SYLLABUS

Class: - B.B.A. VI Semester

Subject: - Merchant Banking and Financial Services

Unit-I	**Merchant Banking:** Nature and scope of Merchant Banking - Regulation of Merchant Banking Activity - overview of current Indian Merchant Banking scene - structure of Merchant Banking industry - primary Markets in India and Abroad - - professional Ethics and code of conduct - current Development.
Unit-II	**Financial Services:** Meaning and Definition, Role of Financial Services in a financial system. **Leasing:** Meaning and features. Introduction to equipment leasing: Types of Leases, Evolution of Indian Leasing Industry. **Legal Aspects of Leasing:** present Legislative Framework. **Hire purchase:** concept and characteristics of Hire purchase. Difference between hire purchase and leasing.
Unit-III	**Factoring:** concept, nature and scope of Factoring - Forms of Factoring - Factoring vis-à-vis Bills Discounting - Factoring vis-à-vis credit Insurance Factoring vis-à-vis Forfeiting-Evaluation of a Factor - Evaluation of Factoring - Factoring in India current Developments.
Unit-IV	**Securitization / Mortgages:** Meaning, nature and scope of securitization, securitization as a Funding Mechanism, securitization of Residential Real Estate - whole Loans - Mortgages -Graduated-payment.
Unit-V	**Depository:** Meaning, Evolution, Merits and Demerits of Depository. Process of Dematerialization and Dematerialization. Brief description of NSDL and CDSL.
Unit-VI	**Security Brokerage:** Meaning of Brokerage, types of brokers. Difference between broker and jobber. SEBI Regulations relating to brokerage business in India.

B.B.A. VI Semester **Subject: Merchant Banking and Financial Services**

UNIT-1
MERCHANT BANKING

1. Introduction:

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

Merchant Banks are issue houses which manage new issues of the companies in the capital market.

According to the Banking Commission (1972), merchant banking institutions are to offer services like syndication of financing, promotion of projects, investment management and advisory services to medium and small savers and to provide funds and trusts to various types. In fact, merchant banking implies a wider range of specialist services, such as:

(i) Loan syndication,
(ii) Financial and management consultancy,
(iii) Project counselling,
(iv) Portfolio management,
(v) Formulation of schemes of rehabilitation,
(vi) Guidance on foreign trade financing,
(vii) Guidance to non-resident Indians for investment in India.

The formal merchant banking services in Indian capital market were initiated in 1967, when Reserve Bank of India granted licence to The National Grindlays Bank to perform the services relating to issue management. The First National City Bank followed Grindlays Bank by opening a 'Management Consultant Division' in 1970. Both these banks acted as 'managers to the issues'. From 1969 to 1992, merchant banks performed the issue management activities under the legislative framework of Capital Issues (Control) Act, 1947.

The procedure of the managing capital issue by a merchant banker is divided into pre-and post issue management activities. Presently, public issue management activities of merchant bankers are regulated and monitored by SEBI through the guidelines, clarifications, circulars containing instructions to merchant bankers, stock exchanges and other constituents of the capital market.

Under the Capital Issues (Control) Act, 1947, companies were required to obtain prior approval from the Controller of Capital Issues (CCI) for raising capital. CCI's permission was required with regard to the timing, size of the issue and the determination of price at which the securities were to be issued. CCI norms for pricing often led to extreme under pricing and heavy oversubscription. The extent of under pricing of public issues deterred the firms from going public. So, debt played a major role in financing the projects.

With the passing of SEBI Act, 1992, and the repeal of Capital Issues (Control) Act, 1947, the government's control over the determination of issue size, time and price of securities ceased and the market was allowed to allocate resources on competitive basis. Under the SEBI (Merchant Bankers) Regulations, 1992, Merchant Bankers were recognized as primary intermediaries in the role of 'issue manager' in the capital market. The regulations provided for the compulsory registration, capital adequacy requirements, general obligations and responsibilities and code of conduct for the merchant bankers as also the procedure for inspection of books of accounts, records and documents of merchant bankers. The initial set of guidelines issued by SEBI allowed almost all firms to freely price their issues and decide on the size of the issue in consultation with lead merchant bankers.

2. Nature of Merchant Banking:

i. Advisory in nature
ii. Financial Arrangement
iii. Corporate Restructuring
iv. Capital Reoprganization
v. Capital Issue Management
vi. Special Assistance to Small Scale Industries.
vii. Portfolio Management
viii. Private Placements
ix. Foreign Currency Loans
x. Technical Assistance

xi. Investment Advisory Services

xii. Revival package for sick units.

3. Scope of Merchant Banking:

Merchant banking activities help in channelizing the financial surplus of the general public into productive investment avenues. They help to coordinate the activities of various intermediaries to the share issue such as the registrar, bankers, advertising agency, printers, underwriters, brokers, etc. and to ensure the compliance with rules and regulations governing the securities market. This being the era where mergers and acquisitions are hot, the scope of merchant banking has grown to a large extent.

1. Raising Finance for Clients
2. Broker in Stock Exchange
3. Project Management
4. Advice on Expansion and Modernisation
5. Managing Public Issue of Companies
6. Handling Government Consent for Industrial Projects
7. Special Assitance to Small Companies and Entreprenuers
8. Services to Public Sector Units
9. Revival of Sick Industrial Units
10. Portfolio Management
11. Corporate Restructuring
12. Money Market Operation
13. Leasing Services
14. Management of Interest and Dividend

4. Regulations of Merchant Banking:

The merchant banking activity in India is governed by SEBI (Merchant Bankers) Regulations, 1992. Registration with SEBI is mandatory to carry out the business of merchant banking in India. An applicant should comply with the following norms:

i) The applicant should be a corporate body.

ii) The applicant should not carry on any business other than those connected with the securities market.

iii) The applicant should have necessary infrastructure like office space, equipment, manpower, etc.

iv) The applicant must have at least two employees with prior experience in merchant banking.
v) Any associate company, group company, subsidiary or interconnected company of the applicant should not have been a registered merchant banker.
vi) The applicant should not have been involved in any securities scam or proved guilt for any offence.
vii) The applicant should have a minimum net worth Rs50 million.

An Overview:
Q. Is it mandatory for a merchant banker to register with the SEBI?
A. Yes. Without holding a certificate of registration granted by the Securities and Exchange Board of India, no person can act as a merchant banker.
Q. Who is eligible to obtain registration as a merchant banker?
A. Only a body corporate other than a non-banking financial company shall be eligible to get registration as merchant banker.
Q. What are the various categories for which registration can be obtained?
A. The categories for which registration may be granted are given below: • Category I – to carry on the activity of issue management and to act as adviser, consultant, manager, underwriter, portfolio manager. • Category II - to act as adviser, consultant, co-manager, underwriter, portfolio manager. • Category III - to act as underwriter, adviser or consultant to an issue • Category IV – to act only as adviser or consultant to an issue
Q. What is the capital requirement for carrying on activity as merchant banker?
A. The capital requirement depends upon the category. The minimum net worth requirement for acting as merchant banker is given below: • Category I – Rs. 5 crores • Category II – Rs, 50 lakhs • Category III – Rs. 20 lakhs • Category IV – Nil
Q. What is the procedure for getting registration?
A. An application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 992. SEBI shall consider the application and on being satisfied issue a certificate of registration in Form B of the SEBI (Merchant Bankers) Regulations, 1992.
Q. What is the registration fee payable to SEBI?
A. Rs. 5 lakhs which should be paid within 15 days of date of receipt of intimation regarding grant of certificate.
Q. What is the validity period of certificate of registration?
A . Three years from the date of issue.
Q. How to renew the certificate?
A. Three months before the expiry period, an application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied renew certificate of registration for a further period of 3 years.
Q. What is the renewal fee payable to SEBI?
A. Rs.2.5 lakhs which should be paid within 15 days of date of receipt of intimation regarding renewal of certificate.
Q. What is the consequence of non-registration or failure to renew registration?
A. The person whose registration is not current shall not carry on the activity as merchant banker from the date of expiry of validity period.

5. Overview of current Indian Merchant Banking Scene:
In India, though the existence of this branch of financial services can be traced to over three decades, investment banking was largely confined to merchant banking services.
In India prior to the enactment on Indian Companies Act, 1956, managing agent acted as issue houses for the securities, evaluated project reports, planned capital structure and to some extent provided venture capital for new firms. Few share broking firm also functioned as Merchant Bankers.
The need for the specialized Merchant Banking services was felt in India with the rapid growth in the

number and size of the issues made in the primary market. The Merchant Banking services were started by foreign banks, namely the National Grindlays Bank in 1967 with licence obtained from RBI followed by the Citi Bank in 1970.

The Banking commission in its report in 1972 recommended the setting up of Merchant Banking institutions by commercial banks and Financial institutions. This marked the beginning of specialized merchant banking in India.

To begin with, Merchant Banking services were offered with traditional banking services. In the mid-eighties, the Banking Regulations Act was amended permitting commercial banks to offer a wide range of financial services through the subsidiaries rule.

The State Bank of India was the first to set up Merchant Banking Division in 1972 and ICICI was the first financial institution to set up its Merchant Banking Division in 1973. This was followed by Bank of India, Central Bank of India, Bank of Baroda, Syndicate Bank, Punjab National Bank, Canara Bank,etc. The later entrant were IFCI and IDBI with the latter setting up its Merchant Banking Division in 1992.

Growth

Merchant Banking in India was given a shot in the arm with the advent of SEBI in 1992 and subsequent introduction of free pricing of primary market equity issues in 1992. However, post-1992, the merchant banking industry was largely driven by issue management activity which fluctuated with the trends in the primary market.

There have been phases of hectic activity followed by a severe setback in business. SEBI started to regulate the merchant banking activity in 1992 and a majority of the merchant bankers who registered with SEBI were either in issue management or associated activity such as underwriting or advisorship. SEBI has four categories of merchant bankers with varying eligibility criteria based on their networth. The highest number of merchant bankers with SEBI was seen in the mid-nineties, but the numbers have reduced since, due to the inactivity in the primary market. The number of registered merchant bankers with SEBI as at end of March 2003 was 124, from a peak of almost a thousand in the nineties and later on number started reducing.

6. Structure of Merchant Banking Industry:

Initially Merchant Bankers were classified into 4 categories with regard to their nature and range of activities and their responsibilities to SEBI, investors and issuers of securities. Since September 1997 only a single category exists. The requirements are as under:

There are four different categories of merchant bankers. Only category 1 merchant bankers are allowed to act as lead managers to the issue:

Category 1: Those merchant bankers who can conduct all above mentioned activities, relating to management of issues. They may, if they so choose, act only in an advisory capacity or as co-manager, underwriter or as portfolio manager.

Category 2: Those merchant bankers who can act as consultant, advisor, portfolio manager and co-manager.

Category 3: Those merchant bankers who can act as underwriter, advisor and consultant.

Category 4: Those merchant bankers who can act only as advisor or consultant to an issue.

Different types of organizations in India which provide merchant baking services:

i. Commercial Banks
ii. All India Financial Institutions
iii. Private Consultancy Firms
iv. Technical Consultancy Organizations.

7. Professional Ethics and Code of Conduct:

i. REGULATORY/STATUTORY COMPLIANCE: The Members/Associates of AMBI are custodians of confidence and a bridge between investors and investees. The role includes reporting obligations which have in essence a legal requirement for meeting certain specific objectives. Accordingly, various Government agencies on the local, state and federal level may require the filing of numerous records and reports which are designed to safeguard public interest. Members/Associates of AMBI are expected to adhere to the Code of Conduct, regulations, guidelines, clarifications, rules, circulars and press releases issued by SEBI from time to time. Special care must be taken to ensure that all reporting to any branch or agency of the government is done with the utmost accuracy and promptness. No attempt should be made to distort or disguise the true nature of any procedure or transaction.

ii. CONFIDENTIALITY: Members/Associates may obtain financial and other "price sensitive" information, information about their client and/or competitors. The success of a Merchant Banker depends on the confidence of the client that its Merchant Banker would maintain confidentiality of the information obtained by it and the assurance that it would be utilized by the Merchant Banker in a proper manner. It goes with assurance that such information shall never be used for gain.

The Member/Associate shall:

Request its clients, other members and others for only such information as may be statutorily required or such information, as may be properly considered as necessary for rendering professional service as a Merchant Banker.

Restrict the use of the information, knowledge, secrets only for the purpose of discharging its functions as Merchant Banker.

Ensure that access to the information about the client and/or its competitors is accessed only by authorized employees/representatives of the Merchant Bankers.

Ensure that the files contained only pertinent data used for advising the client.

Ensure that access to all sensitive or privileged information is denied to others unless for good cause and/or reason and in discharge of their duties.

iii. ACCURATE RECORDS, REPORTING AND FINANCIAL RECORD KEEPING: Merchant Bankers are required by law to maintain financial and other records that will accurately present its activities and transactions. All supporting documents, including agreements, invoices, cheque requests and expense reports, are likewise required to fairly and accurately reflect the information contained therein.

No false or misleading entries should be made in any books or records of the Members/Associates for any reason; either in its accounts or in accounts maintained for and on behalf of clients and no fund, asset or account of the company should be established for any purpose unless it is accurately and fairly recorded in the books and records of the company. All errors and adjustments should be promptly corrected and recorded when discovered. Accounting information should be prepared in conformity with the prescribed accounting standards and generally accepted accounting practices. In the event of the adherence causing any hardship the Members/Associates could refer such situations to AMBI to enable it to examine the same.

No entries should be made which will conceal or differently portray the essence of a transaction.

The need for accurate and proper recording of information is not restricted to the accounting and financial functions of the Members/Associates. Members/Associates are also expected to maintain detailed records of all transactions, correspondence, meetings etc., with their clients/prospective clients. In an evolving regulatory environment, the attempt should be to lay down standards which will stand the test of time and avoid concealing the essence of a transaction behind the legalities of compliance regulations.

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iv. CONFLICT OF INTEREST : Members/Associates shall always endeavour to avoid conflict of interest in performance of its service as a Merchant Banker. Conflict of interest may be actual or apparent. All situations which leads to a conflict of interest should be avoided. This would apply in relation to other Members/Associates, clients, employees, group companies and dealings with other regulatory authorities. Before accepting a new assignment from a prospective client, a merchant banker is expected to conduct its own Due Diligence with the prospective clients' bankers, merchant bankers and other capital market intermediaries with a view to arrive at a decision whether to accept or reject the assignment.

v. ETHICS IN CONDUCTING BUSINES :Members/Associates shall in dealings with other members, clients, investors, institutions, the public, employees and others comply with all applicable laws, rules and regulations both in letter and in spirit. Where there appears any difficulty in interpretation of any law, rules, regulation, the Members/Associates may refer such issues to AMBI.

vi. POLITICAL CONTRIBUTIONS AND ACTIVITY: Members/Associates may, on its absolute sole discretion make political donations and participate in any political activity that are legally permitted. When expressing views on political issues the Member/Associate should make it clear that the views expressed are those of concerned Member/ Associate and not of AMBI.

vii. COMMUNICATION: Members/Associates are required to communicate with the Regulatory Authority, Government departments and Agencies, Public etc.
The Member/Associates shall communicate accurately in a manner which would ensure that the communication is truthful and accurate. All communication by a member to the investor at the instance of a client or based on information available with the client, should be made only if the member is fully aware of the facts and contents of the matter.
Members/Associate would acknowledge the fact that they are an important link between the listed companies and the investment public.
Opinions and recommendations required for from a Merchant Banker regarding any matter within his professional scope of work may be provided by him. The merchant banker shall be free to charge such fees for such professional services as he may deem fit. No incorrect or misleading information should be given. Information regarding advisable investments and update on investments should be given in a professional manner and should not be based on any extraneous motive or consideration.

viii. PUBLIC DISCLOSURE AND REPORTING: Reporting of financial information to the investing stockholders, the SEBI and the financial institutions requires the highest standard of fairness and honesty. Much harm can be caused due to incorrect or fraudulent or misleading reporting. All advice which suppresses or does not wholly disclose the material nature of a transaction should be avoided as being prohibited.

ix. DISPARAGEMENT OF COMPETITORS:
Competition among Merchant Bankers is increasing day after day which is welcome as public interest is best served by free and open competition. Any activity or conduct that reduces or eliminates competition in the market place is not in the interest of the development of a vibrant security market and investors. No Member/Associate shall undertake any activity which tends to or is likely to result in any restrictive trade practice or an unfair trade practice. One may choose not discuss fees, costs, commissions etc. earned/incurred by him with a competitor as this may lead to an unlawful agreement to determine price or restrain competition. However, a member is discouraged from entertaining client solely on the ground of fees when matters may have reached advanced stages of negotiation with other members.

