bills.

9. Venture Capital

It is another financing service where venture capitalists finance a venture based on its potentiality by participating in the equity. Financial intermediaries support ventures involving novel ideas and innovative technologies, and finance for start-up as well as development capital.

10. Custodial Service

Another new financial service gaining significance I is that of a custodian. Financial companies serves foreign investors with agency services like safe custody of shares and debentures, collection of interests and dividends, reporting on corporate developments and corporate securities etc.

11. Corporate Advisory Services

Focussing on corporate customers, banks and other financial institutions now offer corporate advisory services. Setting up of banks' computer terminals at customer's office is one such service that helps corporate customers make the most of new products like Euro loans and GDRs.

12. Securitization

Through securitization, financial companies convert their ill-liquid, non-negotiable and high value financial) assets into securities of small value. These securities are transferable and tradable in the market. In this way, financial companies raise cash against fixed assets that lock huge funds for long-term. The investors also get a new investment channel.

13. New Products in Forex Markets

New products in forex markets of developed countries are also entering Indian markets. Some of them are forwards, options, futures and swaps.

There are some products which have come in foreign exchange market of the developed countries which have not totally entered the market of the developing country like India. The below mentioned products are the new products in foreign exchange market.

(a) Forward Contract

In this type of contract the transaction which take place are called forward transactions, in forward contract the foreign currency is delivered at a future date and agreed amount. The maturity of this contract is also fixed, its the responsibility of the partner involved in the forward contract to honour the contract in case of not honoring the contract the default-party have to pay penalty. These type of contract are used mainly in business transactions and also interest payment transactions.

(b) Options

It is a contract, where the buyer has an option or right to buy and sell a fixed amount of currency against the other currency also at a fixed rate (amount) on a future date according to the option of the buyer. There is no compulsion on the buyer to buy or sell the currency. Options are of two types,

(i) Call option and

(ii) Put option.

(i) Call Option

In call option the buyer has the option to buy any currency.

(ii) Put Option

In this the buyer can sell the currency according to his own option.

(c) Futures

It is an agreement to buy or sell specified quantity of foreign currency at a future date with the price agreed by the 2 parties (the buyer and the seller). On a stated exchange rate. Futures are different from options as the buyer is obliged to either buy or to sell the currency at a future date and time. These type of contracts are seen in the stock exchange market.

(d) Swaps

In swaps the financial intermediary take the responsibility to buy and sell a specified foreign currency for different maturity dates. The swaps include buying and selling of same currency for different dates of maturity to avoid the burden of being exposed to the risk. It is used in arbitrage between two nations and in interest rate market.

(e) Letter of Credit (LOC)

Letter of credit is a document used in import of goods where the bank of one country supports the export of good and services to avoid delayed payments by the importer. It is a security given by the bank or financial institution for payment of money. It not only saves as a sources of foreign exchange to the countries.

Q15. Discuss briefly some of the innovative products introduced in Indian financial service sector recently.

Ans : **(May-16)**

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.

Q16. What are the challanges based by the financial service sector.

(OR)

Discuss the recent challenges that are being faced by the financial service sector in India.

Ans : **(May-16, May-15, Imp.)**

The financial services have to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of them are :

(a) Lack of Qualified Personnel

The financial services sector is fully geared to the tasks of financial creativity 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.

(b) 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 of the advantages of the innovative instruments through literature, seminars, workshops and advertisements.

(c) 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.

(d) Lack of Specialization

In the Indian scene, each financial intermediary seems to deal in different financial services lines without specializing in one or two areas. Each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments.

(e) 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. A proper database 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.

(f) 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 fulfill 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.

Q17. State the present scenario of financial services sector.

Ans : **(Imp.)**

(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 channelize 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 four 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 Liberalization

Realizing 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 issues 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 privatized.

The Finance Act 1992 has brought into effect large scale amendments in the tax structure of long term capital gains. The Finance Act 1934 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 liberalized 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.

Short Question and Answers

1. Venture capital

Ans :

Venture capital simply refers to capital which is available for financing the new business ventures. It involves lending finance to the growing companies. It is the investment in a highly risky project with the objective of earning a high rate of return. In short, venture capital means long term risk capital in the form of equity finance.

2. Loan Syndication.

Ans :

Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. In a loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager.

A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

3. What are Financial Services?

Ans :

Introduction.

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilization and allocation of savings.

Thus, it includes all activities involved in the transformation of savings into investment. Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organizations that deal with the management of money. These organizations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.

Meaning

Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

Financial services can also be called financial intermediation. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers.

4. Explain the Peculiarities of Financial services.

Ans :

From the following characteristics of financial services, we can understand their nature:

1. Intangibility

Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

2. Inseparability

Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect under standing between the financial service institutions and its customers.

3. Perishability

Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

4. **Variability**

In order to cater a variety of financial and related needs of different customers in different areas, financial service organizations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers.The service institutions differentiate their services to develop their individual identity.

5. **Dominance of human element**

Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled personnel to market the quality financial products.

6. **Information based**

Financial service industry is an information based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

5. Merchant Banking.

Ans :

Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined 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 securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

6. Credit Rating.

Ans :

Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the credit worthiness of a company by an independent organization.

7. Securitization of debt.

Ans :

Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of securitization. Securitization is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitized.

Securitization is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non-marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments.

Securitization is different from factoring. Factoring involves transfer of debts without transforming debts into marketable securities. But securitization always involves trans- formation of illiquid assets into liquid assets that can be sold to investors.

8. Corporate Advisory Services.

Ans :

Financial intermediaries like banks have set up corporate advisory service branches to render services exclusively to their corporate customers. 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.

9. Foctoring.

Ans :

Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in respect of account receivables. The factor undertakes the responsibility of collecting the account receivables. The financial institution (factor) undertakes the risk. For this type of service as well as for the interest, the factor charges a fee for the intervening period. This fee or charge is called factorage.

10. Forfaiting.

Ans :

Forfaiting is a form of financing of receivables relating to international trade. It is a non-recourse purchase by a banker or any other financial institution of receivables arising from export of goods and services. The exporter surrenders his right to the for faiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a technique that helps the exporter sells his goods on credit and yet receives the cash well before the due date. In short, forfaiting is a technique by which a for faitor (financing agency) discounts an export bill and pay ready cash to the exporter. The exporter need not bother about collection of export bill. He can just concentrate on export trade.

11. Fund based Activities.

Ans :

Following services are categorized as fund-based activities,

(i) Investment in or underwriting of shares, debentures, bonds etc., of primary markets.

(ii) Investment and underwriting of secondary market securities.

(iii) Activities related to money market instruments like commercial papers, certificates of deposits, treasury bills etc.

(iv) Dealing in equipment leasing, hire-purchase, venture capital, seed capital etc.

(v) Activities related to foreign exchange markets.

12. Non fund based Activities.

Ans :

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 require- ments.

13. Bill Discounting.

Ans :

Discounting of bill is an attractive fund based financial service provided by the finance companies. In the case of time bill (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer's account. Thus, the bank purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In short, discounting of bill means giving loans on the basis of the security of a bill of exchange.

Choose the Correct Answers

1. The following one is a kind of fee based activity of a financial intermediary. [c]

   (a) Hire- purchase financing (b) Leasing

   (c) Capital issue management (d) Underwriting of shares

2. Find the odd man out : [b]

   (a) Commercial paper (b) Share certificate

   (c) Certificate of deposit (d) Treasury bill

3. The process of managing the sales ledger of a client by a financial service company is called: [b]

   (a) Forfeiting (b) Factoring

   (c) Leasing (d) Securitization of debt

4. The inflation free instrument is : [b]

   (a) Option bond (b) Index-linked guilt bond

   (c) Variable rate debenture (d) Deep discount bond

5. Non-banking companies should compulsorily get credit rating for their: [c]

   (a) Capital market instruments (b) Money market instruments

   (c) Debt market instruments (d) All of the above

6. Non-fund based activities are also known as [c]

   (a) Service based (b) Product based activity

   (c) Fee based activities (d) Non-fee based activities.

7. An agreement of a financing institute to support the export of goods to enable the import activity is ________ [b]

   (a) Letter of debit (b) Letter of credit

   (c) Letter of limit (d) Letter of deficit

8. Financial market and financial institutions which support ______ system [b]

   (a) Management system (b) Financial system

   (c) Economic system (d) Barking system.

9. Futures, forwards, options and swaps are part of ________ [c]

(a) Equity market (b) Debt market

(c) Derivative market (d) Debenture market

10. Funds raised by a financial service company by pooling the savings of the public and investing them in a diversified portfolio is ________ [c]

(a) Derivatives (b) Securities

(c) Mutual funds (d) Bonds

11. Financial service institutions pool up savings of small investors to raise fund is [a]

(a) Mutual funds (b) Factoring

(c) Leasing (d) Hire purchase

12. In India, the challenges faced by financial service sector are [d]

(a) No transparency (b) Outdated database

(c) Need for specialization (d) All the above

13. Bonds which ensure monthly income for the investor after a fixed 'wait period' are [b]

(a) Convertible bonds (b) Retirement bonds

(c) Easy exit bonds (d) Option bonds

14. Transfer of funds from those who have it to those who need it is allowed in [c]

(a) Leasing (b) Forfeiting

(c) Merchant banking (d) Factoring

15. New products in forex markets of developed countries are [d]

(a) Forwards (b) Options

(c) Futures (d) All the above

16. Which of the following is not a fund -based activity [b]

(a) Underwriting of shares

(b) Capital issue management

(c) Underwriting of Secondary market securities

(d) Foreign exchange activities

Fill in the blanks

1. The important goal of the financial service industry is to mobilise and allocate ________
2. Underwriting of shares by a financial intermediary is a kind of ________ activity.
3. ________ services are mainly provided to foreign investors.
4. ________ bonds are sold at a large discount to their nominal value.
5. To regulate the securities market and to protect the investor's interest. ________ has been created by the Government of India.
6. Term lending institutions are ________ market intermediaries.
7. ________ facilitate the functions of intermediaries by providing a means and a medium of exchange.
8. ________ mobilize the savings of the people and channel them into productive investments by providing various services.
9. ________ refers to the process of managing sales ledger of a clinet by a financial service company.
10. ________ is another method of financing in the form of equity participation.
11. ________ Funds raised by a financial services comapny by pooling the savings of the public.

Answers

1. Savings
2. Fund based
3. Custodial
4. Deep discount
5. SEBI
6. Capital
7. Financial intermediaries
8. Financial services
9. Factoring
10. Venture capital
11. Mutual funds

UNIT II	**LEASE, HIRE PURCHASE AND HOUSING FINANCE** **Leasing:** Financial Lease and Operating Lease - Lease Vs. Hire Purchase - Types of Financial Leasing - Advantages of Leasing - Consideration under Lease Vs. Buy Decision - Leasing in India - Problems of Leasing Companies - RBI Guidelines on leasing and finance companies (Theory) **Hire Purchase:** Terms of the Agreement under Hire Purchase - Types of Hire Purchase – Advantages (Theory) **Housing Finance:** Housing Finance Policy and Role of National Housing Bank (NHB) - Housing and Urban Development Corporation (HUDCO) - Role of Housing Finance Corporations and the Housing Schemes - Recent Developments (Theory)

2.1 Leasing

Q1. What is Leasing?

(OR)

Define Leasing.

Ans : **(May-17, May-16)**

Meaning

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

(i) A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.

(ii) The document in which this contract is written.

(iii) A great way companies can conserve capital.

(iv) An easy way vendors can increase sales.

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

Definition

'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.

(i) The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities.

(ii) The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

- Equipment Leasing Association of UK

Q2. What are the characteristics and elements of Leasing ?

Ans :

Characteristics

The following are the characteristics of a leasing.

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 (predetermined) 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.

Essential Elements

The essential elements involved in leasing process are

A. Parties to the Contractor

B. Asset

A) Parties to the Contractor

There are two essential parties to a contract of lease financing, namely

- **Lessor** - the lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities.
- **Lessee** - the lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

Apart from these a lease contract may include :

- There may be joint lessor or joint lessees, particularly where the properties or the amount of finance involved is enormous.
- There may be a lease-broker who acts as an intermediary in arranging lease deals.
- A lease contract may involved a lease financier, who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

B) 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.

2.1.1 Types of Leasing

Q3. Describe the various types of leasing.

(OR)

Discuss the financial Implications of different types of leasing.

Ans : **(Imp.)**

1. Financial Lease

Financial lease covers the complete economic life of the asset. During the lease period the lessor receives the lease rental to recover the full cost of the asset and also the reasonable return on the funds. Infact finance lease in also known as capital lease.

Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lessor 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.

From the lessee's perspective it has been viewed that the finance lease assures the lessee an uninterrupted use of the asset. The lessor may not be involved in dealing with the asset. On the basis of the requirement the lessee may select the asset and may even negotiate the price and the delivery schedule and so on with that of the supplier. But, the lessor makes the payment to the supplier and such arrangement is concurrent to the signing of the lease contract.

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.

The asset is returned back to the lessor at the end of the life of the lease who can either offer it to sale to the lessee (or any other person or lease it to any other lessee. Usually, operating lease covers a maintenance clause requiring the lessee to maintain the asset.

The maintenance includes the repairs, insurance and the tax payments. Under, the lease rentals lessor will include a suitable compensation for the expected cost of maintenance of the leased asset.

Usually, the operating lease is cancellable by any of the party and is greatly expensive than a finance lease as the lessee needs to compensate the lessor as the lessor assumes the ownership risk and the lessor does not bear any assets risk of becoming obsolete. Few of the assets which may be acquired on operating lease basis are vehicles, amusement equipments, furniture and fixtures and so on.

3. Other types of leasing

(i) First Amendment Lease

The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.

(ii) Full Payout Lease

A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

(iii) Guideline Lease

A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

(iv) Net Lease

A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.

(v) Open-end Lease

A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

(vi) Sales-type Lease

A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

(vii) Synthetic Lease

A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

(viii) Tax Lease

A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition of this tax incentive.

(ix) True Lease

A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

2.1.2 Financial Lease and Operating Lease

Q4. Distinguish between Financial Lease and Operating Lease.

(OR)

Compare and contrast Financial Lease and Operating Lease.

Ans : **(May-15, Imp.)**

S.No	Financial Lease	S.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 obsole-scence.
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 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.

2.1.3 Types of Financial Leasing

Q5. What is financial lease? Explain various types of Financial Leasing.

(OR)

Explain various types of Financial Leasing.

Ans : **(May-18, May-17, Imp.)**

Meaning

The financial lease covers the complete economic life of the asset. During the lease period the lessor receives the lease rental to recover the full cost of the asset and also the reasonable return on the funds. Infact finance lease in also known as capital lease.

Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lessor 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.

From the lessee's perspective it has been viewed that the finance lease assures the lessee an uninterrupted use of the asset. The lessor may not be involved in dealing with the asset. On the basis of the requirement the lessee may select the asset and may even negotiate the price and the delivery schedule and so on with that of the supplier. But, the lessor makes the payment to the supplier and such arrangement is concurrent to the signing of the lease contract.

Types

1. Leverage Lease

A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from ` 50 lakh to ` 2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties - the lessee, the lessor and the lender, e lessor acquires the assets as per the terms of the lease agreement but finances. Only a part of the total investment, say 20 per cent to 50 per cent. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as railroad, rolling stock, coal mining, electricity generating plants, pipelines, ships, etc. are acquired.

Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment. By investing 20 per cent or 25 per cent of the cost of an asset, the lessor is entitled to 100 percent allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

2. Sale and Lease Back

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the lease period. The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on a net-net basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase the property at the termination of lease.

The sale and lease back agreement is beneficial to both lessor and lessee. The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

Q6. What are the steps involved in Leasing.

Ans :

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. 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.

2.1.4 Advantages of Leasing

Q7. What are the Advantages and dis-advantages of Leasing?

(OR)

Bring out the merits and demerits of leasing.

(OR)

Explain the merits and limitations of leasing as a source of financing.

Ans : **(May-16,May -15)**

The following are the advantages of leasing:

1. Permit Alternative Use of Funds

A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

2. Faster and Cheaper Credit

Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going thorough formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

3. Flexibility

Leasing arrangements may be tailored to the lessee's needs more easily that ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to below.

4. Facilitates Additional Borrowings

Leasing may increase long-term ability to acquire funds. The lessee can utilize more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arises.

5. Protection against obsolescence

A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

6. No Restrictive Covenants

The restrictive covenants such as debt equity ratio, declaration of dividend etc., which are usually imposed under debenture or loan agreement are absolutely absent in a lease agreement.

7. Hundred Percent Financing

Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So hundred percent financing is assured to the lessee.

8. Boon to Small Firm

The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial institutions.

Disadvantages

1. Lease is not suitable mode of project finance. This is because rentals are repayable soon after entering into lease agreement while in new projects cash generations may start only after a long gestation period.
2. Certain tax benefits/incentives such as subsidy may not be available on leased equipment.
3. The value of real assets such as land and building may increase during lease period. In such a case the lessee loses the advantage of a potential capital gain.
4. The cost of financing is generally higher than that of debt financing.
5. A manufacturer who wants to discontinue a particular line of business will not in a position to terminate the contract except by paying heavy penalties. If it is a owned asset the manufacturer can sell the equipment at his will.
6. If the lessee is not able to pay rentals regularly, the lessor would suffer a loss particularly when the asset is a sophisticated one and less liquid.
7. In case of lease agreement, it is lessor who has purchased the asset from the supplier and not the lessee. Hence, the lessee by himself is not entitled to any protection in case the supplier commits breach of warranties in respect of the leased assets.
8. In the absence of exclusive laws dealing with the lease transaction, several problems crop up between lessor and lessee resulting in unnecessary complications and avoidable tension.

2.1.5 Consideration under Lease Vs. Buy Decision

Q8. What are the considerations to be taken under Lease and Buy Decision?

(OR)

Explain the factors to be considered while taking lease Vs Buy decisions

(OR)

Examine the role of consideration in lease and buy decision.

Ans : **(May-15)**

An entity's non-financial assets can be acquired either through outright purchase or leasing arrangements. When making a 'lease or buy' decision an entity must not only consider the financial implications of the options including the government's procurement criterion relating to 'value for money', but consideration must also be given to long-term strategic priorities and to qualitative. It is important to understand the implication of both options for the service delivery needs of the entity when determining the most appropriate option.

When leasing an asset the entity only pays for the use of the asset over the term of the lease and ownership of the asset does not pass to the entity at any stage unless the lease contract specifically states it. Leases where substantially all the risks and rewards incidental to ownership are transferred are usually classified as finance leases.

When buying an asset, the entity pays the full cost of the asset at acquisition date and has full ownership over the asset.

A finance lease is recorded as an asset when the transaction (contract) is entered into and, similar to the outright purchase option, will give rise to depreciation expense as would be the case of other assets controlled by the entity. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset is required to be fully depreciated over the lease term or its useful life, whichever is shorter.

An operating lease on the other hand, will usually specify a period over which an entity will have the right to use the goods, and have them replaced if they stop working during the lease period, but will then return the goods to the lessor at the end of the lease.

Better practice entities will usually undertake a risk assessment and cost benefit analysis to assess the implication of the operating lease vs finance lease vs outright purchase decision when considering key asset acquisitions.

Buying

Advantages

- Out right asset ownership
- Assets can be modified at any stage to suit changing business requirements.
- Asset can be replaced of disposed of at any time.

Disadvantages

- Major capital outlay up front.
- Entity incurs maintenance and repairs costs which typically increase as assets age.
- Entity incurs costs for the replacement or disposal of assets at the end of their useful lives.

Leasing

Advantages

- Cash-flow effective method for gaining access to assets as no major capital outlay up-front.
- Entity may not incur repair and maintenance costs as assets may fall under the warranty of the lessor over the term of the lease.
- The entity may not incur costs associated with disposal and replacement of assets at the end of their useful lives.
- Assets may be replaced more frequently, allowing the entity access to latest technology for no additional cost.
- Possible access to knowledge purchasing power and discounts offered by the lessor.

Disadvantages

- No asset ownership
- Assets may not be able to be modified to suit changing business requirements without lessor approval and attracting fees.
- Lease terms are generally fixed so asset replacements and early terminations at the request of the entity may attract penalties and fees.
- Potential capital outlay at the end of the lease term if purchasing the asset at the end of the lease.

2.1.6 Leasing in India

Q9. State the various legal and tax aspects relating to lease finance.

Ans :

I. Legal Aspects of Leasing

In India, separate law for equipment leasing does not exists. The provisions relating to bailment in the India contract Act are treated as same for equipment leasing agreements. Sec/48 of the Indian contract Act defines bailment as:

"The delivery of goods by one person to another, for some purpose, upon a contact 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'. Provisions of sec 150 and

168 of the Indian contract Act defined that as equipment lease transaction is treated same as contract of bailment. Hence obligations of the lessor and the lessee will be similar to those of the bailor and the bailee.

The following implications are given by the provisions for the lessor and the lessee,

1. It is the duty of lessor to deliver the asset to the lessee for giving legal authorization to lessee to use the asset, and the asset should be left in possession of the lessee during the agreement.

2. The lessee has the obligation to pay the lease rentals as mentioned in lease agreement, to protect the lessors title, to take reasonable care to protect the lessors title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

II. Tax Accepts of Leasing

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) 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 asses 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

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.

(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,

(a) Flexible structuring of lease rentals and

(b) Transfer of unabsorbed capital allowance to the lessor.

(a) Flexible Restructuring of Lease Rentals

The lessee can reduce his current of future tax liability by a flexible structuring of lease rentals. A lessor can structure a lease package in which a substantial part of the lease rentals is payable in the first year and a very small fraction during the remaining lease term.

(b) Transfer of unabsorbed capital allowance to the lessor

The second form of tax planning by a lessee is by way of transfer of investment-related unabsorbed tax shield to the lessor who can absorb it. This type of transfer is on of the significant tax-based advantages of leasing.

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.

Q10. Explain the Regulatory mechanism for leasing system in India.

Ans :

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 leasee 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 /easing 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 bailer.
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 lessees.

2.1.7 Problems of Leasing Companies

Q11. What are the Problems of Leasing Companies?

(OR)

Discuss the problems faced by the lease financing companies in India

Ans : **(Imp.)**

Leasing has great potential in India. However, leasing in India faces serious handicaps which may mar its growth in future. The following are some of the problems.

(i) Unhealthy Competition

The market for leasing has not grown with the same pace as the number of lessors. As a result, there is over supply of lessors leading to competition. With the leasing business becoming more competitive, the margin of profit for lessors has dropped from four to five percent to the present 2.5 to 3 percent. Bank subsidiaries and financial institutions have the competitive edge over the private sector concerns because of cheap source of finance.

(ii) Lack of Qualified Personnel

Leasing requires qualified and experienced people at the helm of its affairs. Leasing is a specialized business and persons constituting its top management should have expertise in accounting, finance, legal and decision areas. In India, the concept of leasing business is of recent one and hence it is difficult to get right man to deal with leasing business. On account of this, operations of leasing business are bound to suffer.

(iii) Tax Considerations

Most people believe that lessees prefer leasing because of the tax benefits if offers. In reality, it only transfers, the benefit, i.e., the lessee's tax shelter is lessor's burden. The lease becomes economically viable only when the transfer's effective tax rate is low. In addition, taxes like sales tax, wealth tax, additional tax, surcharge etc. add to the cost of leasing. Thus leasing becomes more expensive from of financing than conventional mode of finance such as hire purchase.

(iv) Stamp Duty

The States treat a leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as a pure lease transaction. Accordingly a heavy stamp duty is lived on lease documents. This adds to the burden of leasing industry.

(v) Delayed Payment and Bad Debts

The problem of delayed payment of rents and bad debts add to the costs of lease. The lessor does not take into consideration this aspect while fixing the rentals at the time of lease agreement. These problems would disturb prospects of leasing business.

2.1.8 RBI Guidelines on Leasing and Finance Companies

Q12. Explain the RBI Guidelines on Leasing and Finance Companies.

(OR)

Outline the RBI guidelines relating to leasing.

Ans : **(Imp.)**

With the enormous growth in number of NBFCs over the last few years and in order to safeguard the interest of investing public the necessity of regulating the functioning of these NBFCs by Reserve Bank of India was strongly felt. In April May, 1993 NBFCs with Net Owned Funds (NOF) of Rs. 50 lakhs and above were required to register themselves with RBI.

In June 1994, guidelines on prudential norms for income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/investments were issued by RBI. Registered NBFCs were required to get themselves rated by one of the credit rating agencies at least once in a year. NBFCs were also required to attain capital adequacy of 8 per cent by March 31, 1996 after making adequate provision for sub standard, doubtful and loss assets.

These guidelines further laid down exposure norms for maximum commitment to a single party and a group of parties.

In order to have proper control and regulate the functioning of NBFCs, Govt. of India enacted 'The Reserve Bank of India' (Amendment) Act, 1997 conferring wide ranging powers to RBI. As per the Act, no NBFC can commence or carry on business:

(a) Without obtaining from RBI, a certificate of registration, and

(b) Having owned funds of Rs. 200 lacs.

Finance from banks may now be restricted to NBFCs registered with Reserve Bank of India. For the purpose of granting bank advance Non Banking Financial Companies (NBFCs) am basically divided in four broad groups on the basis of their principal business as under :

i) Equipment Leasing (EL),

ii) Hire Purchase (HP),

iii) Loan and investment activities,

iv) Residuary Non Banking Companies (RNBC).

The working and operations of NBFCs are regulated by the Reserve Bank of India (RBI) within the framework of the Reserve Bank of India Act, 1934 and the directions issued by it under the Act. As per the RBI Act, a 'non-banking financial company' is defined as:

(i) a financial institution which is a company;

(ii) a non banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Under the Act, it is mandatory for a NBFC to get itself registered with the RBI as a deposit taking company. This registration authorizes it to conduct its business as an NBFC. For the registration with the RBI, a company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution, should have a minimum net owned fund (NOF) of Rs 25 lakh (raised to Rs 200 lakh w.e.f April 21, 1999). The term 'NOF' means, owned funds (paid-up capital and free reserves, minus accumulated losses, deferred revenue expenditure and other intangible assets) less,

(i) Investments in shares of subsidiaries/ companies in the same group/ all other NBFCs; and

(ii) The book value of debentures/bonds/ outstanding loans and advances, including hire-purchase and lease finance made to, and deposits with, subsidiaries/ companies in the same group, in excess of 10% of the owned funds.

The registration process involves submission of an application by the company in the prescribed format along with the necessary documents for RBI's consideration. If the bank is satisfied that the conditions enumerated in the RBI Act, 1934 are fulfilled, it issues a 'Certificate of Registration' to the company. Only those NBFCs holding a valid Certificate of Registration can accept/hold public deposits. The NBFCs accepting public deposits should comply with the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998, as issued by the bank. Some of the important regulations relating to acceptance of deposits by the NBFCs are:-

- They are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months.
- They cannot accept deposits repayable on demand.
- They cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time.
- They cannot offer gifts/incentives or any other additional benefit to the depositors.
- They should have minimum investment grade credit rating.
- Their deposits are not insured.
- The repayment of deposits by NBFCs is not guaranteed by RBI.

2.2 Hire Purchase

Q13. Define the term Hire Purchase.

(OR)

What is Hire Purchase?

Ans : **(May-18, May-17, May-16, Imp.)**

Meaning

Hire purchase is one of the means of financing the price of goods that are to be sold on a future date. In a hire-purchase transaction, the goods allowed to be hired, whereas the purchase price is being paid in installments and hirer can buy the goods by paying all the installments. A hire-purchase agreement is defined as a particular type of transaction wherein goods are let on hire with an option to the hirer to buy them, with the following specifications,

(a) Payment must be made within a particular period of time in the form of installments.

(b) The ownership would be transferred to the hirer immediately after entering into the contract.

(c) On the payment of last instalment, the property in goods would be passed to the hirer.

(d) Each instalment is considered as hire charges, because if in case default is made in payment of instalment, then seller would be entitled to take back the goods.

(e) The hirer/purchaser can freely return goods without paying any further installments which becomes due after the return.

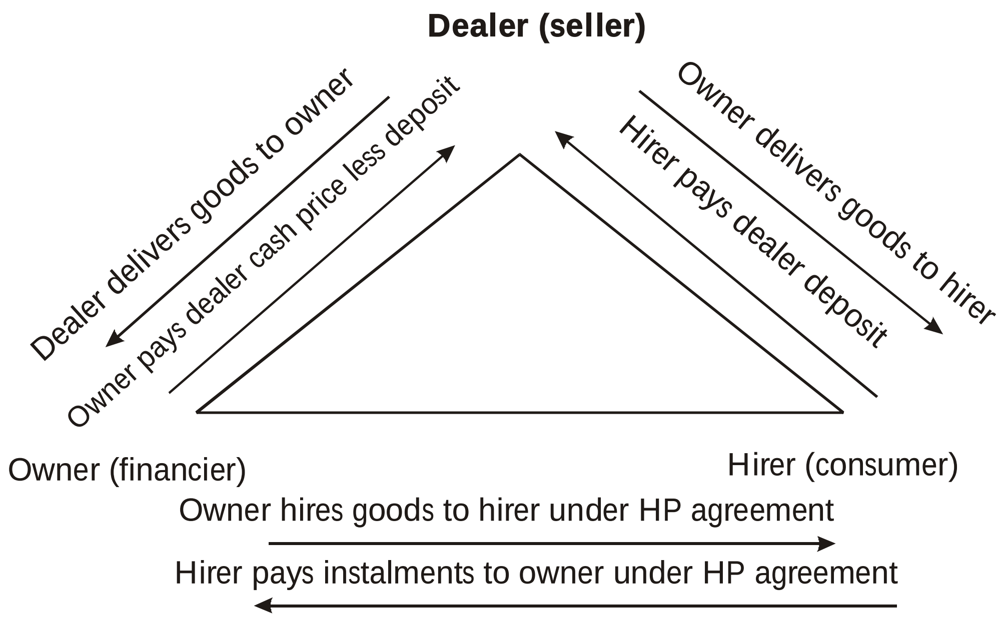

Fig.: Hire-Purchase Transaction

Eventhough in hire purchase contract, the option to purchase is available in the beginning but it can be used only at the end of the agreement. The importance of this agreement is that the property in the goods does not get transferred during agreement but passes when option is used by the intending purchases.

Q14. What are the characteristics of Hire Purchase.

Ans :

Following are the features of a regular hire purchase transaction:

- Rental payments are paid as installments over the period of agreement.
- Each rental payment is considered as a charge for hiring the asset. This means that, if the hirer defaults on any payment, the seller has all the rights to take back the assets.
- All the required terms and conditions between both the parties involved are documented in a contract called Hire-Purchase agreement.
- The frequency of the installments may be annual, half-yearly, quarterly, monthly, etc. according to the terms of the agreement.
- Assets are instantly delivered to the hirer as soon as the agreement is signed.
- If the hirer uses the option to purchase, the assets are passed to him after the last installment is paid.
- If the hirer does not want to own the asset, he can return the assets any time and is not required to pay any installment that falls due after the return.
- However, once the hirer returns the assets, he cannot claim back any payments already paid as they are the charges towards the hire and use of the assets.
- The hirer cannot pledge, sell or mortgage the assets as he is not the owner of the assets till the last payment is made.
- The hirer, usually, pays a certain amount as an initial deposit while signing the agreement.
- Generally, the hirer can terminate the hire purchase agreement any time before the ownership rights pass to him.