In the ordinary course of business one may require information about a competitor, his clients etc. However, a Merchant Banker shall not acquire or seek to acquire information through improper means

such as industrial espionage, hiring an employee of the competitor etc. Should any such instance come to light the same should be reported to the SEBI & AMBI.

x. MARKETING & SALES :Members/Associates are encouraged to compete in the market place solely based on merits and competitive positioning. Abiding by generally accepted practices and norms of fair competition and providing clients with accurate, adequate and prompt information is expected. Business should be obtained on merits, avoiding compromising the loyalty of a customer's employee in an effort to make a sale through misuse of business courtesies.

xi. DISCRIMINATION: No Member/Associate shall discriminate in favour of or against any of its competing customers. No client company shall by an agreement or otherwise be coerced into resorting to the services of a particular Merchant Banker. While AMBI recognizes that collective co-operation strengthens the position of Merchant Banker generally, it should in no circumstances be considered as being a tool adverse to the interest of any client.

xii. CONTRACTS WITH CLIENTS: All agreements with clients shall be in writing and contain detailed scope of services to be rendered by the Members/Associates. The agreement shall include the amount of fees to be charged and the manner of payment thereof. The agreement between the Member/Associate and the client shall be entered into before any service is rendered by the Member/Associate. A Member/Associate before accepting any assignment from the client / prospective client shall obtain information as to whether the client / prospective client has already entered into an MOU / Agreement with any other Merchant Banker in respect of the same assignment and its status thereof.
Member/Associate shall ensure that their clients follow rules, regulations, guidelines etc. issued by SEBI and other regulatory authorities from time to time. A Merchant Banker shall exercise Due Diligence to ensure fair and true disclosures in the offer document so that the investors are in a position to take well informed investment decisions. Apart from informing SEBI, Members/ Associates shall keep AMBI informed about the non-compliance, if any, concerning such matters as reflect the interaction of the clients with the member. Members/Associates shall also keep AMBI informed about the non payment of fees etc. by the client as agreed.

xiii. EXPENSES REIMBURSEMENT: It is customary for a client to reimburse its Merchant Banker for all reasonable and necessary expenses actually incurred in the conduct of the client's business.
Members / Associates are expected to incur such expenditure as would normally have been incurred by them in the discharge of their duties. Without making it mandatory in any manner, Members / Associates are encourage to confirm with clients the particulars of expenses they would be incurring including the nature and class of travel, particulars regarding stay and expected duration etc.

xiv. GIFTS, ENTERTAINMENT, FAVOURS AND OTHER ITEMS OF VALUE: Members / Associates shall not accept or give any gift which may deem to influence the making of any commercial decision by the recipient of the gift. A gift may take various forms including money, tangible property, services free of cost or at concessional rate, discount, credit etc. Member / Associates are required by needs of the profession to interact with a cross section of the society. Members/Associates shall not make any illegal payment either directly or indirectly to any person irrespective of the reason or motive. Even reasonable gifts, be they received or given, should be avoided if to a reasonable observer, it might appear to influence a decision.

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xv. PROCUREMENT / PURCHASING: AMBI may, from time to time, indicate minimum fees for the services to be rendered by members in certain select areas of merchant banking activities, eg. Lead Managers/Joint Managers/ Co-Managers fees. While indicating such fees, AMBI shall keep in mind the cost expected to be incurred in rendering such services.
No undercutting should be resorted to in any circumstances much less in a manner which may not be easily detected in the course of discharging responsibilities.
Similarly all deals for procuring investments, either short, medium or long term should not be structured in a manner as not to be in keeping with the spirit and essence of this code.

xvi. INSIDE INFORMATION: A Merchant Banker will be considered as an "insider" in accordance with the meaning of the term as per the Securities and Exchange Board of India (Insider Trading) Regulations, 1992.
A Member/Associate shall not :
Either on his behalf, or on behalf of any other person, deal in securities of a company listed on any stock exchange on the basis of any unpublished price sensitive information.
Communicate any unpublished price sensitive information to any person except as may be necessary to carry on the business ordinarily on or under any law;
Give advice, suggestions, recommendations, to any person to deal in securities of any company on the basis of unpublished price sensitive information.
No Members/Associates or any of their employees shall indulge in "insider trading". This may require the Members/Associates to obtain from its employees, existing as well as to be employed in their organization in future to give suitable declarations that he/she shall not act on any unpublished price sensitive information. There should be mechanism by which the Members/ Associates are in a position to monitor the compliance. Employees should make periodic disclosure of transactions in securities entered into by them and their dependent relatives. Each Merchant Banker shall fix its own internal limit for transactions above which it would be obligatory for the employees to disclose the same to his employers. The Board/Management Committee should take note of these disclosures for proper monitoring. Every Member/Associate shall co-operate in adopting such regulatory procedure as AMBI may impose for ensuring that the Code of Conduct, Articles of Association of AMBI and other regulatory mandates issued by SEBI and AMBI from time to time are complied with, both in letter and in spirit.

xvii. TRADE SECRETS: During the course of employment, employees may work with innovative derivatives or other tools for financial management. They may also learn valuable information and gather materials relating to the business of the Member / Associate that are not otherwise known or available outside. This information and materials are of great importance in the present day highly competitive business; and to retain their value they must be kept confidential.
Any person taking up employment with a Member / Associate accepts a continuing moral and legal obligation not to disclose any trade secrets to anybody including an earlier or subsequent employer. The obligation to protect the secrets would continue, even after ceasing employment for any reason.

xviii. COMPLIANCE RESPONSIBILITY: Every Member/Associate is expected to be responsible for the conduct of its employees and will be reasonable for his or her compliance with this Code of Conduct. If there be any questions of interpretation they should be directed to AMBI.

xix. POWER OF AMBI TO CALL FOR CERTAIN INFORMATION: AMBI may call for such information from members as it may feel necessary or appropriate.

xx. QUALITY PERFORMANCE: It should be the objective of every Member/Associate, to encourage and develop high-quality performance and excellence in all aspect of operations and fostering of those characteristics in their employees.

xxi. CODE OF CONDUCT VIOLATIONS:AMBI expects every Member/Associate to assist in upholding the high traditions of the profession. AMBI may investigate the cases of violation of the Code of Conduct by its Members/Associates and may take such action against the Member/Associate as it may deem fit. The decision of AMBI Board in this regard shall be final.

xxii. POWER OF AMBI TO AMEND THE CODE: AMBI reserves the right to modify/alter, from time to time, any or all of the provisions of this Code of Conduct.

1.Current Development
The first merchant bank was set up in 1969 by Grind lays Bank. Initially they were issue mangers looking after the issue of shares and raising capital for the company. But subsequently they expanded their activities such as working capital management; syndication of project finance, global loans, mergers, capital restructuring, etc., initially the merchant banker in India was in the form of management of public issue and providing financial consultancy for foreign banks. In 1973, SBI started the merchant banking and it was followed by ICICI. SBI capital market was set up in August 1986 as a full fledged merchant banker. Between 1974 and 1985, the merchant banker has promoted lot of companies. However they were brought under the control of SEBI in 1992.

Recent Developments in Merchant Banking and Challenges Ahead: The recent developments in Merchant banking are due to certain contributory factors in India. They are

i. The Merchant Banking was at its best during 1985-1992 being when there were many new issues. It is expected that 2010 that it is going to be party time for merchant banks, as many new issue are coming up.
ii. The foreign investors – both in the form of portfolio investment and through foreign direct investments are venturing in Indian Economy. It is increasing the scope of merchant bankers in many ways.
iii. Disinvestment in the government sector in the country gives a big scope to the merchant banks to function as consultants.
iv. New financial instruments are introduced in the market time and again. This basically provides more and more opportunity to the merchant banks.
v. The mergers and corporate restructuring along with MOU and MOA are giving immense opportunity to the merchant bankers for consultancy jobs.

However the challenges faced by merchant bankers in India are:

i. SEBI guideline has restricted their operations to Issue Management and Portfolio Management to some extent. So, the scope of work is limited.
ii. In efficiency of the clients are often blamed on to the merchant banks, so they are into trouble without any fault of their own.
iii. The net worth requirement is very high in categories I and II specially, so many professionally experienced person/ organizations cannot come into the picture.
iv. Poor New issues market in India is drying up the business of the merchant bankers. Thus the merchant bankers are those financial intermediary involved with the activity of transferring capital funds to those borrowers who are interested in borrowing. The activities of the merchant banking in India is very vast in the nature of
    - The management of the customers securities

- The management of the portfolio
- The management of projects and counseling as well as appraisal
- The management of underwriting of shares and debentures
- The circumvention of the syndication of loans
- Management of the interest and dividend etc

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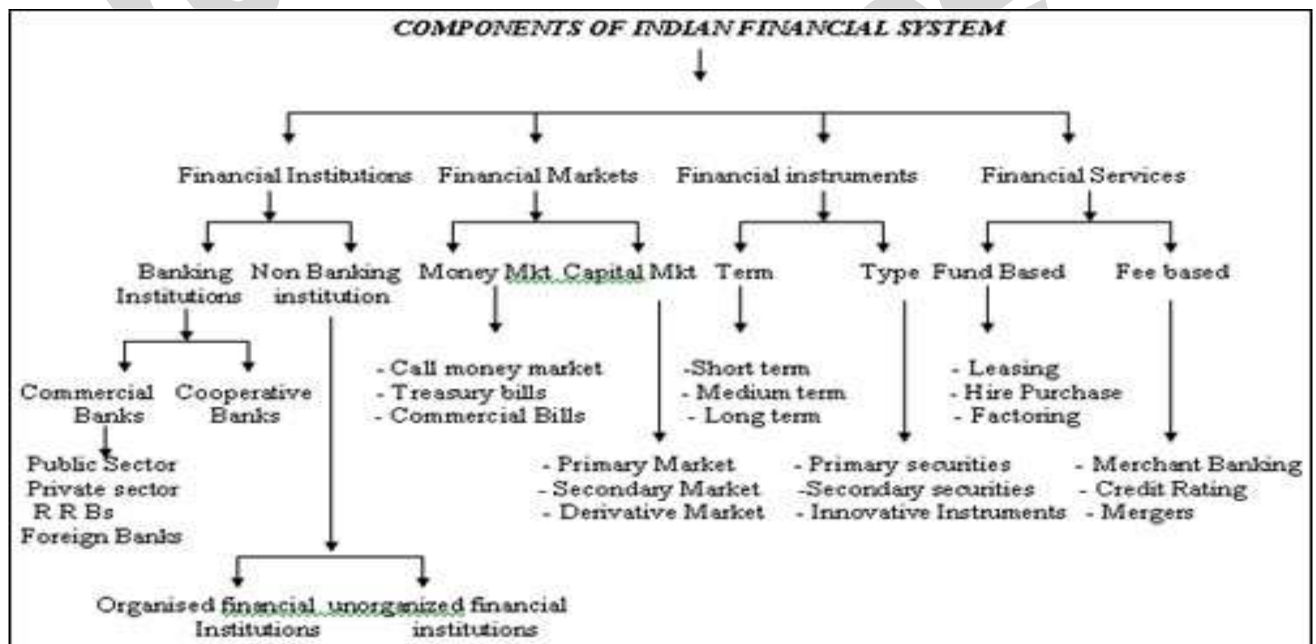
UNIT-2
FINANCIAL SERVICES, LEASING AND HIRE PURCHASE

INTRODUCTION:

Indian Financial System:

Financial system consists of two words i.e. Finance & system. Finance means study of money, its nature, its creation, behaviour, regulations and administration and system means set of instructions, markets, practices, transaction, claims & liabilities in the economy. Hence financial system refers to area in which all those activities, bodies and instruments dealing in finance are organized in to a system.

Indian Financial System includes many institutions and mechanism that effect the generation of savings and distribution of savings amongst all those who demand these funds for investment purpose. Thus financial system is a broader term which brings under its fold financial markets and financial institutions which support the system and major assets/instruments traded in the system. An efficient functioning of financial system facilitates free flow of funds to more productive activities and promotes faster economic growth. Hence financial system plays a crucial role in converting savings into investment and making surplus money available to core sectors of economy i.e. agriculture, industry, infrastructure development and thereby helps in overall development of economy.



Thus, Indian Financial consists of following:
1. Financial markets
2. Financial institutions/intermediaries
3. Financial assets/instruments

Financial markets can be further divided into:
1. Organized sector
2. Unorganized sector

Organized sector markets can be further divided into:
1. Money Market
2. Capital Market (Primary Market & Secondary Market)

Financial institutions / Intermediaries can also be divided into :
1. Regulatory Bodies – Key regulatory bodies are :
- RBI
- Securities & Exchange Board of India (SEBI)
- Insurance Regulatory & Development Authority (IRDA)
- Govt. of India (Dept. of Banking & Insurance, Ministry of Finance)
2. Intermediaries – Which may be :
- Money Market Intermediaries.
- Capital market intermediaries

FINANCIAL SERVICES:

1. Meaning, Definition and Concept:

Financial Services – In general, all types of activities which are of a financial nature can be brought under the term "financial services". In broad sense, it means "mobilizing and allocating savings". Thus it involves all activities involved in the transformation of savings into investment. It can also be called financial intermediation which is a process by which funds are mobilized by large number of sectors and make them available to all those who are in need particularly corporate customers. Thus financial service sector is a key area and is vital for industrial development. Financial service help not only to raise required funds but also ensure their efficient deployment. In order to ensure efficient management of funds, services such as bill discounting, factoring, parking of short term funds in money market, securitization of debt are provided by financial service firms. Besides banking and insurance, this sector provides specialized services such as credit rating, venture capital financing, lease financing, merchant banking, credit cards, housing finance etc. Hence, in brief, these are the services rendered by financial institutions and intermediaries operating in the market.

Financial services cover a wide range of activities. They can be broadly classified into two :
(i) Traditional activities
(ii) Modern activities.

Traditional activities can be further classified as:
(i) Fund based activities/services
(ii) Fee based activities /services

Fund based activities / services are those where funds of financial institutions are involved such as:
- Underwriting of investments in shares, debentures.
- Advancing different types of loans (short term, medium term, long term) and in the form of clean loan, pledge, hypothecation, housing, education, consumption loan etc.
- Investing / participating in money market instruments like CPs, CDs bill discounting, treasury bills etc.
- Providing finance like leasing, hire purchase, venture capital, seed capital etc.

Non-Fund based activities/services are those where funds are not involved and financial institution gets income in the form of fee such as:
- Commission on demand draft.
- Guarantee/Letter of credit
- Managing capital issue (pre-issue & post issue management services)
- Advisory/Consultancy services
- Project preparation/appraisal/arranging finance through projects from
- financial institutions
- Assisting in the process of getting clearances from Govt/Govt bodies.

Modern activities/services provided by financial institutions are like advisory role in corporate restructuring, acting as trustees for debentures, rehabilitation and restructuring sick units, portfolio management of large corporate risk management services, hedging of risks, guiding management in cost minimization efforts, safe custody of securities etc.

Role in financial system:

i. Financial Services are fundamental to economic growth and Development;
ii. Banking, savings and investment, and debt and equity financing, all help us to save our money, guard against uncertainty, and build credit, while enabling our businesses to start up, expand, -increase efficiency, - and compete in local and international markets;
iii. They provide the payment services;
iv. Matching savers and investors;
v. Generating and distributing of crucial information,
vi. Allocation of credits efficiently;
vii. Pricing, pooling and trading risks;
viii. Increasing of asset liquidity.
ix. Accelerate the rate of economic development
x. Allocation of resources to different investment channels.
xi. Catalyst for economic development
xii. Lowers risk and helps in diversification.
xiii. Expert Knowledge and professional guidance
xiv. Fosters industrial development
xv. Revival of sick units
xvi. Investor's education.

LEASING:

1. Meaning:

Lease financing denotes procurement of assets through lease. The subject of leasing falls in the category of finance. Leasing has grown as a big industry in the USA and UK and spread to other countries during the present century. In India, the concept was pioneered in 1973 when the First Leasing Company was set up in Madras and the eighties have seen a rapid growth of this business. Lease as a concept involves a contract whereby the ownership, financing and risk taking of any equipment or asset are separated and shared by two or more parties. Thus, the lessor may finance and lessee may accept the risk through the use of it while a third party may own it. Alternatively the lessor may finance and own it while the lessee enjoys the use of it and bears the risk. There are various combinations in which the above characteristics are shared by the lessor and lessee.

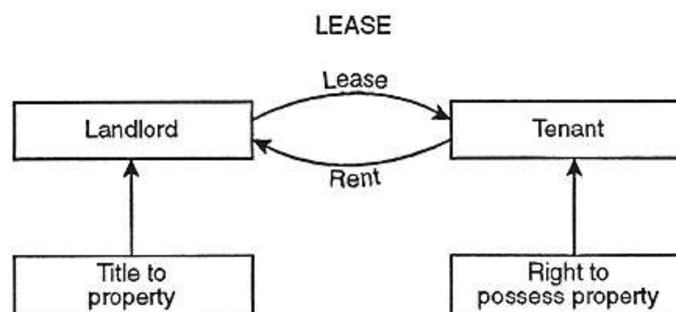


FIGURE 6

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.

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. Lease financing is based on the observation made by Donald B. Grant: "Why own a cow when the milk is so cheap? All you really need is milk and not the cow."

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. A gross lease is when the tenant pays a flat rental amount and the landlord pays for all property charges regularly incurred by the ownership from lawnmowers and washing machines to handbags and jewellry.

2. Features and Benefits of Financial Leasing;

Here are some features and benefits for the landlord/seller:

i. **Top sales price, even if demand is low:** You attract more buyers who are willing to pay a premium because of the exclusive financing terms and value you're offering.
ii. **Higher than usual rent:** Since you are flexible on your financing terms and are offering a tremendous value, you can demand a higher than usual rent.
iii. **Positive cash flow:** Since you can demand a higher than usual rent, your positive cash flow will increase.
iv. **Non-refundable option money:** When a tenant/buyer executes (signs) a Lease 2 Purchase contract, you receive an non-refundable option deposit that is yours to keep should they default or decide not to buy.
v. **Save thousands in fees:** Since you are selling your home by owner, you will avoid paying a 5-10% realtor commission which quickly adds up to thousands of dollars. You will also save on advertising costs because your home will be sold a lot faster.
vi. **Highest quality tenants, minimum risk:** Because you are renting to tenants who have a vested interest in your home, they think like homeowners and tend to take good care of it.
vii. **No maintenance, no landlording headaches:** Tenants who have a vested interest and believe they are a homeowner may feel a "pride of ownership" that encourages them to pay on time, perform routine maintenance and make improvements to your home.
viii. **Tax shelter is held intact:** Because you remain on the deed until the option is exercised, you maintain all of the tax benefits of ownership.
ix. **Largest market of buyers:** You are marketing your home not only to traditional buyers, but also to renters and investors. These three groups make up over 95% of people whom buy real estate.
x. **No vacancies:** When you advertise your home as a Lease 2 Purchase your phone will literally ring off the hook. Typical turnover time is days or weeks instead of months or even years.
xi. **Peace of mind:** It is safer than conventional rentals because of the quality of the tenants and their vested interest in your home. It also means that someone is living on-site who will watch and guard your home against fire, theft, vandalism, etc.

Here are some features and benefits for the tenant/buyer:

i. **Faster equity growth:** Equity accumulates much faster (five times or more!) than with conventional financing through a bank or lender.
ii. **Rent money is working towards purchase:** Every month a portion of your rental payment (typically $100-$500) is credited towards your down payment or off of the sales price.
iii. **Option money is credited towards purchase:** When you sign a Lease 2 Purchase contract, you will pay the seller an option deposit. This money is your vested interest in the home and will be fully (100%) credited to you when you buy the home.

iv. **Minimum cash out of pocket:** When you purchase a home the conventional way, you must pay at least 5% down plus closing costs and prepaid fees. When you buy with a Lease 2 Purchase, you only pay first month's rent and a small option deposit. This will save you between 25% and 85% every time you buy a home.
v. **Frequently no down payment at close:** Since you have given the seller an option deposit and you have been receiving monthly rent credits, there will frequently be very little or nothing left to pay for a down payment at closing.
vi. **Profits from appreciation:** Since the sales price is locked in before closing (as specified in your agreement), any increase in property value will mean that your equity (what you owe minus what it's worth) is increasing in the home.
vii. **Possible sale for a profit:** If you are allowed to sell (assign) your option (it will be in your agreement), you may sell it to a third party for a profit.
viii. **Increased buying power:** When you buy a Lease 2 Purchase home, you can put down as little as first month's rent and a $1 option deposit. Compare that to a typical bank or lender who requires 5-30% down plus closing costs and prepaids.
ix. **Credit problems okay:** Qualification restrictions simply do not exist. You will be approved at the sole discretion of the landlord/seller.
x. **No lengthy escrows or mortgage approvals:** Your approval will be based solely at the discretion of the landlord/seller instead of a lender who can take up to a month (or longer) to render a decision.
xi. **Control of the home:** You will be put in full legal control of the home for a specified period of time without actually having to own it.
xii. **No taxes, less liability:** Since you do not own the home (yet), you will not have to pay property taxes and your liability exposure will be dramatically reduced.
xiii. **Quick move in time:** You can typically take possession of the home in a week or less, instead of conventional move in times of one to three months, after your offer was accepted.
xiv. **Maximum leverage:** You are spending very little (or zero) money to control a potentially very expensive, and very profitable, piece of real estate.
xv. **Time:** Before you actually buy the home, you will have 3-24 months (depending on your agreement) to repair your credit, find the best interest rates, investigate the home and research the neighborhood and/or schools.
xvi. **Minimal maintenance:** Large maintenance problems or any maintenance problems that exceed a certain amount of money can be delegated to the landlord/seller.
xvii. **Privacy:** Your name will not be on the deed or in the public records until you exercise your option to buy.
xviii. **Peace of mind:** You will have full control of the home and can maintain or improve it however you wish.

3. Introduction to equipment leasing:

Equipment leasing is basically a loan in which the lender buys and owns equipment and then "rents" it to a business at a flat monthly rate for a specified number of months. At the end of the lease, the business may purchase the equipment for its fair market value (or a fixed or predetermined amount), continue leasing, lease new equipment or return it.

There are many different avenues through which you can secure an equipment lease:

- **Banks and bank-affiliated firms** that will finance an equipment lease may be difficult to locate, but once found, banks may offer some distinct advantages, including lower costs and better customer service. Find out whether the bank will keep and service the lease transaction after it's set up.
- **Equipment dealers and distributors** can help you arrange financing using an independent leasing company.
- **Independent leasing companies** can vary in size and scope, offering many financing options.
- **Captive leasing companies** are subsidiaries of equipment manufacturers or other firms.
- **Broker/packagers** represent a small percentage of the leasing market. Much like mortgage or real estate brokers, these people charge a fee to act as an intermediary between lessors and lessees.

4. Types of Leases:
There are two main types of lease: **Finance Leases** and **Operating Leases**.

Finance Leases: Under a finance lease, the finance company owns the asset throughout and the agreement covers a set period – considered to be the full economic life of the asset. Often, there is an option to continue leasing at a reduced, or 'peppercorn' rate, at the end of the contracted period. As you are not the owner of the asset, you cannot sell the asset during the rental period. The finance company can claim the writing-down allowances and pass this benefit to you in reduced rentals.

Operating Leases: An operating lease runs for less than the full economic life of the asset, and the lessee is not liable for the financing of its full value. The lessor carries the risk associated with the residual value of the asset at the end of the lease. This type of lease is often used when the asset is likely to have a resale value, for example, aircraft and vehicles. The customer gets the use of the asset, sometimes along with other services. Operating leases are particularly attractive to companies that frequently update or replace equipment and want to use equipment without ownership. The most common form of operating lease in motor finance is contract hire, particularly in the provision of vehicle fleets.

5. Evolution of Indian Leasing Industry:
Leasing activity was initiated in India in 1973. The first leasing company of India, named First Leasing Company of India Ltd. was set up in that year by Farouk Irani, with industrialist A C Muthia. For several years, this company remained the only company in the country until 20th Century Finance Corporation was set up - this was around 1980.
By 1981, the trickle started and Shetty Investment and Finance, Jaybharat Credit and Investment, Motor and General Finance, and Sundaram Finance etc. joined the leasing game. The last three names, already involved with hire-purchase of commercial vehicles, were looking for a tax break and leasing seemed to be the ideal choice.
The industry entered the third stage in the growth phase in late 1982, when numerous financial institutions and commercial banks either started leasing or announced plans to do so. ICICI, prominent among financial institutions, entered the industry in 1983 giving a boost to the concept of leasing. Thereafter, the trickle soon developed into flood, and leasing became the new gold mine. This was also the time when the profit-performance of the two doyen companies, First Leasing and 20th Century had been made public, which contained all the fascination for many more companies to join the industry. In the meantime, International Finance Corporation announced its decision to open four leasing joint ventures in India. To add to the leasing boom, the Finance Ministry announced strict measures for enlistment of investment companies on stock-exchanges, which made many investment companies to turn overnight into leasing companies.
As per RBI's records by 31st March, 1986, there were 339 equipment leasing companies in India whose assets leased totaled Rs. 2395.5 million. One can notice the surge in number - from merely 2 in 1980 to 339 in 6 years.
Subsequent swings in the leasing cycle have always been associated with the capital market - whenever the capital markets were more permissive, leasing companies have flocked the market. There has been appreciable entry of first generation entrepreneurs into leasing, and in retrospect it is possible to say that specialised leasing firms have done better than diversified industrial groups opening a leasing division.
Another significant phase in the development of Indian leasing was the Dahotre Committee's recommendations based on which the RBI formed guidelines on commercial bank funding to leasing companies. The growth of leasing in India has distinctively been assisted by funding from banks and financial institutions.
Banks themselves were allowed to offer leasing facilities much later - in 1994. However, even to date, commercial banking machinery has not been able to gear up to make any remarkable difference to the leasing scenario.

The post-liberalisation era has been witnessing the slow but sure increase in foreign investment into Indian leasing. Starting with GE Capital's entry, an increasing number of foreign-owned financial firms and banks are currently engaged or interested in leasing in India.

6. Legal Aspect of Leasing (The Law of Leasing in India):

i. Sources of Law on leasing and hire-purchase: Leasing and hire-purchase are essentially hiring transactions - transactions in which possession of goods is handed over along with right to use, for a stated period and for consideration.

Hiring transactions are species of bailments in contract law - therefore, the transactions of lease and hire-purchase are governed by the common law of contracts dealing with bailment transactions.

Contracts law, being common law, is codified in the Indian Contracts Act 1872 but is enriched by history of precedents from both English and Indian Courts. Notably, the common law of contracts in India is based largely on the British legal principles, which have by and large been accepted as applicable to India.

Therefore, the principal sources of applicable law on lease and hire-purchase transactions are sections 148 to 171 of the Indian Contracts Act dealing with bailments, and a long series of Court rulings, principally on hire-purchase transactions, but of late, on lease transactions as well.

The law of hire-purchase, essentially with a view to standardize procedures and eliminate malpractice, on the lines of the English Hire-purchase Act, was enacted in 1972. However, the has not been enforced as yet. In the meantime, there has been an attempt to amend it and make it applicable. Reportedly, the Law Commission is again considering it fit to amend and implement the law, but unfortunately, over years, there have been so much change in commercial reality of hire-purchase business that the concepts and calculations relevant in 1972 have become absolutely redundant close to Y2K. Besides, there is no sanctity today to implement a law dealing with hire-purchase, and not lease, or any such instrument in isolation - if at all necessary, India needs a law on consumer credit. Even UK has scrapped the Hire-purchase Act and merged it with consumer credit law.

ii. Leasing and Hire-purchase: From legal rights and obligations viewpoint, there is no difference between lease and hire-purchase transactions. Both are viewed as bailment transactions.

Accordingly, most of the common law applicable to hire-purchase transactions is also applicable to leases, and vice versa.

The difference between the two is principally the non-existence of option to buy in case of lease transactions. In other words, lease transactions carrying an option to buy, explicitly or implicitly, will be treated as hire-purchase transactions. This may lead to differences in taxation treatment, but there is no appreciable difference in legal rights of parties.

Hire-purchase is treated as distinct from conditional sale, since it provides the hirer with an option to buy, and does not impose an obligation to buy. The usual option to buy in case of hire-purchase transactions is for a nominal price of Re.1. If hire-purchase transaction were to force the hirer to continue paying the hire installments through the term of hire, and offer an option to the hirer only for the nominal purchase price of Re. 1, the optionality will be meaningless, and such hire-purchase transaction may be treated as a conditional sale.

iii. Requirements of a valid lease or hire-purchase: Both lease and hire-purchase, to be valid, must be valid bailment transactions. Therefore, all the preconditions of a valid bailment will be applicable to lease and hire-purchase transactions too.

Here is a detailed online article on the requirements of a valid lease and hire-purchase transaction, deriving from the law of bailments.

The requirements for a valid hire-purchase are the same as those in case of a lease, but the additional requirement about an option to terminate the hiring by returning the goods, mentioned above, has been dealt with in detail in the online article on true leases.

iv. Goods features in lease/hire-purchase: No bailment, and hence, no hiring can take place where there are no goods delivered by the hire-grantor to the hirer. In case of a sale and leaseback transaction, a leasing company bought and leased goods which were later found to be non-existent. No lease was held to be created by the agreement, since a lease without goods is not even initiated. [Associated Japanese Bank v. Credit Nuford (1988) 3 All E R 902]

As the lease contract envisages a delivery of goods to the lessee, to be terminated by redelivery of goods at the end of the lease period, the goods must have the following features:

a. **Durability:** The goods must last for at least as long as the lease period. Unless the lessor, or the lessee being under obligation to do so, replaces them and the goods so replaced become the subject matter of the lease, the contract of lease comes to an end as soon as the subject matter of the lease, viz., the leased goods, cease to exist.
   The goods constitute the very string of relation between the lessor and the lessee, and the relation is snapped the moment the string is broken. There may be doubts as to the existence of an intended lease where the goods leased are known not to have an estimated life at least equal to the lease period. For example, a lease of an umbrella could be intended, but not the lease of an ice cream. That is to say, goods which are consumed in the process of using them are incapable of lease.
b. **Movability and severability:** The goods leased are to be returned at the end of the lease period, since the possessory interest is only for a specific period. At the end of the period, the goods must redeliverable. This requires two attributes: that the goods must not have been permanently attached or affixed to an immovable property and hence rendered immovable, nor must they have been attached unseverably to any other property. The law of movable and immovable properties in India is by and large the same as in England - the character of a property is determined by the degree of annexation with land, and the intent of annexation.
c. **Identifiability:** To ensure that the bailee holds the goods owned by the bailor, the goods possessed by the lessee must be held distinct and ascertainable; in other words, the leased goods must not be mixed to render them unascertainable. The law of contracts distinguishes between mixture with or without the bailor's consent. Where the mixture is with the bailor's consent, the bailor and bailee will have proportionate interest in the lot. [Sec. 155]. Where the mixture is without the bailor's consent and the goods are unseverable, the bailor becomes entitled to be compensated by the bailee for the loss of goods.

v. Supreme ownership rights of the lessor: Indian Courts have generally recognized the ownership rights of a lessor over the leased asset. Even if the lease is avowedly a financial lease, such as in case of a hire-purchase transaction, the Courts respect the way the parties have sought to create and protect their rights. These rights are applicable in case of a hire-purchase transaction also.

vi. Obligations relating to the goods: While enjoying all the rights of ownership, the lessor may virtually escape all obligations relating to the goods - conditions of fitness, quality, usefulness for purpose, or any damages on account of defects in goods, can be effectively avoided by a disclaimer clause in the agreement backed by evidence that the lessor was not involved in selection of the goods nor did he influence the lessee's decision as to the goods or the supplier.