2.2.1 Terms of the Agreement under Hire Purchase

Q15. Define Hire Purchase agreement. State the various terms of Hire Purchase agreement.

Ans :

It is defined as peculiar kind of transactions in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations :

- Payment to be made in installments over a specified period
- The possession is delivered to the hirer at the time of entering into the contract
- The property in the goods passes to the hirer on payment of the last installment
- Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods and
- The hirer/purchases are free to return the goods without being required to pay any further installments falling due after the return.

The hire purchase agreement must contain the following :

- The description of goods in a manner sufficient to identify them
- The hire purchase price of the goods
- The date of commencement of the agreement
- The number of installments in which hire purchase price is to be paid, the amount, and due date.

Terms

A hire-purchase agreement contains the following clauses :

1. **Nature of Agreement**

   Stating the nature, terms and commencement of the agreement.

2. **Delivery of Equipment**

   The place and the time of delivery and the hirer's liability to bear delivery charges.

3. **Location**

   The place where the equipment shall be kept during the period of hire.

4. **Inspection**

   That the hirer has examined the equipment and is satisfied with it.

5. **Hire-Charges**

   To be paid by the hirer, the time schedule, the rate of interest for delayed payment.

6. **Repairs**

   The hirer to obtain at his cost, insurance on the equipment and to hand over the insurance policies to the owner.

7. **Alteration**

   The hirer not to make any alternations, additions, and so on to the equipment without the consent of the owner.

8. **Termination**

   The events or acts of hirer that would constitute a default eligible to terminate the agreement.

9. **Risk**

   Of loss and damage to be borne by the hirer.

10. **Registration and Fees**

    The hirer to comply with the relevant laws, obtain registration and bear all requisite fees.

Q16. What are the characteristics of Hire purchase.

Ans :

Hire purchase (as per Hire Purchase Act 1972, India) is a typical transaction in which the assets are allowed to be hired and the hirer is provided an option to later purchase the same assets.

Following are the features of a regular hire purchase transaction:

- Rental payments are paid as installments over the period of agreement.
- Each rental payment is considered as a charge for hiring the asset. This means that, if the hirer defaults on any payment, the seller has all the rights to take back the assets.
- All the required terms and conditions between both the parties involved are documented in a contract called Hire-Purchase agreement.
- The frequency of the installments may be annual, half-yearly, quarterly, monthly, etc. according to the terms of the agreement.
- Assets are instantly delivered to the hirer as soon as the agreement is signed.
- If the hirer uses the option to purchase, the assets are passed to him after the last installment is paid.
- If the hirer does not want to own the asset, he can return the assets any time and is not required to pay any installment that falls due after the return.
- However, once the hirer returns the assets, he cannot claim back any payments already paid as they are the charges towards the hire and use of the assets.
- The hirer cannot pledge, sell or mortgage the assets as he is not the owner of the assets till the last payment is made.
- The hirer, usually, pays a certain amount as an initial deposit while signing the agreement.
- Generally, the hirer can terminate the hire purchase agreement any time before the ownership rights pass to him.

2.2.2 Types of Hire Purchase

Q17. Explain the various Types of Hire Purchase.

Ans :

There are two types of hire-purchase financing.

(a) Consumer hire purchase

This covers the financing of consumer goods purchased for personal, family and household purpose. Therefore, the hirer is a natural person (not business) and the goods are obtained for non-business purpose.

(b) Industrial hire purchase

Industrial hire purchase refers to goods purchased by companies for use in business or industry. Example, the purchase of a machine by a company to be used in business.

2.2.3 Advantages

Q18. What are the advantages of Hire Purchase System.

Ans :

(a) Advantages to Hire Purchase Buyer

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 which is an easy mode of payment.

3. Encouragement to Savings

In hire purchase, 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.

(b) Advantages to Seller

1. Increase in Sales

People who get attracted 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 the amount received in past. In order to overcome this issue, the buyer himself makes the payment on time.

3. Establish 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 installment 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

Q19. State the limitations of Hire Purchase System.

Ans :

Some of the main limitations/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 instalment. 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 installment, 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 through 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 which result in the loss to the society.

2.3 Lease Vs. Hire Purchase

Q20. Differentiate between hire purchasing and leasing.

(OR)

Compare and contrast hire purchase financing and lease financing.

(OR)

Compare and contrast Hire purchase and Lease as a tools of financing.

Ans : **(Imp.)**

S.No	Basis	Hire Purchase	Lease Financing
1.	**Ownership**	Hirer becomes owner on payment of last installment	The lessor is the owner and owner ship never passes to the lessee.
2.	**Down payment**	20-25% of the cost is paid as down payment	No down payment
3.	**Depreciation**	Charged in the books of the hirer	Charged in the books of the lessor
4.	**Maintenance**	Borne by Hirer	Operating lease - Lessor Finance lease - Lessee
5.	**Capitalization**	In the books of the hirer	In the books of the leasing company
6.	**Tax Benefits**	On depreciation and finance charges to Hirer	On lease rentals to lessee On depreciation to lessor
7.	**Risk of obsolescence**	Borne by the Hirer	Operating lease - Lessor finance lease - Lessee
8.	**Reporting**	The asset is shown in the balance sheet of hirer and the installment payable as a liability.	The asset is shown in the Balance Sheet of the lessee in case of finance lease

2.4 Housing Finance

2.4.1 Housing Finance Policy

Q21. Define Housing Finance. Explain the Housing Finance Policy in India.

Ans :

Meaning

Housing finance refers to a collection of all financial arrangements that have been made by Housing Finance Companies (HFCs) in order to meet the needs of housing.

The constitution of India has granted six fundamental rights, out of which the right to live is one of them which, further consists of the right to housing policy. The directive principles of the state policy makes it as an obligation to help in building houses. The demand for houses is increasing day by day due to the increasing population and is becoming one of the global issues. Food, clothing and shelter are the three basic needs of human beings. Out of which food and clothing have been fulfilled to some extent but housing still needs to be fulfilled. The main reasons can be scarcity of capital, insufficient financial institutions, clubbed with the increase in building material, labour and other costs.

As per the estimates nearly 38 million housing units are not being fulfilled, this is because housing has been avoided from the starting. Out of the 11 five year plans only two five year plans i.e., 7^{th} and 8^{th} plan have emphasized upon housing.

The housing contribution to the economic development is usually ascertained in terms of Gross Fixed Capital Formation (GFCF). According to the UN recommendation with respect to the third world countries 8 to 10 dwelling units per 1000 population per annum must be constructed but in India it is not even 4 dwelling units per 1000 of population per annum.

The housing sector of India has been stressed out from the time of independence. Builders and developers have also confronted several problems. The following are some of the major issues of the Indian housing financial sector,

1. Traditional Laws

There are few legislations which restrict the growth and development of housing finance in India. For example, the old Urban Land Ceiling Regulation Act (ULCRA) has not been successful in the Indian housing finance system. It resulted only in increase of land price, inadequate land supply for housing development and financing.

2. Improper Title

Improper/vague title to the property is another major issue. Nearly 90% of the Indian lands are without a proper title. As the ownership is vague, the land is off the market resulting in shortage of land. This is due to poor record keeping.

3. High Stamp Duty

The expenditure involved in transferring the land, stamp duty, the registration charges are very high. Apart from this ,the method followed is also not transparent.

4. Outdated Rental Laws

Majority of the urban properties are out of the market, due to the outdated tenancy and rental control laws. The rental laws needs to be updated from time to time in order to safeguard the owner and the property from the tenant.

5. Foreclosure Laws

Inspite of low levels of foreclosure laws being present i.e., about 1.5 to 2 percent, yet these laws are regarded as outdated. The laws for non-payment of Equated Monthly Installment (EMI) and the foreclosure and repossession of the property should be reviewed from time to time.

6. Inappropriate Building Codes and Standards

Inspite of having many building guidelines and standards in different parts of the country nobody follows them i.e., not even the developers and the authorities. In order to make them follow, the system must be not vague and indirect as this would result in be wilde redness. The system must be made a centralized, systematic, simple, transparent one so that corruption and delays can be avoided to a great extant.

7. Improper Infrastructure

Improper infrastructure is the common and the major problem of Indian cities. It is the duty of both the central and state government to make a provision of adequate electricity, water and roads to cope up with the growing population. The electricity boards should be in a position to provide adequate power and must levy reasonable property tax in order to, cover up the road cost and the water supply cost.

8. Identification of Housing as an Industry

This is an unignorable issue. According to the Me Kinsey report of September 2001, the Indian real-estate industry has been ignored badly which left it behind, but if taken care properly then can act as one of indicators of the economic development.

If incase housing is being recognized as an industry then it would directly effect the capital and tax incentives. Apart from this, the government can provide additional incentives like the tax holidays, greater depreciation and increased equity support from HUDCO and NAREDO.

9. Rent Control Act

Land is the major obstacle in the housing sector development. The rent control act was basically enacted to safeguard the tenants from the selfish landowners. It was successful but it resulted into hurting the landlord by the payment of low rents.

Eventhough the RCA exempts new properties, still the landlord has a limited number of years to recoup the investment in real estate and the rental market has gone berserk.

Q22. Describe the various financial institutions providing Housing finance

Ans :

The following are the various financial institutions providing Housing finance.

a) HUDCO

HUDCO is an important institution in housing finance. It was set up in April 1970 with the specific purpose of providing loans for shelter. It has been financing housing projects located in the areas where there is a keen demand not only for houses but also for commercial and industrial sites. It has been providing mortgage loans to co-operative housing societies also. Its loans are to the extent of 60% of the cost of the houses, and the maturity period of its loans is between 8 to 10 years.

b) SHFs

The State Housing Finance Societies (SHFs) constitute a major source of funds in the residential mortgage market. These societies advance loans to the affiliated primary co-operative housing societies for construction of dwelling houses, purchase of land, additions and improvements to existing houses, purchase of houses, and repayment of earlier mortgage debt. The terms and conditions of loans vary some what from state to state.

The amount of loan is also linked with the primary society's share holding in the apex society. The maturity period varies from 15 to 30 years. The major sources of funds for these institutions are investment in their share capital by the government and co-operative institutions, loans from the government and LIC, fixed deposits from individuals and institutions, issue of debentures guaranteed by the government.

c) HDFC

The Housing Development Finance Corporation Ltd. (HDFC) has been playing an important role in meeting housing finance requirements. The HDFC was set up in 1977 by the ICICI out of the consideration that a specialized institution was needed to channel household savings as well as funds from the capital market into the housing sector. The sources of funds for the HDFC are : deposits collected through various deposit schemes, domestic long-term funds from commercial banks and financial institutions, long-term loans from international institutions such as World Bank and United States Agency for International Development.

d) New Developments

The various new developments in the field of housing finance in India are

(a) LIC – The LIC also set up in 1991 a housing finance company, LIC Housing Finance Ltd. These loans have a repayment period up to 10 years and repayment is through monthly installments and a small premium on Bhima Sandesh Policy.

(b) Commercial Banks - The role of commercial banks in housing finance had remained negligible for long. The overall policy of banks and the guidelines issued by the RBI in 1979 in this respect had tended to restrict the flow of bank funds in the housing sector. With this the loans were made available for repairs, additions, acquisition and development of land. Apart from individuals, housing finance institutions, private housing finance companies, and private builders also can obtain housing loans from banks.

(c) GIC – The GIC set up GC Grih Vitta Ltd. In July 1990 as a joint venture with it is four subsidiaries UTI, ICICI, IFC, HDFC and SBI Capital Markets. It has linked its activities with those of GC Mutual Fund

(d) Two regional housing finance companies by the UTI

(e) **National Housing Bank –** It was set up in July 1988 as an apex level housing finance institution and as a wholly-owned subsidiary of the RBI. It began its operations with a total capital of Rs. 170 crore. The explicit and primary aim of the NHB is to promote housing finance institutions at local and regional levels in the private and joint sectors by providing financial and other support to such institutions. The NHB has taken steps to augment real resources also for housing by extending term loans at market rates of interest for land development projects to be completed within a specified time limit. It also supports industries that augment supplies of building materials so as to lower the construction cost.

2.4.2 Role of National Housing Bank (NHB)

Q23. Examine the role of National Housing Bank NHB in Supervising housing finance activities in India.

(OR)

Explain the role of NHB in Housing Finance.

(OR)

What is the role of National Housing Bank in housing finance policy?

Ans : **(May-18, May-17, May-16, Imp.)**

The NHB was established in July 1988, under the National Housing Bank Act, 1987, as an apex bank, on the lines of IDBI and as a wholly-owned subsidiary of the RBI. It is the principal agency to promote housing finance institutions, at the regional and local levels, and to provide financial and other support to such institutions connected with housing and human settlements.

Objectives

The major objectives of the NHB are :

- To promote, establish, support or aid in the promotion, establishment and support of housing finance institutions;
- To make loans and advances or render any other form of financial assistance whatsoever to housing finance institutions and scheduled bank or to any authority established by/under any central state act and engaged in slum clearance;
- To subscribe to or purchase stocks, shares, bonds, debentures and securities of every other description;
- To guarantee the financial obligations of housing finance institutions and underwrite the issues of stocks, shares, bonds, debentures and securities of every other description of housing finance institutions;
- To draw, accept, discount/rediscount, buy or sell and deal in bills of exchange, promissory notes, bonds, debentures, hundies, coupons and other instruments;
- To form, promote and manage subsidiaries;
- To undertake research and surveys on construction techniques and other studies relating to, or connected with, shelter, housing and human settlement;
- To formulate schemes for mobilization of resources and extension of credit for housing;
- To formulate schemes for the economically weaker sections of society which may be subsidized by the central, state government(s) or any other source;
- To organize training programmes, seminars/ symposia on matters relating to housing;
- To provide guidelines to the housing finance institutions to ensure their growth on sound lines;
- To provide technical and administrative assistance to housing finance institutions;
- To coordinate with LIC, UTI, GIC and other financial institutions in the discharge of its overall functions;
- To act as agent of the central/state government(s) or RBI/any authority authorized by RBI.

(i) Borrowing and Deposits

To carry out its functions, the NHB is empowered to :

- Issue/sell bonds/debentures with/without guarantee of the central government in the prescribed manner and terms;
- Borrow from the central government/ any other authority/organization/ institution approved by the government on agreed terms and conditions;
- Accept deposits repayable after the expiry of a period not less than 12 months from the date of making the deposit on such terms, as may be generally/specially approved by the RBI;
- Repayable on demand/on the expiry of fixed periods not exceeding 18 months;

  Out of the National Housing Credit (Long Term Operations) Fund;
- Receive for services rendered such remuneration,commission, commitment charges, consultancy charges, service charges, royalties, premium, licence fees and any other consideration;
- Receive gilts, grants, donations/ benefaction from government/any other source.

(ii) Loans in Foreign Currency

In consultation with the RBI and with the prior approval of the central government, NHB can borrow in foreign currency from any bank/financial institution in India or elsewhere. Such loans may be guaranteed, if necessary, by the central government as to the repayment of principal/and the payment of interest and other incidental charges.

(iii) Power to Acquire Rights

The NHB has the right to acquire by transfer or assignment, the rights and interests of any housing finance institution in relation to any loan/advances made or any amount recoverable by such institution either in whole or part.

(iv) Access to Records

The NHB has the right to have free access to all necessary records of (i) any housing finance institution which seeks to avail of any credit facility from it, (ii) any person who seeks to avail of credit facility from such housing finance institution.

(v) Power to Inspect

If directed by the RBI, the NHB can conduct an inspection by its officers of a housing finance institution to which it has provided any loan/advance/any other financial assistance and its books, accounts and other documents.

(vi) Power to Collect Credit Information

The housing finance institutions can be directed by the NHB to submit specified credit information :

- The amount of loans and advances and other credit facilities;
- The nature of security taken for such loans;
- The guarantees furnished; and
- Any other having a bearing on the credit worthiness of the borrower.

It can also collect credit and other information from the government, local authorities, RBI, any bank/ financial institution/other institutions.

(vii) Advisory Services

The NHB is empowered to provide advisory services to government, local bodies and other agencies connected with housing in respect of

(a) Formulation of overall policies aimed at promoting the growth of housing/ housing finance institutions;

(b) Legislation relating to matters having a bearing on shelter, housing and human settlements.

Resources

(i) Capital

The equity capital of the NHB is fully subscribed by the RBI. Set up with an equity capital of Rs 100 crore, it had been receiving an equity of Rs 50 crore each year till 1992, when its capital stood at Rs 250 crore. After a gap of three years, the RBI has recently released an additional equity of Rs 50 crore. Thus, the total capital of NHB now stands at Rs 300 crore.

(ii) Schemes to Mobilize Savings

The NHB has launched various schemes to mobilize savings of households. This forms a substantial part of its resources. It formulated a loan-linked savings scheme, namely, Home Loan Scheme (HLS) for the households, under which banks/HFCs are authorized to collect deposits for purposes of housing finance.

It was permitted by the Government in 1989, to issue capital gains bonds having a maturity period of three years and carrying an interest @ 9 per cent per annum payable half-yearly or on a discounted basis in the beginning itself. This constituted one of the essential sources of financing housing loans at the lower end carrying subsidized interest rates. The capital gains bonds scheme was discontinued after September 30, 1992.

(iii) Government Guaranteed Bonds

Another source of funds for NHB is bonds which are guaranteed by the Central Government in respect of the principal amount and the interest. These bonds qualify as approved securities for SLR purposes.

(iv) External Assistance

The NHB also receives financial assistance from international agencies like USAID and OECF (Japan). It has been authorized to borrow from the US capital market $100 million with the guarantee from USAID. The first tranche of US $25 million was raised by it in 1991. Loan assistance has been also provided by the Overseas Economic Cooperation Fund (OECF) of Japan to support its housing programmes.

(v) Refinancing

The overall direction provided by the RBI for the development of the financial sector is kept in view while formulating the refinance schemes. Taking into account the emerging needs and socio-economic factors, changes are effected by the NHB in its refinance schemes. The various refinance schemes are available to the following categories of primary lenders :

i) Scheduled commercial banks;

ii) Scheduled state cooperative banks;

iii) Scheduled urban cooperative banks;

iv) Select HFCs; and

v) Apex cooperative housing finance societies.

(vi) Refinancing Policy

Annual limits are fixed for the primary lenders based on various parameters such as average refinance drawn during the previous years, repayment of refinance earlier availed from it and the overall borrowing limit prescribed under the refinance policy. In the case of HFCs, annual limits are so fixed that no HFC gets more than 25 per cent of aggregate of such limits fixed for all HFCs. The refinance made available to any HFC is not to be more than 60 per cent of its outstanding housing loans at any point of time. The HFCs, whose overdues of over three months exceed 5 per cent of the aggregate demand for that year, are ineligible to draw further refinance.

The cumulative refinance assistance at the end of May 1995 aggregated Rs 2,306 crore. The percentage of different eligible institutions stood at 82 per cent (HFCs including HUDCO), 11 per cent (cooperatives) and 7 per cent (commercial banks). The cumulative disbursement by the NHB since its inception up to April 30,1996 amounted to Rs 2,531 crore. The additional equity provided by the RBI after a gap of three years signals a change in policy to “push the NHB along the right track”. The NHB would hopefully play a more active role in providing housing finance in India.

Q24. Explain the Regulatory Mechanism of NHB.

Ans :

The NHB is empowered under the provision of the NHB Act, 1987, in public interest by general/ special order to regulate/prohibit issue of advertisement to solicit deposits from public by HFCs. It can also specify the conditions subject to which such advertisement is issued.

(i) Power to Collect Information and Give Directions

It can direct HFCs to furnish in the prescribed form, at specified intervals, within the stipulated time, information/particulars in the prescribed statements relating to/connected with deposits collected by them. The information, inter alia, may relate to the amount of deposits, purpose and periods of deposits, rates of interest and other terms and conditions. In public interest, directions can be given to HFCs in general or in particular regarding matters such as receipts of deposits, rates of interest and periods of deposits and so on. If HFCs do not comply with any such direction, the NHB can prohibit the acceptance of deposits by them. It is also empowered to direct HFCs to send a copy of the balance sheets, profit and loss account/ other annual accounts of depositors holding specified amount of deposits.

(ii) Duty of HFCs

They must furnish statements/information/ particulars in compliance with directions in the prescribed form from time to time.

(iii) Powers and Duties of Auditors

It is the duty of the auditors of HFCs to enquire about the compliance with the NHB directions/submission of statements/ information/ particulars. If they are not satisfied, they must submit a report to the NHB giving the aggregate deposits. Such reports should also form part of their statutory reports under the Companies Act.

(iv) Inspection

The NHB can conduct an inspection by its officers/employees or other persons (called inspecting authority) of HFCs to verify the correctness and completeness of statements/ information/particulars furnished by them. Such inspection can also be conducted to obtain information which the HFCs have failed to furnish in compliance with the directions.

The directors/members of committees/other bodies and persons associated with the management of the HFCs and other employees/officers must provide to the inspecting authority all statements/ information within the specified time. They can also be examined on oath in relation to the business of the HFCs.

Q25. Elucidate the Guidelines of National Housing Bank.

Ans :

In pursuance of its objectives, as the principal agency to promote a sound, healthy, viable and cost effective housing finance institutions/companies and to provide financial and other support to them, the NHB has issued operating guidelines for the MFCs in India. They must conform to these guidelines to be eligible for financial/ refinance support from the NHB. Presently, it provides to eligible HFCs refinance facilities in respect of housing loans for acquisition/construction of new housing units. The important guidelines are briefly summarized in this section.

(i) Eligible Institutions

There are 21 HFCs in the country which are registered with the NHB as the apex institution/housing bank with statutory obligation to regulate and supervise the housing finance industry. The criterion for registration are as follows:

(ii) Share Capital Norms

The minimum capital of the HFCs registered with the NHB must be Rs 3 crore. The contribution of promoters to their share capital should be in conformity with the guidelines issued by the Securities and Exchange Board of India (SEBI) from time to time. According to these, as applicable now, such contribution must be 25 per cent and 20 per cent of the post-issue capital up to Rs 100 crore and more than Rs 100 crore respectively as long as HFCs owe any money to the NHB. In addition, HFCs must offer at least 25 per cent of equity capital to the public as a condition precedent to listing of shares on stock exchanges.

According to NHB stipulations, HFCs should list shares on at least one stock exchange. However, the stipulation relating to the offer of the minimum specified amount for public subscription can be relaxed by NHB for HFCs promoted by Government, scheduled commercial banks, public/development financial institutions, as also those promoted by sufficiently financially sound and managerially corporate groups in the initial stages of their working. The NHB in its discretion and on the merits of each case is willing to participate in the share capital of HFCs to the extent of 20 per cent of their paid-up capital.

(iii) Activity Norms

To be eligible for refinance and other support from NHB, the HFCs should be registered as public limited companies. Their main objective should be to provide long-term finance for construction/purchase of houses for residential purposes. At least 75 per cent of its financial activity/lending has to be in the form of such loans for housing. In order to ensure that the focus of their main activity of providing housing finance is not diluted, the NHB operational guidelines impose restrictions as regards their names, relation ship with construction companies and so on. Thus, the names of HFCs should not resemble the name of any construction company with which the promoters of the HFCs may be associated.

The HFCs should also not be subsidiaries of construction companies. Neither should they have or promote subsidiary construction companies. It is also mandated that the top management of HFCs, namely, chairmen, managing directors, whole-time directors and so on, should not hold similar offices in construction companies associated with the promoters of the HFCs and vice versa. The NHB has the discretionary power to relax these conditions/ restrictions in case of the HFCs promoted by scheduled banks, public financial institutions and so on.

(iv) Nominee Directors and Auditors

The NHB has powers to nominate two directors on the board of the HFCs who do not have participation in their equity capital by banks, public financial institutions and corporate groups. In case of the HFCs to whose capital banks/financial institutions/ NHB/ Government have contributed, their nominees will be represented on the board of such HFCs. But in the event of the number of such nominee directors being less than two, the NHB has the right to nominate up to a maximum of two directors on the board of such HFCs. The appointment of the chief executives of the HFCs is also subject to the prior approval of the NHB. Similarly, the prior approval of the NHB is mandatory for appointment, reappointment/removal of auditor(s) by the HFCs excepting Government companies.

(v) Loans/Lending Norms

The main objective underlying the promotion of NHB-supported HFCs is to extend access of institutional finance to provide a solution to the serious shortage of dwelling units. The main elements of the NHB guidelines in this regard are briefly listed below.

(vi) Target Group

The bulk of lending by the HFCs has to be directed to individuals/groups of individuals. In other words, the target group of institutional housing finance is individual households.

(vii) Financial/Refinance Assistance from NHB

For eligible HFCs, the NHB provides financial assistance by way of refinance to the extent of 60 per cent in respect of housing loans, up to Rs 5 lakh for acquisition/construction of new housing units and up to Rs 30,000 for upgradation including major repairs irrespective of any area or cost/parameters. However, refinance for loans for new housing units exceeding Rs 3 lakh and up to Rs 5 lakh are subject to restriction of 40 per cent of total refinance from NHB during a financial year. The rates for NHB refinance for acquisition of new housing unit as in force currently are 10 per cent and 14.25 per cent for loans up to Rs 25,000 and Rs 25,000 to Rs 5 lakh respectively. For upgradation/major repairs up to Rs 30,000, the NHB charges 14.25 per cent on its refinancing.

(viii) Lending Rates by HFCs

The NHB prescribes from time to time the rates of interest exclusive of interest tax on housing loans eligible for refinance. According to the rates in force now, the HFCs can charge a maximum of 12 per cent on loans up to Rs 25,000 and 15.5 per cent on loans ranging between Rs 25,000 and Rs 1 lakh for acquiring new houses. They are free to charge any rate of interest on loans exceeding Rs 1 lakh. The maximum rate of interest prescribed by the NHB on loans up to Rs 30,000 for upgradation including major repairs is 15.5 percent.

(ix) Front-end Charges

The ceiling prescribed by NHB on front-end charges is 2 per cent of the loan amount. Included in such charges are (i) application/ registration fee, (ii) processing fee, (iii) administrative fee, (iv) out-of-pocket expenses connected with technical inspection (v) any other fee/charge/expense and so on. But document registration charges, stamp duty etc. are excluded from such charges. Apart from the overall ceiling, there is no minimum amount for any head of expenses.

(x) Ceiling on Administrative Cost

In order to ensure as low as possible administrative cost of the HFCs, the NHB has imposed a ceiling on such costs of 1.5 per cent of the outstanding loan.

2.4.3 Housing and Urban Development Corporation (HUDCO)

Q26. Examine the role of Housing and Urban Development Corporation in Supervising housing finance activities in India.

(OR)

Explain the role of HUDCO in Housing Finance.

(OR)

What is the role of Housing and Urban Development Corporation in housing finance policy?

Ans : **(Imp.)**

HUDCO was established on 25th April 1970, as a fully owned Government of India Enterprise with the following objectives:

(i) To provide long term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country;

(ii) To finance or undertake, the setting up of new satellite towns,

(iii) To finance or undertake the setting up of the building materials industries,

(iv) To administer the moneys received, from Government of India and other such grants, for purposes of financing or undertaking housing and urban development programmes.

(v) To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities, etc., specifically for the purpose of financing housing and urban development programmes.

In brief, the principal mandate of HUDCO is to ameliorate the housing conditions of Low Income Group (LIG) and Economically Weaker Sections (EWS).

(i) Resource Base

HUDCO was established with an equity base of Rs 2 crore. Over the years, the equity base has bee-expanded by the Government. The present paid-up capital of HUDCO is Rs 298 crore, as against the authorized capital of Rs 385 crore. It has further been able to mobilize resources from institutional agencies like LIC, GIC, UTI, banks, international assistance (KFW, OECF, ODA, USAID), as well as through put deposits.

The cumulative resource base of HUDCO is Rs 5,065 crore comprising of equity Rs 298 crore, reserves Rs 367 crore, borrowings Rs 4,400 crore.

(ii) Form of Assistance

HUDCO extends assistance benefiting masses in urban and rural areas under a broad spectrum of programmes given as follows:

Housing rural housing, cooperative housing, urban employment through housing and shelter upgradation

Infrastructure land acquisition, basic sanitation and environmental improvement of slums.

Consultancy Services building centres for technology transfer, building materials industries and building technology.

Training in human settlements and technical assistance to all borrowing agencies.

The financial assistance from HUDCO for these projects is made available to agencies which include state housing boards, rural housing boards, slum clearance boards, development authorities, improvement trusts, municipal corporations, primary cooperative societies and so on.

(iii) Operations

Since its inception and up to the end of March, 1995, it has sanctioned over 11,041 projects worth Rs 16,577, crore for which HUDCO's loan commitment was Rs 10,116 crore, out of which Rs 7,342 crore has been already released. These projects on completion, will help provide over 57 lakh residential units, over 4 lakh developed plots, 29.3 lakh sanitation units and 319 urban infrastructure projects.

Though HUDCO started its assistance for rural housing only from 1977-78, its contribution to rural housing for weaker sections has been significant and has assisted in the construction of over 28.5 lakh rural houses.

HUDCO's contribution in its 25 years of existence, has been very significant. It has reached people over 1,440 towns and hundreds of villages. The number of its borrowing agencies is on the ascent and have reached a high of over 600 from a partly 12 in the beginning.

It follows a differential interest rate policy, for various categories of households with overriding emphasis on concessional rate of lending for EWS and LIG families. Such a differential rate policy provides incentive for executing agencies to promote housing for the less privileged, and help reduce the loan repayment by the families to bring it within affordable limits:

Income category	ROI (gross) (percentage)
EWS	9.5
LIG	12.5-13.5
MIG	15.5-16.0
HIG	16.5

Repayment period of 10 years; otherwise 15 years.

Similarly, lower the cost of the shelter unit the higher is HUDCO's loan component as part of the project cost. In case of EWS sites and services where the unit cost is Rs 7,500 or below, HUDCO finances the entire project cost.

Income category	Extent of financing of the house cost (percentage)
Economically Weaker Section (EWS)	90
Low Income Groups (LIG)	85
Middle Income Groups (MIG)	75
High Income Group (HIG)	60

(v) Urban Infrastructure

HUDCO has also been entrusted with the responsibility to finance urban infrastructure projects. For this, additional equity support of Rs 38.5 crore was provided by the Ministry of Urban Affairs and Employment, Government of India, up to the year 1993-94. As of March, 1995, HUDCO has sanctioned a loan of Rs 1,957 crore for 320 infrastructure projects. These cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars/terminals, commercial, social infrastructure, roads/bridges and area development projects and so on. During the Eighth Plan period, the sanctions arc expected to be of the order of Rs 8,230 crore and disbursements would be above Rs 5,551 crore.

HUDCO plans to stress, in future, on the expansion of urban infrastructure lending, housing delivery through expanded avenues including retail financing, increased consultancy assistance, services for projects in India and abroad, impetus to building, technology transfer initiatives and in-house research and training programmes with national/ international working. The HUDCO Vision 2002 projects its activity levels of financial sanction and releases of the order of Rs 14,746 crore and Rs 12,534 crore.