There is no categorical Indian case on the quality claims against the lessor - but the English principles of Astley Industrial Trust v. Grimley (1963) 2 All E. R. 33 apply in India too.

vii. Obligations regarding operation and use of the goods: While being the owner of the goods, the lessor may completely distance himself from obligations relating to the operation and use of the goods. This issue is very comfortably settled in India though there is a raging controversy on this point in number of other markets. The lessor is not in effective possession and is not the user of the goods. The lessee cannot be taken to be the agent of the lessor. See the following instances:

- A bus given on hire-purchase collided with a tree and killed several people. Hire-purchase financier as owner was not responsible. The driver of the bus was not to be taken as agent and the financier a "master". [Sundaram Finance Ltd. v. D G Nanajappa and Others]
- A truck given on hire-purchase was found carrying opium. The financier cannot be held responsible as the misuse of the vehicle could not have been with his consent and there was no possibility of the financier having control over the actual use by the hirer. [Great Finance (P) Ltd. v.The State]
- While the owner of the asset has been held not to be responsible for misuse, he still claims right to be notified before confiscation of his asset. [Pradeep and Co. v. Collector of Customs AIR 1973 Cal 131.]

viii. Repossession of the goods: On the lessee committing a breach of contract, the lessor being the owner of the goods is entitled to terminate the agreement of lease or hiring and repossess the goods.
No judicial intervention is required in case of repossession of goods - however, the practice depends upon the physical ease in repossession and the need to enter private premises or enclosures.
Repossession being an extra-ordinary remedy should be resorted to with great caution and with full force to the rules of fair play. In case of UP State Financial Corporation, the Supreme Court set a number of preconditions for possession and sale of confiscated properties - though those conditions were imposed due to the benevolent position of the Corporation, to a large extent, these conditions apply to every repossession. Hence, it is considered appropriate that before sale of the confiscated goods, the lessee should be given a right of buying the goods at the best available price.
ix. Motor vehicles law on lease and hire-purchase: Motor vehicles law in India contains specific provisions relating to lease and hire-purchase transactions. In respect of all motor vehicles, registration with motor vehicles authorities is compulsory.
The motor vehicle is given a registration certificate, which contains the name of the "owner". Owner, for the purposes of the motor vehicles law, is defined as the person effectively using the asset- obviously therefore, the name of the lessee/hirer is reflected as owner there. The name of the legal owner, viz., the lessor or hire-vendor, is reflected merely by way of an endorsement.
However, it is clear understanding of the law that the neither the name on the registration certificate, nor the endorsement therein, have any reflection on the legal ownership of the vehicle.
It is also provided that no transfer of a motor vehicle bearing the endorsement of a lease or hire-purchase (or hypothecation) shall be permitted without the non-objection letter of the lessor/hire-vendor.

x. Lease and Hire-purchase documentation: The documentation recommended for an ordinary lease/hire-purchase transaction is a simple lease or hire-purchase agreement. Evidence of having received delivery of goods should be obtained from the lessee/hirer. In general, it is advisable that the lessor limits himself to giving delivery of the leased asset, and commences the lease/hire instantly on delivery of the goods.

HIRE PURCHASE:

1. Concept:

Hire purchase is the legal term for a contract, in which persons usually agree to pay for goods in parts or a percentage at a time. It was developed in the United Kingdom and can now be found in Australia, China, India, Jamaica, Japan, Malaysia, New Zealand, and South Africa. It is also called closed-end leasing. In cases where a buyer cannot afford to pay the asked price for an item of property as a lump sum but can afford to pay a percentage as a deposit, a hire-purchase contract allows the buyer to hire the goods for a not rent. When a sum equal to the original full price plus interest has been paid in equal installments, the buyer may then exercise an option to buy the goods at a predetermined price (usually a nominal sum) or return the goods to the owner. In Canada and the United States, a hire purchase is termed an **installment plan**; other analogous practices are described as closed-end leasing or rent to own.
Purchase and sale of goods under a hire purchase system is different from cash sale and credit sale. In case of cash sale, the buyer pays the lump sum to the seller and immediately ownership is passed along with the

goods. While in credit sale the payment is made in future. In these both cases the ownership and possession of goods pass on the buyer. However, hire purchase system is a special system of purchase and sale.
In hire purchase system, the buyer acquires the property by promising to pay necessary installment payment of monthly, quarterly, half yearly or any other period. The period of payment has to be fixed while, signing the hire sell agreement. Though, the buyer acquires the asset under hire purchase system after signing the agreement, the title of ownership remains with vendor until the buyer squares up his/her entire liability. When the buyer pays the final installment and any other obligation according to hire purchase agreement, only then the title of ownership of the goods would be transferred to hirer. If the hirer makes default in the payment of any installment, the hire vendor has the right to re-possess the goods. When the vendor re-possesses the goods due to the default of payment of installment, in this case the amount already paid so far by the hirer will be forfeited.
The hire purchase price of goods is normally higher than the cash down price of article because it includes interest as well as cash price. Under hire purchase system, the vendor is responsible to repair the goods which are in the possession of buyer provided that the buyer takes the utmost proper care of the goods acquired. The risk is also borne by the vendor until the payment of last installment. The buyer has the right to return the goods to the vendor, if they are not according to the terms and condition of hire purchase agreement.

2. Characteristics:

i. The hiree (counterpart of lessor) purchases the asset and after agreement gives it on hire to the hirer (counterpart of lessee).
ii. At the time of hire purchase agreement, the hirer pays an agreed amount to the hiree and the balance in the form of hire purchase installments over the specified period of time.
iii. The hire purchase installments cover interest as well as principal payments. When the hirer pays the last installment, the title of the asset is transferred from the hiree to the hirer.
iv. The hiree charges the interest on the flat basis. The interest is charged on the initial investment and not on the diminishing balance.
v. The total interest collected by the hiree is allotted over various years. For this purpose 'sum of the years digit' method is generally applied.
vi. On default in paying installments by the hirer, the hiree has the right ti forfeit the installments already paid considering them as rent and to take back the asset.
vii. The hirer shows the asset in the balance sheet and can claim depreciation from the taxable income, although he may not be the owner at that time. He can also claim deductions from the taxable income on the interest part of the installments paid to the hiree.

3. Difference between Leasing and Hire Purchase:
Lease finance and hire purchase are the options of financing the assets. These options vary from each other in many aspects viz. ownership of the asset, depreciation, rental payments, duration, tax impact, repairs and maintenance of the asset and the extent of finance.
Starting any business involves a lot of financial planning for acquisition of fixed assets like land, plant and machinery etc. Most entrepreneurs are scared of capital intensive projects due to huge financial commitments. When large capital is involved in the business, an entrepreneur wishes to spread his cost of acquisition of fixed assets over a longer period. Longer period would reduce per year commitment towards the cost of asset. The intention is to match the commitment with the revenue generated per year so that the payments are easily manageable without any cash flow mismatch.
Lease and Hire purchase is an exact solution to that kind of financial arrangement where the cash commitment is spread over the life of the asset and on the top, lease financing does not even require any initial capital outflow also. Hence under lease, the entrepreneur can use his capital for other working capital requirements.

i. **Meaning:** In simple words, Lease is a financial contract between the business customer (user) and the equipment supplier (normally owner) for using a particular asset/equipment over a period of time against the periodic payments called “Lease rentals”. Lease generally involves two parties i.e. the lessor (owner) and the lessee (user). Under this arrangement, the lessor transfers the right to use to the lessee in return of the lease rentals agreed upon. Lease agreement can be made flexible enough to meet the financial requirements of both the parties.
Hire Purchase is a kind of installment purchase where the businessman (hirer) agrees to pay the cost of the equipment in different installments over a period of time. This installment covers the principal amount and the interest cost towards the purchase of an asset for the period the asset is utilized. The hirer gets the possession of the asset as soon as the hire purchase agreement is signed. The hirer becomes the owner of the equipment after the last payment is made. The hirer has the right to terminate the agreement anytime before taking the title or the ownership of the asset.

ii. **Ownership of the Asset:** In lease, ownership lies with the lessor. The lessee has the right to use the equipment and does not have an option to purchase. Whereas in hire purchase, the hirer has the option to purchase. The hirer becomes the owner of the asset/equipment immediately after the last installment is paid.

iii. **Depreciation:** In lease financing, the depreciation is claimed as an expense in the books of lessor. On the other hand, the depreciation claim is allowed to the hirer in case of hire purchase transaction.

iv. **Rental Payments:** The lease rentals cover the cost of using an asset. Normally, it is derived with the cost of an asset over the asset life. In case of hire purchase, installment is inclusive of the principal amount and the interest for the time period the asset is utilized.

v. **Duration:** Generally lease agreements are done for longer duration and for bigger assets like land, property etc. Hire Purchase agreements are done mostly for shorter duration and cheaper assets like hiring a car, machinery etc.

vi. **Tax Impact:** In lease agreement, the total lease rentals are shown as expenditure by the lessee. In hire purchase, the hirer claims the depreciation of asset as an expense.

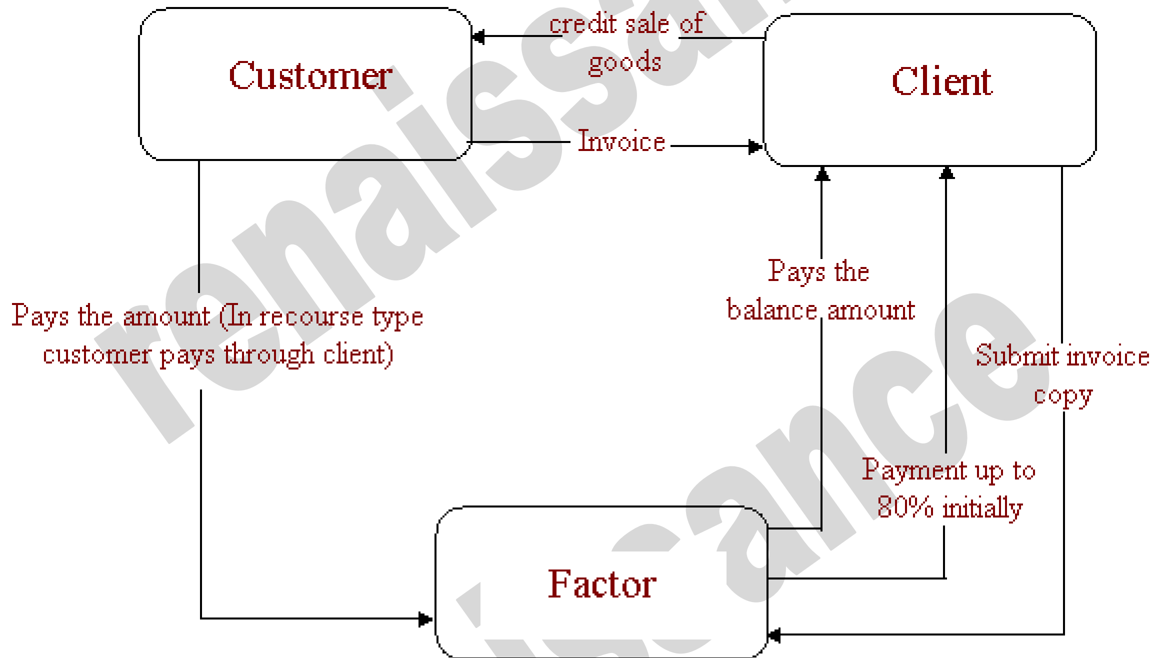
vii. **Repairs and Maintenance:** Repairs and maintenance of the asset in financial lease is the responsibility of the lessee but in operating lease, it is the responsibility of the lessor. In hire purchase, the responsibility lies with the hirer.

viii. **Extent of Finance:** Lease financing can be called the complete financing option in which no down payments are required but in case of hire purchase, the normally 20 to 25 % margin money is required to be paid upfront by the hirer. Therefore, we call it a partial finance like loans etc.

UNIT-3
FACTORING (INVOICE DISCOUNTING)

1. Concept:

Factoring is a financial transaction whereby a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount.



Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80%(rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount (Balance 20%-finance cost-operating cost) to the client when the customer pays the debt. Collection of debt from the customer is done either by the factor or the client depending upon the type of factoring. We will see different types of factoring in this article. The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance etc.

The mechanism of factoring is summed up as below:

i. An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
ii. The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
iii. When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
iv. The factor may provide advance finance to the selling firm conditions of the agreement so require.

Parties to the Factoring

There are basically three parties involved in a factoring transaction.

1. The buyer of the goods.

2. The seller of the goods
3. The factor i.e. financial institution.

The three parties interact with each other during the purchase/ sale of goods. The possible procedure that may be followed is summarized below.

The Buyer

1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
2. He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date.
3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

The Seller

1. The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
2. Sells goods to the buyer as per the contract.
3. Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
4. The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance.
5. The seller receives the balance payment from the factor after paying the service charges.

The Factor

1. The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables/debts.
2. The factor pays 80% or more of the amount of receivables copies of sale documents.
3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.

2. Nature/ Characteristics and Scope:

Factoring is a tool of receivable management employed to release funds tied up in credit extended to customers.

i. Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear in the books of account as book credits.
ii. The risk associated with credit are taken over by the factor which purchases these credit receivables without recourse and collects them when due.
iii. A factor performs at least two of the following functions: i. Provides finance for the supplier including loans and advance payments. ii. Maintains accounts, ledgers relating to receivables. iii. Collects receivables. iv. Protects risk of default in payments by debtors.
iv. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. It acts as another financial intermediary between the buyer and seller.
v. Unlike a bank, a factor specialises in handling and collecting receivables in an efficient manner. Payments are received by the factor directly since the invoices are assigned in favor of the factor.
vi. Factor is responsible for sales accounting, debt collection and credit control protection from bad debts, and rendering of advisory services to their clients.
vii. Factoring is a tool of receivables management employed to release funds tied up in credit extended to customers and to solve the problems relating to collection, delays and defaults of the receivables.

viii. Usually the period for factoring is 90 to 150 days. Some factoring companies allow even more than 150 days.
ix. Factoring is considered to be a costly source of finance compared to other sources of short term borrowings.
x. Factoring receivables is an ideal financial solution for new and emerging firms without strong financials. This is because credit worthiness is evaluated based on the financial strength of the customer (debtor). Hence these companies can leverage on the financial strength of their customers.
xi. Bad debts will not be considered for factoring.
xii. Credit rating is not mandatory. But the factoring companies usually carry out credit risk analysis before entering into the agreement.
xiii. Factoring is a method of off balance sheet financing.
xiv. Cost of factoring=finance cost + operating cost. Factoring cost vary according to the transaction size, financial strength of the customer etc. The cost of factoring vary from 1.5% to 3% per month depending upon the financial strength of the client's customer.
xv. Indian firms offer factoring for invoices as low as 1000Rs
xvi. For delayed payments beyond the approved credit period, penal charge of around 1-2% per month over and above the normal cost is charged (it varies like 1% for the first month and 2% afterwards).

3. Forms/ Types of Factoring:

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transactions is collection of receivables and administration of sale ledger. However, following are some of the important types of factoring arrangements.

i. Recourse and Non-recourse Factoring

In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, Let the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, commission or fees charged for the services in case of nonrecourse factoring is higher than under the recourse factoring. The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called del credere commission.

ii. Advance and Maturity Factoring

Under advance factoring arrangement, the factor pays only a certain percentage (between 75 % to 90 %) of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of actual collection of receivables by the factor. The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate. Sometimes, banks also participate in factoring transactions. A bank agrees to provide an advance to the client to finance a part say 50% of the (factored receivables - advance given by the factor).

In case of maturity factoring, no advance is paid to client and the payment is made to the client only on collection of receivables or the guaranteed payment data as the case may be agreed between the parties. Thus, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at

the time of sale.

iii. Conventional or Full Factoring

Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance. The factor also fixes up a draw limit based on the bills outstanding maturity wise and takes the corresponding risk of default or credit risk and the factor will have claims on the debtor as also the client creditor.

It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular but in India only a beginning has been made. Factoring agencies like SBI Factors are doing full factoring for good companies with recourse.

iv. Domestic and Export Factoring

The basic difference between the domestic and export factoring is on account of the number of parties involved. In the domestic factoring three parties are involved, namely: The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language.

1. Customer (buyer)
2. Client (seller)
3. Factor (financial intermediary)

All the three parties reside in the same country. Export factoring is also termed as cross-border/international factoring and is almost similar to domestic factoring except that there are four parties to the factoring transaction. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring, it is also called two-factor system of factoring. Two factor system results in two separate but inter-related contracts:

1. between the exporter (client) and the export factor.
2. export factor and import factor.

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language. He also assumes customer trade credit risk, and agrees to collect receivables and transfer funds to the export factor in the currency of the invoice. Export/International factoring provides a non-recourse factoring deal. The exporter has 100 % protection against bad debts loss arising on account of credit sales.

v. Limited Factoring

Under limited factoring, the factor discounts only certain invoices on selective basis and converts credit bills into cash in respect of those bills only.

vi. Selected Seller Based Factoring

The seller sells all his accounts receivables to the factor along with invoice delivery challans, contracts etc. after invoicing the customers. The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and do all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement.

vii. Selected Buyer Based Factoring

The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepares an approved list of them. The approved buyers of a company approach the factor for discounting their purchases of bills receivables drawn in the favour of the company in question (i.e. seller). The factor discounts the bills without recourse to seller and makes the payment to the seller.

viii. Disclosed and Undisclosed Factoring

In disclosed factoring, the name of the factor is mentioned in the invoice by the supplier telling the buyer to make payment to the factor on due date. However, the supplier may continue to bear the risk of bad debts (i.e. non-payments) without passing to the factor. The factor assumes the risk only under nonrecourse factoring agreements. Generally, the factor lays down a limit within which it will work as a non-recourse. Beyond this limit the dealings are done on recourse basis i.e. the seller bears the risk. Under undisclosed factoring, the name of the factor is not disclosed in the invoice. But still the control lies with the factor. The factor maintain sales ledger of the seller of goods, provides short-term finance against the sales invoices but the entire transactions take place in the name of the supplier company (seller).

4. Factoring vis-à-vis Bills Discounting:

Similarities: Factoring is somewhat similar to bills discounting in the sense that both these services provide short term finance. Again discount account receivables which the client would have otherwise received from the buyer at the end of the credit period.

Differences: Nonetheless, the two receivables financing arrangements differ in important respects.

1. Bill discounting is always with recourse whereas factoring can be either with recourse or without recourse.
2. In bill discounting the drawer undertakes the responsibility of collecting the bills and remitting the proceeds to the financing agency, while the factor usually undertakes to collect the bills of the client.
3. Bills discounting facility implies provision of finance and only that, but a factor also provides other services like sales ledger maintenance and advisory services.
4. Discounted bills may be rediscounted several times before they mature for payment. Debts purchased for factoring cannot be rediscounted, they can only be refinanced.
5. Factoring implies the provision of bulk finance against several unpaid trade generated invoices in batches; bill financing is individual transaction oriented i.e. each bill is separately assessed and discounted.
6. Factoring is an off balance mode of financing
7. Bills discounting does to involve assignment of debt as is the case with factoring.

5. Factors Vs Credit Insurance:

Credit insurance is a way to provide your business with protection against the failure of a customer to pay their trade credit debts.

The principle difference between Credit Insurance vs. Factoring is that with Credit Insurance you are insuring your A/R, with Factoring you are selling your A/R. Both involve forms of risk mitigation, shifting the credit, collections and financing responsibilities outside of the company, but in very different ways. Consider too, often with Factors once a receivable is considered uncollectable, the risk is transferred back to the business who sold it. Credit Insurance indemnifies the loss, guaranteeing payment for approved buyers within the terms of the policy, regardless of whether that A/R is ever collected.

6. Factoring Vs Forfeiting:

A forfeiter is a specialized finance firm or a department in banks offers non-recourse export financing through the purchase of medium-term trade receivables. Similar to factoring, forfeiting virtually eliminates the risk of nonpayment, once the goods have been delivered to the foreign buyer in accordance with the terms of sale. However, unlike factors, forfeiters typically work with the exporter who sells capital goods, commodities, or large projects and needs to offer periods of credit from 180 days to up to seven years.

1) Forfeiting applies to international trade only, while factoring refers to both domestic and export business.
2) Factoring is done for short term financing whereas forfeiting is for medium term (fixed interest rate) financing.
3) In case of factoring the invoice of the client is purchased and in forfeiting the export bill is purchased.

4) Forfeiting is done without recourse to the client whereas it may be with or without recourse in case of factoring.
5) In factoring arrangement, the 80%-85% of the total invoice is paid by the factor upfront but in the case of forfeiting 100% of the value of export bill is given to the client by the forfeiture.
6) Factoring is a broader in the sense it other than collection of debts also performs other functions such as maintenance of sales ledger, advisory services etc, whereas forfeiting mainly concentrates on collection of debts only.

8. Evaluation of Factor:

Risks to a factor include:

- Counter party credit risk related to clients and risk covered debtors. Risk covered debtors can be reinsured, which limit the risks of a factor. Trade receivables are a fairly low risk asset due to their short duration.
- External fraud by clients: fake invoicing, mis-directed payments, pre-invoicing, not assigned credit notes, etc. A fraud insurance policy and subjecting the client to audit could limit the risks.
- Legal, compliance and tax risks: large number of applicable laws and regulations in different countries.
- Operational risks, such as contractual disputes.
- Uniform Commercial Code (UCC-1) securing rights to assets.
- IRS liens associated with payroll taxes etc.
- ICT risks: complicated, integrated factoring system, extensive data exchange with client.

9. Evaluation of Factoring:

Following are the advantages of factoring:

1. Factoring is a way to finance requirement of working capital of the company in respect of receivables.
2. It provides a large and quick increase in cash flow of the business.
3. Due to existence of many factoring companies prices are usually competitive.
4. It is a cost effective way of outsourcing your sales ledger at the same time managing your business.
5. Factoring firms are specialized in their field thus the company might get useful information about the creditworthiness of its customers.
6. Protection from bad debts if non-recourse factoring is chosen.
7. Factors check the credibility of company's customers which help business trade with better quality customers.

Following are the disadvantages of factoring:

1. Cost: Factoring is a costly mean of financing as the cash price of the invoices is discounted by the factor company, the upfront cash price being usually 70-90% of the face value, depending on the credit history of the customers and the nature of selling company's business which reduces the profit margin of the selling company.
2. Selling company gets locked in to the relationship with the factor as they rely completely on the services of a factor because of the cash flow implications of any arrangements.
3. Possible harm to the customer: Selling Company fully gives the charge of collecting invoice to the factoring company and pays more attention on money collection methods which impairs company's relationship with their customers.
4. Company image distortion: In the past, factoring was considered a sign on the financial difficulties of the company. However in recent times this perception has changed and it has considered a normal way of doing business.
5. Impose constrains the way of doing business: In the case of non-recourse factoring the factoring company pre-approve the selling company's customers, which cause delay in placing new orders. Also the factoring company applies its credit limits to individual customers and will apply credit limits to individual customers.
6. The selling company may have to pay extra to remove its liability for bad debtors.

7. Some customers might want to deal directly with the selling company instead of dealing with factor.

10. Factoring in India – Current Developments.

In India, while discounting was resorted to by commercial banks, factoring is now being adopted in the wake of growth in financial service sector. Working group on money market known as Vaghul Committee first recommended the use of factoring services in India. This was later on endorsed by Kalyanasundaram Committee. RBI perceived factoring as one of the measures which could assist suppliers with timely finance and in expediting collection of dues.

RBI allowed SBI Factors and Commercial Services Pvt Ltd, Canbank Factoring Ltd, PNB and other banks to commence factoring services in India.

SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of Rs. 25 crores to undertake factoring services. It has been identified to provide services in the western region. It contemplated to undertake collection and credit services to improve cash flows of business houses by timely realization of debts. It also undertakes maintenance of clients sales ledger by using monthly sales analysis, overdue invoice analysis and credit analysis. It has designed its services on the basis of factoring services in Singapore and Indonesia.

Canara Bank Factors Ltd commenced operation in August 1991 and operates in the south zone. It provides same services as those of SBI Factors. PNB has been identified for the north region and Allahabad Bank, United Bank of India and UCO Bank have been identified for the eastern region.

Although, factoring services can solve the working capital needs of the MSMEs yet its penetration in India is very low. As per the report, Factoring turnover in India in 2008 constituted merely 1.24 per cent of total bank credit. The concept is still struggling to find its foothold as both factors and the MSMEs suspect each other.

SBI Global Factors Limited (SBIGFL) is the only service provider of International factoring, import factoring, domestic factoring and forfeiting services under one roof in India. It has established itself as a market leader in international factoring providing improved value added services to its clients.

According to **Swati Babel, BDM,** the service is still at a nascent stage and still evolving. Their client list include around 5 to 6 companies which is a mix of domestic and export. She further informs that status, constitution, produce line, seller-buyer relationship are a few parameters that they see while deciding to provide factoring services and the maximum amount that they forward currently is 1 cr.

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B.B.A. VI Semester **Subject: Merchant Banking and Financial Services**

UNIT-4
SECURITIZATION/MORTGAGES

1. Meaning of securitization:

Securitization is the process of transforming the assets of a lending institution into a negotiable instrument. The assets could be in the form of receivables of term lending institution, a housing finance company or automobile loan. It is a structured finance originated in USA in 1970s.

Securitization of debt, or asset securitization as is more often referred to, is a process by which identified pools of receivables, which are usually illiquid on their own, are transformed into marketable securities through suitable repackaging of cash flows that they generate. Securitization, in effect, is a credit arbitrage transaction that permits for more efficient management of risks by isolating a specific pool of assets from the originator's balance sheet. Further, unlike the case of conventional debt financing, where the interest and principal obligations of a borrowing entity are serviced out of its own general cash flows, debt servicing with asset backed securities (ABS) is from the cash flows originating from its underlying assets.

Securitization is the financial practice of pooling various types of contractual debt such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and selling said consolidated debt as bonds, pass-through securities, or collateralized mortgage obligation (CMOs), to various investors. The principal and interest on the debt, underlying the security, is paid back to the various investors regularly. Securities backed by mortgage receivables are called mortgage-backed securities (MBS), while those backed by other types of receivables are asset-backed securities (ABS).

Essential features of a securitization transaction comprise the following:

1. Creation of asset pool and its sale

The originator/seller (of assets) creates a pool of assets and executes a legal true sale of the same to a special purpose vehicle (SPV). An SPV in such cases is either a trust or a company, as may be appropriate under applicable law, setup to carry out a restricted set of activities, management of which would usually rest with an independent board of directors.

2. Issuance of the securitised paper

This activity is usually performed by the SPV. Design of the instrument however would be based on the nature of interest that investors would have on the asset pool. In the case of pass-through issuances, the investors will have a direct ownership interest in the underlying assets, while pay-throughs are debt issued by the SPV secured by the assets and their cash flows.

3. Credit Risk

It must be made abundantly clear at the very outset that the accretions on the asset-backed security, i.e., interest, amortisation and redemption payments, are entirely dependent on the performance of the pooled assets, and will have nothing to do with the credit of the originator. By the same argument, such cash flows would also be not influenced by events affecting the condition of the originator, including insolvency.

4. Pool Selection

The process of selecting assets to build a securitization pool would take into careful consideration, loan characteristics that are important from a cash flow, legal, and credit points of view, such as type of asset, minimum and maximum loan size, vintage, rate, maturity and concentration limits (geographic, single-borrower, etc.). 'Cherry-picking' to include only the highest quality assets in the pool should be consciously avoided. Ideal selection would be a random choice among assets conforming only to cash flow or legal criteria. Often, substitution of eligible assets in the place of original assets that mature/prepay in order to maintain the level of asset cover would also be required.

5. Administration

Formal delineation of duties and responsibilities relating to administration of securitised assets, including payment servicing and managing relationship with the final obligors must be spelt out clearly through a contractual agreement with the entity who would perform those functions.

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In addition, the following features are often included as part of a securitization transaction:
• Credit enhancement to support timely payments of interest and principal and to handle delinquencies,
• Independent credit rating of the securitised paper from a well known credit rating agency, and,
• Providing liquidity support to investors, such as appointment of market makers.

2. Nature:

i. Marketability:

The very purpose of securitization is to ensure marketability to financial claims. Hence, the instrument is structured in such a way as to be marketable. This is one of the most important features of a securitized instrument, and the others that follow are mostly imported only to ensure this feature. Marketability involves two concepts: (1) the legal and systematic possibility of marketing the instrument; (2) the existence of a market for the instrument.
As far as the legal possibility of marketing the instrument is concerned, traditional mercantile law took a contemporaneous view of marketable documents. In most jurisdictions in the world, laws dealing with marketable instruments (also referred to as negotiable instruments) were mostly limited in relation to what was then in circulation.
The very purpose of securitization will be defeated if the instrument is loaded on to a few professional investors without any possibility of having a liquid market. Liquidity is afforded to a securitized instruments either by introducing it in to an organized market (such as securities exchanges) or by one or more agencies acting as, market makers i.e. agreeing to buy and sell the instrument at either pre-determined or market-determined prices.

ii. Merchantable Quality:

To be market acceptable a securitized product should be of saleable quality. This concept, in case of physical goods, is something which is acceptable to merchants in normal trade. When applied to financial products, it would mean that the financial commitments embodied in the instruments are secured to the investors' satisfaction. To the investors satisfaction is a relative term and therefore, the originator of the securitized instrument secures the instrument based on the needs of the investors.
For widely distributed securitized instruments, evaluation of the quality, and its certification by an independent expert, viz., rating is common. The rating is for the benefit of the lay investor, who otherwise not expected to be in a position to appraise the degree of risk involved.
In case of securitization of receivables, the concept of quality undergoes a drastic change, making rating a universal requirement for securitization. As already discussed, securitization is a case where a claim on the debtors of the originator is being bought by the investors. Hence, the quality of the debtors' claim assumes significance, which at times enables investors to reply purely on the credit rating of debtors (or a portfolio of debtors) and so, make the instrument totally independent of the originators' own rating.

iii. Wide Distribution:

The basic purpose of securitization is to distribute the product. The extent of distribution which the originator would like to achieve is based on a comparative analysis of the costs and the benefits that can be achieved Wider distribution leads to a cost benefit, in that the issuer is able to market the product with lower return, and hence, lower financial cost to him. But a wide investor base involves the high cost of distribution and servicing.
In practice, securitization issues are still difficult for retail investors to understand. Hence, most securitizations are privately placed with professional investors. However, it is likely that in the future, retail investors could be attracted into buying securitized products.

iv. Commoditization:

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Securitization is the process of commoditization, where the basic idea is to take the outcome of this process into the capital market. Thus, the result of every securitization process, whatever might be the area to which it is applied, is to create certain instruments which can be placed in the market.

v. Funding alternative:

Being distinct and different from the originator's own obligations, a well structured ABS stands on its own credit rating and thus generates genuine incremental funding. This is so as the originator's existing creditors may invest in the ABS in addition to providing lines of credit to the originator. Further, there may also be other investors in the ABS who do not have a lending relationship with the originator. It is also possible to achieve a superior credit rating for the ABS than the originator's own through appropriate structuring and credit enhancement. This could mean accessing an investor base focusing on high grades, which otherwise may not be possible for an originator. Also, where the originator is not permitted to issue capital market instruments on his own ABS could help overcome such constraints.