(vi) Insurance Organizations/Corporations

The LIC and GIC support housing activity both directly and indirectly. The LIC is statutorily required to invest 25 per cent of the net accretion of funds in socially oriented schemes like housing, electrification, water supply and so on. Besides subscribing to bonds of HUDCO and state housing boards, LIC grants loans to state governments for their rural housing programmes and to public sector companies for construction of staff quarters. Though LIC has been granting loans directly to individuals, the thrust to housing finance was provided when, in June 1989, LIC promoted a subsidiary for the purpose, namely, LIC Home Finance.

The GIC and its subsidiaries are required to invest 35 per cent of their annual accretions by way of loans to socially oriented schemes such as housing. It supports housing almost exclusively and indirectly by subscribing to bonds/ debentures floated by HUDCO and state housing boards. It has also set up a housing finance subsidiary called GIC Housing Finance Ltd. in July 1990, to enable it to lend directly to individuals.

(vii) Commercial Banks

Commercial banks lending to individuals for housing, emerged in the wake of the report of the working group on, the Role of Banking System in Providing Finance for Housing Schemes. They have been lending to the housing sector based on annual credit allocations made by RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate every year 1.5 per cent of their incremental deposits for disbursing as housing finance. Of this allocation, 20 per cent has to be by way of direct housing loans of which again at least half, i.e., 10 per cent of the allocation has to be in rural and semi-urban areas. Another 30 per cent could be for indirect lending by way of term loans to Housing Finance Institutions (HFIs), Housing Finance Companies (HFCs), public housing agencies for acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to HUDCO, and NHB bonds.

(viii) Cooperative Banks

The cooperative banking sector consists of State Cooperative Banks (SCBs), District Central Cooperative Banks (DCBs) and Primary Urban Cooperative Banks (PUCBs). The first set of comprehensive guidelines for these cooperative banks were issued in 1984 by the RBI. Cooperative banks finance individuals, cooperative group housing societies, housing boards etc., who undertake housing projects for EWS, LIGs and MIGs.

(ix) Specialized Housing Finance Institutions (HFIs)

There are certain institutions which cater only to the needs of the housing sector termed as 'specialized HFIs'. They can further be classified as Housing Finance Companies (HFCs) promoted in the public/joint/ private sectors and cooperative housing finance societies. A lead player in the HFC category is Housing Development Finance Corporation (HDFC) which holds over 50 percent of the total disbursements made by the HFCs. It has been set up by ICICI and lends mainly for new residential housing to individuals, groups of individuals, and individual members of cooperative societies.

Besides HDFC, a number of HFCs have been sponsored by banks such as SBI Home Finance Ltd., Can fin, Homes Ltd., Ind. bank Housing Finance Ltd., Citi home and so on.

2.4.4 Role of Housing Finance Corporations and the Housing Schemes

Q27. Explain the Role of Housing Finance Corporations and the Housing Schemes.

Ans : **(Imp.)**

To cater to the diverse needs of housing in India, the HFIs/HFCs have tailored a variety of housing finance schemes.

(i) Schemes of Commercial Banks

Only 1.5 per cent of incremental deposits of commercial banks have to be made available to the housing sector every year. These have to be done in accordance with the guidelines issued by the RBI. The housing loans/finance are provided to individuals, institutions, public agencies and so on. The salient features of the schemes of housing finance of banks are described below.

(ii) Loans / Advances / Finance to Individuals

Individuals eligible for housing loans from banks fall into four categories, namely, those belonging to economically weaker sections/ low, middle and higher income groups; those owning land and capable of liquidating the loan within stipulated time; those purchasing residential flats from state housing boards/ improvement trusts/ cooperative societies/ private builders, etc., and those belonging to scheduled castes/ scheduled tribes who have been allotted land by the government.

The rate of interest is charged according to the amount of advance. Presently, the banks charge inclusive of interest tax 12.5 per cent on loans up to Rs 25,000 and 14 per cent between Rs 25,000 to Rs 2,00,000. They have discretion as regards interest on loans over Rs 2,00,000. The SC/ST borrowers have to pay 4.25 per cent interest on housing loan including repairs to damaged houses loans up to Rs 5,000.

(iii) Margin Requirements

The banks do not finance the full cost of the house and the owners-borrowers have to bring in the margin, as detailed below, from their own resources as a part of the cost. The maximum loan as percentage of estimated cost including the cost of land and the margin requirement are:

Size of loan	Maximum loan	Margin requirement
Up to Rs 20,000	80	20
Above Rs 20,000-Rs 50,000	75	25
Above Rs50,000-Rs 1,00,000	70	30
Above Rs 1,00,000	65	35

(iv) Quantum of Loan

The quantum of loan is determined on the basis of two different parameters:

- **On the Basis of Income of the Borrower**

  The eligibility for the quantum of loan is arrived at in a manner that the instalment does not exceed 30 per cent of net take home income of the borrower.

- **On the Basis of Estimated Cost of Construction**

  The second parameter is based on the estimated cost of construction less necessary margin requirement. The quantum of loan is the lower amount arrived at on the basis of (a) or (b) above. The loan amount is further subject to a ceiling of Rs 10 lakh per borrower.

(v) Repayment

The loan is repayable in equated monthly installments within a maximum period of 15 years. Initial moratorium period of 18 months or till completion of construction whichever is earlier may also be allowed. Banks may also consider fixing up of graduated installments if it is expected that income of the borrower is likely to grow in the coming years.

(vi) Security

The normal security for the housing loan is mortgage of property purchased from the proceeds of the loan. However, where it is not feasible the banks may accept security of adequate value, in the form of life insurance policies, Government promissory notes, shares and debentures, gold ornaments and such other securities.

(vii) Supplementary Finance

Requests for additional finance for carrying out alterations/additions/repairs to the house/flat already financed by banks are also entertained by the banks. In the case of individuals who might have raised funds for construction/acquisition of accommodation from other sources and need supplementary finance, banks may extend credit after obtaining pari passu or second mortgage charge over the property mortgaged in favour of other lenders and/or against such securities as the banks may require. In both cases, the terms and conditions are related to the size of the accommodation. Need-based credit to owners is extended for repairs/additions etc. whether the house is owner-occupied or tenant-occupied.

The upper limit of Rs 5 lakh is for the purpose of obtaining refinance from NHB. The banks may grant loans of higher amounts as per their discretion on case-to-case basis on mutually acceptable terms.

2.4.5 Recent Developments

Q28. Explain the Recent Developments of Housing finance.

Ans : **(Imp.)**

The following are the different factors which foster the growth of housing finance services in India.

1. **Budgetary Support**

   The housing finance services in India has developed greatly due to the tax benefits, low interest rates and high salary of the individuals. Tax benefits greatly contributes :towards the housing development. RBI is playing an important role by maintaining a soft interest rate regime. The bank rates are also kept very low so that there would be greater housing demand.

2. **New Dynamics**

   The entry of new players is acting as the another vital source of developing housing finance. The number of new comers in the housing finance is increasing due to less risk levels in the housing portfolio.

3. **Distinguishing Service**

   The housing finance companies have been always trying out to be different from others in providing service standards. It is focussed upon that service quality acts as an important competitive strength. Therefore, a strong brand name like the HDFC, ICICI or the LIC holds greater access to the customers and the resources. Thus, the big players are usually the dominant players.

4. **Access to Resources**

   LIC plays an important role in housing finance, due to its large financial resources. This assisted LIC in larger disbursements. The access to resources assures that the major companies would dominate the market and would control the growth of others. Similarly, the new instrument, asset securitization would also bring about observant change in housing finance.

5. **Changing Contours**

   The changing environment along with the stiff competition has been effecting the housing finance companies (HFCs). The competition has brought down the profit levels and is making the housing finance a low margin, low-risk business. With the help of their geographical location and knowledge of the customers the HFCs are making efforts to make use of the new opportunities. The establishment of the insurance companies have limited the scope of HFCs.

Short Question and Answers

1. What is Hire Purchase?

Ans :

Meaning

Hire purchase is one of the means of financing the price of goods that are to be sold on a future date. In a hire-purchase transaction, the goods allowed to be hired, whereas the purchase price is being paid in installments and hirer can buy the goods by paying all the installments. A hire-purchase agreement is defined as a particular type of transaction wherein goods are let on hire with an option to the hirer to buy them, with the following specifications,

(a) Payment must be made within a particular period of time in the form of installments.

(b) The ownership would be transferred to the hirer immediately after entering into the contract.

(c) On the payment of last instalment, the property in goods would be passed to the hirer.

(d) Each instalment is considered as hire charges, because if in case default is made in payment of instalment, then seller would be entitled to take back the goods.

(e) The hirer/purchaser can freely return goods without paying any further installments which becomes due after the return.

2. Compare and contrast Financial Lease and Operating Lease.

Ans :

S.No	Financial Lease	S.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.

3. Compare and contrast hire purchase financing and lease financing.

Ans :

S.No	Basis	Hire Purchase	Lease Financing
1.	**Ownership**	Hirer becomes owner on payment of last installment	The lessor is the owner and owner ship never passes to the lessee.
2.	**Down payment**	20-25% of the cost is paid as down payment	No down payment
3.	**Depreciation**	Charged in the books of the hirer	Charged in the books of the lessor
4.	**Maintenance**	Borne by Hirer	Operating lease - Lessor Finance lease - Lessee
5.	**Capitalization**	In the books of the hirer	In the books of the leasing company

4. Examine the role of consideration in lease and buy decision.

Ans :

An entity's non-financial assets can be acquired either through outright purchase or leasing arrangements. When making a 'lease or buy' decision an entity must not only consider the financial implications of the options including the government's procurement criterion relating to 'value for money', but consideration must also be given to long-term strategic priorities and to qualitative. It is important to understand the implication of both options for the service delivery needs of the entity when determining the most appropriate option.

When leasing an asset the entity only pays for the use of the asset over the term of the lease and ownership of the asset does not pass to the entity at any stage unless the lease contract specifically states it. Leases where substantially all the risks and rewards incidental to ownership are transferred are usually classified as finance leases. When buying an asset, the entity pays the full cost of the asset at acquisition date and has full ownership over the asset.

A finance lease is recorded as an asset when the transaction (contract) is entered into and, similar to the outright purchase option, will give rise to depreciation expense as would be the case of other assets controlled by the entity. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset is required to be fully depreciated over the lease term or its useful life, whichever is shorter.

An operating lease on the other hand, will usually specify a period over which an entity will have the right to use the goods, and have them replaced if they stop working during the lease period, but will then return the goods to the lessor at the end of the lease.

Better practice entities will usually undertake a risk assessment and cost benefit analysis to assess the implication of the operating lease vs finance lease vs outright purchase decision when considering key asset acquisitions.

5. Outline the RBI guidelines relating to leasing.

Ans :

With the enormous growth in number of NBFCs over the last few years and in order to safeguard the interest of investing public the necessity of regulating the functioning of these NBFCs by Reserve Bank of India was strongly felt. In April May, 1993 NBFCs with Net Owned Funds (NOF) of Rs. 50 lakhs and above were required to register themselves with RBI.

In June 1994, guidelines on prudential norms for income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/investments were issued by RBI. Registered NBFCs were required to get themselves rated by one of the credit rating agencies at least once in a year. NBFCs were also required to attain capital adequacy of 8 per cent by March 31, 1996 after making adequate provision for sub standard, doubtful and loss assets.

These guidelines further laid down exposure norms for maximum commitment to a single party and a group of parties.

In order to have proper control and regulate the functioning of NBFCs, Govt. of India enacted 'The Reserve Bank of India' (Amendment) Act, 1997 conferring wide ranging powers to RBI. As per the Act, no NBFC can commence or carry on business:

(a) Without obtaining from RBI, a certificate of registration, and

(b) Having owned funds of Rs. 200 lacs.

6. Define Leasing.

Ans :

Meaning

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

(i) A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.

(ii) The document in which this contract is written.

(iii) A great way companies can conserve capital.

(iv) An easy way vendors can increase sales.

7. Financial Lease

Ans :

Financial lease covers the complete economic life of the asset. During the lease period the lessor receives the lease rental to recover the full cost of the asset and also the reasonable return on the funds. Infact finance lease in also known as capital lease.

Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lessor 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.

From the lessee's perspective it has been viewed that the finance lease assures the lessee an uninterrupted use of the asset. The lessor may not be involved in dealing with the asset. On the basis of the requirement the lessee may select the asset and may even negotiate the price and the delivery schedule and so on with that of the supplier. But, the lessor makes the payment to the supplier and such arrangement is concurrent to the signing of the lease contract.

8. Operating Lease

Ans :

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.

The asset is returned back to the lessor at the end of the life of the lease who can either offer it to sale to the lessee (or any other person or lease it to any other lessee. Usually, operating lease covers a maintenance clause requiring the lessee to maintain the asset.

The maintenance includes the repairs, insurance and the tax payments. Under, the lease rentals lessor will include a suitable compensation for the expected cost of maintenance of the leased asset.

Usually, the operating lease is cancellable by any of the party and is greatly expensive than a finance lease as the lessee needs to compensate the lessor as the lessor assumes the ownership risk and the lessor does not bear any assets risk of becoming obsolete. Few of the assets which may be acquired on operating lease basis are vehicles, amusement equipments, furniture and fixtures and so on.

9. Characteristics of a leasing.

Ans :

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 (predetermined) 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.

10. Leverage Lease

Ans :

A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from ` 50 lakh to ` 2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties - the lessee, the lessor and the lender, e lessor acquires the assets as per the terms of the lease agreement but finances.

Only a part of the total investment, say 20 per cent to 50 per cent. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as railroad, rolling stock, coal mining, electricity generating plants, pipelines, ships, etc. are acquired.

Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment. By investing 20 per cent or 25 per cent of the cost of an asset, the lessor is entitled to 100 percent allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

11. Sale and Lease Back

Ans :

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the lease period. The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on a net-net basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase the property at the termination of lease.

The sale and lease back agreement is beneficial to both lessor and lessee. The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

12. Explain the various Types of Hire Purchase.

Ans :

Types

There are two types of hire-purchase financing.

(a) Consumer hire purchase

This covers the financing of consumer goods purchased for personal, family and household purpose. Therefore, the hirer is a natural person (not business) and the goods are obtained for non-business purpose.

(b) Industrial hire purchase

Industrial hire purchase refers to goods purchased by companies for use in business or industry. Example, the purchase of a machine by a company to be used in business.

13. Limitations of Hire Purchase System.

Ans :

(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 instalment. 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 installment, he has to incur actual loss as goods taken back may not yield reasonable price on resale.

14. Define Housing Finance.

Ans :

Meaning

Housing finance refers to a collection of all financial arrangements that have been made by Housing Finance Companies (HFCs) in order to meet the needs of housing.

The constitution of India has granted six fundamental rights, out of which the right to live is one of them which, further consists of the right to housing policy. The directive principles of the state policy makes it as an obligation to help in building houses. The demand for houses is increasing day by day due to the increasing population and is becoming one of the global issues. Food, clothing and shelter are the three basic needs of human beings. Out of which food and clothing have been fulfilled to some extent but housing still needs to be fulfilled. The main reasons can be scarcity of capital, insufficient financial institutions, clubbed with the increase in building material, labour and other costs.

Choose the Correct Answers

1. ________ is the owner of the asset in a lease agreement [c]
   (a) Lessee (b) Tenant
   (c) Lessor (d) All of the above
2. Hire Purchase provisions are covered under Hire Purchase Act of ________ [a]
   (a) 1972 (b) 1982
   (c) 1962 (d) 1989
3. In Hire Purchase, the person who sells the goods to the buyer is known as ________ [c]
   (a) Hire Purchaser (b) Buyer
   (c) Hire Vendor (d) All of the above
4. Royalty Account is ________ type of Account [a]
   (a) Nominal Account (b) Personal Account
   (c) Real Account (d) None of the above
5. In Hire Purchase System the amount which has to be paid on entering into the agreement is known as ________ [c]
   (a) First Payment (b) First Installment
   (c) Down Payment (d) Second Installment
6. In a lease agreement, a clause may be included to direct the Lessee to pay ________ whether the Lessee benefits or not in the stipulated period of time. [c]
   (a) Royalty (b) Down Payment
   (c) Minimum Rent (d) Maximum Rent
7. If the Lessor and Lessee are situated in two different countries, the type of lease is known as ________ [a]
   (a) Cross Border Lease (b) Financial Lease
   (c) Operating Lease (d) Leverage Lease
8. In this type of Lease the final intention of the Lessor is to transfer and sell of the asset to the Lessee. [c]
   (a) Operating Lease (b) Leveraged Lease
   (c) Financial Lease (d) Cross Border Lease
9. The following is advantage of Lease arrangement to the Lessee [c]
   (a) Can make use of the Asset without investing in the asset
   (b) Can dispose or change the Asset whenever desired
   (c) Both a and b
   (d) None of the above

10. Under this type of Lease the Lessor can Lease the Asset to more than one person. [c]
   (a) Financial Lease (b) Leveraged Lease
   (c) Operating Lease (d) All of the above

11. Hire Purchase system is governed by: [a]
   (a) Hire Purchase Act, 1972 (b) Sale of Goods Act
   (c) Installment Act (d) Properties Registration Act.

12. Installment system is governed by: [b]
   (a) Hire Purchase Act (b) Sale of Goods Act
   (c) Installment Act (d) Properties Registration Act.

13. Under hire purchase system, the agreement can be ________ anytime. [c]
   (a) Renewed (b) Registered
   (c) Terminated (d) Endorsed.

14. When an asset is acquired on hire purchase system, the asset account is debited with of ________ the assets in the books of the hire purchaser. [b]
   (a) Hire purchase price (b) Cash price
   (c) Instalment price (d) None of these

15. On the balance sheet of a company, the value of the asset bought through hire purchase will appear as: [a]
   (a) Cost less depreciation to date less Balance in hire vendor's account
   (b) Cost less amounts owing on hire purchase
   (c) Cost less depreciation to date less amount owing on hire purchase
   (d) Cost less depreciation to date

16. The depreciation on an asset purchased through hire purchase should be: [b]
   (a) Should be straight line only
   (b) Based on the cost price of the asset only
   (c) Based on the total cost including interest
   (d) No depreciation should be provide until the final payment is made

17. Ownership of goods under hire purchase agreement is transferred at the time of: [c]
   (a) Payment of down payment
   (b) Payment of first installment
   (c) Full and final Payment of last installment
   (d) All of the above

Fill in the blanks

1. ________ is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments.
2. The ________ retains the ownership of the asset.
3. The ________ has possession and use of the asset on payment of specified retain over the period.
4. ________ lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance.
5. An ________ lease is an agreement where in the lessee obtains the use of an asset on a periodical basis.
6. The financial ________ covers the complete economic life of the asset.
7. Lease ________ 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.
8. The cost of financing is generally higher than that of ________ financing.
9. A ________ agreement is defined as a particular type of transaction wherein goods are let on hire with an option to the hirer to buy them.
10. ________ finance refers to a collection of all financial arrangements that have been made by Housing Finance Companies (HFCs) in order to meet the needs of housing.
11. GFCF stands for ________.
12. ________ is an important institution in housing finance.
13. The LIC also set up in ________.
14. HDFC stands for ________.
15. NHB stands for ________.
16. The NHB was established in ________ .
17. OECF stands for ________.
18. HUDCO was established on ________.
19. There are certain institutions which cater only to the needs of the housing sector termed as ________.
20. The LIC is statutorily required to invest ________ per cent of the net accretion of funds in socially oriented schemes like housing, electrification, water supply and so on.

ANSWERS

1. Leasing
2. Lessor
3. Lessee

4. Finance
5. Operating
6. Lease
7. Rental
8. Debt
9. Hire-purchase
10. Housing
11. Gross Fixed Capital Formation
12. HUDCO
13. 1991
14. The Housing Development Finance Corporation Ltd
15. National Housing Bank
16. July 1988
17. Overseas Economic Cooperation Fund
18. 25th April 1970
19. Specialized HFIs
20. 25

UNIT III	**MUTUAL FUNDS** **Mutual Funds**: Fund Unit Vs. Equity Share - Importance of Mutual Funds - Types of Mutual Funds: Close Ended Funds - Open Ended Funds, Income Funds, Growth Funds - Risks involved - Organization of Firm - Facilities Available to Investors - Guidelines from the Government of India - Recent Reforms in Mutual Funds - Banks Providing Mutual Fund Services - Factors to be considered in Selection of Fund - Reasons for Commercial Banks to offer mutual funds - Scenario of Mutual funds in India - Problems in future prospects

3.1 Mutual Funds

Q1. Define Mutual Funds.

(OR)

Explain briefly about Mutual Funds.

(OR)

What are Mutual Funds?

Ans : **(May-18)**

Introduction

Small investors generally do not have adequate time, knowledge, experience and resources for directly entering the capital market. Hence they depend on an intermediary. This financial intermediary is called mutual fund.

Mutual funds are corporations that accept money from savers and then use these funds to buy stocks, long term funds or short term debt instruments issued by firms or governments. These are financial intermediaries that collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. They invest the funds collected from investors in a wide variety of securities i.e. through diversification. In this way it reduces risk.

Mutual fund works on the principle of "small drops of water make a big ocean". It is a form of collective investment. To get the surplus funds from investors, it adopts a simple technique. Each fund is divided into a small share called 'units' of equal value. Each investor is allocated units in promotion to the size of his investment.

Mutual fund is a trust that pools the savings of investors. The money collected is then invested in financial market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. Thus mutual fund invests in a variety of securities (called diversification). This reduces risk. Diversification reduces the risk because all stock and/ or debt instruments may not move in the same direction.

Definitions

(i) According to the Mutual Fund Fact Book (published by the Investment Company Institute of USA), "a mutual fund is a financial service organization that receives money from share holders, invests it, earns return on it, attempts to make it grow and agrees to pay the shareholder cash demand for the current value of his investment".

(ii) SEBI (mutual funds) Regulations, 1993 defines a mutual fund as 'a fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations.

In short, a mutual fund collects the savings from small investors, invests them in government and other corporate securities and earns income through interest and dividends, besides capital gains.

Q2. What are the features of Mutual Funds?

Ans :

Mutual fund possesses the following features:

(i) Mutual fund mobilizes funds from small as well as large investors by selling units.

(ii) Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.

(iii) Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.

(iv) Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.

(v) Mutual fund provides switching facilities to investors who can switch from one scheme to another.

(vi) Various schemes offered by mutual funds provide tax benefits to the investors.

(vii) In India mutual funds are regulated by agencies like SEBI.

(viii) The cost of purchase and sale of mutual fund units is low.

(ix) Mutual funds contribute to the economic development of a country.

3.1.1 Fund Unit Vs. Equity Share

Q3. How do you differentiate Fund Unit and Equity Share?

Ans :

Just like shares, the price of units of a fund is also quoted in the market. This price is governed basically by the value of the underlying investments held by that fund. At this juncture, one should not confuse a mutual fund investment on units with that of an investment on equity shares. Investment on equity share represents investment in a particular company alone.

On the other hand, investment on an unit of a Fund represents investment in the parts of shares of a large number of companies. This itself gives an idea how safe the units are. If a particular company fails, the shareholders of that company are affected very much whereas the unit holders of that company are able to withstand that risk by means of their profitable holdings in other companies shares.

Again, investment on equity shares can be used as a tool by speculators and inveterate stock market enthusiasts with a view to gaining abnormal profits. These people play an investment game in the stock market on the basis of daily movement of prices. But, mutual funds cannot be invested for such purposes and the mutual fund is not at all concerned with the daily ebbs and flows of the market. In short, mutual fund is not the right investment vehicle for speculators. Mutual funds are, therefore, suitable only to genuine investors whereas shares are suitable to both the genuine investors and the speculators.

Q4. Explain the role of Mutual Funds.

(OR)

Describe the role of Mutual funds

Ans :

Mutual funds plays an important ROLE in promoting a healthy capital market. They provide active support to secondary market and increase liquidity of capital market and bring stability in financial market. Role of mutual fund can be explained with the help of following points

1. Mobilizes Savings

Mutual funds play an important role in mobilizing savings of millions of investors across the country. In mutual funds, savings of small investors are mobilized, invested and returns are distributed in the same proportion to the unit holders.

2. Instrument Of Investing Money

Now-a-days bank rates have become very low so, keeping large amount of money in bank does not give higher returns. People can invest in stock market. But a common investor is not well informed about the complexities involved in stock market movements. Here mutual funds play an important role in helping common public to get higher returns.

3. Protection To Small Investors

A small investor is not safe in share market. In mutual industry there is no such risk. Mutual funds help to reduce the risk of investing in stocks by spreading or diversifying investments. Small investors enjoy the benefit of diversification.

4. Tax Benefit

Investors in mutual funds enjoy tax benefits. Dividend received by investors is tax free. Tax exemption is allowed on income received on units of mutual funds and UTI. Investment in mutual funds enjoy wealth tax exemption within the overall limit of Rs. 5 lakhs.. No tax shall be charged on gifts of mutual fund units upto Rs. 30,000.

5. Diversification

Investment in mutual funds enable investors to spread out and minimize the risks upto certain extent. Mutual fund invests in a diversified portfolio of securities. This diversification helps to reduce risk since all the stocks do not fall at same time. Thus investors are assured of average income which is not possible in other sources.

6. Multi - Purpose Service

Mutual funds introduces variety of innovative schemes containing various benefits. Innovative schemes are designed to meet the needs of different types of investors in terms of investment, dividend distribution, liquidity etc.

7. Boost To Capital Market

Mutual fund has become a capital market intermediary. It bridges the gap between retail investors and capital market. The rapid growth of mutual fund industry leads to increased vibrancy of capital market.

8. Arrival Of Foreign Capital

Mutual funds attract foreign capital. Indian Mutual Fund Industries open offshore funds in various foreign countries and secure safe investment avenues abroad to domestic savings. These funds enable NRI's and foreign investors to participate in Indian Capital Market.

9. Savings For Retirement And Education

Various schemes of funds with their tax benefits can help the households to save for the retirements and education of their children.

3.1.2 Importance of Mutual Funds

Q5. Explain the Importance of Mutual Funds.

Ans : **(May-17, May-15)**

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. The following are some of the important advantages of mutual funds:

(i) Channelizing Savings for Investment

Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage.

(iv) Rendering Expertised Investment Service at Low Cost

The management of the Fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each Fund rhaintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share.

(vii) Introducing Flexible Investment Schedule

Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income Units can be exchanged for growth units depending upon the performance of the funds. One can not derive such a flexibility in any other investments.

(viii) Providing Greater Affordability and Liquidity

Even a very small investor can afford to invest in Mutual Funds. They provide an attractive and cost effective alternative to direct purchase of shares. In the absence of MFs, small investors cannot think of participating in a number of investments with such a meagre sum. Again, there is greater liquidity.

(ix) Simplified Record Keeping

An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is very tedious and consumes a lot of time.

(x) Supporting Capital Market

Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. Thus, funds serve as a conduit for dis-intermediating bank deposits into stocks, shares and bonds.

(xi) Promoting Industrial Development

The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures.

(xii) Acting as Substitute for Initial Public Offerings (IPOs)

In most cases investors are not able to get allotment in IPOs of companies because they are often oversubscribed many time. Moreover, they have to apply for a minimum of 500 shares which is very difficult particularly for small investors. But, in mutual funds, allotment is more or less guaranteed. Mutual Funds are also guaranteed a certain percentage of IPOs by companies. Thus, by participating in MFs, investors are able to get the satisfaction of participating in hundreds of varieties of companies.

(xiii) Reducing the Marketing Cost of New Issues

Moreover the mutual funds help to reduce the marketing cost of the new issues. The promoters used to allot a major share of the

Initial Public offering to the mutual funds and thus they are saved from the marketing cost of such issues.

(xiv) Keeping the Money Market Active

An individual investor can not have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand, mutual funds keep the money market active by investing money on the money market instruments.

Q6. What are the advantages and dis-advantages of mutual funds?

Ans :

Advantages

Mutual funds are growing all over the world. They are growing because of their importance to investors and their contributions in the economy of a country. The following are the advantages of mutual funds:

1. Mobilize small savings

Mutual funds mobilize small savings from the investors by offering various schemes. These schemes meet the varied requirements of the people. The savings of the people are channelized for the development of the economy. In the absence of mutual funds, these savings would have remained idle.

2. Diversified investment

Small investors cannot afford to purchase the shares of the highly established companies because of high market price. The mutual funds provide this opportunity to small investors. Even a very small investor can afford to invest in mutual funds. The investors can enjoy the wide portfolio of the investments held by the fund. It diversified its risks by investing in a variety of securities (equity shares, bonds etc.) The small and medium investors cannot do this.

3. Provide better returns

Mutual funds can pool funds from a large number of investors. In this way huge funds can be mobilized. Because of the huge funds, the mutual funds are in a position to buy securities at cheaper rates and sell securities at higher prices. This is not possible for individual investors. In short, mutual funds are able to give good and regular returns to their investors.

4. Better liquidity

At any time the units can be sold and converted into cash. Whenever investors require cash, they can avail loans facilities from the sponsoring banks against the unit certificates.

5. Low transaction costs

The cost of purchase and sale of mutual fund units is relatively less. The brokerage fee or trading commission etc. are lower. This is due to the large volume of money being handled by mutual funds in the capital market.

6. Reduce risk

There is only a minimum risk attached to the principal amount and return for the investments made in mutual funds. This is due to expert supervision, diversification and liquidity of units.

7. Professional management

Mutual funds are managed by professionals. They are well trained. They have adequate experience in the field of investment. Thus investors get quality services from the mutual funds. An individual investor would never get such a service from the securities market.

8. Offer tax benefits

Mutual funds offer tax benefits to investors. For instance, under section 80 L of the Income Tax Act, a sum of Rs. 10,000 received as dividend from a mutual fund (in case of UTI, it is Rs. 13,000) is deductible from the gross total income.

9. Support capital market

The savings of the people are directed towards investments in capital markets through mutual funds. They also provide a valuable liquidity to the capital market.

In this way, the mutual funds make the capital market active and stable.

10. Promote industrial development

The economic development of any nation depends upon its industrial advancement and agricultural development. Industrial units raise funds from capital markets through the issue of shares and debentures. Mutual funds supply large funds to capital markets. Besides, they create demand for capital market instruments (share, debentures etc.).

Thus mutual funds provide finance to industries and thereby contributing towards the economic development of a country.

11. Keep the money market active

An individual investor cannot have any access to money market instruments. Mutual funds invest money on the money market instruments. In this way, they keep the money market active.

Disadvantages

The following factors have impeded the growth of muthuraman industry in India,

1. Limited Product Range

Indian mutual funds have remained centered around a limited product range basically income, income-cum-growth and tax saving schemes. Efforts to develop and expand the market through innovative new products have been negligible.

2. Confused Market Situation

Probably the introduction and implementation of new regulatory norms has contributed in some measure to market sluggishness, as the emerging market was initially, not able to respond to the regulatory objectives.

3. Absence of Innovative Marketing Network

The absence of product diversification and a confused market situation has been made worse by the absence of an innovative marketing network for mutual funds. The agent oriented network has largely been a failure because most of the agents have not been specifically trained to sell mutual fund products. This has led to a significant communication gap which has come in the way of market expansion.

4. Lack of Adequate Research Infrastructure

The passive approach of some mutual funds in managing investors funds is compounded by the lack of adequate research infrastructure. Consequently, returns commensurate with the market movement could not be realized by many schemes, which has tended to show up Indian mutual funds in a bad light.