vi. Balance sheet management:

Fundamental benefit of a true sale, i.e., freeing up the capital of the originator would apply in the case of all securitization transactions. In response, the balance sheet gets compressed and becomes more robust. Its ratios improve. Alternately, reduction in leverage post-securitised sale can be restored by adding on new assets to the balance sheet. Thus the asset through-put of the originator's balance sheet increases. Securitization can also generate matched funding for balance sheet assets. Further, it may also enable the disposal of non-core assets through suitable structuring.

vii. Re-allocation of risks:

Securitization transfers much of the credit risk in the portfolio to the ABS investors and helps to quantify the residual credit risk that the originator is exposed to. This is very useful, as the originator can then take larger exposure to individual obligors as well as provides a higher degree of comfort to his creditors. Securitization also transfers the originator's market risks, i.e., liquidity, interest rate and prepayment risks, to ABS investors and reduces risk capital requirement. This can lead to more competitive pricing of the underlying asset products.

viiii. Operating process efficiency:

The extent of portfolio analysis and information demanded by securitization programs often lead to serious re-examination and consequent reengineering of operating processes within the originator organisation. Further, specialist handling of various functional components, such as origination, funding, risk management and administration, often achieved through outsourcing, promotes efficiency across operating processes.

ix. Securitization improves operating leverage:

The originator usually assumes the function of the servicer, the issuing and paying agent, and sometimes that of the credit enhancer. Fees accrue on account of all of these. Excess servicing, i.e., the difference between the asset yield and the cost of funds, is also normally extracted by the originator. These income streams can push up the operating leverage of the originator generating income from a larger asset base than what may be otherwise possible for a given capital structure.

x. Low event risk:

The pool of assets representing the obligations of a number of entities is usually more resilient to event risks than the obligations of a single borrower – i.e. the risk that the credit rating of the security will deteriorate due to circumstances usually beyond the obligor's control is much higher in the latter case. The diversity that the securitization pool represents makes the ABS largely immune to event risks. Higher yields for lower/similar risk ABS usually offer higher yields over securities of comparable credit and maturities. The yield spread typically represents the premium paid to compensate for prepayment risk, amortizing cash flows and the uniqueness of the instrument. In some cases, ABS also provide an opportunity to invest into a pool of

otherwise illiquid and inaccessible assets.

xii. Structured issuances:
Through appropriate structuring, an ABS can be tailored to meet investor standards on credit quality, yield and maturity. Working with a pool of receivables gives the originator the needed flexibility to be able to offer investors a menu of options around which issuances could be made.

xiii. Secondary Market Liquidity:
Investment decisions of institutional investors accord a sizeable weightage to instrument liquidity. ABS does fit the requirement in this regard. While the ideal scenario would be to have an active secondary market trading in ABS, institutional investors are often willing to settle for credible liquidity backstops provided by well-rated institutions.

3. Scope:
While securitization started off in the housing loan sector, the development of the securitization market as a standard funding option across most industries has been the result of a constantly expanding universe of securitizable non-mortgage asset types. This chapter lays emphasis on three potential areas of securitization in India - MBS, ABS and Infrastructure Sector.

Mortgage Backed Securities (MBS)
The securitisation of assets historically began with, and in sheer volume remains dominated by residential mortgages. The receivables are generally secured by way of mortgage over the property being financed, thereby enhancing the comfort for investors. This is because mortgaged property does not normally suffer erosion in its value like other physical assets through depreciation. Rather, it is more likely that real estate appreciates in value over time. Further, the receivables are medium to long-term, thus catering to the needs of different categories of investors; the receivables consist of a large number of individual homogenous loans that have been underwritten using standardised procedures. It is hence suitable for securitisation; in the US where it originated, these mortgages were also secured by guarantees from the Government; · the receivables also satisfy investor preference for diversification of risk, as the geographical spread and diversity of receivable profile is very large.

Asset Backed Securities (ABS) – Existing assets
(a) Auto loans:
Though securitization was made popular by housing finance companies, it has found wide application in other areas of retail financing, particularly financing of cars and commercial vehicles. In India, the auto sector has been thrown open to international participation, greatly expanding the scope of the market. Auto loans (including installment and hire purchase finance) broadly fulfil the features necessary in securitization. The security in this case is also considered good, because of title over a utility asset. The development of a second hand market for cars in India has also meant that foreclosure is an effective tool in the hands of auto loan financiers in delinquent cases. Originators are NBFCs and auto finance divisions of commercial banks.
(b) Investments:
Investments in long dated securities as also the periodical interest instruments on these securities can also be pooled and securitized. This is considered relevant particularly for Indian situation wherein the FIs are carrying huge portfolios in Government securities and other debt instruments, which are creating huge asset-liability mismatches for the institutions. Government securities issued domestically in Indian Rupee can be bundled and used to back foreign currency denominated bonds issues. It would more be of the nature of derivative. The subordinated Government securities are intended to absorb depreciation in the value of the rupee thereby protecting to certain extent the senior securities that the Government securities back. The senior securities are directed at the international capital markets and are structured using offshore SPVs by countries like Mexico. Similarly, under the STRIPs mechanism, the interest coupons on the Government dated

securities are separated and traded in the secondary markets. Such interest instruments can also be bundled and securitized in the normal asset securitization method.
(c) Others:
Financiers of consumer durable, Corporate whose deferred trade receivables are not funded by working capital finance, etc are Originators of other asset classes amenable to securitization. Corporate loans, in a homogeneous pool of assets, are also subject to securitization There is virtually no known instance so far in the United States or in other countries of an ABS transaction having failed. This is despite the fact that the markets for ABS are exceptionally large. Industry experts attribute this to three main factors. ABS transactions are always planned, prepared and carried out with great care. Second reason is the intrinsic value of the paper and in particular the high level of transparency on the quality of the underlying assets. Third, ABS transactions are sponsored generally by large and well known institutions which can't afford to jeopardize their reputation with investors, the majority of which are institutional investors.

Securitization of infrastructure receivables
Securitisation of wholesale assets refers mainly to the use of securitisation as a technique for infrastructure funding. The availability of an efficient infrastructure framework is vital to the economic growth and prosperity of any country. Traditionally, infrastructure facilities have been developed and provided by Governments and are looked upon as basic privileges of a citizen and have thus been accorded priority for Government investment. The Central Government has envisaged that more than 40% of the annual central plan outlay would be for the development of infrastructure.ii In the context of India's size, population, and economic growth, the present infrastructure continues to be inadequate and will require massive incremental investment to sustain economic growth. Hence, the participation of private capital in the development of infrastructure (over and above the Government's direct involvement) is essential.
Along with the Government's earnest attempt at attracting private investment into infrastructure funding, the role of innovative funding techniques such as securitization is vital. The suitability of securitization for infrastructure funding stems from the fact that cash flows are stable and concession driven, and also because ultimate credit risk (which is central to the concept of securitization) is partly guaranteed by Government. Securitization is particularly appropriate at the post-commissioning stage when the project begins to generate cash, with overall project risk being largely replaced by credit risk.
Securitization will benefit infrastructure financing because it:
· permits funding agencies whose sector exposures are choked, to continue funding to those sectors.
· permits the participation of a much larger number of investors by issue of marketable securities.
· lowers the cost of funding infrastructure projects; long term funding (a sine quo non for most infrastructure projects) is more feasible in securitized structures than conventional lending.
· facilitates risk participation amongst intermediaries that specialize in handling each of the component risks associated with infrastructure funding (while these may initially be borne by regular financial intermediaries and insurance companies, it is expected that specialized institutions would develop over time).
· shifts the focus of funding agencies to evaluation of credit risk of the transaction structure rather than overall project risk. This is because the other components of project risk (as mentioned above) would be borne by specialized intermediaries, at a fee.

4. Securitization as a funding mechanism:
The rationale of securitizations is very simple. The first motivation is arbitraging the cost of funding in the market with funding on-balance sheet, for a bank or a corporate entity. The second motivation is off-loading credit risk to free capital for new operations or to modify the risk-return profile of the loan portfolio of banks.
Figure 60.1 summarizes the basic mechanism of a securitization. The seller of the assets is often a bank, or a corporate firm looking for attractive funding of account receivables. The SPV assets generate cash flows that serve to pay the note holders. The structured notes have different risk-return profiles, and different

maturities. Rating agencies provide a rating for each class of structured note, and provide the necessary information to investors to make the notes tradable. The arranger structures the transaction. The servicer takes care of day-to-day operations during the life of the transaction.

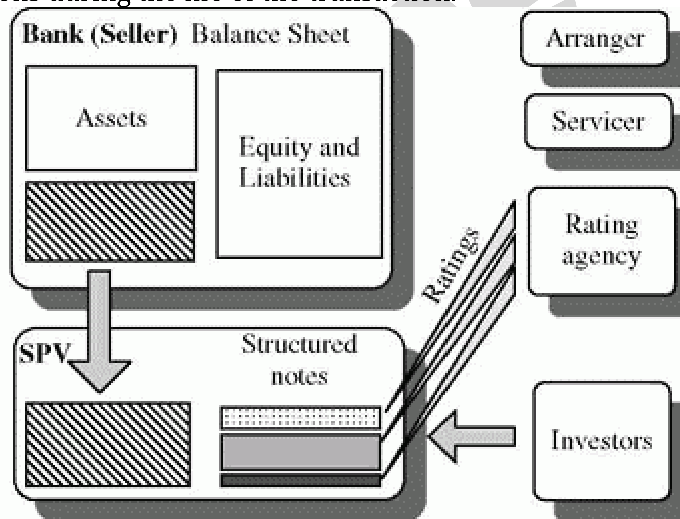

FIGURE 60.1 Structuring a securitization

The SPV isolates the pool of assets from the seller. The non-recourse sale implies that the seller is not responsible for losses by note holders. The SPV, or the fund, is a shield between lenders to the SPV and the seller of assets. The distinction between selling the assets and selling their risk only became practical with the development of synthetic structures in recent years. Sometimes, selling the assets is difficult because the authorization of borrowers is necessary. Selling the risk without selling the assets is feasible with credit derivatives such as credit-linked notes or similar,.

The structuring of the transaction relies on covenants that rule the governance of the SPV during its life. It also refers to the structuring of the notes issued to investors: size, seniority level in terms of claims on SPV cash flows, customizing risk-return profiles so they fit the needs of investors. To customize the risk-return profile of the structured notes issued to fund the SPV, it is necessary to set up an insurance mechanism that differentiates their risks, makes them explicit and makes these notes marketable.

The Insurance Mechanism

The basic insurance mechanisms consist of differentiating the seniority levels of notes issued, so that some have a higher priority claim on the cash flows of the SPV, and others a subordinated claim. This differentiates the risks across notes, while simultaneously ensuring a protection for the more senior notes. The protection simply results from the fact that equity and subordinated notes provide first loss protection.

The pool of assets generates future flows of different types: interest, capital repayment and prepayment of existing loans. A fraction of these flows is uncertain since defaults, payment delays and prepayments can happen at any date. However, the grouping of the assets into large pools of transactions makes it feasible to capture such uncertainties through statistics.

The simple way to provide a safety cushion is to use an oversized pool of assets. Since only a fraction of the pool suffices to pay investors, they have a protection against adverse deviations of the flows generated by the pool because of this safety cushion. For instance, a pool of assets can generate 100, and only 90 is necessary to pay off low-risk investors. The risk of loss for these investors materializes when the actual flow goes under 90. The excess of 10 means that the structure pays the flows promised to investors as long as the flows generated by the assets do not decrease by more than 10%. In practice, there are several classes of structured notes ranked by seniority level.

Structured Notes

The structuring of the transaction consists of defining the amounts of the various notes issued and their risk-return profile. The main structuring factors are the seniority levels and the amounts of the notes. All

notes subordinated to a given senior note absorb losses first. They act as a safety cushion, protecting the senior note. When cash flows do not suffice to pay all the obligations to all note holders, the deficiencies hit the subordinated notes first. At the lower end of subordination, the risk is maximal, since this range concentrates all the risk of the pool of assets. At the upper range of senior notes, the risk is quasi-zero because it is practically impossible for losses to reach a level such that they would hit this upper class of notes.

The subordination level of a note is the amount (as a percentage of total assets funded) of subordinated notes that protect the senior ones. The higher this safety cushion, the lower the risk of the notes protected by the subordinated notes. Agencies rate notes according to risk. The last subordinated note, which is like equity, gets all the first losses and has no rating. Senior notes can be investment grade, because the likelihood that the loss in pool of assets exceeds the safety cushion provided by the subordinated notes is near zero for the highest grades. When moving down the scale of seniority, the loss franchise provided by the subordinated notes shrinks. Either the seller of assets or a third party, acting as a credit enhancer for others, holds the last tranche. Since the equity tranche bears all the risk of the assets, the spread compensating credit enhancers is high.

The Waterfall of Cash Flows and Losses

The structure re-routes the flows generated by the pool of assets to investors using priority rules based on the seniority level of the structured notes, first to senior notes and last to the equity tranche. This is the waterfall of cash flows. The waterfall of losses follows a symmetrical path. First, they hit the credit enhancer, then the subordinated notes and only then the senior notes. The first cash flows go to the senior notes. The first losses go to the subordinated notes (Figure 60.2).

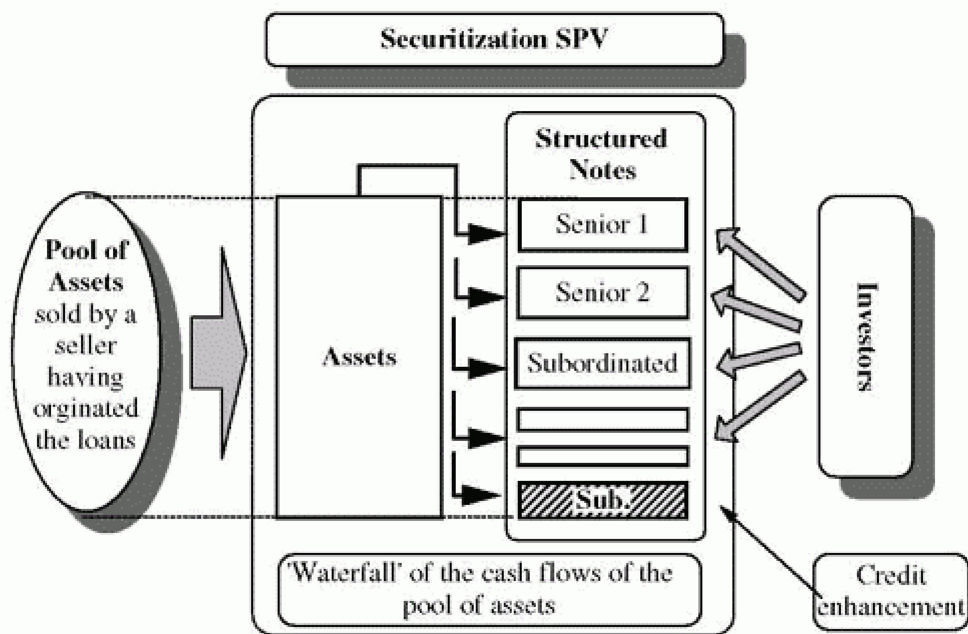

FIGURE 60.2 Securitization and structured notes

Customization of Structured Notes

Structuring through differentiated seniority levels allows the issuance of several types of securities differing in terms of their risk-return profile and maturity. Issuing several classes of structured notes of different seniority levels makes the securities attractive to various populations of investors, over the entire spectrum of risks. High-risk notes are of interest to investors looking for a higher expected spread in compensation for the added risk. Investors in senior notes benefit from a good rating, while having a return higher than with the same rating bonds, perhaps because the market values the risk differently for structured notes and plain bonds. Maturities vary across notes, under the sequential amortization scheme, because the payments flow

first to senior notes, thereby amortizing them quicker. The concurrent amortization scheme requires amortizing notes in parallel. The seniority level of a structured note drives the required return, hence its cost.

Resiliency and Stress Testing Securitizations

The resiliency of a structure designates its ability to sustain large variations in risk drivers without generating losses to the various classes of structured notes. Critical parameters that determine the resiliency of structures depend on the type of structure. For consumers or mortgage loans, typical critical parameters include: the delinquency rate (delays in payment), the charge-off rate (losses due to default), the payment rate (both monthly payments of interest and principal), the recovery rate (both percentage amount and timing of recoveries) and the average yield of the portfolio of loans. For other structures such as CDOs, critical parameters include: the degree of over-collateralization, or the excess amount of asset value over note value, the diversification of the portfolio of assets and the interest rate risk.

Stress scenarios on critical parameters such as charge-offs and minimum amounts of collateral serve to assess the resiliency of the structure and the risk of the various classes of structured notes issued. A typical way to assess the resiliency of structures by rating agencies consists of stress testing all critical risk drivers, such as the ones above. The same stress tests serve for rating the notes, in addition to measuring the resiliency of the structure.

The first purpose is to check whether each class of structured note suffers from loss when stress testing the values of these risk drivers. A very common way of validating the risk of a structured note is to apply to the portfolio of assets a multiple of the expected charge-off rate and check that notes do not suffer from losses. For a given note, the higher the multiple of charge-offs sustainable by the note without any loss, the higher the rating. For instance, the required multiple for a triple AAA scenario is obviously higher than for a risky subordinated note. The terminology might be confusing. An AAA scenario designates the minimum required multiple to have an AAA rating, and is a highly stressed scenario, because it is the one required to assign the best rating. Typical stress tests apply a high multiple to charge-off rates, for example five or six times the expected average charge-off rate for senior notes.

One easy way to assign ratings to notes is to map these multiples with the note ratings. Evidently, the minimum multiple required to have a given rating also depends on the quality of the assets. Hence, the AAA scenario, or the AAA multiple of expected loss, is lower when the average risk of assets is medium or low than when the risk of assets is high (average rating low). This is a practical shortcut to full modeling of the risk of the portfolio of assets in CDOs, as detailed in the following two sections explaining the economics of securitizations for the seller of assets. The full assessment of the structured note ratings requires plugging these scenarios into the spreadsheet model of the waterfall of cash flows and redirecting the loss to the notes, allocating first losses to the lower seniority levels. The simulation tells us whether a loss occurs to notes other than the equity.

5. Securitization of Residential Real Estate:

Real Estate Securitization as a Concept for Disintermediation of Lending Institutions

In recent times financing for real estate companies has become more and more difficult because banks have become very cautious with loan origination. This is due to the fact that a lot of banks have made an enormous amount of bad loans during the last decade and now those big bad loan portfolios weigh hard on the banks' balance sheets. However, Capital markets dictate that banks are more bottom line oriented. Therefore a lot of big commercial banks have decided to go away from the classic lending business and go into fee income business. This goes in hand with a second big trend, a trend that has been going on in the financial industry for many years. It can be described as the desintermediation of financial intermediaries; lending banks as such intermediaries will be more and more cut out of the lending process as they only function as an intermediary between the borrower and the capital market. Therefore the current trend in the banking industry can be described as a shift from credit to capital markets.

Real Estate Securitisation is a classic case of a desintermediation in the real estate lending industry. The

reason why this is happening is twofold. Firstly many banks have made bad real estate loans in the times of the economic upturn that have had a detrimental effect on the banks' ROE as discussed above. Secondly investors are always willing to get a higher return for the same amount of risk. So if the banks are desintermediated the usual lending spread can be distributed to the investor, the arranger and the borrower. Hence, this is a win-win situation for all the parties involved: the banks as arrangers make more fee income, investors get more return for the same amount of risk, and the borrowers get better financing conditions than before.

Different angles to view Real Estate Securitization

Each transaction structure is different and the ultimate structure depends on whichever angle one looks at the securitization.

First of all a categorization into securitizable assets, originator type, and goals and motives of the originator can be made. This makes sense because for instance different originators hold different assets and might have various motives of doing a real estate securitization. The three classifications overlap and most of the time a transaction structure is constructed by looking at it from every angle. Each category will be described in the following chapters.

Categorization by Type of Asset:

All the assets for a real estate securitisation are cash flows that are derived from real estate, in one way or another. Those assets can be summarised in the following categories:

- Real estate rental cash flows
- Future real estate rental cash flows (secured either by the real estate itself or by a leasehold interest in the real estate)
- Future cash flows derived from real estate
  - o Cash Flows from Toll roads or income from other public infrastructure projects
  - o Income from usage of oil pipelines or dams
  - o Ticket sales from football stadiums and multi-purpose arenas
- Real estate sale and leaseback payments
- Future real estate reversion proceeds
- Corporate Real Estate (to be divested)
- Inheritable building rights
- Cash flows from real estate backed Whole Company Securitisations (e.g. Pub deals) ! the assets are the cash flows from the company, but the collateral is the real estate of the company
- Future proceeds from real estate development projects (problem to be solved is how an effective distribution of the risks can be done).

Categorization by Type of Real Estate Originator:

There are various originators of real estate related cash flows and real estate assets in the property industry. Depending on the type of incorporation, the core competencies and the business model of those originator, it can be delineated for whom a securitisation transaction might be feasible or not.

- Corporates, that have defined real estate as a non-core business and that try to desinvest their real estate holdings in order to raise shareholder value.
- Corporates, that have defined real estate as a core business and that are looking to finance or refinance their existing holdings.
- Real estate holders, that are looking at financing or refinancing their existing real estate. The following list belongs to that category:
  - o Open-ended real estate funds
  - o Closed-ended real estate funds
  - o Listed property companies

o Real estate specialty funds (for insurances etc.)
o Opportunity Funds

Categorization by Motivations of the Originator:

- Real Estate Investors, that are financing new acquisitions by issuing Asset-Backed Securities.
- Real Estate Sellers, that are trying to generate solvency for a sale that will only take place sometime in the future (advance sale)
- Governments that have solvency problems but that also have a lot of real estate holdings. In the European Union, member countries are only allowed to take on a certain amount of debt (Maastricht Criteria). Therefore the governments are looking for ways to access solvency without raising the national debt (compare Italian Treasury Real Estate Securitisation).
- Real estate project developer
- Suppliers of Multi-Seller Platforms; those enable a pool of small originators to pool their assets.

In general, there must be some kind of motive or a goal that an origiantor follows with a securitisation, otherwise it would not be done. Usually originators want to have all the following goals and motives satisfied, however that is not always possible. Contradictions of goals often occur:

- Off-Balance Sheet Financing
- Generation of solvency
  o by selling future real estate cash flows
  o by selling the real estate itself
- Development of new financing sources and opening up a new investor base
- Capital market financing without having a rating
- To get a cheaper financing if the asset rating is better than the corporate rating
- Realisation of balance sheet reserves
- Higher loan to value ratios (LTV)
- Opportunity to realise future real estate cash flows today (at a present value)
- Improvement of the Return on Equity (ROE) and increase of the shareholder value
- Increase of the company's solvency
- Gain of flexibility for controlling the earnings (tax optimisation) and use of securitisation as a balance sheet management tool

Benefits and Limits of Real Estate Securitization:

Of course there are not only benefits associated with the use of real estate securitisation as an alternative financing source, but there are also limits that restrict the use of this financing tool. Both will be delineated in the following paragraphs.

Benefits

There can be benefits for both the originating company and those who will ultimately invest into Real Estate ABS, i.e. the institutional investors.

Benefits for the originator:

- Securitisation can lead to higher leverage, i.e. higher loan to value ratios (LTV) than would normally be achievable using more traditional financing methods. Typically, standard bank lending will assume LTV ratios of between 60-70%. A well structured securitisation can realise LTV ratios of 90-95%. A company can therefore unlock more capital than might be the case through normal bank lending arrangements.

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- Real estate securitisation may lower the cost of debt for the borrower compared to traditional sources of financing. The lower percentage of equity invested raises the return on invested capital.
- Real estate Securitisation is an Alternative to traditional sale and leaseback deals as a means of raising capital from an existing corporate real estate portfolio. The main benefit with this is that the originating company can retain ultimate ownership of the income producing assets and simply create or assign an appropriate interest for the purposes of securitisation. For example, a property company might create a long leasehold interest in its freehold portfolio so as to divert the income stream to the newly created leasehold interest.
- It allows non-investment grade companies to access the capital markets.
- The structure is individually tailored to suit the originating company and can therefore be adjusted to meet the nature of each portfolio.
- Investors are comfortable with the concept and the security which the structure will create.
- For the originator it should be possible to achieve a coupon which is below the rate which would be payable on a standard bank facility where a fixed number of percentage points above EURIBOR is usual.
- The focus is shifted onto the income generation of the asset, i.e. cash flow rather than the volume of the asset or the company itself. This allows segregation of good assets from what otherwise may be a poorly performing company or sector of the economy whose lack of profit might otherwise make fund raising difficult. Therefore issuers with a below-investment-grade unsecured debt rating are able to sell investment-grade, even triple-A-rated debt. The debt costs far less than a non-investment-grade firm would be able to access in the capital markets on an unsecured basis.
- Real Estate Securitisation diversifies the sources of capital, reduces the size of the balance sheet and frees up capital associated with the securitised real estate assets. The released capital can be put back to work and the originator may replace the securitised real estate assets with new ones. A higher volume of origination would, therefore, provide the issuer with the potential to generate higher revenues and earnings. In effect, this allows the issuing corporation to leverage off its capital base.
- In general, for investment-grade companies the non-recourse sale of assets enables the issuers to reduce the exposure to higher risk-weighted assets, and to fund portfolio growth through off-balance sheet treatment.
- Change of perception on the market and a possible gain of prestige due to the fact that the company is going new ways and is financing its real estate over the capital markets. Thereby a part of independence from the traditional lending institutions will be gained.
- Possibility to gain the upside potential of the property without really owning the real estate anymore.

Benefits for the investor:
- For the investor real estate securitisation creates a relative value gain, because the coupon on the notes is usually well above that payable on comparable bonds, hence making it an attractive investment.
- The issued Real Estate ABS notes are rated at their issuance and underlie a constant monitoring by the rating agencies.
- Real estate assets represent a very stable asset base and have a good reputation on the market.
- New assets and new structures that might be tailored to the needs of the investors create a better diversification of the investors' portfolios. For example, in Germany real estate ABS would represent a perfect substitute product to the existing real estate investment vehicles that have all proven to be ineffective for international institutional investors.
- Investing in original real estate risk without having to administer and manage the property.

Limits:
The limits of the securitisation transactions can be found on the cost side and on the legal and structuring side. Depending on the country of origination there are tax as well as legal challenges. For example in Germany, for a real estate securitisation where real estate receivables are sold to an SPV and the real estate is transferred to the SPV because it serves as additional collateral, a transfer tax of 3.5% applies. This does not only apply once, but twice, once the real estate is transferred back to the originator after the notes have

matured and the transaction is finished. Taking this extra cost of 7% into account, does not make the real estate securitisation look very favorable. So therefore the local tax rules are very important in the structuring of a real estate ABS transaction. Apart from that the biggest legal problem is the achievement of the bankruptcy remoteness of the SPV. It is for that reason that most of the time the real estate has to be transferred as additional collateral. In most countries there are different bankruptcy laws and especially in Europe it is a real challenge to structure a transaction of such sort.
Moreover the new accounting rules concerning securitisation within IAS and especially US GAAP (after Enron) are making it very difficult for companies to reach off-balance sheet treatment. This makes especially those transactions very difficult, where the originator wants to achieve an off-balance sheet treatment, but doesn't want to sacrifice the upside of the portfolio.
Finally, issuers need to weigh the cost of the transaction, which can be very high, versus the benefits of a real estate securitisation. The costs are not only up-front legal and structuring fees, but also issuing and administrative costs. Therefore it is essential that a minimum volume as defined earlier is reached.

6. Whole Loans:
The term whole loan is used in the secondary mortgage market to discuss a loan which is sold in entirety rather than being pooled with other mortgages. When a buyer purchases a whole loan the buyer takes on the full obligation associated with the loan, rather than sharing the risks with other investors. Of course, the buyer also obtains all of the potential profits associated with the loan, including late fees, interest payments, and so forth.

Banks buy and sell loans all the time in a variety of ways. Products are packaged for the secondary mortgage market with different types of investment styles in mind so that the bank will be likely to find interested investors who will be prepared to make purchases. Banks in turn use the money they raise by selling loans to increase their capital, which can be used to make more loans and to engage in other financial activities. The debtor who owes money on the loan usually finds out about the sale after the fact.

In the case of a whole loan a seller usually buys a group of loans packaged together, rather than just one. In some cases, buyers will contract with the seller to have the seller handle administration of the loan. The buyer pays a fee for this service and does not have to worry about collecting loan payments and handling other administrative tasks related to the whole loans it holds. Sellers in turn get the money from the sale and can enjoy a steady profit on the loan as long as it is in service.

The risk of an investment in a whole loan varies depending on the credit rating associated with the loan, the economic climate, and other factors. Investors who buy whole loans usually try to distribute their risk so that the failure of some investments will not be catastrophic for the investor's entire portfolio.
By contrast, pass through securities and other types of secondary mortgage market products involve groups or pools of loans which people can buy into. Investors do not assume individual loans in the group in the same way that they do with a whole loan and their risk is instead spread out. Lenders trying to sell loans with a mix of credit ratings may use such products to create packages of mixed quality. Investors would not buy loans with poor ratings independently, but they might be willing to take on the risk if the pool also included loans with high credit ratings.

7. Mortgages:
A **mortgage loan** is a loan secured by real property through the use of a mortgage note which evidences the existence of the loan and the encumbrance of that realty through the granting of a mortgage which secures the loan. However, the word mortgage alone, in everyday usage, is most often used to mean mortgage loan.
A home buyer or builder can obtain financing (a loan) either to purchase or secure against the property from a financial institution, such as a bank or credit union, either directly or indirectly through intermediaries. Features of mortgage loans such as the size of the loan, maturity of the loan, interest rate, method of paying

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off the loan, and other characteristics can vary considerably.

Basic concepts and legal regulation

The mortgage loan involves two separate documents[3] the mortgage note (a promissory note) and the security interest evidenced by the "mortgage" document; generally, the two are assigned together, but if they are split traditionally the holder of the note and not the mortgage has the right to foreclose.[4] According to Anglo-American property law, a mortgage occurs when an owner (usually of a fee simple interest in realty) pledges his or her interest (right to the property) as security or collateral for a loan. Therefore, a mortgage is an encumbrance (limitation) on the right to the property just as an easement would be, but because most mortgages occur as a condition for new loan money, the word mortgage has become the generic term for a loan secured by such real property. As with other types of loans, mortgages have an interest rate and are scheduled to amortize over a set period of time, typically 30 years. All types of real property can be, and usually are, secured with a mortgage and bear an interest rate that is supposed to reflect the lender's risk.

Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential and commercial property (see commercial mortgages). Although the terminology and precise forms will differ from country to country, the basic components tend to be similar:

- Property: the physical residence being financed. The exact form of ownership will vary from country to country, and may restrict the types of lending that are possible.
- Mortgage: the security interest of the lender in the property, which may entail restrictions on the use or disposal of the property. Restrictions may include requirements to purchase home insurance and mortgage insurance, or pay off outstanding debt before selling the property.
- Borrower: the person borrowing who either has or is creating an ownership interest in the property.
- Lender: any lender, but usually a bank or other financial institution. Lenders may also be investors who own an interest in the mortgage through a mortgage-backed security. In such a situation, the initial lender is known as the mortgage originator, which then packages and sells the loan to investors. The payments from the borrower are thereafter collected by a loan servicer.[5]
- Principal: the original size of the loan, which may or may not include certain other costs; as any principal is repaid, the principal will go down in size.
- Interest: a financial charge for use of the lender's money.
- Foreclosure or repossession: the possibility that the lender has to foreclose, repossess or seize the property under certain circumstances is essential to a mortgage loan; without this aspect, the loan is arguably no different from any other type of loan.
- Completion: legal completion of the mortgage deed, and hence the start of the mortgage.
- Redemption: final repayment of the amount outstanding, which may be a "natural redemption" at the end of the scheduled term or a lump sum redemption, typically when the borrower decides to sell the property. a closed mortgage account is said to be "redeemed".