5. Inefficient Management

Management is considered to be a key factor for the operational efficiency of any business venture. This factor becomes even more crucial for service ventures such as mutual funds. What mutual funds require ask managers who have a clear understanding of the prevailing and emerging market potential, investor preference and macro economic fundamentals.

6. Lack of Investors Education

The market success of any new product, particularly a financial product, depends largely on its acceptance by consumers. In the case of investors, mutual funds must undertake a well-designed and comprehensive programme of investor education, especially aimed at investors in rural and semi-urban areas. However, this has been mostly neglected in India.

Q7. What are the functions of mutual funds?

Ans :

The following are the functions of mutual fund are

1. It mobilize the savings of small investors and use them as investment in securities market.
2. It helps the small investors to hold a share in a diversified portfolio of assets which may lower the risks of investment.

3. It pools the investors savings in a scheme and distribute the returns among investors in the proportion equal to their investment.
4. It helps the small investors to secure ‘high return and low risk out of their equities and other assets.
5. It enables the small investors to take the professional management advantage which there by increases the earning rate.
6. Mutual funds operate in various diversified areas such as,
   (i) Offshore funds management.
   (ii) Management of money market funds.
   (iii) Provident funds and pension funds management
   (iv) Real estate funds management etc.

3.2 Types of Mutual Funds

3.2.1 Close Ended Funds - Open Ended Funds, Income Funds, Growth Funds

Q8. Explain various types of mutual funds.

(OR)

Furnish the classification of mutual funds.

(OR)

Discuss the various types of mutual funds.

Ans : **(May-18, May-17, May-16)**

Mutual funds (or mutual fund schemes) can be classified into many types. The following chart shows the classification of mutual funds:

Mutual Funds

- A. On the basis of operation
  - Close ended Mutual funds
  - Open ended Mutual funds
- B. On the basic of return/income
  - Income fund
  - Growth fund
  - Conservative fund
- C. On the basis of Investment
  - Equity fund
  - Bond fund
  - Balance fund
  - Fund of fund scheme
  - Taxation fund
  - Leverage fund
  - Index bonds
  - Money market mutual funds
  - Off shore mutual funds
  - Guilt funds

These may be briefly described as follows:

A) On the basis of Operation

1. Close ended Mutual funds

Under this type of fund, the size of the fund and its duration are fixed in advance. Once the subscription reaches the predetermined level, the entry of investors will be closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to their holding.

Features

(a) The period and the target amount of the fund is fixed beforehand.

(b) Once the period is over and/ or the target is reached, the subscription will be closed (i.e. investors cannot purchase any more units).

(c) The main objective is capital appreciation.

(d) At the time of redemption, the entire investment is liquidated and the proceeds are liquidated and the proceeds are distributed among the unit holders.

(e) Units are listed and traded in stock exchanges.

(f) Generally the prices of units are quoted at a discount of upto 40% below their net asset value.

2. Open-ended Mutual funds

This is the just reverse of close-ended funds. Under this scheme the size of the fund and / or the period of the fund is not fixed in advance. The investors are free to buy and sell any number of units at any point of time.

Features

(a) The investors are free to buy and sell units. There is no time limit.

(b) These are not trade in stock exchanges.

(c) Units can be sold at any time.

(d) The main motive income generation (dividend etc.)

(e) The prices are linked to the net asset value because units are not listed on the stock exchange.

Difference between Open-ended and Close-ended Schemes

(i) The close-ended schemes are open to the public for a limited period, but the open-ended schemes are always open to be subscribed all the time.

(ii) Close-ended schemes will have a definite period of life. But he open-ended schemes are transacted in the company.

(iii) Close-ended schemes are transacted at stock exchanges, where as open-ended schemes are transacted (bought and sold) in the company.

(iv) Close-ended schemes are terminated at the end of the specified period. Open-ended schemes can be terminated only if the total number of units outstanding after repurchase fall below 50% of the original number of units.

B) On the basis of return/ income

1. Income fund

This scheme aims at generating regular and periodical income to the members.

Such funds are offered in two forms. The first scheme earns a target constant income at relatively low risk. The second scheme offers the maximum possible income.

Features

(a) The investors get a regular income at periodic intervals.

(b) The main objective is to declare dividend and not capital appreciation.

(c) The pattern of investment is oriented towards high and fixed income yielding securities like bonds, debentures etc.

(d) It is best suited to the old and retired people.

(e) It focuses on short run gains only.

2. Growth fund

Growth fund offers the advantage of capital appreciation. It means growth fund concentrates mainly on long run gains. It does not offers regular income. In short, growth funds aim at capital appreciation in the long run. Hence they have been described as "Nest Eggs" investments or long haul investments.

Features

(a) It meets the investors' need for capital appreciation.

(b) Funds are invested in equities with high growth potentials in order to get capital appreciation.

(c) It tries to get capital appreciation by taking much risk.

(d) It may declare dividend. But the main objective is capital appreciation.

(e) This is best suited to salaried and business people.

3. Conservative fund

This aims at providing a reasonable rate of return, protecting the value of the investment and getting capital appreciation. Hence the investment is made in growth oriented securities that are capable of appreciating in the long run.

C) On the basis of Investment

1. Equity fund

It mainly consists of equity based investments. It carried a high degree of risk. Such funds do well in periods of favourable capital market trends.

2. Bond fund

It mainly consists of fixed income securities like bonds, debentures etc. It concentrates mostly on income rather than capital gains. It carries lower risk. It offers secure and steady income. But there is no chance of capital appreciation.

3. Balanced fund

It has a mix of debt and equity in the portfolio of investments. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

4. Fund of fund scheme

In this case funds of one mutual fund are invested in the units of other mutual funds.

5. Taxation fund

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under Sec. 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs. 10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic type.

6. Leverage fund

In this case the funds are invested from the amounts mobilized from small investors as well as money borrowed from capital market. Thus it gives the benefit of leverage to the mutual fund investors. The main aim is to increase the size of the value of portfolio. This occurs when the gains from the borrowed funds are more than the cost of the borrowed funds. The gains are distributed to unit holders.

7. Index bonds

These are linked to a specific index of share prices. This means that the funds mobilized under such schemes are invested principally in the securities of companies whose securities are included in the index concerned and in the same proportion. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

8. Money market mutual funds

These funds are basically open ended mutual funds. They have all the features of open ended mutual funds. But the investment is made is highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills etc. These are money market instruments.

9. Off shore mutual funds

The sources of investments for these funds are from abroad.

10. Guilt funds

This is a type of mutual fund in which the funds are invested in guilt edged securities like government securities. It means funds are not invested in corporate securities like shares, bonds etc.

Q9. What are the differences between open - ended and closed ended mutual funds.

Ans :

Open-ended Mutual funds	Closed ended Mutual funds
1. Open-ended schemes accept funds from investors and sell shares to the investors on a regular basis.	1. Closed-ended schemes offer subscription only for a limited period.
2. Open-ended schemes provide the facility of withdrawing funds to the investors by following the re-purchase arrangement.	2. Closed-ended schemes do not provide the facility of withdrawing funds to the investors as per their preference.
3. Open-ended schemes are not listed on secondary market.	3. Closed ended schemes are listed on stock exchange/secondary market.
4. In open-ended schemes of mutual fund duration is not specified for redemption.	4. In closed-ended schemes of mutual fund duration is specified for redemption.
5. The main feature of open-ended scheme is the liquidity.	5. The main feature of closed-ended schemes are market forces of demand and supply.

3.3 Risks Involved in Mutual Funds

Q10. What are the risks associated with mutual funds?

Ans :

Mutual Funds are not free from risks. It is so because basically the mutual funds also invest their funds in the stock market on shares which are volatile in nature and are not risk free. Hence, the following risks are inherent in their dealings:

(i) Market Risks

In general, there are certain risks associated with every kind of investment on shares. They are called market risks These market risks can be reduced, but cannot be completely eliminated even by a good investment management. The prices of shares are subject to wide price fluctuations depending upon market conditions over which nobody has a control. Moreover, every economy has to pass through a cycle-Boom, Recession, Slump and Recovery. The phase of the business cycle affects the market conditions to a larger extent.

(ii) Scheme Risks

There are certain risks inherent in the scheme itself. It all depends upon the nature of the scheme. For instance, in a pure growth scheme, risks are greater. It is obvious because if one expects more returns as in the case of a growth scheme, one has to take more risks.

(iii) Investment Risk

Whether the Mutual Fund makes money in shares or loses depends upon the investment expertise of the Asset Management Company (AMC). If the investment advice goes wrong, the Fund has to suffer a lot. The investment expertise of various funds are different and it is reflected on the returns which they offer to investors.

(iv) Business Risk

The corpus of a mutual fund might have been invested in a company's shares. If the business of that company suffers any set back, it cannot declare any dividend. It may even go to the extent of winding up its business. Through the mutual fund can withstand such a risk, its income paying capacity is affected.

(v) Political Risks

Successive Governments bring with them fancy new economic idealogies and policies. It is often said that many economic decisions are politically motivated. Change in Government bring in the risk of uncertainty which every player in the financial service industry has to face. So mutual funds are no exception to it.

3.4 Organization of Firm

Q11. Describe the structure of the mutual fund operations in India.

(OR)

Explain the operational mechanism of Mutual funds.

Ans : **(May-15)**

The structure of mutual fund operations in India envisages a three tier establishment namely:

(i) A sponsor institution to promote the Fund

(ii) A team of trustees to oversee the operations and to provide checks for the efficient, profitable and transparent operations of the fund and

(iii) An Asset Management Company (AMC) to actually deal with the funds.

(i) Sponsoring Institution

The company which sets up the Mutual Fund is called the sponsor. The SEBI has laid down certain criteria to be met by the sponsor. These criteria mainly deal with adequate experience, good past track record, net worth etc.

(ii) Trustees

Trustees are people with long experience and good integrity in their respective fields. They carry the crucial responsibility of safeguarding the interest of investors. For this purpose, they monitor the operations of the different schemes. They have wide ranging powers and they can even dismiss Asset Management Companies with the approval of the SEBI.

(iii) Asset Management Company (AMC)

The AMC actually manages the funds of the various schemes The AMC employs a large number of professionals to make investments, carry out research and to do agent and investor servicing. Infact, the success of any Mutual Fund depends upon the efficiency of this AMC. The AMC submits a quarterly report on the functioning of the mutual fund to the trustees who will guide and control the AMC.

Operation of the Fund

A mutual fund invites the prospective investors to join the fund by offering various schemes so as to suit to the requirements of different categories of investors. The resources of individual investors are pooled together and the investors are issued units /shares for the money invested. The amount so collected is invested in capital market instruments like shares and debentures and money market instruments like treasury bills, commercial papers, etc.

For managing this fund, a mutual fund gets an annual fee of 1.25% of funds managed at the maximum as fixed by the SEBI (MF) Regulations, 1993 and if the funds exceed Rs.100 crores, it is only 1%. It can not take more than that. Of course regular expenses like custodial fee, cost of dividend warrants, fee for registration, the asset management fee etc. are debited to the respective schemes. These expenses cannot exceed 3% of the assets in the respective schemes each year. The remaining amount is given back to the investors in full.

Q12. Explain the role of Asset Management Company (AMC) in mutual funds business.

(OR)

Explain the regulatory framework for mutual funds in India.

Ans : **(May-16)**

1. Formulation

(i) Mutual funds are to be established in the form of trusts under the Indian Trust Act and are to be operated by separate Asset Management Companies (AMCs).

(ii) AMCs should have a minimum net worth of ` 10 crore.

(iii) AMCs and trustees of mutual funds are to be two separate legal entities. An AMC to its affiliate cannot act as a manager in any other fund.

(iv) All the schemes launched by the Asset Management Company should be approved by the trustees and a copy of the offer document should be filed with SEBI.

2. Schemes

(i) The AMC should mention the following in offer document.

(a) The minimum amount it wishes to raise under the scheme and

(b) The amount of funds it may retain in case of over subscription. In this case, all the applications who apply for five thousand units or less should be given full allotment keeping in view the over subscription levels.

(ii) The mutual fund as well as the AMC are liable to refund the application money back wholly or in part if,

(a) The mutual funds does not receive the minimum amount which it mentions in the prospectus and

(b) The amount received for units is in excess of subscription.

(iii) Every close-ended scheme launched by the AMC should be listed on a recognized stock exchange within a period of six months from the date of closure of the subscription.

However, this is not mandatory in cases where,

(a) There is a provision in the scheme for periodic repurchase facility to all the unit holders.

(b) The scheme provides for monthly income or if it takes into account the needs of certain classes of persons like senior citizens, women, widows or physically handicapped and children with a provision for periodic repurchase of units.

(c) The details of the repurchase facility are disclosed in the offer document.

(d) The scheme opens for repurchase within a period of six months from the date of closure of the subscription.

(iv) The AMC at its discretion can repurchase or reissue the units under the close-ended scheme.

(v) The close-ended scheme should be redeemed completely at the end of its maturity period.

3. Investment Norms

(i) If the AMC decides to invest in debt instruments, they should be rated and it should not be below the investment grade. The rating should be from an authorized credit rating agency.

In case the debt instrument is not rated, the AMC should take the approach from its board.

(ii) No mutual fund, under all its schemes can own more than ten percent of any company's paid-up capital carrying voting rights.

(iii) If the AMC wishes to transfer investments from one of its schemes to its other schemes, it will be allowed only if,

(a) The transfer of funds is done at the current market price of the said instruments on spot basis and

(b) The securities transferred satisfy the objectives of the scheme to which they are transferred.

(iv) A scheme can invest in other scheme managed by the same AMC or in a scheme managed by other mutual fund without charging any fees, only if the total interscheme investment made by the schemes managed by the same AMC or in schemes of other mutual funds does not exceed 5% of the NAV of the mutual fund.

4. Rights of Investors

(i) Certificates

An investor is entitled to receive shares/unit certificates allotted to him within a period of 6 weeks from the date of closure of the subscription.

(ii) Transfer

An investor is entitled to get the unit/share certificates transferred within a period of 3 days from the date of lodgment for transfer.

(iii) Refund

If the total collection of the funds by a mutual fund is less than the minimum amount of subscription planned to be raised, as mentioned in the prospectus, the applicants are entitled to receive the entire application money as refund, within a period of six weeks from the date of closure of subscription.

The refund may be delayed beyond this period, the applicants are entitled to receive, along with the application money, interest at the rate of 15% p.a for the period of delay.

3.5 Facilities Available to Investors

Q13. What facilities are available to an investors of a mutual fund?

Ans :

1. Repurchase Facilities

The units of closed ended schemes must be compulsorily listed in recognized stock exchanges. Such units can be sold or bought at market prices. But, units of open ended schemes are not at all listed and hence they have to be bought only from the Fund. So, the Fund reserves the right to buy back the units from its members. This process of buying back the units from the investors by the Fund is called repurchase facility. This is available in both schemes so as to provide liquidity to investors. The price fixed for this purpose is called repurchase price.

2. Reissue Facilities

In the case of open ended schemes, units can be bought only from the Fund and not in the open market. The units bought from the investors are again reissued to those who are interested in purchasing them. The price fixed for this purpose is called re-issue price.

3. Roll over Facilities

At the time of redemption, the investor is given an option to reinvest his entire investment once again for another term. An investor can overcome an adverse market condition prevailing at the time of redemption by resorting to this Roll over facility. This is applicable in the case of close- ended funds.

4. Lateral Shifting Facilities

Some mutual funds permit the investors to shift from one scheme to another on the basis of the Net Asset Values with a view to providing total flexibility in their operation. This is done without any discount on the fund and without any additional charges. This is a great privilege given to the investors. This shifting is called 'lateral shifting'.

Q14. Explain the Criteria for selection of Mutual funds.

(OR)

Explain factors to be considered while a selecting a mutual fund.

Ans : **(May-15)**

Mutual funds are not magic institutions which can bring treasure to the millions of their investors within a short span of time. All funds are equal to start with. But in due course of time, some excel the other. It all depends upon the efficiency with which the fund is being managed by the professionals of the fund. Hence, the investor has to be very careful in selecting a fund. He must take into account the following factors for evaluating the performance of any fund and then finally decide the one he has to choose:

(i) Objective of the fund

First of all, he must see the objective of the fund whether income-oriented or growth-oriented. Income-oriented are backed mainly by fixed interest yielding securities like debentures and bonds, whereas growth-oriented are backed by equities. It is obvious that growth- oriented schemes are more risky than income-oriented schemes, and hence, the returns from such schemes are not comparable with each other. The investor should compare the particular scheme of one fund with the same scheme of another fund and make a comparative analysis. His objective should also coincide with the objective of the scheme which he proposes to choose.

(ii) Consistency of performance

A mutual fund is always intended to give steady long-term returns, and hence, the investor should measure the performance of a fund over a period of at least three years. Investors are satisfied with a fund that shows a steady and consistent performance than a fund which performs superbly in one year and then fails in the next year. Consistency in performance is a good indicator of its investment expertise.

(iii) Historical background

The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. The fund's integrity should be above suspicion. A good historical record could be a better horse to bet on than new funds. It is in accordance with the maxim A known devil is better than an unknown angel'.

(iv) Cost of operation

Mutual funds seek to do a better job of the investible funds at a lower cost than the individuals could do for themselves. Hence, the prospective investor should scrutinise the expense ratio of the fund and compare it with others. Higher the ratio, lower will be the actual returns to the investor.

(v) Capacity for innovation

The efficiency of a fund manager can be tested by means of the innovative schemes he has introduced in the market so as to meet the diverse needs of investors. An innovator will be always a successful man. It is quite natural that an investor will look for funds which are capable of introducing innovations in the financial market.

(vi) Investor servicing

The most important factor to be considered is prompt and efficient servicing. Services like quick response to investor's queries, prompt despatch of unit certificates, quick transfer of units, immediate encashment of units, etc., will go a long way in creating a lasting impression in the minds of investors.

(vii) Market trends

Traditionally, it has been found that the stock market index and the inflation rate tend to move in the same direction, whereas the interest rates and the stock market index tend to move in the opposite direction. This sets the time for the investor to enter into the fund and come out of it. A prudent investor must keep his eyes on the stock market index, interest rate and the inflation rate. Of course, there is no scientific reasoning behind it.

(viii) Transparency of the fund management

Again, the success of a mutual fund depends to a large extent on the transparency of the fund management. In these days of investor awareness, it is very vital that the fund should disclose the complete details regarding the operation of the fund. It will go a long way in creating a lasting impression in the minds of the investors to patronise the fund for ever.

In fact, the wider range of products/services offered by the different funds, have made the investor quality-conscious. He is now in a position to assess the quality of the products offered by MFs in the financial market. MFs cannot simply attract savings by mere lucrative advertisements. The cult of the equity has spread to many investors who have become very discerning in selecting mutual funds.

Q15. Explain various techniques to evaluate mutual funds.

Ans :

(i) Sharpe's Model

William Sharpe has given a model for evaluating the fund's performance on a risk-adjusted basis. His model is based on the comparison of 'excess return' per unit of risk for both the fund and the benchmark. The risk is measured by the standard deviation. The excess return is ascertained with the help of risk-free rate.

Excess return = Actual return of the fund - Risk-free rate

(ii) Treynor's Model For Evaluation

In Sharpe's model, the return per unit of risk is measured with the help of standard deviation (risk). But in Jack Treynor's model, we measure return per unit of Beta (risk).

Treynor's Ratio (Ti) = (Ri - Rf)/βi where

Ri represents return on fund, Rf is risk-free rate of return and βi is beta of the fund. A high and positive Treynor's ratio shows a superior risk-adjusted performance of a fund and *vice versa.*

(iii) Jenson Model

Michael Jenson has developed another model to measure the performance of a fund on the basis of risk-adjusted factor. It is called Differential Return Method. It measures the performance of a fund by comparing the actual returns of the fund with the returns actually expected out of it over a given period at the given level of its systematic risk. The surplus between the two returns is called Alpha.

The expected return of a fund can be calculated by means of the following formula:

Expected rate (Ri) = Rf + Pi(Rm - Rf)

where βi is the given level of risk and Rm the average market return during the given period.

Then Alpha = Actual return - Expected or required return.

Higher the Alpha, superior is the performance of the fund and *vice versa.*

3.6 Guidelines from the Government of India

Q16. Explain the various guidelines framed by the Government of India for the issue of mutual funds.

Ans :

For proper functioning of mutual funds and for ensuring investor protection, the following important guidelines have been framed by the Government of India:

(A) General

(i) Money market mutual funds would be regulated by the RBI while other mutual funds would be regulated by the Securities and Exchange Board of India (SEBI).

(ii) Mutual Fund shall be established in the form of Trusts under the Indian Trust Act and be authorized for business by the SEBI.

(iii) Mutual Funds shall be operated only by separately established Asset Management Companies (AMCs).

(iv) At least 50% of the Board of AMC must be independent directors who have no connections with the sponsoring organization. The directors must have professional experience of at least 10 years in the relevant fields such as portfolio management, financial administration etc.

(v) The AMC should have a minimum net worth of Rs. 5 crores at all times.

(vi) The SEBI is given the power to withdraw the authorization given to any AMC if it is found to be not serving the best interest of investors as well as the capital market. It is not applicable to bank sponsored AMCs.

(B) Business Activities

(i) Both AMCs and trustees should be treated as two separate legal entities.

(ii) AMCs should not be permitted to undertake any other business activity except mutual funds.

(iii) One AMC cannot act as the AMC for another mutual fund.

(C) Schemes

(i) Each scheme of a mutual fund must be compulsorily registered with the SEBI before it is floated in the market.

(ii) The minimum size of the fund should be Rs.20 crores in the case of each closed-end scheme and it is Rs.50 crores for each open-end scheme.

(iii) Closed-end schemes should not be kept opened for subscription for more than 45 days. For open-end schemes, the first 45 days should be considered for determining the target figure or the minimum size.

(iv) If the minimum amount or 60 per cent of the targeted amount, whichever is higher, is not raised, then, the entire subscription has to be refunded to the investors.

(v) To provide continuous liquidity, closed-end schemes should be listed on stock exchanges. In the case of open-end schemes, mutual funds shall sell and re-purchase units at pre-determined prices based on the Net Asset Value and such prices should be published at least once in a week.

(vi) For each scheme, there should be a separate and responsible fund manager.

(D) Investment Norms

(i) Mutual Funds should invest only in transferable securities either in the capital market or money market or securitized debt. It cannot exceed 10 per cent in the case of growth funds and 40 per cent in the case of income funds.

(ii) The mutual fund should not invest more than 5% of its corpus of any scheme in any one company's shares.

(iii) This list of 5% can be extended to 10% if all the schemes of a mutual fund are taken together.

(iv) No scheme should invest in any other scheme under the same AMC.

(v) No mutual fund under all its schemes take together can invest more than 15 per cent of the funds in the shares and debentures of any specific industry, except in the case of those schemes which are specifically floated for investment in one or more specified industries.

(E) Expenses

(i) The AMC may charge the mutual fund with Investment management and Advisory fees. Such fees should have been disclosed in the prospectus.

(ii) The initial issue expenses should not exceed 6% of the funds raised under each scheme.

(iii) Excepting the initial issue expenses, all other expenses to be charged to the fund should not exceed 3% of the weekly average net assets outstanding during the current year. It must be disclosed through advertisements, accounts etc.

(F) Income Distribution

All mutual funds must distribute a minimum of 90% of their profits in any given year.

(G) Disclosure and Reporting

(i) The SEBI is given wide powers to call for any information regarding the operation of mutual funds and any of its schemes from the mutual fund or any person associated with it like the AMC, Trustee, Sponsor etc.

(ii) Every mutual fund is required to send its copies of duly audited annual statements of accounts, six monthly unaudited accounts, quarterly statements of movements in net assets for each of its schemes to the SEBI.

(iii) The SEBI can lay down the accounting policies, the format and contents of financial statements and other reports.

(iv) The SEBI shall also lay down a common advertising code for all mutual funds to comply with.

(H) Accounting Norm

(i) All mutual funds should segregate their earnings as current income, short term capital gains and long term capital gains.

(ii) Accounting for all the schemes must be done for the same year ending.

(I) Winding Up

(i) Each closed-end scheme should be wound up or extended with the permission of the SEBI as soon as the pre-determined period is over.

(ii) An open-end scheme shall be wound up, if the total number of units outstanding after re-purchases at a point of time falls below 50% of the originally issued number of units.

(J) Violation of Guidelines

The SEBI can, after due investigation, impose penalties on mutual funds for violating the guidelines as may be necessary.

3.7 Recent Reforms in Mutual Funds

Q17. Discuss the present state of mutual funds in India.

(OR)

What is the present scenario of mutual funds in India?

Ans : **(May-18, May-17)**

Recently, SEBI has made some of the biggest changes in mutual fund regulations to revive the mutual fund industry. Some of the measures which are made are said to be helping AMCs and distributors more than investors.

SEBI today notified wide-ranging reforms for mutual fund sector, which would provide incentives to fund houses for expanding to small cities but might result in additional costs for investors.

The changes, which would come into effect from next month, would require fund houses to make half-yearly financial results within one month of the end of every six-month period,

The decisions were approved by Sebi's board in its last meeting on August 16 with an aim to re-energies the mutual fund industry, by expanding its distribution network among other steps.

Notifying the proposals approved by its board, Sebi said today that the fund houses might charge investment and advisory fees on their schemes, which would have to be fully disclosed in the offer document.

In case of a fund of funds scheme, the total expenses of levied on the scheme would be capped at 2.50 per cent of the daily net assets of the scheme.

In addition to the total expenses already levied on schemes, Sebi would allow the fund houses to levy brokerage and transaction costs, which is incurred for the purpose of execution of trade and is included in the cost of investment, with a ceiling of 0.12 per cent in case of cash market and 0.05 per cent in case of derivatives transactions.

Besides, mutual funds can charge additional expenses of up to 0.30 per cent of daily net assets, if the new inflows from places other than top-15 cities are 30 per cent of the gross new inflows in the scheme, or are 15 per cent of the average assets under management (year to date) of the scheme, whichever is higher.

SEBI further said that the expenses charged under these clauses would have to be utilized for distribution expenses incurred for bringing inflows from such cities, and the amount incurred as expense on account of inflows from such cities would have to be credited back to the scheme in case the said inflows are redeemed within a period of one year.

Among other measures, the fund houses would have to calculate the Net Asset Value (NAV) of the scheme on daily basis and publish the same in at least two daily newspapers with nation wide circulation.

It also, any exit load charged by the fund houses would have to be credited to back to the scheme. This measure, along with capping of the total additional expenses at 0.2 per cent in normal case, would encourage long term holding and to reduce churn and align the interests of the fund houses and distributors with that of the investors.

These particular steps would not result in any additional cost to the investors, but the provision for additional expenses of up to 0.3 per cent for inflows from smaller cities could make the investments costlier at the investors' end.

3.8 Banks Providing Mutual Fund Services

Q18. Discuss the role of banks in mutual fund services in India.

Ans : **(May-16)**

In evaluating whether a bank or bank affiliate may provide administrative services to a mutual fund, look to whether they would provide the bank with control over the mutual fund. The list of administrative services traditionally are as follows :

(i) Maintaining and preserving the fund records, including financial corporate records;

(ii) Computing net asset values, dividends, performance data, and financial information regarding the funds;

(iii) Furnishing statistical and research data;

(iv) Preparing and filing with the SEC and state securities regulators registration statements (including prospectuses), notices, reports, and other material required to be filed under applicable laws;

(v) Preparing reports and other informational materials regarding the funds, including proxies and other shareholder communications;

(vi) Providing legal and other regulatory advice to the funds in connection with other administrative services;

(vii) Providing office facilities and clerical support for the funds;

(viii) Developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the funds' investment objectives, policies, and restrictions as established by the board of directors;

(ix) Providing routine fund accounting services and liaison with outside auditors;

(x) Preparing and filing tax returns;

(xi) Reviewing and arranging for payment of fund expenses;

(xii) Providing communication and coordination services with regard to the transfer agent, custodian, and other service organizations that render record keeping or shareholder communication services;

(xiii) Reviewing and providing advice to the fund regarding sales literature and marketing plans to assure regulatory compliance;

(xiv) Participation in seminars, meetings, and conferences designed to present information to brokers;

(xv) Assisting existing funds in the development of additional portfolios;

(xvi) Providing reports to the fund's board with regard to its activities; and

(xvii) Providing shareholder services.

3.9 Factors to be considered in Selection of Fund

Q19. What Factors to be considered before Selecting a Mutual Fund?

Ans :

(i) Objective of the Fund

First of all, he must see the objective of the fund whether income oriented or growth oriented. Income oriented are backed mainly by fixed interest yielding securities like debentures and bonds whereas growth oriented are backed by equities. It is obvious that growth oriented schemes are more risky than income oriented schemes, and hence, the returns from such schemes are not comparable with each other. The investor should compare the particular scheme of one fund with the same scheme of another fund and make a comparative analysis. His objective should also coincide with the objective of the scheme which he proposes to choose.

(il) Consistency of Performance

A mutual fund is always intended to give steady long-term return and hence, the investor should measure the performance of a fund over a period of at least three years. Investors are satisfied with a fund that shows a steady and consistent performance than a fund which performs superbly in one year and then fails in the next year. Consistency in performance is a good indicator of its investment expertise.

(iii) Historical Background

The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. The fund's integrity should be above suspicion. A good historical record could be a better horse to bet on than new funds. It is m accordance with the maxim "A know devil is better than an unknown angel."

(iv) Cost of Operation

Mutual Funds seek to do a better job of the investible funds at a lower cost than the individuals could do for themselves. Hence, the prospective investor should scrutinise the expense ratio of the fund and compare it with others. Higher the ratio, lower will be the actual returns to the investor.

(v) Capacity for Innovation

The efficiency of a fund manager can be tested by means of the innovative schemes he has introduced in the market so as to meet the diverse needs of investors. An innovator will be always a successful man. It is quite natural that an investor will look for funds which are capable of introducing innovations in the financial market.

(vi) Investor Servicing

The most important factor to be considered is prompt and efficient servicing. Services like quick response to investor queries, prompt despatch of unit certificates, quick transfer of units, immediate encashment of units etc. will go a long way in creating a lasting impression in the minds of investors.

(vii) Market Trends

Traditionally it has been found that the stock market index and the inflation rate tend to move in the same direction whereas the interest rates and the stock market index tend to move in the opposite direction. This sets the time for the investor to enter into the fund and come out of it. A prudent investor must keep his eyes on the stock market index, interest rate and the inflation rate. Of course, there is so scientific reasoning behind it.

3.10 Reasons for Commercial Banks to Offer Mutual Funds

Q20. To what extent commercial banks in India are better fitted to take up the mutual fund business? What problems do they encounter in this direction?

Ans :

(i) Banks are not able to provide better yields to the investing public with their savings and fixed deposit interest rates whereas many financial intermediaries, with innovative market instruments offering very attractive returns, have entered the financial market. So banks are not able to compete with them in tapping the savings. Hence there is a necessity to enter into the field of MFs.

(ii) The Gross Domestic Savings has risen from 10% in Fifties to 20% in Eighties, thanks to the massive branch expansion programme of banks and their growing deposit mobilization. Since the banks have branches in the rural as well as urban sectors, they can reach out to everyone in the country. Hence, a MF backed by a bank will be in a better position to tap the savings effectively and vigorously for the capital market.

(iii) Indian investors, particularly small and medium ones, are not very keen in investing any substantial amount directly in capital market instruments. They may also hesitate to invest in an indirect way through private financial intermediaries. On the other hand, if such intermediary has the backing of a bank, investors may have confidence and come forward to invest. Thus, banks have the advantage of 'public confidence' which is very essential for the success of mutual funds.

(iv) Earlier banks were not permitted to tap the capital market for funds or to invest their funds in the market. Now, a green signal has been given to them to enter into this market and reap the maximum benefits.

(v) Banks can provide a wider range of products/ services in Mutual Funds by introducing innovative schemes and extend their professionalism to the mutual funds industry.

(vi) Banks, as merchant banks have wide experience in the capital market and hence managing a Mutual Fund may not be a big problem for them.

(vii) The entry of banks would provide much needed competition in the Mutual Fund industry which has been hitherto monopolized by the U.T.I. This competition will improve customer service and widen customer choice also.

(viii) In the Indian economy, the Eighties witnessed the operation of both the process of intermediation and dis-intermediation. The dis-intermediation process can be easily harnessed by commercial banks through mutual funds. The process of dis-intermediation of time deposits into mutual funds would benefit the capital market because it would provide a sustainable domestic source of demand.

(ix) Above all the, investor servicing can be effectively done by banks through their network of branches spread throughout the country. Hence, the commercial banks have entered into the Mutual Fund market without any hesitancy.

(x) Moreover, the profitability of banks has been very much affected due to too many restrictions on their lending policies. They have been compelled to seek some other alternatives to increase their profits by means of diversifying their activities. Mutual Funds offer an excellent outlet for diversification.

3.11 Scenario of Mutual funds in India

Q21. Explain the present scenario of mutual funds in India.

(OR)

Describe the present state of the Mutual funds in India.

(OR)

What is the present scenario of Mutual funds in India?

Ans : **(May-18, May-17)**

The growth of mutual funds in India are categorized into four phases,

1. Phase-I (1964-87)
2. Phase-11 (1987-92)
3. Phase-III (1992-97) and
4. Phase-IV (beyond 1997).

1. Phase-I (1964 - 87)

The concept of mutual funds emerged in with the establishment of UT1 in 1963. The Unit Trust of India (UTI) was considered as the first mutual fund established under UTI Act, 1963, a special act of the parliament. It commenced its operations in 1964 with the objective of mobilizing saving and again reinvesting them with the help of corporate securities in order to achieve maximizing yield and capital appreciation. The launch of the unit scheme led to the emergence of phase-I. The unit scheme is the first open ended scheme. UTi's investible funds progressed when its market value raised from ` 149 crore in 1965 to ` 219 crore in 1970-71 to ` 1,126 crore in 1980-81 and in June 1987 it raised to ` 5068 crore. This phase introduced innovative scheme which attracted investors. This phase launched five income oriented, open ended schemes and are sold across the globe. UTI introduced master share, the equity growth fund and India fund in 1986. Both of these funds emerged as a marketing success for UTI and India fund was listed on the London Stock Exchange (LSE).

2. Phase-II (1987-92)

The second phase started with the entry of mutual fund which is sponsored by nationalized banks and insurance companies. During the year 1987, the two funds launched in Indian Trust Act, 1882 are SBI mutual fund and Canbank mutual fund. In 1988, the UTI launched another fund called the India Growth Fund and this fund is listed on the New York Stock Exchange (NYSE). During the year 1990, the insurance companies, LIC and GIC and banks which are nationalized such as Indian Bank, Bank of India and Punjab National Bank commenced its operations of wholly owned mutual fund subsidiaries. The other banking product provided by the arms of sponsor banks during the second phase of mutual fund is 'assured return type of scheme'. RBI issued some guidelines which are applicable only to mutual funds in the year 1989. The government of India offered some guidelines in June 1990 and these guidelines are for all mutual funds operating in India. The guidelines focused on compulsory registration with the SB1 and to maintain an arms length relationship between the sponsor and Assets Management Company (AMC). Entry of public sector funds in the mutual fund industry raised the growth of market value to ` 53,462 crore and number of investors to more than 23 million. The factor which is responsible for attractiveness of equity funds is tax benefits under equity linked savings scheme.

3. Phase-III (1992-97)

The history of mutual funds changed during the year 1993. The Securities and Exchange Board of India (SEBI) in January 1993 issued mutual fund regulations. The common regulatory framework of SEBI notified regulations for all mutual funds except UTI. The entry in the mutual fund industry was opened for private domestic and foreign players. The first private mutual fund was introduced with the merger of Kothari Group of Companies and Pioneer, a US Fund Company and together called as Kothari Pioneer Mutual Fund in 1993. They both established the first open ended fund in 1993. In May 1992 the UTI introduced a new scheme called master gain and proved a phenomenal market success during this phase.

Market value increased to ` 4700 crores and number of investors increased to 50 million. The phase-III suffered huge losses during the year 1995 and 1996 due to significant fall in NAV's of the equity funds, the service quality of mutual fund, lack of service infrastruc-ture, ineffective performance of the public sector funds, failure of foreign funds like Morgan Stanley etc. Because of this significant downfall the investor had negative impact for investing in mutual funds. Mutual funds sales suffered heavy losses in the year 1995-96.

4. Phase-IV (Beyond 1997)

This phase had a significant increase in the flow of funds towards mutual funds. This phase had a positive impact on capital market, tax benefits and improvement in the quality of investor service. In the year 1999-2000, sales mobilization level increased significantly from 31,420 crore to ` 73,000 crore. In the year 2000-01, the trend changed when UTI gave a shock to the investing public by disclosing NAV related to the country's largest mutual ftind scheme. Because of this disclosure, Pioneer ITI, JP Morgan and Newton investment management were pulled out from the Indian market. The Bank of India MF liquidated all its schemes in 2002.

The Indian mutual fund industry during the years 2000-01 and 2001-02 stagnated to around ` 1,00,000 crore assets. The reason for stagnation in the Indian mutual fund industry are stagnated equity markets and in indifferent performance by players. On May 3rd 2002, the aggregate deposits of Scheduled Commercial Banks (SCBs) was ` 11,86,468 crore. Mutual fund Assets Under Management (AUM) form nearly 10% of deposits of SCBs.

During this phase, increase in AUM by 11% led downfall in UTI. The private sector mutual funds earned huge profits from the debacle of US-64 of UTI. The AUM belonging to this sector also increased 60% in March 2002. The asset under management in the year 2004-05 was ` 1,49,554 crore and rose to ` 4,17,300 crore on March 31,2009. Thus, during this phase Assets Under Management (AUM) underwent phenomenal success.

3.12 Problems in Future Prospects

Q22. Explain the future of mutual funds industry.

Ans :

Inspite of the above bottlenecks, the mutual fund industry is having a good prospect in our country. It is likely to show a good progress in the coming years due to a variety of factors:

(i) The Securities and Exchanges Board of India is lending its full support for the promotion of the mutual fund industry directly as well as indirectly. For instance, it has allowed the promoters of a company to retain 75 per cent holding. It has raised the minimum subscription amount to Rs. 5000 for an individual investor for direct investment. It has also introduced the proportionate allotment scheme. All these factors stand in the way of small investors from entering into the capital market directly and they favour only big investors. So, a small investor has to necessarily seek the services of a mutual fund industry with his meagre savings.

(ii) Moreover, ever since the disbanding of the Controller of Capital issues Office, many companies have entered into the market with a petty premium on their shares. Naturally, the small investors find them out of their reach, and hence, they have to seek the blessings of the mutual fund industry. One can easily subscribe to mutual funds shares at par with one's little investment.

(iii) In recent times, the interest rates on bank deposits have been declining. The household savers are looking for alternative avenues which could bring higher returns. The returns on the mutual fund schemes compare favourably with the returns on bank deposits.

(iv) The trend of rising PE ratio, the entry of large domestic institutional investors, the opening of the market to the foreign investors etc. would make stock market inaccessible to the small investors. Hence, they have to necessarily go to the mutual fund industry.

(v) Mutual Funds provide a wider range of products so as to meet the diverse needs of the investing public. The investors have a good choice to meet their different expectations like security, growth and liquidity.

(vi) The Government has also given the necessary impetus by providing tax concessions and tax exemptions. When the mutual fund industry is receiving a preferential treatment at the hands of the Government, it is bound to grow in future.

(vii) The Department of Company Affairs has agreed to amend the companies Act to grant voting rights in companies for mutual funds.

(viii) Again mutual hands have been permitted to underwrite shares also.

(ix) The Union Budget 1999-2000 contains many measures to encourage the mutual fund industry. These measures include.

(x) a three year dividend tax exemption from U.T.I. and equity dominated open-ended mutual funds, and

(xi) a full income tax exemption for all income from the U.T.I. and other mutual funds in the hands of the investors.

Q23. What is AMFI? Write about the role played by AMFI in regulation and supervision of mutual funds.

Ans :

Association of Mutual Funds of India (AMFI) along with the Securities and Exchange Board of India (SEBI), and the Reserve Bank of India jRBI), has a regulatory framework, concentrating on the regulation and supervision of mutual funds. Through such a framework, the requirements of developing economy and the investors can be fulfilled.

Role of AMFI

The following points highlights the role of AMFI in regulating mutual funds,

1. Reserve Bank of India regulates the money market mutual funds as per its guidelines, which are specifically meant for the investment in money market instruments. The money market schemes of other mutual funds are regulated by the Securities and Exchange Board of India. These regulations must comply with the guidelines of RBI.

2. The guidelines of RBI are not concerned with the offshore funds which include non-residential investors. Such funds need to be governed by the rules and procedure laid down for approving and supervising the offshore funds.

3. SEBI is formulating the policies by regulating the mutual funds so as to protect the interest of the investors. Each and every mutual fund either promoted by public sector or private sector firms comprising the mutual funds promoted by foriegn organsations are governed by the similar regulations. All mutual funds must be registered with SEBI prior to their introduction in the market.

   The basic purpose behind the regulation of mutual funds in India by the RBI and the SEBI has been to make sure the adequate functioning of mutual funds, stability, investor's protection and to maintain reliability in the mutual funds/AUMs through increasing its efficiency.

   The regulator has initiated various practices with an intention of developing the preferences of mutual funds. Indian mutual fund regulations have created elite standards in Accounting. Corporate valuation, NAV computation and also for the disclosure norms.

Short Question and Answers

1. Open-ended Mutual funds

Ans :

This is the just reverse of close-ended funds. Under this scheme the size of the fund and / or the period of the fund is not fixed in advance. The investors are free to buy and sell any number of units at any point of time.

Features

(a) The investors are free to buy and sell units. There is no time limit.

(b) These are not trade in stock exchanges.

(c) Units can be sold at any time.

(d) The main motive income generation (dividend etc.)

(e) The prices are linked to the net asset value because units are not listed on the stock exchange.

2. Income fund

Ans :

This scheme aims at generating regular and periodical income to the members.

Such funds are offered in two forms. The first scheme earns a target constant income at relatively low risk. The second scheme offers the maximum possible income.

Features

(a) The investors get a regular income at periodic intervals.

(b) The main objective is to declare dividend and not capital appreciation.

(c) The pattern of investment is oriented towards high and fixed income yielding securities like bonds, debentures etc.

(d) It is best suited to the old and retired people.

(e) It focuses on short run gains only.

3. Explain the Importance of Mutual Funds.

Ans :

(i) Channelizing Savings for Investment

Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage.

(iv) Rendering Expertised Investment Service at Low Cost

The management of the Fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each Fund rhaintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share.

(vii) Introducing Flexible Investment Schedule

Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income Units can be exchanged for growth units depending upon the performance of the funds. One can not derive such a flexibility in any other investments.

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4. Define Mutual Funds.

Ans :

Introduction

Small investors generally do not have adequate time, knowledge, experience and resources for directly entering the capital market. Hence they depend on an intermediary. This financial intermediary is called mutual fund.

Mutual funds are corporations that accept money from savers and then use these funds to buy stocks, long term funds or short term debt instruments issued by firms or governments.

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5. Features of Mutual Funds?

Ans :

Mutual fund possesses the following features:

(i) Mutual fund mobilizes funds from small as well as large investors by selling units.

(ii) Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.

(iii) Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.

(iv) Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.

(v) Mutual fund provides switching facilities to investors who can switch from one scheme to another.

(vi) Various schemes offered by mutual funds provide tax benefits to the investors.

(vii) In India mutual funds are regulated by agencies like SEBI.

(viii) The cost of purchase and sale of mutual fund units is low.

6. Advantages of Mutual funds.

Ans :

1. Mobilizes Savings

Mutual funds play an important role in mobilizing savings of millions of investors across the country. In mutual funds, savings of small investors are mobilized, invested and returns are distributed in the same proportion to the unit holders.

2. Instrument Of Investing Money

Now-a-days bank rates have become very low so, keeping large amount of money in bank does not give higher returns. People can invest in stock market. But a common investor is not well informed about the complexities involved in stock market movements. Here mutual funds play an important role in helping common public to get higher returns.

3. Protection To Small Investors

A small investor is not safe in share market. In mutual industry there is no such risk. Mutual funds help to reduce the risk of investing in stocks by spreading or diversifying investments. Small investors enjoy the benefit of diversification.

4. Tax Benefit

Investors in mutual funds enjoy tax benefits. Dividend received by investors is tax free. Tax exemption is allowed on income received on units of mutual funds and UTI. Investment in mutual funds enjoy wealth tax exemption within the overall limit of Rs. 5 lakhs.. No tax shall be charged on gifts of mutual fund units upto Rs. 30,000.

5. Diversification

Investment in mutual funds enable investors to spread out and minimize the risks upto certain extent. Mutual fund invests in a diversified portfolio of securities. This diversification helps to reduce risk since all the stocks do not fall at same time. Thus investors are assured of average income which is not possible in other sources.

6. Multi - Purpose Service

Mutual funds introduces variety of innovative schemes containing various benefits. Innovative schemes are designed to meet the needs of different types of investors in terms of investment, dividend distribution, liquidity etc.

7. Boost To Capital Market

Mutual fund has become a capital market intermediary. It bridges the gap between retail investors and capital market. The rapid growth of mutual fund industry leads to increased vibrancy of capital market.

7. What are the functions of mutual funds?

Ans :

The following are the functions of mutual fund are

1. It mobilize the savings of small investors and use them as investment in securities market.
2. It helps the small investors to hold a share in a diversified portfolio of assets which may lower the risks of investment.
3. It pools the investors savings in a scheme and distribute the returns among investors in the proportion equal to their investment.
4. It helps the small investors to secure 'high return and low risk out of their equities and other assets.
5. It enables the small investors to take the professional management advantage which there by increases the earning rate.
6. Mutual funds operate in various diversified areas such as,
   (i) Offshore funds management.
   (ii) Management of money market funds.

8. Close ended Mutual funds

Ans :

Under this type of fund, the size of the fund and its duration are fixed in advance. Once the subscription reaches the predetermined level, the entry of investors will be closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to their holding.

Features

(a) The period and the target amount of the fund is fixed beforehand.

(b) Once the period is over and/ or the target is reached, the subscription will be closed (i.e. investors cannot purchase any more units).

(c) The main objective is capital appreciation.

(d) At the time of redemption, the entire investment is liquidated and the proceeds are liquidated and the proceeds are distributed among the unit holders.

(e) Units are listed and traded in stock exchanges.

(f) Generally the prices of units are quoted at a discount of upto 40% below their net asset value.

9. Growth fund

Ans :

Growth fund offers the advantage of capital appreciation. It means growth fund concentrates mainly on long run gains. It does not offers regular income. In short, growth funds aim at capital appreciation in the long run. Hence they have been described as "Nest Eggs" investments or long haul investments.

Features

(a) It meets the investors' need for capital appreciation.

(b) Funds are invested in equities with high growth potentials in order to get capital appreciation.

(c) It tries to get capital appreciation by taking much risk.

(d) It may declare dividend. But the main objective is capital appreciation.

(e) This is best suited to salaried and business people.

10. Leverage fund

Ans :

In this case the funds are invested from the amounts mobilized from small investors as well as money borrowed from capital market. Thus it gives the benefit of leverage to the mutual fund investors. The main aim is to increase the size of the value of portfolio. This occurs when the gains from the borrowed funds are more than the cost of the borrowed funds. The gains are distributed to unit holders.

11. Balanced fund

Ans :

It has a mix of debt and equity in the portfolio of investments. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

12. Conservative fund

Ans :

This aims at providing a reasonable rate of return, protecting the value of the investment and getting capital appreciation. Hence the investment is made in growth oriented securities that are capable of appreciating in the long run.

13. Money market mutual funds

Ans :

These funds are basically open ended mutual funds. They have all the features of open ended mutual funds. But the investment is made is highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills etc. These are money market instruments.

14. What are the differences between open-ended and closed ended mutual funds.

Ans :

S.No.	Open-ended Mutual funds	S.No.	Closed ended Mutual funds
1.	Open-ended schemes accept funds from investors and sell shares to the investors on a regular basis.	1.	Closed-ended schemes offer subscription only for a limited period.
2.	Open-ended schemes provide the facility of withdrawing funds to the investors by following the re-purchase arrangement.	2.	Closed-ended schemes do not provide the facility of withdrawing funds to the investors as per their preference.
3.	Open-ended schemes are not listed on secondary market.	3.	Closed ended schemes are listed on stock exchange/secondary market.
4.	In open-ended schemes of mutual fund duration is not specified for redemption.	4.	In closed-ended schemes of mutual fund duration is specified for redemption.
5.	The main feature of open-ended scheme is the liquidity.	5.	The main feature of closed-ended schemes are market forces of demand and supply.

15. Asset Management Company (AMC) in mutual funds business.

Ans :

1. Formulation

(i) Mutual funds are to be established in the form of trusts under the Indian Trust Act and are to be operated by separate Asset Management Companies (AMCs).

(ii) AMCs should have a minimum net worth of ` 10 crore.

(iii) AMCs and trustees of mutual funds are to be two separate legal entities. An AMC to its affiliate cannot act as a manager in any other fund.

(iv) All the schemes launched by the Asset Management Company should be approved by the trustees and a copy of the offer document should be filed with SEBI.

16. How do you differentiate Fund Unit and Equity Share?

Ans :

Just like shares, the price of units of a fund is also quoted in the market. This price is governed basically by the value of the underlying investments held by that fund. At this juncture, one should not confuse a mutual fund investment on units with that of an investment on equity shares. Investment on equity share represents investment in a particular company alone.

On the other hand, investment on an unit of a Fund represents investment in the parts of shares of a large number of companies. This itself gives an idea how safe the units are. If a particular company fails, the shareholders of that company are affected very much whereas the unit holders of that company are able to withstand that risk by means of their profitable holdings in other companies shares.

17. Explain the role of Mutual Funds.

Ans :

Role of mutual fund can be explained with the help of following points

1. Mobilizes Savings

Mutual funds play an important role in mobilizing savings of millions of investors across the country. In mutual funds, savings of small investors are mobilized, invested and returns are distributed in the same proportion to the unit holders.

2. Instrument Of Investing Money

Now-a-days bank rates have become very low so, keeping large amount of money in bank does not give higher returns. People can invest in stock market. But a common investor is not well informed about the complexities involved in stock market movements. Here mutual funds play an important role in helping common public to get higher returns.

3. Protection To Small Investors

A small investor is not safe in share market. In mutual industry there is no such risk. Mutual funds help to reduce the risk of investing in stocks by spreading or diversifying investments. Small investors enjoy the benefit of diversification.

4. Tax Benefit

Investors in mutual funds enjoy tax benefits. Dividend received by investors is tax free. Tax exemption is allowed on income received on units of mutual funds and UTI. Investment in mutual funds enjoy wealth tax exemption within the overall limit of Rs. 5 lakhs.. No tax shall be charged on gifts of mutual fund units upto Rs. 30,000.

5. Diversification

Investment in mutual funds enable investors to spread out and minimize the risks upto certain extent. Mutual fund invests in a diversified portfolio of securities. This diversification helps to reduce risk since all the stocks do not fall at same time. Thus investors are assured of average income which is not possible in other sources.

Choose the Correct Answers

1. The First player of the Mutual fund industry was ________ [b]
   (a) ICICI MF (b) UTI MF
   (c) SBI MF (d) LIC MF

2 . UTI mutual fund was set up in the Year ________ [a]
   (a) 1963 (b) 1986
   (c) 1956 (d) 1947

3. ________ Mutual fund company was set up as a joint venture between RBI and Government of India [a]
   (a) UTI MF (b) LIC MF
   (c) SBI MF (d) ICICI MF

4. Who establishes the Mutual Fund in India ? [c]
   (a) Securities Exchange Board of India
   (b) Asset Management Company
   (c) Sponsor
   (d) Shareholders

5. In India, AMC must be registered with ________. [c]
   (a) Company's Act, 2013
   (b) No registration required.
   (c) Securities Exchange Board of India
   (d) Reserve Bank of India

6. ________ is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities. [b]
   (a) Government Securities (b) Mutual Funds
   (c) Derivatives (d) Shares

7. The value of one unit of investment in Mutual fund is called the ________ [a]
   (a) Net Asset Value (b) Issue value
   (c) Market value (d) Gross Asset value

8. ________ regulates the Mutual fund industry in India. [c]
   (a) Reserve Bank of India
   (b) Association of Mutual Funds of India
   (c) Securities Exchange Board of India
   (d) State Bank of India

9. What is the full form of NAV? [c]

(a) Net Assessment Value (b) National Asset Value

(c) Net Asset Value (d) National Asset variation

10. ________ schemes not exposed to sudden and large movements of funds. [c]

(a) Fixed maturity plan (b) Open-Ended Funds

(c) Close-Ended Funds (d) Interval fund

11. ________ The feature of a mutual fund, where it spreads the investment in varied stocks and sectors by pooling the funds of various investors, is called as ________ [c]

(a) Professional Management (b) Affordability

(c) Diversification (d) Profit

12. Dividend income received from mutual in the hands of unit holders [b]

(a) Fully Taxable (b) Fully Exempt

(c) Partly Exempt (d) Partly Taxable

13. Which of the following is not a limitation of mutual funds? [d]

(a) No guarantee of return (b) Fees and Expenses

(c) Poor Performance (d) Professional Management

14. The Mutual fund industry follows which of the following regulation? [a]

(a) SEBI (Mutual fund) regulations 1996

(b) Mutual fund regulation 2004

(c) Mutual fund regulation 2003

(d) RBI

15. Presently there are ________ AMC in India [c]

(a) 40 (a) 50

(c) 44 (d) 39

Fill in the blanks

1. ________ funds are concernate mainly on long run gains i.e., capital appreciaiton.
2. Balance funds are also known ________ fund.
3. Leveraged funds are also called ________ .
4. REMF stands for ________.
5. Repurchase price is always linked to the ________.
6. Treynor's ratio =________.
7. SEBI stands for ________.
8. Mutual fund industry has been monopolised by ________
9. ________ model for evaluating the fund's performance on a risk adjusted basis.
10. Expected rate (R_i) = ________
11. ________ are corporations that accept money from savers and then use these funds to buy stocks, long term funds or short term debt instruments issued by firms or governments.
12. ________ is a trust that pools the savings of investors.
13. Investment in mutual funds enable investors to spread out and minimize the ________ upto certain extent.
14. Mutual fund has become a ________ market intermediary.
15. ________ schemes accept funds from investors and sell shares to the investors on a regular basis.
16. ________ schemes offer subscription only for a limited period.
17. Open-ended schemes are not listed on ________ market.
18. The main feature of open-ended scheme is the ________ .
19. The main feature of closed-ended schemes are market forces of ________ .
20. AMC stands for ________.
21. ________ Sharpe has given a model for evaluating the fund's performance on a risk-adjusted basis.

Answers

1. Growth oriented
2. Income cum growth
3. Borrowed funds
4. Real estate mutal fund
5. Net Asset Value
6. $(R_i - R_f)/\beta_i$
7. Securities exchange and Board of India

8. UTI
9. Sharpe's
10. $R_f + P_i(R_m - R_f)$
11. Mutual funds
12. Mutual fund
13. Risks
14. Capital
15. Open-ended
16. Closed-ended
17. Secondary
18. Liquidity
19. Demand and supply
20. Asset Management Company
21. William

UNIT IV	**DISCOUNTING, FACTORING AND FORFAITING** **Discounting and Factoring:** Meaning of Discounting - Factoring: Meaning, Modus Operandi of factoring scheme, Terms and conditions in factoring agreement - Function of factoring services - Types of factoring - Role of Banks in providing discounting, factoring and forfeiting services, Cost of factoring and pricing of factoring services, Benefit to the clients, Export factoring (Theory) **Forfeiting:** Factoring Vs. Forfeiting - Advantages and limitations of forfeiting - Forfeiting in India (Theory)

4.1 Discounting

4.1.1 Meaning of Discounting

Q1. Define Discounting.

(OR)

What is Discounting?

(OR)

Discuss the concept of Discounting.

Ans : **(May-18)**

Introduction

In India, the financial services sector, is developing at a faster rate so as meet the emerging needs of the economy. Many innovative schemes have been introduced by this sector and one such area wherein it has been introduced is book debt financing. Financial institutions try to extend their financial assistance to a larger cross-section of the trading community through book debt financing. A kind of book debt financing is already practised in India by the commercial banks. It is nothing but bill financing. This type of financing is done either by way of direct purchase of bills of customers or discounting them.

Meaning

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where the commercial banks enter into as a financier.

The commercial banks provide immediate cash by discounting genuine trade bills. They deduct a certain charge as discount charges from the amount of the bill and the balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills. Of course, this discount charges include interest for the unexpired period of the bill plus some service charges. Bill financing is the most liquid one from the banker's point of view since, in time of emergencies, they can take those bills to the Reserve Bank of India for rediscounting purposes. Infact, it was viewed primarily as a scheme of accommodation for banks. Now, the situation is completely changed. Today it is viewed as a kind of loan backed by the security of bills.

Bill financing is superior to the conventional and traditional system of cash credit in many ways.

(i) First of all, it offers high liquidity, in the sense, funds could be recycled promptly and quickly through rediscounting.

(ii) It offers quick and high yield. The banker gets income in the form of discount charges at the time of discounting the bills.

(iii) Again, there is every opportunity to earn the spread between the rates of discount and rediscount

(iv) Moreover, bills drawn by business people would never be dishonoured and they are not subject to any fluctuations in their values.

(v) Cumbersome procedures to create the security and the positive obligations to maintain it are comparatively very fewer.

(vi) Even if the bill is dishonoured, there is a simple legal remedy. The banker has to simply note and protest the bill and debit the customer's account. Bills are always drawn with recourse and hence, all the parties on the instrument are liable till the bill is finally discharged.

(vii) Above all, these bills would be very much useful as a base for the maintenance of reserve requirements like CRR and SLR.

It is for these reasons, the Reserve Bank of India has been trying its best to develop a good bill market in India. The Reserve Bank of India introduced.

4.1.2 Role of Banks in Providing Discounting

Q2. What is the role of Banks in Providing Discounting Services?

Ans : **(Imp.)**

Financial services companies had been acting till the early nineties as bill-brokers for sellers and buyers of bills arising out of business transactions. They were acting as link between banks and business firms. At times they used to take up bills on their own account, using own funds or taking short-term accommodation from banks working as acceptance/ discount houses. They had been handling business approximating Rs 5,000 crores annually. Bill discounting, as a fund-based service, made available funds at rates 1 per cent lower than on ash credit finance and bill finance constituted about one-fourth of bank finance.

However, the bill re-discounting facility was misused by banks as well as the bill-brokers. The jankiraman Committee appointed by the RBI which examined the factors responsible for the securities-scam identified the following misuse of the scheme:

Banks have been providing bill finance outside the consortium without informing the consortium bankers;

- They have been drawing bills on companies and they themselves discounted such bills to avail of rediscount facilities;
- In cases where banks provided additional finance outside the consortium arrangement by way of bill limits covering sales of goods, the sales proceeds had been unavailable to them to provide production finance;
- Bill finance had been provided to dealers/ stockists of large manufacturing companies without proper appraisal of their credit needs;
- Bills discounted by front companies set up by industrial groups on their parent companies which were obviously accommodation bills were discounted/ rediscounted by banks;
- The rediscounting of bills by finance companies with banks was done at a much lower rate of interest;
- Although bills are essentially trade documents, bills related to electricity charges, custom charges, lease rentals etc. were also discounted. This was mainly due to the lack of depth in the bill market and NBFCs felt the need for new instrument or schemes to increase their business.
- No records regarding bill discounting were ever maintained by banks.

In order to stop misuse of the bill discounting facility by banks, the RBI issued guidelines to banks in July 1992.

Elements

The main elements of these guidelines are as follows:

i) No fund/non-fund based facility should be provided by banks outside the consortium arrangement;

ii) Bill finance should be a part of the working capital/credit limit;

iii) Only bills covering purchase of raw materials/ inventory for production purposes and sale of goods should be discounted by banks;

iv) Accommodation bill should never be discounted;

v) Bill rediscounting should be restricted to usance bills held by other banks. The banks should not rediscount bills earlier discounted by finance companies;

vi) Funds accepted by banks for portfolio management should not be deployed for discounting bills.

vil) Overall credit limit to finance companies including bills discounting should not exceed three times the net worth of such companies; and

viii) For discounting LC-backed bills by NBFCs, the bill must be accompanied by a no-objection certificate from the beneficiary hank.

As a result, there was substantial decline in the volume of bill discounting. Presently, the volumes are on an average Rs 80-100 crore per month and Rs 800-900 crore per year. The ban on re-discounting has also resulted in falling margins for the NBFCs. They are not able to find cash rich companies/ individuals ready to discount/rediscount bills.

Q3. Define Bill discounting. What are the advantages of Bill discounting.

Ans :

Meaning

Bill discounting is a fund-based activity and has emerged as a profitable business in the early nineties for finance companies. According to the Indian Negotiable Instruments Act, 1881, the Bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to his order of a certain person or to the bearer of that instrument. The bill of exchange is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Advantages

The advantages are :

(a) To Investors

- Short-term sources of finance
- Bills discounting being in the nature of a transaction is outside the purview of Section 370 of the Indian Companies Act 1956 that restricts the amount of loans that can be given by group companies.
- Since it is not a lending, no tax at source is deducted while making the payment charges which is convenient, not only from cash flow point of view, but also from the point of view of companies that do not envisage tax liabilities.
- Rates of discount are better than those available on ICDs
- Flexibility, not only in the quantum of investments but also in the duration of investments.

(b) To Banks

(a) Safety of Funds

The greatest security for a banker is that a B/E is a negotiable instrument bearing signatures of two parties considered good for the amount of bill so he can enforce his claim easily.

(b) Certainty of Payment

A B/E is a self-liquidating asset with the banker knowing in advance the date of its maturity. Thus, bill finance obviates the need for maintaining large, unutilized, ideal cash balances as under the cash credit system. It also provides banks greater control over their drawls.

(c) Profitability

Since the discount on a bill is front-ended, the yield is much higher than in other loans and advances, where interest is paid quarterly or half yearly.

(d) Even out inter-bank liquidity problems

The development of healthy parallel bill discounting market would have stabilized the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.

(e) Discount Rate and Effective Rate of Interest

Banks and finance companies discounting bills prefer to discount letter of credit backed bills compared to clean bills. The rate of discount applicable to clean bills is usually higher than the rate applicable to L/C based bills. The bills are generally discounted up-front, that is the discount is payable in advance.

Q4. What are the characteristics of Bills discounting.

Ans :

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.

4.2 Factoring

4.2.1 Meaning

Q5. What is Factoring?

(OR)

Define the term Factoring.

Ans : **(May-18, May-17)**

Meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done . According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

(i) **According to Robert W. Johnson** in his book 'Financial Management' states, "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".

(ii) **According to V.A. Avadhani,** "factoring is a service of financial nature involving the conversion of credit bills into cash".

(iii) **According to Kohok,** "factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods".

(iv) **According to S.P. Singh,** a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that "factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance".

Q6. Explain the process of factoring.

Ans :

The factoring business is generated by credit sales in the ordinary course of business dealings. The realization of credit sales are considered as the fundamental function of factoring services. After the completion of sales transaction the factor takes steps to realize the sales. The factor operates between the seller and the buyer and sometimes along with the seller's banks.

A schematic representation of factoring mechanism desorbing 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 then or an agreement entered into between them.

(b) The seller sells goods to the buyer according to the MOU.

(c) The sellers 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 chargers 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 factors 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, gen, 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.

(iv) The seller must ensure that all the conditions of sell-buy contract between him and the buyer have been followed and the transactions are completed.

(v) The seller must receive a letter of wainer from a bank for factor if the bank has control over the assets which are sold to the buyer and the sale proceeds must be deposited in the bank account.

Q7. 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.

4.2.2 Modus Operandi of Factoring Scheme

Q8. Explain Modus Operandi of factoring scheme.

Ans :

A factor provides finance to his client upto a certain percentage of the unpaid invoices which represent the sale of goods or services to approved customers. The modus operandi of the factoring scheme is as follows :

i) There should be a factoring arrangement (invoice purchasing arrangement) between the client (which sells goods and services to trade customers on credit) and the factor, which is the financing organization.

ii) Whenever the client sells goods to trade customers on credit, he prepares invoices in the usual way.

iii) The goods are sent to the buyers without raising a bill of exchange but accompanied by an invoice.

iv) The debt due by the purchaser to the client is assigned to the factor by advising the trade customers, to pay the amount due to the client, to the factor.

v) The client hands over the invoices to the factor under cover of a schedule of offer along with the copies of invoices and receipted delivery challans or copies of R/R or L/R.

vi) The factor makes an immediate payment upto 80% of the assigned invoices and the balance 20% will be paid on realization of the debt.

Q9. What are the essential features of factoring?

Ans :

From the following essential features of factoring, we can understand its nature:

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The factor purchases the credit/receivables and collects them on the due date. Thus the risks associated with credit are assumed by the factor.
3. A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).
4. A factor specializes in handling and collecting receivables in an efficient manner.
5. Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.
6. Factoring is a technique of receivables management. It is used to release funds tied up in receivables (credit given to customers) and to solve the problems relating to collection, delays and defaults of the receivables.

Q10. What are the advantages and limitations of factoring?

Ans : **(May-15)**

Advantages

A firm that enters into factoring agreement is benefited in a number of ways. Some of the important benefits of factoring are summarized as follows:

1. Improves efficiency

Factoring is an important tool for efficient receivables management. Factors provide specialized services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.

2. Higher credit standing

Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.

3. Reduces cost

The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.

4. Additional source

Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

5. Advisory service

A factor firm is a specialized agency for better management of receivables. The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.

6. Acceleration of production cycle

With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.

7. Adequate credit period for customers

Customers get adequate credit period for payment of assigned debts.

8. Competitive terms to offer

The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

Limitations

The main limitations of factoring are outlined as below:

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.
5. Factoring may impose constraints on the way to do business. For non - recourse factoring most factors will want to pre-approve customers. This may cause delays. Further the factor will apply credit limits to individual customers.

Q11. Explain the legal aspects of financial evaluation of factorial services.

Ans :

India does not have any codified legal framework / code for controlling the factoring services. Factoring contract is regulated under the law of contract. The terms of factoring contract which is entered before starting the factoring process determines the legal relationship existing between a factor and a client. The following are some of the contents of a factoring agreement and the legal obligations of the parties,

1. The client offers an undertaking to the factor to sell and the factor agrees to purchase the receivables in accordance with the terms and conditions specified in the agreements.
2. The client gives guarantee that the receivables are valid, enforceable, undisputed and recoverable. The client also settles the disputes, damages and deductions related to the bills assigned to the factor.
3. The client gives the notices of assignments in the specified form to all these customers whose receivables are factored.
4. The client feels that the bills purchased by the factor on the basis of non-recourse will occur from the transactions that are approved by the factor or those which occurs under the credit limits authorized by the factor.
5. The factor gets the power of attorney for assigning the debts and for drawing the negotiable instruments with regard to such debts.
6. The client is ready to offer copies of invoices, credit notes and so on related to the factored accounts, to the factor, and the factor would ultimately remit the received amount against the factored invoices to the client.
7. The agreement clearly specifies the time limit and the agreement termination mode.
8. Legally, the factor is considered as an assignee. The defence which the customer has against the factor is same like the defence which the customers have against the client.
9. The customer is sometimes under a legal obligation to remit or transfer the amount directly to the factor but if he fails, then in such case he will not be discharged from his obligations to pay the factor (even if he pays directly to the client) till the client remits the amount to the factor.
10. The factor needs a letter of disclaimer from the bank before factoring a receivable.
11. It is very essential for the factor to assure that the book debts which it manages are free from any impediments which would autherize others to the money due. The firm should

provide guarantee that the book debts are free from any rights of a third party in the factoring agreement.

12. The factor has to recover the money which is due on an invoice. The agreement must specify that the factor should promptly act in his own name whenever required.

13. Factoring agreement will comprehensively specify the way in which the firm has to be paid.

14. The factoring offers an insurance to the firms against those customers who does not make payments. This will rely on determining whether the debt is approved or not which is basically decided before starting the factoring process.

15. The factoring agreements specifies that the payment to the factor should be made by the customer directly. In case if a customer pays the amount to the client by mistake, then the agreement states that the firm must hold the money for the factor. In case it a firm does not holds the money then it will be breach of trust and the firm may be liable for losses.

16. Some warrants that are needed are as follows,

(i) The firm needs to disclose the material facts which may influence the decision of a factor to approve a debt.

(ii) The firm needs to even warrant that the invoices sent for factoring signifies an adequate debt for the goods supplied.

17. In case of disputed debts, the factor requires the customer to notify it immediately. A firm is expected to return back the advances which are made to it with regard to the disputed debt.

18. The factor has the power to examine the books and accounts of a firm and the factoring arrangement period is specified in the agreement.

19. The client will,

(i) Have a factor which acts as the role factor.

(ii) Give a satisfactory assignment along with actual invoices and evidence on delivery.

(iii) Submit all the sales to the factor before shipping for credit approval.

(iv) Provide a warranty that every customer has received his merchandise and will accept it without any dispute and claim.

(v) Give the right to the factor to hold the balances of credit as security for any debts owed by the client to the factor.

20. The factor will,

(i) Purchase the bona fide accounts receivable which it has approved previously.

(ii) Charge interest on the sums advanced at a specific defined interest rate.

(iii) Render a statement of account monthly.

(iv) Advance against the purchase price, and will remit the balance on the monthly average due date of the receivables allotted along with 5 to 10 days for collection.

The legal implications of factoring are as follows,

(i) The factor needs to, firstly determine whether there is a genuine underlying trade transaction or not, if a customer presents a bills of exchange or hundi along with his invoice.

(ii) The factor should also examine with the banker of a client for assuring that there is no double financing.

(iii) The factoring needs to provide contingency and for ensuring against default, the factor must obtain a personal guarantee of the proprietor or the directors of the company.

(iv) The interest of the factor relating to the assignment of book debts of clients is protected by the provisions of section 130 of the Transfer of Property Act.

4.2.3 Terms and Conditions in Factoring Agreement

Q12. What are the terms and conditions in factoring agreement?

Ans : **(May-18)**

The existence of an agreement between the factor and the client is center the function of factoring. The main terms and conditions generally included in a factoring agreement are the following:

(i) Assignment of debt in favour of the factor.

(ii) Selling limits for the client.

(iii) Conditions within which the factor will have recourse to the client in case of non-payment by the trade customer.

(iv) Circumstances under which the factor will have recourse in case of non-payment.

(v) Details regarding the payment to the factor for his services, say for instance, as a certain percentage on turnover.

(vi) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier, and

(vii) Limit of any overdraft facility and the rate of interest to be charged by the factor.

4.2.4 Function of Factoring Services

Q13. Explain clearly the various functions involved in factoring services.

(OR)

Discuss the functions of factoring units.

Ans : **(May-15)**

Factoring involves the following functions:

(i) Purchase and Collection of Debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

(ii) Credit Investigation and Undertaking of Credit Risk

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus, the factor takes up the work of monthly sales analysis, overdue, invoice analysis and credit analysis.

(iii) Credit Investigation and Undertaking of Credit Risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of he most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

(iv) Provision of Finance

After the finalization of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

(v) Rendering Consultancy Services

Apart from the above, the factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and financial profiles of the customers, the likelihood of coming recession etc.

(vi) 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.

(vii) 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.

4.2.5 Types of Factoring

Q14. Discuss the various types of factoring services in India.

(OR)

Explain the different types of factoring and their significance.

Ans : **(May-17, May-15)**

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring (or) without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

(viii) Suppliers Guarantee Factoring

(ix) Limited Factoring

(x) Buyer Based Factoring

(xi) Seller Based Factoring

(i) Full service Factoring

Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility rails on the shoulders of the factor since he assumes the credit risk also. He can not pass on this responsibility to his client and, hence, this type of Factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges'.

(iii) Maturity Factoring

Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire .amount collected less factoring fees is paid to the client immediately. Hence it is also called 'Collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client himself.

Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as "Disclosed Factoring" or "Notified Factoring".

(v) Invoice Factoring

Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc. have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called 'Confidential Invoice Discounting' or 'Undisclosed Factoring'.

(vi) Agency Factoring

The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows:

- The client has to look after the sales ledger administration and collection work and
- The factor has to provide finance and assume the credit risk.

(vii) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(viii) Suppliers Guarantee Factoring

This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix) Limited Factoring

Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer Based Factoring

In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected Buyer Based Factoring.

(xi) Seller Based Factoring

Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called 'Selected Seller Based Factoring'.

4.2.6 Cost of Factoring and Pricing of Factoring Services

Q15. Explain the mechanism of Cost of factoring and pricing of factoring services.

(OR)

Explain the factors to be considered while considering factoring decision.

Ans :

(I) Cost of Factoring

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%, if the bills get paid earlier, service charges could be reduced depending upon the volume of work involved.

(II) 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.

(i) Factoring Fees

This is charged mainly as administrative expenses for providing various services to the clients namely:

- Sales ledger administration.
- Credit control administration.
- 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% and 2.5% 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.

(ii) 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.

4.2.7 Benefit to the Clients

Q16. What are the benefits of factoring?

Ans :

Factoring offers a number of benefits to the clients. Some of the important benefits are :

(i) Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realize their debts. In the meantime, the ‘business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. 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. They need not wait for months together to get cash for recycling.

Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grows and both are directly proportional to each other.

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.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on “On Account Terms of Payment”, i.e., credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) ‘Credit risk’Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, 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.

(iv) Provision of Expertized ‘Sales Ledger Management’ Service

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. Infact, the success of any organization depends upon the efficiency with which the sales ledger is managed. It requires a specialized knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the factor’s responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy Service

Factors are professionals in offering management services like consultancy. They collect information regarding the credit worthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally, no time is available to the client for investigating his customer’s credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in Servicing

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80% of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(viii) Trade Benefits

Availability of ready cash against bills enables the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, factoring enables the supplier to concentrate on production and materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customers and thus to attract more business. Thus many trade benefits are available under factoring.

(ix) Miscellaneous Service

Generally, factors are able to computerise their operations fully. So they are able to render prompt service at reasonable rates. They spend more on M.I.S. analysis. They also build bigger credit library of debtors by means of collecting information about new debtors.

Thus, improved cash flow through realization of trade debts by factoring, efficient follow up of collections, computerised sales ledger maintenance and the competitive rates are the main benefits of factoring.

4.2.8 Export Factoring

Q17. Briefly explain export factoring services.

Ans :

Generally, in the absence of factoring, all export finance transactions are backed by Letters of Credit. But, factoring relates purely to 'Open Account Transactions' with no promissory notes and collateral. Factoring is done entirely on the basis of the invoice prepared by the exporter and so it is purely an "invoice-based export finance" technique.

In an international factoring transaction, the 3 four parties namely :

- The exporter who is taking the place of a client in a domestic transaction.
- The importer who is taking the role of a customer in a domestic transaction.
- Export Factor (EF) and
- Import Factor (IF)

The exporter (client) and the factor enter into an agreement for export factoring which may take any one of the following types :

(i) Two factor system.

(ii) Single factor system.

(iii) Direct Export factor system.

(iv) Direct Import factor system.

(i) Two Factor System

There are two factors under this system — one in the export's country and the other in the importer's country. When the exporter wants to do business with some importer or importers, he approaches the factor in his country and informs him of his business proposal, the likely size of the business the number of invoices likely to be raised, the value of the consignment ana the currency involved.

This export factor inturn informs the same to his counterpart, i.e., important factor in the importing country. The import factor makes enquiries regarding the financial position of the importer and his dealings and, if satisfied, he conveys the message to the export factor. He also indicates the limit of: factoring and his commission for undertaking this work. Then, the export factor contacts the exporter and conveys the positive findings and his readiness to cover the credit risk through factoring. If the rates are acceptable to the exporter, he signs an agreement with the export factor.

Once this factoring relationship is established, the exporter sends the goods to the importer along with the invoice with a condition that the payments should be made to the import factor. Two copies of the invoices are sent to the export factor along with a notification that the debts have been assigned to the import factor. At this stage, the export factor makes payment immediately to the extent of 80 per cent of the invoice amount to the exporter.

When the amount is realized from the import factor, the export factor pays the balance of 20 per cent of the invoice amount to the exporter. The cost of factoring is debited to the exporter's account and the commission due to the import factor is also sent. Thus, the financial dealing has to be carried out with the help of two factors and hence it is called 'Two factor system'.

(ii) Single Factor System

Under this system also, two factoring companies, as stated earlier, are involved. However, the responsibility of making the payment, maintenance of books of accounts, its administration, etc., initially rest with the export factor. But, just to cover the credit risk, the export factor enters into an agreement with the import factor to collect the debt from the importer, in case the export factor is not able to realize the amount.

If such a contingency arises, the export factor has to assign the debt in favour of the import factor. Thus, the import factor is called upon to assist the export factor only during the times of difficulties in realizing the debt. Otherwise, the export factor himself will do all the work. So, it is called 'Single factor system'.

(iii) Direct Export Factor System

Under the system, there is a factoring agreement directly between the exporter and this export factor and no other party is involved. The entire export credit risk, the administration of the account, the advance payments, etc., have to be done only by the export factor. Hence, it is called 'direct' export factor system'.

(iv) Direct Import Factor System

It is just the opposite of direct export factor system. The agreement is between the exporter and the import factor in the importer's country. The import factor assumes all responsibilities for the collection of the debt from the importer.

Q18. Elaborate a Factoring system in India.

Ans :

Banks do provide non-banking financial services such as housing finance, leasing and hire-purchase, factoring and forfeiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either through their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries.

Factoring and forfeiting services were of recent origin following the recommendation of the Kalyanasundaram Committee, set up by the RBI in 1988. The Committee was constituted to examine the feasibility of factoring services in India, their constitution, organizational setup and scope of activities. The group recommended setting up of specified agencies or subsidiaries for providing the factoring services in India.

While attempting to assess the potential demand for factoring services in India, the study group under the leadership of Mr. C. S. Kalyanasundaram estimated the value of outstanding open account credit sales available for financing during 1989-90 at Rs. 12,000 crores in respect of SSI and Rs. 4500 crores for medium and large scale sector. Assuming only 50% of the above business will be available for factoring, the aggregate potential demand for factoring was expected to be around Rs. 4000 crores per annum mainly emerging from the SSI and large and medium companies.

Q19. What are the problems and prospectus of factoring in India?

Ans : **(May-16)**

In India, the factoring services are at the initial stage so their quantitative growth is very limited and its future rely on the abolition of several genuine operational problems/ barriers which are as follows,

1. Credit Information

There is no authentic source of information available for factors so they have to rely on their own database for evaluating the credit of the clients. The system of multiple data bases formed by individual factors is expensive and lacks uniformity which is a serious obstacle in the growth of factoring service. The development of specialized credit information agency is needed urgently.

2. **Stamp Duty**

The stamp duty which is changed by the states is influenced by debt assignment, the stamp duty is more than 15 percent on the amount which is more than ` 2 lakh. It increases the cost of operations of service and minimizes the profitability of the factors. A very strong case is available for waiving the stamp duty on the assignment of debt factors.

3. **Legal Framework**

The kalyansundaram Committee suggested that changes are to be made in the other parts of the present legal framework for assuring that the factoring attains success in India.

4. **Funding**

In India, the factors are not allowed to access extensive funding sources on scales provided for other finance companies. The virtual dependence on equity funds, does not allows them to have optimal funding. In order to have cost effective financing of these companies, there is an urgent need to have greater access to the debt and money markets such as leasing and other finance companies.

5. **Disclaimer Certificate**

A factor requires a disclaimer certificate from banks for purchasing a book debt of its clients. In the present scenario, they are not willing to issue such a certificate, hence the factoring companies must be allowed to purchase book debts without needing such certificate from banks.

6. **Limited Coverage**

In India, only domestic factoring of the advance with recourse in allowed and offered. Even though, ECGC and SBI FACS have introduced various measures for export factoring, headway has not been made. Hence, it is necessary and is the right time to offer export factoring to Indian exporters.

4.3 Forfeiting

Q20. What is Forfeiting?

(OR)

Define the term Forfeiting?

Ans : **(May-18, May-16, May-15)**

Meaning

The term 'forfait' is a French world. It means 'to surrender something' or 'give up one's right'. Thus forfaiting means giving up the right of exporter to the forfaitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without resource' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money.

Forfeiting is a mechanism of financing exports :

(a) by discounting export receivables

(b) evidenced by bills of exchanges or promissory notes

(c) without recourse to the seller (viz; exporter)

(d) carrying medium to long-term maturities

(e) on a fixed rate basis upto 100% of the contract value.

It is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount. Forfeiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms.

Recourse to forfeiting usually takes place where the credit is for long date maturities and there is no prohibition for extending the facility where the credits are maturing in periods less than one year.

Definition

Forfeiting has been defined as 'the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services'.

Parties to Forfeiting

There are five parties in a transaction of forfeiting. These are

(i) Exporter

(ii) Importer

(iii) Exporter's bank

(iv) Importer's bank

(v) The forfeiter.

Q21. What are the characteristics of Forfeiting?

Ans :

The main characteristics of forfeiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'avail').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

4.3.1 Advantages and Limitations of Forfeiting

Q22. What are the advantages and limitations of forfeiting?

(OR)

Explain the advantages and limitations of forfeiting in Indian context.

Ans : **(May-18, May-16)**

Benefits of Forfaiting

(i) Profitable and Liquid

From the forfeiter's point of view, it is very advantageous because he not only gets immediate income in the form of discount charges, but also, can sell them in the secondary market or to any investor for cash.

(ii) Simple and Flexible

It is also beneficial to the exporter. All the benefits that are available to a client under factoring are automatically available under forfaiting also. However, the greatest advantage is its simplicity and flexibility. It can be adopted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and the forfaitor.

(iii) Avoids Export Credit Risks

The exporter is completely free from many export credit risks that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations or any political upheaval that may affect the collection of bills. Forfaiting acts as an insurance against all these risks.

(iv) Avoids Export Credit Insurance

In the absence of forfaiting, the exporter has to go for export credit insurance. It is very costly and at the same time it involves very cumbersome procedures. Hence, if an exporter goes for forfaiting, he need not purchase any export credit insurance.

(v) Confidential and Speedy

International trade transactions can be carried out very quickly through a forfaitor. It does not involve much documentary procedures. Above all, it is very confidential. The speed and confidentiality with which deals are made are very beneficial for both the parties namely the exporter and the importer. No banking relationship with the forfaitor is necessary, since, it is a one time transaction only.

(vi) Suitable to all Kinds of Export Deal

It is suitable to any kind of goods whether capital goods exports or commodity exports. Any export deal can be subject to forfaiting.

(vii) Cent per cent Finance

The exporter is able to convert his deferred transaction into cash transaction through a forfaitor. He is able to get 100 per cent finance against export receivables.

(viii) Fixed Rate Finance

Forfaiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

Drawbacks

(i) Non-availability for Short and Long Periods

Forfaiting is highly suitable to only medium term deferred payments. Forfaitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short term and long term credit have to seek some other alternative source.

(ii) Non-availability for Financially weak Countries

Similarly, forfaitors generally do not come forward to undertake any forfeit financing deal involving an importer from a financially weak country. Generally, the forfaitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be undertaken at a higher price.

(iii) Dominance of Western Currencies

In International forfaiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutshe Mark and French and Swiss Francs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in Procuring International Bank's Guarantee

Forfaitors do not normally finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfaitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

4.3.2 Role of Banks in Providing, Factoring and Forfeiting Services

Q23. What is the role of banks in providing factoring and Forfeiting Services?

(OR)

Critically assess the role of forfeiting as a source of financing.

Ans : **(May-19)**

Both factoring and forfeiting are used as tools of financing. But there are some differences:

i) Factoring is always used as a tool for short-term financing, whereas forfeiting is for medium-term financing at a fixed rate of interest.

ii) Factoring is generally employed to finance both the domestic and export business. But, forfeiting is invariably employed in export business only.

iii) The central theme of factoring is the purchase of the invoice of the client, whereas it is only the purchase of the export bill under forfaiting.

iv) Factoring is much broader in the sense. It includes the administration of the sales ledger, assumption of credit risk, recovery of debts and rendering of consultancy services. On the other hand, forfeiting mainly concentrates on financing aspects only and that too in respect of a particular export bill.

v) Under factoring, the client is able to get only 80 per cent of the total invoice as 'credit facility', whereas the 100 per cent of the value of the export bill (of course deducting service charges) is given as credit under forfaiting.

vi) Forfeiting is done without recourse to the client, whereas it may or may not be so under factoring.

vii) The bills under forfeiting may be held by the forfaitor till the due date or they can be sold in the secondary market or to any investor for cash. Such a possibility does not exist under factoring.

viii) Forfeiting is a specific one in the sense that it is based on a single export bill arising out of an individual transaction only. But, factoring is based on the 'whole turnover', i.e., a bulk finance is provided against a number of unpaid invoices.

Q24. Explain the steps in the process of forfeiting.

Ans :

Step-1: Commercial Contract

A contract is made between the buyer and the seller, which includes various basic terms like the forfeiting cost, margin to cover risk, commitment cost, grace days, fee to compensate the forfeiter for loss of interest because of transfer and payment delays, forfeiting period, repayment instalment, interest rate and so on. The factoring cost depends on the term of the bill, the denominated currency, the credit rating, the nation, importer's risk and so on.

Step-2: Transaction

The seller sells and delivers the goods to the buyer on the deferred payment system.

Step-3: Notes Acceptance

The buyer accepts the promissory notes in favour of seller for payment inclusive of the interest charges. These notes are then sent to the seller. Bank guarantee with respect to the promissory note is also acquired.

Step-4: Forfeiting Contract

The seller and the forfeiting agent signs a forfeiting contract, along with the forfeiter which is mostly re-owned bank inclusive of the seller's bank.

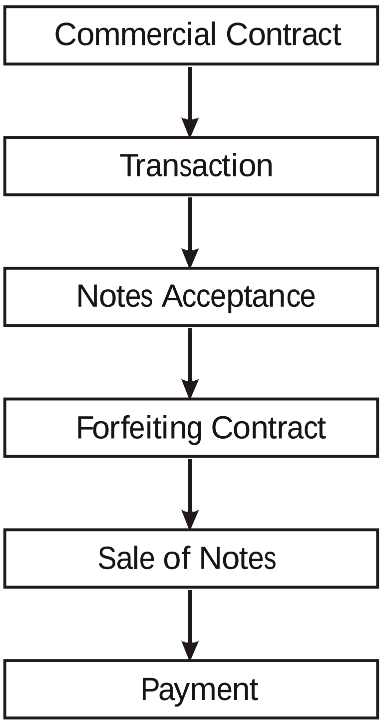

Fig : Process of forfeiting

Step-5: Sale of Notes

The seller sells the note or a bill to the forfeiter at a discount without recourse.

Step-6: Payment

The seller makes the payment to the forfeiter as the face value of the note or bill, with less discount. The forfeiter can keep these notes or bills upto their maturity for making payment by the importer's bank or securities them for selling them as short-term high-yielding unsecured paper in the secondary market.

4.3.3 Forfeiting in India

Q25. Briefly explain Forfeiting in India.

Ans :

Forfeiting, as a source of finance, has gained substantial momentum abroad. Though it had its origin in 'Zurich', it has been well established in all the financial centres of the world. Some of the important forfaiting centres are London, Zurich, Hong Kong, Singapore and Frankfurt. It has become a popular source of finance among Europeans.

In India, forfeiting is slowly emerging as a new product in the liberalized financial market. It was approved by the Union Government only in January, 1994. The existing scheme available for exporters like concessional finance by commercial banks, insurance cover against export credit risks by ECGC etc. are available mainly to large and well established exporters. In this context, forfeiting may be a real boon to the small, as well as, new exporters.

In India, forfeiting is done by the EXIM Bank. The minimum value of a forfeiting transaction is Rs. 5,00,000/-. A special form of pronate/Bill has to be used for forfeiting transactions. An Indian exporter who wants to avail of this service has to approach the EXIM bank through his bank.

The EXIM Bank would obtain the forfeiting quotation from the forfeiting agency abroad. Based on this, the exporter would work out his price to be quoted to the importer. If the importer accepts the price and the payment terms, the contract would be finalized and executed. The exporter would then get cash through forfeiting arrangements for which he has to enter into a separate contract with the forfeiture through the EXIM bank.

However, in order to encourage forfaiting finance business, it is necessary to designate export contracts in leading international currencies. In the wake of economic liberalization and opening of our economy to the global market, there are good prospects for forfaiting business in India. To promote forfaiting business, it is essential that we should denominate our trade contracts in foreign currencies rather than in Indian rupees. Now, since the rupee has gained strength, it is time for us to denominate our trade obligations in foreign currencies so that the pace of forfaiting business may be accelerated mainly to boost our export trade.

4.4 Factoring Vs. Forfeiting

Q26. Compare and contrast Factoring and Forfeiting.

(OR)

Distinguish between Factoring and Forfeiting.

Ans : **(Imp.)**

Forfaiting and factoring have similarities. Both have similar features of advance payment and non-recourse dealing. But there are some differences between them. The differences are as follows:

S.No.	Characteristic	Factoring	Forfaiting
1.	Suitability	For transactions with short term maturity.	For transactions with medium term maturity period.
2.	Recourse	Can be either with or without recourse.	Can be without recourse only
3.	Risk	Risk can transferred to seller.	All risks are assumed by the forfaiter.
4.	Cost	Cost of factoring is usually borne by the seller.	Cost of forfeiting is borne by the overseas buyer (importer)
5.	Coverage	Covers a whole set of jobs at predetermined price.	Structuring and costing is done on a case-to-case basis.
6.	Extent of Financing	Only a certain percent of receivables factors is advanced	Hundred percent finance is available
7.	Basis of financing	Financing depends on the credit standing of the exporter.	Financing depends on the financial standing of the availing bank.
8.	Service	Beside financing a Factor also provides other services such as ledger administration etc.	It is a pure financing arrangement.
9.	Exchange fluctuations	No security against exchange rate fluctuations.	A forfeiter guards against exchange rate fluctuations for a premium charge.
10.	Contract	Between seller and Factor	Between exporter and Forfaiter

Q27. Distinguish between Factoring and Forfeiting.

Ans :

Compare and contrast Factoring and Forfeiting

The various differences between factoring and bills discounting are as follows,

S.No.	Nature	Factoring	Bills Discounting
1.	**Services**	Factoring involves many other services besides financing facility.	In Bills Discounting, only financing is available.
2.	**Bulk Finance**	Complete quantum of receivable are covered under financing arrangement.	Here, the financing is based on bills.
3.	**Refinancing**	It is not possible to refactor the receivable which are once factored.	It is possible to rediscount the bills even if they are once discounted.
4.	**Mode of Accounting**	Factoring is an off-balance sheet financing.	Bills discounting doesnt have any such facility.
5.	**Collector**	The collector of receivables is the factor.	The collector of receivable is the Drawer.

Short Question and Answers

1. Define Discounting.

Ans :

In India, the financial services sector, is developing at a faster rate so as meet the emerging needs of the economy. Many innovative schemes have been introduced by this sector and one such area wherein it has been introduced is book debt financing. Financial institutions try to extend their financial assistance to a larger cross-section of the trading community through book debt financing. A kind of book debt financing is already practised in India by the commercial banks. It is nothing but bill financing. This type of financing is done either by way of direct purchase of bills of customers or discounting them.

Meaning

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where the commercial banks enter into as a financier.

The commercial banks provide immediate cash by discounting genuine trade bills. They deduct a certain charge as discount charges from the amount of the bill and the balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills. Of course, this discount charges include interest for the unexpired period of the bill plus some service charges. Bill financing is the most liquid one from the banker's point of view since, in time of emergencies, they can take those bills to the Reserve Bank of India for rediscounting purposes. Infact, it was viewed primarily as a scheme of accommodation for banks. Now, the situation is completely changed. Today it is viewed as a kind of loan backed by the security of bills.

2. Define the term Factoring.

Ans :

Meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done . According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

(i) **According to Robert W. Johnson** in his book 'Financial Management' states, "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".

(ii) **According to V.A. Avadhani,** "factoring is a service of financial nature involving the conversion of credit bills into cash".

(iii) **According to Kohok,** "factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods".

(iv) **According to S.P. Singh,** a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that "factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance".

3. What is Forfeiting?

Ans :

Meaning

The term 'forfait' is a French world. It means 'to surrender something' or 'give up one's right'. Thus forfaiting means giving up the right of exporter to the forfaitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without resource' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money.

Forfeiting is a mechanism of financing exports :

(a) by discounting export receivables

(b) evidenced by bills of exchanges or promissory notes

(c) without recourse to the seller (viz; exporter)

(d) carrying medium to long-term maturities

(e) on a fixed rate basis upto 100% of the contract value.

It is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount. Forfeiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms.

Recourse to forfeiting usually takes place where the credit is for long date maturities and there is no prohibition for extending the facility where the credits are maturing in periods less than one year.

Definition

Forfeiting has been defined as 'the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services'.

4. Discuss the various types of factoring services in India.

Ans :

(i) Full service Factoring

Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility rails on the shoulders of the factor since he assumes the credit risk also. He can not pass on this responsibility to his client and, hence, this type of Factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges'.

(iii) Maturity Factoring

Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire .amount collected less factoring fees is paid to the client immediately. Hence it is also called 'Collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client himself.

5. Discuss the functions of factoring units.

Ans :

Factoring involves the following functions:

(i) Purchase and Collection of Debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

(ii) Credit Investigation and Undertaking of Credit Risk

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus, the factor takes up the work of monthly sales analysis, overdue, invoice analysis and credit analysis.

(iii) Credit Investigation and Undertaking of Credit Risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of he most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

(iv) Provision of Finance

After the finalization of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

6. Define Bill discounting.

Ans :

Meaning

Bill discounting is a fund-based activity and has emerged as a profitable business in the early nineties for finance companies. According to the Indian Negotiable Instruments Act, 1881, the Bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to his order of a certain person or to the bearer of that instrument. The bill of exchange is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

7. 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.

8. What are the essential features of factoring?

Ans :

From the following essential features of factoring, we can understand its nature:

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The factor purchases the credit/receivables and collects them on the due date. Thus the risks associated with credit are assumed by the factor.
3. A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).
4. A factor specializes in handling and collecting receivables in an efficient manner.
5. Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.

9. What are the benefits of factoring?

Ans :

Factoring offers a number of benefits to the clients. Some of the important benefits are :

(i) Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realize their debts. In the meantime, the 'business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. 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. They need not wait for months together to get cash for recycling.

Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grows and both are directly proportional to each other.

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.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on "On Account Terms of Payment", i.e., credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) 'Credit risk'Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, 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.

10. Briefly explain export factoring services.

Ans :

Generally, in the absence of factoring, all export finance transactions are backed by Letters of Credit. But, factoring relates purely to 'Open Account Transactions' with no promissory notes and collateral. Factoring is done entirely on the basis of the invoice prepared by the exporter and so it is purely an "invoice-based export finance" technique.

In an international factoring transaction, the 3 four parties namely :

- The exporter who is taking the place of a client in a domestic transaction.
- The importer who is taking the role of a customer in a domestic transaction.
- Export Factor (EF) and
- Import Factor (IF)

11. What are the characteristics of Forfeiting?

Ans :

The main characteristics of forfaiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'avail').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

12. Compare and contrast Factoring and Forfeiting.

Ans :

Forfaiting and factoring have similarities. Both have similar features of advance payment and non-recourse dealing. But there are some differences between them. The differences are as follows:

S.No.	Characteristic	Factoring	Forfaiting
1.	Suitability	For transactions with short term maturity.	For transactions with medium term maturity period.
2.	Recourse	Can be either with or without recourse.	Can be without recourse only
3.	Risk	Risk can transferred to seller.	All risks are assumed by the forfaiter.
4.	Cost	Cost of factoring is usually borne by the seller.	Cost of forfeiting is borne by the overseas buyer (importer)
5.	Coverage	Covers a whole set of jobs at predetermined price.	Structuring and costing is done on a case-to-case basis.

13. Limitations of forfeiting?

Ans :

Drawbacks

(i) Non-availability for Short and Long Periods

Forfaiting is highly suitable to only medium term deferred payments. Forfaitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short term and long term credit have to seek some other alternative source.

(ii) Non-availability for Financially weak Countries

Similarly, forfaitors generally do not come forward to undertake any forfeit financing deal involving an importer from a financially weak country. Generally, the forfaitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be undertaken at a higher price.

(iii) Dominance of Western Currencies

In International forfaiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutshe Mark and French and Swiss Francs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in Procuring International Bank's Guarantee

Forfaitors do not normally finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfaitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

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. How many parties are involved in Bank Guarantee? [c]
   (a) One (b) Two
   (c) Three (d) Four

4. 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

5. 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

6. The factor generally makes prepayment of ________ of invoice value after acceptance of bill of exchange [d]
   (a) 40% (b) 50%
   (c) 60% (d) 80%

7. How many factors are there in International Factoring? [b]
   (a) One (b) Two
   (c) Three (d) Four

8. Which out of the following are rules governing letter of credit? [a]
   (a) UCP 600 (b) UCP 1200
   (c) UCP 1800 (d) UCP 2400

9. In forfaiting, the forfaiter makes payment of ________ % of export value. [d]
   (a) 70% (b) 80%
   (c) 90% (d) 100%

10. Which out of the following is not one of the party in a Bank guarantee? [c]
   (a) Guarantor (b) Principal Debtor
   (c) Agent (d) Creditor

11. Which among the following is a non-fund based facility? [b]
   (a) Term Loan (b) Bank guarantee
   (c) Working Capital (d) Packing credit

12. Which out the following is not a type of bank guarantee? [a]
   (a) Bill Guarantee (b) Performance Guarantee
   (c) Financial Guarantee (d) Deferred Payment Guarantee

13. How many contractual relationships are there in letter of credit? [c]
   (a) One (b) Two
   (c) Three (d) Four

14. Name the letter of credit in which an advance payment is made to exporter for purpose of procuring shipment material? [a]
   (a) Red Clause Letter of credit (b) Green Clause Letter of credit
   (c) Yellow Clause Letter of credit (d) Pink Clause Letter of credit

15. Name the letter of credit in which an advance payment is made to exporter for temporary storage of good at exporter end? [b]
   (a) Red Clause Letter of credit (b) Green Clause Letter of credit
   (c) Yellow Clause Letter of credit (d) Pink Clause Letter of credit

16. Which type of risk is hedged by forward rate agreement? [d]
   (a) Reputation Risk (b) Operational Risk
   (c) Liquidity Risk (d) Interest Rate Risk

17. __________ provide immediate cash by discounting genuine trade bills. [a]
   (a) Commercial banks (b) RRB
   (c) NABARD (d) SFC

18. __________ is a fund based activity and has emerged as profitable business. [b]
   (a) Bill financing (b) Bill discounting
   (c) Bills rediscounting (d) None

19. __________ is payable immediately at sight (or) presentment to the drawee. [b]
   (a) Unsance bill (b) Demand bill
   (c) Clean bill (d) D/A bill

20. __________ is also called time bill options above same. [a]
   (a) Unsance bill (b) Demand bill
   (c) Clean bill (d) D/A bill

21. __________ documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee. [d]

    (a) Unsance bill (b) Demand bill

    (c) Clean bill (d) D/A bill

22. __________ is a fund based financial service which provides resources to finance receivable and collection of receivables. [c]

    (a) Bill discounting (b) Bills financing

    (c) Factoring (d) None

23. __________ Factor does not assume the credit risk [b]

    (a) Full service factoring (b) With resource factoring

    (c) Maturity factoring (d) Bulk factoring

24. __________ factor and the client share the work between themselves [c]

    (a) Bulk factoring (b) Invoice factoring

    (c) Agency factoring (d) Maturity factoring

25. __________ factor does not take-up all the invoices of a client. [b]

    (a) International factoring (b) Limited factoring

    (c) Buyer based costing (d) None

26. Factoring is an off balance mode of [a]

    (a) Financing (b) Leasing

    (c) Forfeiting (d) VCF

Fill in the blanks

1. __________ institutions try to extend their financial assistance to a larger cross-section of the trading community through book debt financing.
2. __________ had been provided to dealers/ stockists of large manufacturing companies without proper appraisal of their credit needs.
3. Bill __________ is a fund-based activity and has emerged as a profitable business in the early nineties for finance companies.
4. The word 'Factor' has been derived from the Latin word 'Facere' which means __________
5. __________ is a service of financial nature involving the conversion of credit bills into cash".
6. Factoring is a service of __________ nature.
7. __________ is a fund based activity and has emerged as a profitable business.
8. Usance bill is also called __________ .
9. __________ with the buyer in the form of letter exchanged between them (or) agreement entired into between them.
10. Cost of factoring comprises two aspects namely __________ and __________.
11. Discount charges is normally linked with the __________.
12. Factoring and forfeiting services were of rent origin following recommendation of __________ committee.
13. Forfeiting is derived from french term "forefeit" which means __________.
14. There are __________ parties involved in forfeiting.
15. If a factor provides finance after disclosing the fat of assignment of debts to the debtors concerned it is called __________ .
16. The process of selling trade debts of a client to a financial intermediary is called __________

ANSWERS

1. Financial
2. Bill finance
3. Discounting
4. To make
5. Factoring

6. Financial
7. Bills discounting
8. Time bill
9. Memorandum of understanding
10. Finance charges, Service fee
11. Base rate
12. Kalyansundaram
13. One's right on something to someone else
14. 5
15. Bulk factoring
16. Factoring

UNIT V

SECURITISAION OF DEBT

Securitization of Debt: Meaning and Concept of Securitization - Structured Securities Vs. Conventional Securities - Securitization Vs. Factoring - Operational Mechanism of Securitization - Types of Securitized Assets - Securitization and Role of Banks - Advantages and Limitation of Securitization - Future Prospects of Securitization (Theory)

5.1 Securitization of Debt

5.1.1 Meaning and Concept of Securitization

Q1. What is Securitization?

(OR)

Define the term Securitization.

(OR)

Explain the concept of securitization.

(OR)

What is securitization of debt.

Ans : **(May-18, May-17, May-16, May-15)**

Introduction

The financial system all over the world is in the process of rapid transformation. As a result, the capital market, money market and the debt market are getting widened and deepened. It is interesting to note that new instruments and new products are emerging in the debt market too. Infact the development of a debt market increases the efficiency of a capital market to a greater extent. Again, along with the equity market, there is bound to be a natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary markets.

In this context, debt or asset securitisation assumes a significant role and it is one of the most innovative techniques introduced in the debt market to achieve the above objective. Moreover, it is the debt market which has provided more impetus for capital formation than the equity market in the economically advanced countries.

Securitisation of debt or asset refers to the process of liquidating the liquid and long term assets like loans and receivables of financial institutions like banks by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Definition

(i) A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities.

(ii) Another simple definition is as follows: Securitisation is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

(iii) According to Hendersen, J. and Scott, J.P. "Securitisation is the process which takes when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead, by investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse, to the original lender". Thus, financial assets can be made liquid through securitisation, *i.e.*, through packaging loans and selling them in the market. It is very clear from the above definitions that securitisation is nothing but the packaging of a pool of financial assets into marketable securities. In brief, ill-liquid assets are converted into tradable securities.

Q2. Explain the features of securitization.

Ans : **(May-16)**

The securitization has the following features:

(i) Creation of Financial Instruments: The process of securities can be viewed as process of creation of additional financial product of securities in market backed by collaterals.

(ii) Bundling and Unbundling: When all the assets are combined in one pool it is bundling and when these are broken into instruments of fixed denomination it is unbundling.

(iii) Tool of Risk Management: In case of assets are securitized on non-recourse basis, then securitization process acts as risk management as the risk of default is shifted.

(iv) Structured Finance: In the process of securitization, financial instruments are tailor structured to meet the risk return trade of profile of investor, and hence, these securitized instruments are considered as best examples of structured finance.

(v) Trenching: Portfolio of different receivable or loan or asset are split into several parts based on risk and return they carry called 'Trenche'. Each Trench carries a different level of risk and return.

(vi) Homogeneity: Under each trenche the securities are issued of homogenous nature and even meant for small investors the who can afford to invest in small amounts.

Q3. Explain the need for securitization.

(OR)

Explain the need for and essential of the success of Securitization of debt.

Ans : **(Imp.)**

The generic need for securitization is similar to that of organized financial markets. From the distinction between a financial relation and a financial transaction earlier, we understand that a relation invariably needs the coming together and remaining together of two entities. Not that the two entities would necessarily come together of their own, or directly. They might involve a number of financial intermediaries in the process, but a relation involves fix over a certain time. Financial relations are created to back another financial relation, such as a loan being taken to acquire an asset, and in that case, the needed fixed period of the relation hinges on the other that it seeks to back-up.

Financial markets developed in response to the need to involve a large number of investors. As the number of investor's keeps on increasing, the average size per investors keeps on coming down, because growing number means involvement of a wider base of investors.

The small investor is not a professional investor. He needs an instrument, which is easier to understand, and provides liquidity and legal sanction. These needs set the stage for evolution of financial instruments which would convert financial claims into liquid, easy to understand and homogenous products. They would be available in small denominations to suit even a small investor. Therefore, securitization in a generic sense is basic to the world of finance, and it is right for us to say that securitization envelopes the entire range of financial instruments, and the range of financial markets.

5.1.2 Structured Securities Vs. Conventional Securities

Q4. Compare and contrast Structured Securities and Conventional Securities.

Ans :

Securitisation is basically a structured financial transaction. It envisages the issue of securities against ill-liquid assets and such securities are really structured securities. It is so because, they are backed by the value of the underlying financial asset and the credit support of a third party also. At this stage, one should not confuse such structured securities with conventional securities like bonds, debentures etc. They differ from each other in the following respects.

1. **Source of repayment :** In the case of conventional securities, the primary source of repayment is the earning power and cash flow of the issuing company. But, under securitisation, the issuing company is completely free from this botheration since the burden of repayment is shifted to a pool of assets or to a third party.

2. **Structure :** Under securitisation, the securities may be structured in such a way so as to achieve a desired level of risk and a desired level of rating depending upon the type and amount of assets pooled. Such a choice is not available in the case of conventional securities.

3. **Nature :** In fact, these structured securities are basically derivatives of the traditional debt instruments. Of course, the credit standing of these securities is well supported by a pool of assets or by a guarantee or by both.

5.1.3 Securitization Vs. Factoring

Q5. Compare and contrast Securitization and Factoring.

(OR)

Differentiate between Securitization and Factoring

Ans :

While both factoring and securitization involves capitalizing the receivables of the company, however there are many differences between factoring and securitization.

1. While factoring is arrangement between the banks and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables whereas Securitization is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows.

2. Under factoring there are two parties that is the bank and the company while under securitization there are many investors involved who invest in the securitized asset.

3. While factoring is done for short term account receivables ranging from 1 month to 6 months whereas securitization is done for long term receivables of the company.

4. While factoring is of many types and can be with or without recourse while securitization is done without recourse.

5. Since factoring involves only bank and the company there is no need for any credit rating while securitization involves many investors and therefore it is necessary to take credit rating before going for securitization of receivables.

Q6. Explain the participants in securitization.

Ans :

Broadly, the participants in the process of securitization can be divided into two categories; one is Primary Participant and the other is Secondary Participant.

Primary Participants

Primary Participants are main parties to this process. The primary participants in the process of securitization are as follows:

(a) Originator: It is the initiator of deal or can be termed as securitizer. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets. The originator transfers both legal as well as beneficial interest to the Special Purpose Vehicle.

(b) Special Purpose Vehicle: Also, called SPV is created for the purpose of executing the deal. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only and normally could be in form of a company, a firm, a society or a trust.

The main objective of creating SPV to remove the asset from the Balance Sheet of Originator. Since, SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization. Further, it also issues the securities (called Asset Based Securities or Mortgage Based Securities) to the investors.

(c) The Investors: Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.

Since, they acquire a participating in the total pool of assets/receivable, they receive their money back in the form of interest and principal as per the terms agree.

II) Secondary Participants

Besides the primary participants other parties involved into the securitization process are as follows:

(a) Obligors: Actually they are the main source of the whole securitization process. They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator. The amount due from the obligor is transferred to SPV and hence they form the basis of securitization process and their credit standing is of paramount importance in the whole process.

(b) Rating Agency: Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available. Rating agency assesses the following:

- Strength of the Cash Flow.
- Mechanism to ensure timely payment of interest and principle repayment.
- Credit quality of securities.
- Liquidity support.
- Strength of legal framework.

Although rating agency is secondary to the process of securitization but it plays a vital role.

(c) Receiving and Paying agent (RPA): Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV. It also follow up with defaulting borrower and if required initiate appropriate legal action against them. Generally, an originator or its affiliates acts as servicer.

(d) Agent or Trustee: Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement. Normally, it takes care of interest of investors who acquires the securities.

(e) Credit Enhancer: Since investors in securitized instruments are directly exposed to performance of the underlying and sometime may have limited or no recourse to the originator, they seek additional comfort in the form of credit enhancement. In other words, they require credit rating of issued securities which also empowers marketability of the securities.

Originator itself or a third party say a bank may provide this additional context called Credit Enhancer. While originator provides his comfort in the form of over collateralization or cash collateral, the third party provides it in form of letter of credit or surety bonds.

(f) Structurer: It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal. It ensures that deal meets all legal, regulatory, accounting and tax laws requirements.

Q7. Explain various securitization instruments.

Ans :

On the basis of different maturity characteristics, the securitized instruments can be divided into following three categories:

1. Pass Through Certificates (PTCs)

As the title suggests originator (seller of eh assets) transfers the entire receipt of cash in form of interest or principal repayment from the assets sold. Thus, these securities represent direct claim of the investors on all the assets that has been securitized through SPV.

Since all cash flows are transferred the investors carry proportional beneficial interest in the asset held in the trust by SPV.

It should be noted that since it is a direct route any prepayment of principal is also proportionately distributed among the securities holders. Further, due to these characteristics on completion of securitization by the final payment of assets, all the securities are terminated simultaneously.

Skewness of cash flows occurs in early stage if principals are repaid before the scheduled time.

2. Pay Through Security (PTS)

As mentioned earlier, since, in PTCs all cash flows are passed to the performance of the securitized assets. To overcome this limitation and limitation to single mature there is another structure i.e. PTS.

In contrast to PTC in PTS, SPV debt securities backed by the assets and hence it can restructure different tranches from varying maturities of receivables.

In other words, this structure permits desynchronization of servicing of securities issued from cash flow generating from the asset. Further, this structure also permits funds for short term as per their requirement.

Since, in Pass Through, all cash flow immediately in PTS in case of early retirement of receivables plus cash can be used for short term yield. This structure also provides the freedom to issue several debt trances with varying maturities.

3. Stripped Securities

Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities. Those two securities are as follows:

(i) Interest Only (IO) Securities

(ii) Principle Only (PO) Securities

As each investor receives a combination of principal and interest, it can be stripped into two portion of Interest and Principle.

Accordingly, the holder of IO securities receives only interest while PO security holder receives only principal. Being highly volatile in nature these securities are less preferred by investors.

In case yield to maturity in market rises, PO price tends to fall as borrower prefers to postpone the payment on cheaper loans. Whereas if interest rate in market falls, the borrower tends to repay the loans as they prefer to borrow fresh at lower rate of interest.

In contrast, value of IO's securities increases when interest rate goes up in the market as more interest is calculated on borrowings.

However, when interest rate due to prepayments of principals, IO's tends to fall.

Thus, from the above, it is clear that it is mainly perception of investors that determines the prices of IOs and POs.

5.1.4 Operational Mechanism of Securitization

Q8. Explain the Operational Mechanism of Securitization in India.

Ans : **(May-18, May-17, Imp.)**

i) Identification Process

The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called 'identification process'.

ii) Transfer Process

After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale, i.e., full transfer of assets in question for valuable consideration or by passing them for a collateralised loan. Generally, it is done on an outright sale basis. This process of passing through the selected pool of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

iii) Issue Process

After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different names like 'Pay through Certificates', 'Pass through Certificates'. Interest only Certificates, Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronise with the maturities of the securitised loans or receivables.

iv) Redemption Process

The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator or a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer. Thus, under securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either 'with recourse' to the originator or 'without recourse'. The usual practice is to make it 'without recourse'. Hence, the holder of a pass through certificate has to look to the SPV for payment of the principal and interest on the certificates held by him. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment of interest and principal to the investors.

v) Credit Rating Process

Since the pass through certificates have to be publicly issued, they require credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least by one credit rating agency on the eve of the securitisation. The issues could also be guaranteed by external guarantor institutions like merchant bankers which would enhance the credit worthiness of the certificates and would be readily acceptable to investors. Ofcourse, this rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interest by the SPV.

Pass through certificates, like debentures, directly reflect the ownership rights in the assets securitised, their repayment schedule, interest rate etc. These certificates, before maturity, are tradable in a secondary market to ensure liquidity for the investors. They are negotiable securities and hence they can be easily tradable in the market.

5.2 Types of Securitized Assets

Q9. Explain various types of types of Securitized Assets.

(OR)

Discuss various types of debt Securitization.

Ans : **(May-17)**

All assets are not suitable for securitisation. For instance, trade debts and receivables are not generally suitable for securitisation whereas they are readily acceptable to a factor. Only in rare cases, they are securitised. Example: Preferred Stock Certificates.

The following assets are generally securitised by financial institutions:

(i) Term loans to financially reputed companies

(ii) Receivables from Government Departments and Companies

(iii) Credit card receivables

(iv) Hire purchase loans like vehicle loans

(v) Lease Finance

(vi) Mortgage Loans etc.

The general principle is that the securities must be structured in such a way that the maturity of these securities may coincide with the maturity of the securitised loans. However, there are three important types of securities as listed below:

(i) Pass through and pay through certificates,

(ii) Preferred stock certificates, and

(iii) Asset based commercial papers.

(i) Pass through and Pay through Certificates

In the case of pass through certificates, payments to investors depend upon the cash flow from the assets backing such certificates. In other words, as and when cash (principal and interest) is received from the original borrower by the SPV, it is passed on to the holders of certificates at regular intervals and the entire principal is returned with the retirement of the assets packed in the pool. Thus, pass through certificates have a single maturity structure and the tenure of these certificates is matched with the life of the securitised assets.

On the other hand, pay through certificates have a multiple maturity structure depending upon the maturity pattern of underlying assets. Thus, two or three types of securities with different maturity patterns like short-term, medium term and long term may be issued. The greatest advantage is that they can be issued depending upon the investor's demand for varying maturity patterns. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves, i.e., they are offered at a discount to face value as in the case of deep discount bonds.

(ii) Preferred Stock Certificates

Preferred stocks are instruments issued by a subsidiary company against the trade debts and consumer receivables of its parent company. In other words, subsidiary companies buy the trade dqbts and receivables of parent companies, convert them into short term securities, and help the parent companies to enjoy liquidity. Thus trade debts can also be securitised through the issue of preferred stocks. Generally, these stocks are backed by guarantees given by highly rated merchant banks and hence they are also attractive from the investor's point of view. These instruments are mostly short-term in nature.

(iii) Asset-based Commercial Papers

This type of structure is mostly prevalent in mortgage backed securities. Under this type, the SPV purchases portfolio of mortgages from different sources (various lending institutions) and they are combined into a single group on the basis of interest rates, maturity dates and underlying collaterals. They are, then, transferred to a Trust which, in turn, issues mortgage backed certificates to the investors. These certificates are issued against the combined principal value of the mortgages and they are also short term instruments. Each certificate holder is entitled to participate in the cash flow from underlying mortgages to the extent of his investments in the certificates.

Other Types

Apart form the above, there are also other types of certificates namely:

(i) Interest only certificates and

(ii) Principal only certificates.

In the case of Interest only Certificates, payments are made to investors only from the interest incomes earned from the assets securitised. As the very name suggests, payments are made to investors only from the repayment of principal by the original borrowers, in the case of principal only certificates. These certificates enable speculative dealings since the speculators know well that the interest rate movements would affect the bond values immediately. For instance, the principal only certificates would increase in value when interest rates go down. It is so because, it becomes advantageous to repay the existing debts and resort to fresh borrowings at lower cost. This early redemption of securities would benefit the investors to a greater extent. Similarly, when the interest rates go up, interest only certificate holders stand to gain since more interest would be available from the underlying assets. One cannot exactly predict the future movements of interest, and hence, these certificates give much scope for speculators to play their game.

Thus, securitisation offers much scope for the introduction of newer and newer instruments so as to meet the varying requirements of investors. Debt securitisation offers a variety of investment instruments to the investing public at large as well as to the financial intermediaries like mutual funds, insurance companies etc.

5.3 Securitization and Role of Banks

Q10. "Securitization is a financial boon to commercial banks". Do you agree?

(OR)

Explain the role of banks in securitization of debt.

(OR)

Examine the role of banks in debt securitization.

Ans : **(May-18, May-16, May-15)**

There is a vast scope for commercial banks to go in for securitisation due to the following factors:

(i) Innovative and Low Cost Source of Fund

Traditionally deposit has been the only dependable source of funds for banks over the years. But, in recent times, banks have to face severe competition from other non-banking institutions in deposit mobilization. Now, securitisation offers an excellent source of funds at cheaper rates. Unlike deposits, it will not entail any servicing needs and the consequent increase in costs.

(ii) Better Capital Adequacy Norms

Securitisation has the effect of improving the capital adequacy norms of banks. Generally, commercial firms utilize the cash flow from securitisation for repayment of their borrowings, and thus, they can achieve a good debt-equity ratio. But, in the case of banks, borrowings are limited. So they can better utilize the cash flow to create lower risk weighted assets. Hence, high risk weighted assets can be easily converted into lower risk weighted assets. Thus, it helps banks to achieve better capital adequacy norms.

(iii) Creation of Mere Credit

In India, banks are subject to high statutory pre-emptions for which more liquid cash is essential now and then. This has necessarily impaired the capacity of banks to create credit. Infact, securiti-sation is not at all affected by these factors. The cash flow from securitisation could be very well used for further expansion of credit without any statutory restrictions.

(iv) Increased Profitability

The profitability of banks has been very much affected to a greater extent in these days due to many factors. In this context, securitisation has a salutary impact on the profitability of banks. It provides for more liquidity, quicker recycling of funds and greater economy in the use of capital. This has the effect of improving the profitability of banks. Besides, they can also earn income in the form of service fee by acting as Receiving and Paying agent.

(v) Tool for Asset liability Management and Risk Management

Securitisation can be better used as a tool to avoid mismatch in the asset-liability management. It would reduce the over dependence of banks on the market for money at call and short notice as well as the refinancing agencies for recycling of funds. Again, it can be used as a risk management tool also. It completely eliminates the interest risks and thus it provides a hedge to baizes against interest risks which are inherent in the free interest rate market.

5.4 Advantages and Limitation of Securitization

Q11. Explain the Advantages and Limitation of Securitization.

(OR)

Critically examine the pros and cons of securitization.

Ans : **(May-17, Imp.)**

Advantages

Debt securitisation provides many benefits to all the parties, such as the originator, investors and the regulatory authorities. Some of the important benefits are the following:

(i) Additional Source of Fund

The originator (i.e., the lending institution) is much benefitted because securitisation provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result, there is an immediate improvement in the cash flow of the originator. Thus, it acts as a source of liquidity.

(ii) Greater Profitability

Securitisation helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which, in turn, leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability. Moreover, economies of scale can be achieved since securitisation offers scope for the fuller utilization of the existing capabilities by providing liquid cash immediately. It results in additional business turnover.

Again, the originator can also act as the Receiving and Paying agent. If so, it gets additional income in the form of servicing fee.

(iii) Enhancement of Capital Adequacy Ratio

Securitisation enables financial institutions to enhance their capital adequacy ratio by reducing their assets volume. The process of securitisation necessitates the selection of a pool of assets by the financial institutions to be sold or transferred to another institution called SPV. Once the assets are transferred, they are removed from the balance sheet of the originator. It results in the reduction of assets volume, thereby increasing the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets. Thus, the removal of assets from the Balance Sheet under a true sale improves the capital adequacy norms.

(iv) Spreading of Credit Risk

Securitisation facilities the spreading of credit risk to different parties involved in the process of securitisation. In the absence of securitisation, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Now, the originator is able to diversify the risk factors among the various parties involved in securitisation. Thus, securitisation helps to achieve diversification of credit risks which are greater in the case of medium term and long term loans. Thus, it is used as tool for risk management.

(v) Lower Cost of Funding

In view of enhancement of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market at debt ratings higher than its overall corporate rating. It means that companies with low credit rating can issue asset backed securities at lower interest cost due to high credit rating on such securities. This helps it to secure funds at lower cost. Moreover, the criteria for choosing the pool of assets ensures an efficient cost of funds. In the present context of scarcity of funds and higher interest rates, securitisation provides a good scope for cheap funding.

(vi) Provision of Multiple Instruments

From the investor's point of view, securitisation provides multiple new investment instruments so as to meet the varying requirements of the investing public. It also offers varieties of instruments for other financial intermediaries like mutual funds, insurance companies, pension funds etc. giving them many choices.

(vii) Higher Rate of Return

When compared to traditional debt securities like bonds and debentures, securitised securities offer better rate of return along with better liquidity. These instruments are rated by good credit rating agencies and hence more attractive. Being structured assets based securities, they offer more protection and yield a good return. The bankruptcy/winding up of the originator does not affect the investors since the payment is guaranteed by the SPV.

(viii) Prevention of Idle Capital

In the absence of securitisation, capital would remain idle in the form of ill-liquid assets like mortgages, term loans etc., in many of the lending institutions. Now, securitisation helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

(ix) Better than Traditional Instruments

Certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as a collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not entail any servicing needs and hence does not require much costs. It is better than even mutual fund units because it is issued against the backing of collateral securities whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset backed securities, afford a greater protection to investors.

Again, there is much transparency from the investor's point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

(x) Other Benefits

Securitisation, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not reeded.

In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrowers. There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.

Limitations

(i) New Concept

Securitisation itself is a new concept in debt market. There is much unawareness not only among the investors but also among the various financial intermediaries. Though securitisation brings immediate benefits to the lending institutions, most of them neither aware of this concept nor its advantages.

(ii) Heavy Stamp duty and Registration Fees

Basically, securitisation requires the transfer of various illiquid and non-performing assets to a central agency called Special Purpose Vehicle. This transfer involves heavy stamp duty and Registration fees. These costs are so exhorbitant that people are automatically discouraged to go in for this innovative technique of financing.

(iii) Cumbersome Transfer Procedures

Again, the transfer of assets involves very complicated and cumbersome legal procedures which stand as a real impediment in the way of securitisation.

(iv) Difficulty in Assignment of Debts

The right to assign debts to third parties has been permitted only under certain circumstances under the Transfer of Property Act and infact, this transfer/sale of debts forms the central theme of securitisation. Hence, the Transfer of Property Act should be suitably amended so as to facilitate securitisation in India.

(v) Absence of Standardised Loan Documentation

As it is, there is no standardised loan documentation procedure in India. There is no uniformity between different financial institutions regarding the loan documentation even for the same type of loans. In such a case, it becomes very difficult for an agency like the Special Purpose Vehicle to pool the similar assets of the various financial institutions for securitisation.

(vi) Inadequate Credit Rating Facilities

Credit rating is an integral part of securitisation. Unfortunately, credit rating in India is at its infancy level. Now only, it becomes obligatory to get credit rating for all debt instruments issued by non-banking companies. The credit rating agencies are not adequately available in India at present to take up the stupendous task of credit rating instruments for securitisation purposes. However, a good progress has been made in this direction in recent times.

(vii) Absence of proper accounting procedures

Proper accounting procedure should be evolved for securitisation. Creation of a Trust or Special Purpose Vehicle is a must for securitisation and as such there is no accounting procedure for the recognition of this trust. Again, securitisation paves way for the removal of the securitised assets from the

Balance sheet of the originator. How should one account for it? It is a challenge to the accounting professionals in the country to evolve suitable accounting procedures for securitisation.

(viii) Absence of Proper Guidelines

One can find a lot of guidelines issued by the Regulatory authorities to deal with mutual funds, non-banking companies etc. But, they are conspicuously absent in the field of securitisation. There are various processes involved in securitisation right from the identification process to the redemption process. Again, various types of structures are available. Hence, proper guidelines must be issued covering all these aspects so that financial intermediaries can go for securitisation without any hesitation and thus securitisation becomes a smooth affair.

5.5 Future Prospects of Securitization

Q12. Elucidate the Future Prospects of Securitization.

(OR)

Discuss the prospects of securitization in India.

Ans : **(May-18)**

There is a bright future for securitsation in India due to the following factors :

i) With the liberalization of the financial markets, there is bound to be more demand for capital.

ii) There has been an explosive growth of capital market and a vast increase in the investor base in recent times.

iii) The entry of newer financial intermediaries like mutual funds, money market, pension funds etc. has paved the way for floating debt instruments easily in the market.

iv) Debt instruments have become popular in recent times since corporate customers are not willing to take recourse to the equity route as a major source of financing their projects.

v) There is a proposal to establish Asset Reconstruction Fund as per the Narasimhan Committee recommen-dations for the purpose of securitisation of non-performing assets.

vi) Since the financial institutions and banks have to follow the capital adequacy norms as recommended by the Narasimhan Committee, they have to necessarily go for securitisation.

The above factors clearly indicate that there is a vast scope for the introduction of the concept of securitisation of assets on a large scale as an innovative step for resource mobilisation. More than that, it is used as a tool to improve the balance sheets by bringing out changes in the critical financial ratios like debt-equity ratio, return on assets ratio, asset turnover ratio, capital adequacy ratio etc.

Q13. Explain the scenario of securitisation in India.

Ans :

The concept of asset securitisation is slowly entering into the Indian soil. Financial institutions have not yet come forward to make use of this avenue for financing on a large scale. However, there is a tardy movement of the financial institutions in resorting to this mode of financing. The securitisation of the ICICI's receivables by the Citibank in February 1991 is the first attempt in this direction. A sum of Rs. 15 crores was raised by means of securitisation *of* assets.

Following this, the Hire purchase portfolio of TELCO was securitised by 'the Citibank. Again, the Retail Residential Receivables of DLF International were also securitised by the Citibank in June 1992. The Citibank's own portfolio of "Citimobile Scheme" was subject to securitisation. Infact the Citibank has pioneered this trend in India. Now, the HDFC has taken up this route along with the Citibank. The HDFC is on the way to securities its housing loan portfolio around Rs. 50 crores.

Infrastructure Leasing and Financial services is also expected to enter into this field by setting up a SPV. If securitisation has to become popular in India, the commercial banks should enter into this field in a big way. Infact, the commercial banks can remove the non-performing assets from their balance sheet by resorting to this technique. At the same time, they can recycle the funds for greater profitability. If financial institutions have to meet their ever-increasing capital requirements, securitisation would go a long way in mobilising adequate resources.

New Guide Lines

Recently, the RBI has issued guidelines allowing commercial banks to finance Special Purpose Vehicles (SPVs) which have been formed to transfer securitised assets separated from them. Some of the important guidelines are:

(i) All banks, term lending institutions and NBFCs have to securities only standard assets.

(ii) Banks can finance SPVs which are engaged in transferring securitised assets.

(iii) 'While financing SPVs, an independent third party, other than the originator's (banks) group entities, should provide at least 25 per cent of the liquidity facility. It means that every bank should locate a third party for financing SPVs.

(iv) The liquidity facility provided by banks should not be available for:

  (a) Meeting recurring lapses of securitisation,

  (b) Funding acquisition of additional assets by SPVs,

  (c) Funding the financial scheduled repayment of investors, and

  (d) Funding breach of warranties.

Legal Frame Work

The Securities Contracts (Regulation) Act, 1956 has been amended in 2007 with a view to providing a legal framework for trading in securitised debt. The important amendments are:

  i) The term 'securities' as mentioned in the Act includes securitisation instruments.

  ii) The SEBI's permission is necessary to issue securitisation instruments.

  iii) A legal framework has been provided for trading in securitised debt, mortgage-backed debt, etc.

New Regulations and Guidelines 2010

The SEBI has recently released SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations 2008, continuity rules and regulations governing the issue and listing of securitised debt instruments.

In April 2010, draft guidelines have been issued in respect of securitisation transactions. These include:

(i) A Minimum Holding Period (MHP) of 9 months and 12 months respectively by the originators for loans with maturity of less than 24 months and more than 24 months.

(ii) A Minimum Retention Requirement (MRR) of 5 per cent and 10 per cent by the originators has been proposed for loans with a maturity of less than 24 months and more than 24 months respectively.

(iii) The total exposure of banks to the: (i) Special Purpose Vehicle, (ii) Securitised assets, and (iii) Credit enhancements not to exceed 20 per cent.

(iv) Resecuritisation, synthetic securitisation and securitisation with revolving structures to be prohibited.

Future Prospects of Securitization

There is a bright future for securitsation in India due to the following factors :

i) With the liberalization of the financial markets, there is bound to be more demand for capital.

ii) There has been an explosive growth of capital market and a vast increase in the investor base in recent times.

iii) The entry of newer financial interme-diaries like mutual funds, money market, pension funds etc. has paved the way for floating debt instruments easily in the market.

iv) Debt instruments have become popular in recent times since corporate customers are not willing to take recourse to the equity route as a major source of financing their projects.

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The above factors clearly indicate that there is a vast scope for the introduction of the concept of securitisation of assets on a large scale as an innovative step for resource mobilisation. More than that, it is used as a tool to improve the balance sheets by bringing out changes in the critical financial ratios like debt-equity ratio, return on assets ratio, asset turnover ratio, capital adequacy ratio etc.

Q14. Discuss the problems of securitization in India.

Ans : **(May-15)**

1. **Stamp Duty :** One of the major hurdles facing the development of the securitisation market is the stamp duty structure. In India, stamp duty is payable on any instrument which seeks to transfer rights or receivables. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitisation commer-cially unviable in states that still have a high stamp duty.

   Few states have reduced their stamp duty rates, though quite a few still maintain very high rates ranging from 5-12 per cent. To the investor, if the securitised instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty, and if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty.

   SEBI has suggested to the government on the need for rationalisation of stamp duty with a view to developing the corporate debt and securitisation markets in the country, which may going forward be made uniform across states as also recommended by the Patil Committee.

2. **Foreclosure Laws :** Lack of effective foreclosure laws also prohibits the growth of securitisation in India. The existing foreclosure laws are not lender friendly and increase the risks of MBS by making it difficult to transfer property in cases of default.

3. **Taxation related issues:** There is ambiguity in the tax treatment of mortgage-based securities, SPV trusts, and NPL trusts. Presently, the investors or the buyers (PTC and SR holders) pay tax on the earnings from the SPV trust. As a result the trustee makes income payouts to the investors without any payment of tax. The Income Tax law envisages the taxation of an unincorporated SPV either at the trust SPV level or the investor level in order to avoid double taxation. Therefore, any tax pass through regime merely represents a stance that the investors in the trust will bear the tax liability instead of the Trust being held liable to tax the investors on their respective earnings.

4. **Issues under the SARFAESI Act:** A security receipt (SR) gives its holder a right of title or interest in the financial assets included in securitisation. This definition holds good for securitisation structures where the securities issued are referred to as pass through certificates. However, the rationale fails in the case of pay through certificates with different classes of primary and secondary rights to the cash flow. Also, the SARFAESI Act has been structured such that SRs can be issued and held only to Qualified Institutional Buyers (QIBs). There is a need to expand the investor base by including NBFCs, non-NBFCs, private equity funds, etc.

5. **Legal Issues:** Investments in PTCs are typically held-to-maturity. As there is no trading activity in these instruments, the yield on PTCs and the demand for longer tenures especially from mutual funds is dampened. Till recently, Pass through Certificates (PTC) were not explicitly covered under the Securities Contracts (Regulation) Act, definition of securities. This was however amended with the Securities Contracts (Regulation) Amendment Act, 2007 passed with a view to providing a legal framework for enabling listing and trading of securitised debt instruments. This will bring about listing of PTCs which in turn will support market growth.

Short Question and Answers

1. Structured Securities and Conventional Securities.

Ans :

Securitisation is basically a structured financial transaction. It envisages the issue of securities against ill-liquid assets and such securities are really structured securities. It is so because, they are backed by the value of the underlying financial asset and the credit support of a third party also. At this stage, one should not confuse such structured securities with conventional securities like bonds, debentures etc. They differ from each other in the following respects.

2. Define the term Securitization.

Ans :

Introduction

The financial system all over the world is in the process of rapid transformation. As a result, the capital market, money market and the debt market are getting widened and deepened. It is interesting to note that new instruments and new products are emerging in the debt market too. Infact the development of a debt market increases the efficiency of a capital market to a greater extent. Again, along with the equity market, there is bound to be a natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary markets.

In this context, debt or asset securitisation assumes a significant role and it is one of the most innovative techniques introduced in the debt market to achieve the above objective. Moreover, it is the debt market which has provided more impetus for capital formation than the equity market in the economically advanced countries.

Securitisation of debt or asset refers to the process of liquidating the liquid and long term assets like loans and receivables of financial institutions like banks by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Definition

(i) A carefully structured process whereby loans and other receivables are packaged, under-written and sold in the form of asset backed securities.

(ii) Another simple definition is as follows: Securitisation is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

3. Explain the Operational Mechanism of Securitization in India.

Ans :

i) Identification Process

The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called 'identification process'.

ii) Transfer Process

After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale, i.e., full transfer of assets in question for valuable consideration or by passing them for a collateralised loan. Generally, it is done on an outright sale basis. This process of passing through the selected pool of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

iii) Issue Process

After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different names like 'Pay through Certificates', 'Pass through Certificates'. Interest only Certificates, Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronise with the maturities of the securitised loans or receivables.

4. Compare and contrast Securitization and Factoring.

Ans :

While both factoring and securitization involves capitalizing the receivables of the company, however there are many differences between factoring and securitization.

1. While factoring is arrangement between the banks and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables whereas Securitization is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows.
2. Under factoring there are two parties that is the bank and the company while under securitization there are many investors involved who invest in the securitized asset.
3. While factoring is done for short term account receivables ranging from 1 month to 6 months whereas securitization is done for long term receivables of the company.
4. While factoring is of many types and can be with or without recourse while securitization is done without recourse.

5. Explain the features of securitization.

Ans :

The securitization has the following features:

(i) Creation of Financial Instruments: The process of securities can be viewed as process of creation of additional financial product of securities in market backed by collaterals.

(ii) Bundling and Unbundling: When all the assets are combined in one pool it is bundling and when these are broken into instruments of fixed denomination it is unbundling.

(iii) Tool of Risk Management: In case of assets are securitized on non-recourse basis, then securitization process acts as risk management as the risk of default is shifted.

(iv) Structured Finance: In the process of securitization, financial instruments are tailor structured to meet the risk return trade of profile of investor, and hence, these securitized instruments are considered as best examples of structured finance.

(v) Trenching: Portfolio of different receivable or loan or asset are split into several parts based on risk and return they carry called 'Trenche'. Each Trench carries a different level of risk and return.

6. Special Purpose Vehicle

Ans :

It also, called SPV is created for the purpose of executing the deal. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only and normally could be in form of a company, a firm, a society or a trust.

The main objective of creating SPV to remove the asset from the Balance Sheet of Originator. Since, SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization. Further, it also issues the securities (called Asset Based Securities or Mortgage Based Securities) to the investors.

7. Rating Agency

Ans :

Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available. Rating agency assesses the following:

- Strength of the Cash Flow.
- Mechanism to ensure timely payment of interest and principle repayment.
- Credit quality of securities.
- Liquidity support.
- Strength of legal framework.

Although rating agency is secondary to the process of securitization but it plays a vital role.

8. Pass Through Certificates (PTCs)

Ans :

As the title suggests originator (seller of eh assets) transfers the entire receipt of cash in form of interest or principal repayment from the assets sold. Thus, these securities represent direct claim of the investors on all the assets that has been securitized through SPV.

Since all cash flows are transferred the investors carry proportional beneficial interest in the asset held in the trust by SPV.

It should be noted that since it is a direct route any prepayment of principal is also proportionately distributed among the securities holders. Further, due to these characteristics on completion of securitization by the final payment of assets, all the securities are terminated simultaneously.

Skewness of cash flows occurs in early stage if principals are repaid before the scheduled time.

9. Pay Through Security (PTS)

Ans :

As mentioned earlier, since, in PTCs all cash flows are passed to the performance of the securitized assets. To overcome this limitation and limitation to single mature there is another structure i.e. PTS.

In contrast to PTC in PTS, SPV debt securities backed by the assets and hence it can restructure different tranches from varying maturities of receivables.

In other words, this structure permits desynchronization of servicing of securities issued from cash flow generating from the asset. Further, this structure also permits funds for short term as per their requirement.

Since, in Pass Through, all cash flow immediately in PTS in case of early retirement of receivables plus cash can be used for short term yield. This structure also provides the freedom to issue several debt trances with varying maturities.

10. Stripped Securities

Ans :

Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities. Those two securities are as follows:

(i) Interest Only (IO) Securities

(ii) Principle Only (PO) Securities

As each investor receives a combination of principal and interest, it can be stripped into two portion of Interest and Principle.

Accordingly, the holder of IO securities receives only interest while PO security holder receives only principal. Being highly volatile in nature these securities are less preferred by investors.

In case yield to maturity in market rises, PO price tends to fall as borrower prefers to postpone the payment on cheaper loans. Whereas if interest rate in market falls, the borrower tends to repay the loans as they prefer to borrow fresh at lower rate of interest.

In contrast, value of IO's securities increases when interest rate goes up in the market as more interest is calculated on borrowings.

However, when interest rate due to prepayments of principals, IO's tends to fall.

Thus, from the above, it is clear that it is mainly perception of investors that determines the prices of IOs and POs.

11. Types of debt Securitization.

Ans :

(i) Pass through and Pay through Certificates

In the case of pass through certificates, payments to investors depend upon the cash flow from the assets backing such certificates. In other words, as and when cash (principal and interest) is received from the original borrower by the SPV, it is passed on to the holders of certificates at regular intervals and the entire principal is returned with the retirement of the assets packed in the pool. Thus, pass through certificates have a single maturity structure and the tenure of these certificates is matched with the life of the securitised assets.

On the other hand, pay through certificates have a multiple maturity structure depending upon the maturity pattern of underlying assets. Thus, two or three types of securities with different maturity patterns like short-term, medium term and long term may be issued. The greatest advantage is that they can be issued depending upon the investor's demand for varying maturity patterns. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves, i.e., they are offered at a discount to face value as in the case of deep discount bonds.

(ii) Preferred Stock Certificates

Preferred stocks are instruments issued by a subsidiary company against the trade debts and consumer receivables of its parent company. In other words, subsidiary companies buy the trade dqbts and receivables of parent companies, convert them into short term securities, and help the parent companies to enjoy liquidity. Thus trade debts can also be securitised through the issue of preferred stocks. Generally, these stocks are backed by guarantees given by highly rated merchant banks and hence they are also attractive from the investor's point of view. These instruments are mostly short-term in nature.

(iii) Asset-based Commercial Papers

This type of structure is mostly prevalent in mortgage backed securities. Under this type, the SPV purchases portfolio of mortgages from different sources (various lending institutions) and they are combined into a single group on the basis of interest rates, maturity dates and underlying collaterals. They are, then, transferred to a Trust which, in turn, issues mortgage backed certificates to the investors. These certificates are issued against the combined principal value of the mortgages and they are also short term instruments. Each certificate holder is entitled to participate in the cash flow from underlying mortgages to the extent of his investments in the certificates.

12. Limitation of Securitization.

Ans :

(i) New Concept

Securitisation itself is a new concept in debt market. There is much unawareness not only among the investors but also among the various financial intermediaries. Though securitisation brings immediate benefits to the lending institutions, most of them neither aware of this concept nor its advantages.

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13. Problems of securitization in India.

Ans :

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3. **Taxation related issues:** There is ambiguity in the tax treatment of mortgage-based securities, SPV trusts, and NPL trusts. Presently, the investors or the buyers (PTC and SR holders) pay tax on the earnings from the SPV trust. As a result the trustee makes income payouts to the investors without any payment of tax. The Income Tax law envisages the taxation of an unincorporated SPV either at the trust SPV level or the investor level in order to avoid double taxation. Therefore, any tax pass through regime merely represents a stance that the investors in the trust will bear the tax liability instead of the Trust being held liable to tax the investors on their respective earnings.

Choose the Correct Answers

1. ________ helps to liquify assets mainly of medium and longterm loans receivable of financial institution. [a]
   (a) Securitisation (b) Loans
   (c) Mutual funds (d) All
2. ________ Source of repayment is the earning power and cashflow of the issuing company.[b]
   (a) Structured Securities (b) Conventional Securities
   (c) Both (d) None
3. ________ Deals with the assets i.e., book debts and receivable. [c]
   (a) Securitization (b) Factoring
   (c) Both (d) None
4. MRR stands for ________ [b]
   (a) Minimum retention ratio (b) Minimum retention requirement
   (c) Minimum Ratio requirement (d) Minimum rate requirement
5. ________ instruments issued by a subsidiary company against the trade debts and consumer receivables of a parent company. [a]
   (a) Preferred stock certificates (b) Asset based commercial papers
   (c) Pay through certificate (d) None of the above
6. ________ payments are made to investor only from the interest income earned from the assets securitised. [b]
   (a) Preferred stock certificate (b) Interest only certificate
   (c) Pay through certificate (d) Asset based papers
7. ________ mainly associated with the assets of manufacturing and trading companies [a]
   (a) Factoring (b) Securitization
   (c) Both (d) None
8. Securitized assets are classified into ________ types [c]
   (a) 2 (b) 4
   (c) 3 (d) 6
9. RPA stands for ________ . [a]
   (a) Receiving and paying agent (b) Receipts and payment account
   (c) Receiving and paying account (d) None
10. Selecting a pool of loans and receivables from the asset portfolio for securitisation is called ________. [c]
    (a) Transfer process (b) Redemption process
    (c) Identification process (d) Issue process

Fill in the Blanks

1. __________ Refers to the process of liquidating the illiquid and long term assets.
2. The lending financial institution either a bank (or) other institution for the matter which decides to go in securitisation of assets is called the __________.
3. SPV stands for __________.
4. Asset based commercial papers is mostly prevalent in __________ securities.
5. Securitisation offers an excellent source of funds at __________ rates.
6. Commercial firms utilise the cash flow from securitisation for repayment of their __________.
7. __________ ratio can also be improved by replacing the loan assets with the lesser risk weighted assets.
8. The first attempt securitisation of the ICICI's receivables by the Citibank in __________ .
9. MHP stands for __________ .
10. __________ committee recommended securitisation are non-performing assets.
11. __________ of debt or asset refers to the process of liquidating the liquid and long term assets like loans and receivables of financial institutions
12. In the case of __________ securities, the primary source of repayment is the earning power and cash flow of the issuing company.
13. __________ is arrangement between the banks and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables.
14. SPV stands for __________
15. RPA stands for __________
16. __________ are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement.
17. PTC stands for __________
18. __________ stocks are instrumnets issued by a subsidiary company against the trade debts and consumer receivables of its parent company.
19. __________ has suggested to the government on the need for rationalisation of stamp duty with a view to developing the corporate debt.

ANSWERS

1. Securitisation
2. Originators
3. Special purpose vehicle
4. Mortage backed
5. Cheaper
6. Borrowings
7. Capital adequacy
8. February 1991
9. Minimum holding period
10. Narasimhan
11. Securitisation
12. Conventional
13. Factoring
14. Special Purpose Vehicle
15. Receiving and Paying Agent
16. Trustees
17. Pass Through Certificates
18. Preferred
19. SEBI

FACULTY OF COMMERCE

M.Com. IV Semester (CBCS) Examination

May / June - 2018

FINANCIAL SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1. What is venture capital ? **(Unit-I, SQA.1)**
2. What is hire purchase ? **(Unit-II, SQA.1)**
3. Open ended mutual funds **(Unit-III, SQA.1)**
4. Discounting. **(Unit-IV, SQA.1)**
5. Structured securities. **(Unit-V, SQA.1)**

PART - B (5 × 12 = 60 Marks)

Note: Answer all the questions by using internal choice

6. (a) What do you mean by Financial Services? Explain various traditional activities of financial services. **(Unit-I, Q.No.1,6)**

OR

(b) Discuss briefly some of the innovative financial instruments introduced in recent times in the financial service sector. **(Unit-I, Q.No.15)**

7. (a) What is financial lease? Explain various types of financial leasing. **(Unit-II, Q.No.5)**

OR

(b) Explain the role of NHB in housing finance. **(Unit-II, Q.No.23)**

8. (a) Define a Mutual Fund and describe the various schemes that are offered by it. **(Unit-III, Q.No.1,8)**

OR

(b) Discuss the present state of the Mutual Funds in India. **(Unit-III, Q.No. 21)**

9. (a) What is Factoring ? What are the terms and conditions in Factoring Agreement ? **(Unit-IV, Q.No.5,12)**

OR

(b) What is Forfeiting? What are the advantages and disadvantages of forfeiting ? **(Unit-IV, Q.No.20,22)**

10. (a) What is Securitization? Explain operational mechanism of securitization. **(Unit-V, Q.No.1,8)**

OR

(b) Explain the role of banks securization. **(Unit-V, Q.No.10)**

FACULTY OF COMMERCE

M.Com. IV Semester (CBCS) Examination

May- 2017

FINANCIAL SERVICES

Time : 3 Hours Max. Marks: 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1.	Venture capital	**(Unit-I, SQA.1)**
2.	Hire purchase	**(Unit-II, SQA.1)**
3.	Income funds	**(Unit-III, SQA.2)**
4.	Factoring	**(Unit-IV, SQA.2)**
5.	Concept of Securitization	**(Unit-IV, SQA.2)**

PART - B (5 × 12 = 60 Marks)

Note: Answer all the questions by using internal choice

6. (a) What are the various financial products and services of Non-Banking? **(Out of Syllabus)**

OR

(b) What are the recent trends in Indian Commercial Banking ? Explain. **(Out of Syllabus)**

7. (a) Define leasing. Explain various types of financial leasing. **(Unit-II, Q.No.1,5)**

OR

(b) What is the role of National Housing Bank **(Unit-II, Q.No.23)**

8. (a) What is the present scenario of mutual funds in India? **(Unit-III, Q.No.21)**

OR

(b) Explain various types of mutual funds and also the importance of mutual funds. **(Unit-III, Q.No.8,5)**

9. (a) What is the role of banks in providing factoring and forfeiting services? **(Unit-IV, Q.No.23)**

OR

(b) Discuss the various types of factoring services in India. **(Unit-IV, Q.No.14)**

10. (a) Explain the operational mechanism of securitization in India. **(Unit-IV, Q.No.8)**

OR

(b) Discuss various types of debt securitization and explain the advantages and limitations of securitization. **(Unit-V, Q.No.9,11)**

FACULTY OF COMMERCE

M.Com. IV Semester (CBCS) Examination

May/June- 2016

FINANCIAL SERVICES

Time : 3 Hours Max. Marks: 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1.	Loan Syndication	**(Unit-I, SQA.2)**
2.	Hire purchase	**(Unit-II, SQA.1)**
3.	Income funds	**(Unit-III, SQA.2)**
4.	Forfeiting	**(Unit-IV, SQA.3)**
5.	Structured securities	**(Unit-IV, SQA.1)**

PART - B (5 × 12 = 60 Marks)

Note: Answer all the questions by using internal choice

6. (a) Discuss briefly some of the innovative products introduced in Indian Financial Service Sector recently. **(Unit-I, Q.No.15)**

OR

(b) Critically examine the challenges faced by Indian Financial Service Sector. **(Unit-I, Q.No.16)**

7. (a) What is leasing? Bring out the merits and demerits of leasing. **(Unit-II, Q.No.1,7)**

OR

(b) Examine the role of National Housing Bank (NHB) in supervising housing finance activities in India. **(Unit-II, Q.No.23)**

8. (a) Explain the role of Asset Management Company (AMC) in mutual funds business. **(Unit-III, Q.No.12)**

OR

(b) Discuss the role of banks in mutual funds servies in India. **(Unit-III, Q.No.18)**

9. (a) What are the problems and prospects of factoring in India. **(Unit-IV, Q.No.19)**

OR

(b) What is forfeiting ? Explain the advantages and limitations of forfeiting in Indian Context. **(Unit-IV, Q.No.20,22)**

10. (a) What is securitization? Explain its features. **(Unit-V, Q.No.1,2)**

OR

(b) Examine the role of banks in debt securitization. **(Unit-V, Q.No.10)**

FACULTY OF COMMERCE

M.Com. IV Semester (CBCS) Examination

May/June - 2015

FINANCIAL SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1. What are financial services ? Explain their peculiarities. **(Unit-I, SQA.3,4)**
2 Compare and contrast operating lease and financial lease. **(Unit-II, SQA.2)**
3. Explain the importance of mutual funds in Indian economy. **(Unit-III, SQA.3)**
4. What are the different types of factoring ? Explain. **(Unit-IV, SQA.4)**
5. What is securitization of debt ? Explain how does it differ from factoring. **(Unit-IV, SQA.2,4)**

SECTION - B (5 × 12 = 60)

Note : Answer all the questions by using internal choice in not exceeding 4 pages each.

6. (a) Explain the different types of financial services. **(Unit-I, Q.No.5)**

OR

(b) Critically examine the challenges that are being faced by the financial services sector in India. **(Unit-I, Q.No.16)**

7. (a) Explain the merits and limitations of leasing as a source of financing. **(Unit-II, Q.No.7)**

OR

(b) Explain the factors to be considered while taking lease Vs. Buy decision. **(Unit-II, Q.No.8)**

8. (a) Explain the operational mechanism of mutual funds. **(Unit-III, Q.No.11)**

OR

(b) Discuss the determinants of a mutual fund. **(Unit-III, Q.No.14)**

9. (a) Discuss the functions of factoring units. **(Unit-IV, Q.No.13)**

OR

(b) Define forfeiting. Explain the advantages and limitations of factoring. **(Unit-IV, Q.No.20,22)**

10. (a) Explain the role of banks in securitization of debt. **(Unit-V, Q.No.10)**

OR

(b) Discuss the problems and prospects of securitization in India. **(Unit-V, Q.No.12,14)**

FACULTY OF COMMERCE

M.Com. IV - Semester (CBCS) Examination

Model Paper - I

FINANCIAL SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1.	What are Financial Services?	**(Unit-I, SQA.3)**
2.	Define Leasing.	**(Unit-II, SQA.6)**
3.	Explain the Importance of Mutual Funds.	**(Unit-III, SQA.3)**
4.	What is Forfeiting?	**(Unit-IV, SQA.3)**
5.	Limitation of Securitization.	**(Unit-V, SQA.12)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions by using internal choice in not exceeding 4 pages each.

6. (a) Explain traditional and modern activities of financial services. **(Unit-I, Q.No.6)**

OR

(b) What are the challanges based by the financial service sector. **(Unit-I, Q.No.16)**

7. (a) What is Leasing? Describe the various types of leasing. **(Unit-II, Q.No.1,3)**

OR

(b) Examine the role of Housing and Urban Development Corporation in Super-vising housing finance activities in India. **(Unit-II, Q.No.26)**

8. (a) Define Mutual Funds. Explain the Importance of Mutual Funds. **(Unit-III, Q.No.1,5)**

OR

(b) Explain the role of Asset Management Company (AMC) in mutual funds business. **(Unit-III, Q.No.12)**

9. (a) Define Discounting. What is the role of Banks in Providing Discounting Services ? **(Unit-IV, Q.No.1,2)**

OR

(b) What is the role of banks in providing factoring and Forfeiting Services? **(Unit-IV, Q.No.23)**

10. (a) What is Securitization? Explain the features of securitization. **(Unit-V, Q.No.1,2)**

OR

(b) Explain the Advantages and Limitation of Securitization. **(Unit-V, Q.No.11)**

FACULTY OF COMMERCE

M.Com. IV - Semester (CBCS) Examination

Model Paper - II

FINANCIAL SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1. Merchant Banking. **(Unit-I, SQA.5)**
2. Characteristics of a leasing. **(Unit-II, SQA.9)**
3. What are the differences between open-ended and closed ended mutual funds. **(Unit-III, SQA.14)**
4. Define Bill discounting. **(Unit-IV, SQA.6)**
5. Structured Securities and Conventional Securities. **(Unit-V, SQA.1)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions by using internal choice in not exceeding 4 pages each.

6. (a) Define non-fund based services. Explain the various services of non-fund based services. **(Unit-I, Q.No.10)**

OR

(b) State the present scenario of financial services sector. **(Unit-I, Q.No.17)**

7. (a) What is financial lease? Explain various types of Financial Leasing. **(Unit-II, Q.No.5)**

OR

(b) Examine the role of National Housing Bank NHB in Supervising housing finance activities in India. **(Unit-II, Q.No.23)**

8. (a) Explain various types of mutual funds. **(Unit-III, Q.No.8)**

OR

(b) Discuss the role of banks in mutual fund services in India. **(Unit-III, Q.No.18)**

9. (a) What are the advantages and limitations of factoring? **(Unit-IV, Q.No.10)**

OR

(b) What are the advantages and limitations of forfeiting? **(Unit-IV, Q.No.22)**

10. (a) Explain the Operational Mechanism of Securitization in India. **(Unit-V, Q.No.8)**

OR

(b) Discuss the problems of securitization in India. **(Unit-V, Q.No. 14)**

FACULTY OF COMMERCE

M.Com. IV - Semester (CBCS) Examination

Model Paper - III

FINANCIAL SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

ANSWERS

Note : Answer all the questions in not more than one page each.

1.	Non fund based Activities.	**(Unit-I, SQA.12)**
2.	Define Housing Finance.	**(Unit-II, SQA.14)**
3.	Open-ended Mutual funds	**(Unit-III, SQA.1)**
4.	What are the benefits of factoring?	**(Unit-IV, SQA.9)**
5.	Pass Through Certificates (PTCs)	**(Unit-V, SQA.8)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions by using internal choice in not exceeding 4 pages each.

6. (a) Define fund based services. Explain briefly about various fund based services. **(Unit-I, Q.No.7)**

OR

(b) Discuss briefly some of the innovative products introduced in Indian financial service sector recently. **(Unit-I, Q.No.15)**

7. (a) What are the Advantages and dis- advantages of Leasing? **(Unit-II, Q.No.7)**

OR

(b) Differentiate between hire purchasing and leasing. **(Unit-II, Q.No.20)**

8. (a) Describe the structure of the mutual fund operations in India. **(Unit-III, Q.No.11)**

OR

(b) Discuss the present state of mutual funds in India. **(Unit-III, Q.No.17)**

9. (a) Discuss the various types of factoring services in India. **(Unit-IV, Q.No.14)**

OR

(b) Compare and contrast Factoring and Forfeiting. **(Unit-IV, Q.No.26)**

10. (a) Explain the role of banks in securitiza-tion of debt. **(Unit-V, Q.No.10)**

OR

(b) Discuss the prospects of securitization in India. **(Unit-V, Q.No.12)**