Many other specific characteristics are common to many markets, but the above are the essential features. Governments usually regulate many aspects of mortgage lending, either directly (through legal requirements, for example) or indirectly (through regulation of the participants or the financial markets, such as the banking industry), and often through state intervention (direct lending by the government, by state-owned banks, or sponsorship of various entities). Other aspects that define a specific mortgage market may be regional, historical, or driven by specific characteristics of the legal or financial system.

Mortgage loans are generally structured as long-term loans, the periodic payments for which are similar to an annuity and calculated according to the time value of money formulae. The most basic arrangement would require a fixed monthly payment over a period of ten to thirty years, depending on local conditions. Over this period the principal component of the loan (the original loan) would be slowly paid down through amortization. In practice, many variants are possible and common worldwide and within each country.

Lenders provide funds against property to earn interest income, and generally borrow these funds themselves (for example, by taking deposits or issuing bonds). The price at which the lenders borrow

money therefore affects the cost of borrowing. Lenders may also, in many countries, sell the mortgage loan to other parties who are interested in receiving the stream of cash payments from the borrower, often in the form of a security (by means of a securitization).
Mortgage lending will also take into account the (perceived) riskiness of the mortgage loan, that is, the likelihood that the funds will be repaid (usually considered a function of the creditworthiness of the borrower); that if they are not repaid, the lender will be able to foreclose and recoup some or all of its original capital; and the financial, interest rate risk and time delays that may be involved in certain circumstances.

Mortgage loan types
There are many types of mortgages used worldwide, but several factors broadly define the characteristics of the mortgage. All of these may be subject to local regulation and legal requirements.

- interest: Interest may be fixed for the life of the loan or variable, and change at certain pre-defined periods; the interest rate can also, of course, be higher or lower.
- term: Mortgage loans generally have a maximum term, that is, the number of years after which an amortizing loan will be repaid. Some mortgage loans may have no amortization, or require full repayment of any remaining balance at a certain date, or even negative amortization.
- payment amount and frequency: The amount paid per period and the frequency of payments; in some cases, the amount paid per period may change or the borrower may have the option to increase or decrease the amount paid.
- prepayment: Some types of mortgages may limit or restrict prepayment of all or a portion of the loan, or require payment of a penalty to the lender for prepayment.

The two basic types of amortized loans are the fixed rate mortgage (FRM) and adjustable-rate mortgage (ARM) (also known as a floating rate or variable rate mortgage). In some countries, such as the United States, fixed rate mortgages are the norm, but floating rate mortgages are relatively common. Combinations of fixed and floating rate mortgages are also common, whereby a mortgage loan will have a fixed rate for some period, for example the first five years, and vary after the end of that period.

- In a fixed rate mortgage, the interest rate, and hence periodic payment, remains fixed for the life (or term) of the loan. Therefore the payment is fixed, although ancillary costs (such as property taxes and insurance) can and do change. For a fixed rate mortgage, payments for principal and interest should not change over the life of the loan,
- In an adjustable rate mortgage, the interest rate is generally fixed for a period of time, after which it will periodically (for example, annually or monthly) adjust up or down to some market index. Adjustable rates transfer part of the interest rate risk from the lender to the borrower, and thus are widely used where fixed rate funding is difficult to obtain or prohibitively expensive. Since the risk is transferred to the borrower, the initial interest rate may be, for example, 0.5% to 2% lower than the average 30-year fixed rate; the size of the price differential will be related to debt market conditions, including the yield curve.

The charge to the borrower depends upon the credit risk in addition to the interest rate risk. The mortgage origination and underwriting process involves checking credit scores, debt-to-income, downpayments, and assets. Jumbo mortgages and subprime lending are not supported by government guarantees and face higher interest rates. Other innovations described below can affect the rates as well.

8. Graduated Payment:
Graduated Payments are repayment terms involving gradual increases in the payments on a closed-end obligation. A graduated payment loan typically involves negative amortization, and is intended for young people who currently have low income but foresee a greater future income. These terms are only offered when banks have reason to assume that the borrower's income will rise during the 10 year loan period.

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A **graduated payment mortgage loan**, often referred to as GPM, is a mortgage with low initial monthly payments which gradually increase over a specified time frame. These plans are mostly geared towards young men and women who cannot afford large payments now, but can realistically expect to do better financially in the future. For instance a medical student who is just about to finish medical school might not have the financial capability to pay for a mortgage loan, but once he graduates, it is more than probable that he will be earning a high income. It is a form of negative amortization loan.

Mechanism

GPMs are available in 30 year and 15 year amortization, and for both conforming and jumbo mortgage. Over a period of time, typically 5 to 15 years, the monthly payments increase every year according to a predetermined percentage. For instance, a borrower may have a 30-year graduated payment mortgage with monthly payments that increase by 7% every year for five years. At the end of five years, the increases stop. The borrower would then pay this new increased amount monthly for the rest of the 25-year loan term.

Risk

The graduated payment mortgage seems to be an attractive option for first-time home buyers or those who currently do not have the resources to afford high monthly home mortgage payments. Even though the amounts of payments are drawn out and scheduled, it requires borrowers to predict their future earnings potential and how much they are able to pay in the future, which may be tricky. Borrowers could overestimate their future earning potential and not be able to keep up with the increased monthly payments.

Eventually, even if the graduated payment mortgage lets borrowers save at the present time by paying low monthly amounts; the overall expense of a graduated payment mortgage loan is higher than that of conventional mortgages, especially when negative amortization is involved.

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UNIT-5
Depository

2.Meaning
3.Evolution
4.Merits
5.Demerits.
6.Dematerialization
7.Process of Dematerialization.
8.NSDL
9.CDSL

1. Meaning:

A depository is an institution that facilitates the investors in holding securities in a book entry form, which is maintained electronically. It is similar to a bank where one can deposit cash and can be withdrawn and/or transferred to any body at your instruction by issuing a cheque. Similarly your investment can be sold in the stock exchange or transferred to any body at your instruction through a Depository Participant (DP).

On the simplest level, depository is used to refer to any place where something is deposited for storage or security purposes. More specifically, it can refer to a company, bank or an institution that holds and facilitates the exchange of securities. Or a depository can refer to a depository institution that is allowed to accept monetary deposits from customers.

Central security depositories allow brokers and other financial companies to deposit securities where book entry and other services can be performed, like clearance, settlement and securities borrowing and lending.

Basics of Depository

Depository is an institution or a kind of organization which holds securities with it, in which trading is done among shares, debentures, mutual funds, derivatives, F&O and commodities. The intermediaries perform their actions in variety of securities at Depository on behalf of their clients. These intermediaries are known as Depositories Participants. Fundamentally, There are two sorts of depositories in India. One is the National Securities Depository Limited(NSDL) and the other is the Central Depository Service (India) Limited(CDSL). Every Depository Participant(DP) needs to be registered under this Depository before it begins its operation or trade in the market.

How do Depository operate

Depository interacts with its clients / investors through its agents, called Depository Participants normally known as DPs.

For any investor / client, to avail the services provided by the Depository, has to open Depository account, known as Demat A/c, with any of the DPs.

Demat Account Opening

A demat account is opened on the same lines as that of a Bank Account. Prescribed Account opening forms are available with the DP, needs to be filled in. Standard Agreements are to be signed by the Client and the DP, which details the rights and obligations of both parties. Along with the form the client requires to attach Photographs of Account holder, Attested copies of proof of residence and proof of identity needs to be submitted along with the account opening form.

In case of Corporate clients, additional attachments required are - true copy of the resolution for Demat a/c opening along with signatories to operate the account and true copy of the Memorandum and Articles of Association is to be attached.

Services provided by Depository

- Dematerialisation (usually known as demat) is converting physical certificates to electronic form
- Rematerialisation, known as remat, is reverse of demat, i.e. getting physical certificates from the electronic securities
- Transfer of securities, change of beneficial ownership
- Settlement of trades done on exchange connected to the Depository

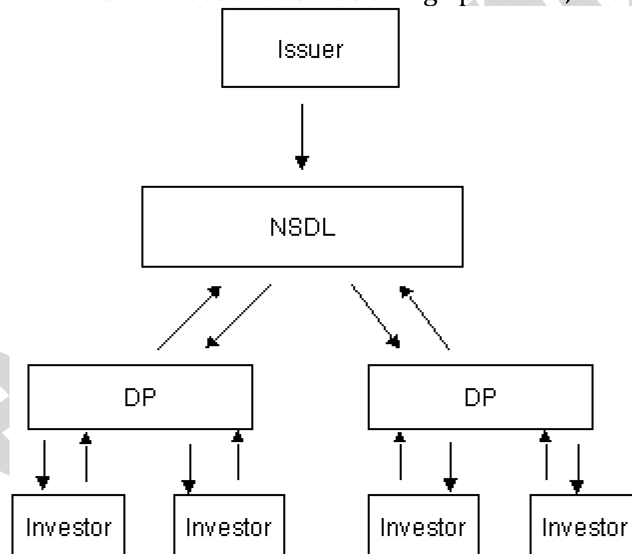
No. of Depository in the country

Currently there are two depositories operational in the country.

1. National Securities Depository Ltd. - NSDL - Having 1.25 crores Demat A/c as on 01-12-2012 - 288 DPs in India
2. Central Depository Services Ltd. - CDSL - Having 80 lakhs Demat A/c as on 31-08-2011 - 643 DPs in India

Depository System in India:

India has adopted the Depository System for securities trading in which book entry is done electronically and no paper is involved. The physical form of securities is extinguished and shares or securities are held in an electronic form. Before the introduction of the depository system through the Depository Act, 1996, the process of sale, purchase and transfer of securities was a huge problem, and there was no safety at all.



Key Features of the Depository System in India:

1. Multi-Depository System: The depository model adopted in India provides for a competitive multi-depository system. There can be various entities providing depository services. A depository should be a company formed under the Company Act, 1956 and should have been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992. Presently, there are two depositories registered with SEBI, namely:

- National Securities Depository Limited (NSDL), and
- Central Depository Service Limited (CDSL)

2. Depository services through depository participants: The depositories can provide their services to investors through their agents called depository participants. These agents are appointed subject to the conditions prescribed under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and other applicable conditions.

3. Dematerialization: The model adopted in India provides for dematerialisation of securities. This is a significant step in the direction of achieving a completely paper-free securities market. Dematerialization is a process by which physical certificates of an investor are converted into electronic form and credited to the account of the depository participant.
4. Fungibility: The securities held in dematerialized form do not bear any notable feature like distinctive number, folio number or certificate number. Once shares get dematerialized, they lose their identity in terms of share certificate distinctive numbers and folio numbers. Thus all securities in the same class are identical and interchangeable. For example, all equity shares in the class of fully paid up shares are interchangeable.
5. Registered Owner/ Beneficial Owner: In the depository system, the ownership of securities dematerialized is bifurcated between Registered Owner and Beneficial Owner. According to the Depositories Act, 'Registered Owner' means a depository whose name is entered as such in the register of the issuer. A 'Beneficial Owner' means a person whose name is recorded as such with the depository. Though the securities are registered in the name of the depository actually holding them, the rights, benefits and liabilities in respect of the securities held by the depository remain with the beneficial owner. For the securities dematerialized, NSDL/CDSL is the Registered Owner in the books of the issuer; but ownership rights and liabilities rest with Beneficial Owner. All the rights, duties and liabilities underlying the security are on the beneficial owner of the security.
6. Free Transferability of shares: Transfer of shares held in dematerialized form takes place freely through electronic book-entry system.

2. Evolution:

Although India had a vibrant capital market which is more than a century old, the paper-based settlement of trades caused substantial problems such as bad delivery and delayed transfer of title. The enactment of Depositories Act in August 1996 paved the way for establishment of **National Securities Depository Limited** (NSDL), the first depository in India. It went on to established infrastructure based on international standards that handles most of the securities held and settled in de-materialised form in the Indian capital markets.

NSDL has stated it aims are to ensuring the safety and soundness of Indian marketplaces by developing settlement solutions that increase efficiency, minimise risk and reduce costs. NSDL plays a quiet but central role in developing products and services that will continue to nurture the growing needs of the financial services industry.

In the depository system, securities are held in depository accounts, which are similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers. This method does away with all the risks and hassles normally associated with paperwork. Consequently, the cost of transacting in a depository environment is considerably lower as compared to transacting in certificates. In August 2009, number of Demat accounts held with NSDL crossed one crore.

3.**Merits/ Advantages of the Depository System:**

The advantages of dematerialization of securities are as follows:

i. Share certificates, on dematerialization, are cancelled and the same will not be sent back to the investor. The shares, represented by dematerialized share certificates are fungible and, therefore, certificate numbers and distinctive numbers are cancelled and become non-operative.
ii. It enables processing of share trading and transfers electronically without involving share certificates and transfer deeds, thus eliminating the paper work involved in scrip-based trading and share transfer system.
iii. Transfer of dematerialized securities is immediate and unlike in the case of physical transfer where the change of ownership has to be informed to the company in order to be registered as such, in case of transfer in dematerialized form, beneficial ownership will be transferred as soon as the shares are transferred from one account to another.

iv. The investor is also relieved of problems like bad delivery, fake certificates, shares under litigation, signature difference of transferor and the like.
v. There is no need to fill a transfer form for transfer of shares and affix share transfer stamps.
vi. There is saving in time and cost on account of elimination of posting of certificates.
vii. The threat of loss of certificates or fraudulent interception of certificates in transit that causes anxiety to the investors, are eliminated.

4. Demerits:

Some disadvantages were about the depository system were known beforehand. But since the advantages outweighed the shortcomings of dematerialisation, the depository system was given the go-ahead.

i. **Lack of control:** Trading in securities may become uncontrolled in case of dematerialized securities.
ii. **Need for greater supervision:** It is incumbent upon the capital market regulator to keep a close watch on the trading in dematerialized securities and see to it that trading does not act as a detriment to investors. The role of key market players in case of dematerialized securities, such as stock brokers, needs to be supervised as they have the capability of manipulating the market.
iii. **Complexity of the system:** Multiple regulatory frameworks have to be confirmed to, including the Depositories Act, Regulations and the various Bye Laws of various depositories. Additionally, agreements are entered at various levels in the process of dematerialization. These may cause anxiety to the investor desirous of simplicity in terms of transactions in dematerialized securities.

Besides the above mentioned disadvantages, some other problems with the system have been discovered subsequently. With new regulations people are finding more and more loopholes in the system. Some examples of the malpractices and fraudulent activities that take place are:

iv. Current regulations prohibit multiple bids or applications by a single person. But investors open multiple demat accounts and make multiple applications to subscribe to IPOs in the hope of getting allotment of shares.
v. Some listed companies had obtained duplicate shares after the originals were pledged with banks and then sold the duplicates in the secondary market to make a profit.
vi. Promoters of some companies dematerialised shares in excess of the company's issued capital.
vii. Certain investors pledged shares with banks and got the same shares reissued as duplicates.
viii. There is an undue delay in the settlement of complaints by investors against depository participants. This is because there is no single body that is in chargeof ensuring full compliance by these companies.

5. Dematerialization:

Indian investor community has undergone sea changes in the past few years. India now has a very large investor population and ever increasing volumes of trades. However, this continuous growth in activities has also increased problems associated with stock trading. Most of these problems arise due to the intrinsic nature of paper based trading and settlement, like theft or loss of share certificates. This system requires handling of huge volumes of paper leading to increased costs and inefficiencies. Risk exposure of the investor also increases due to this trading in paper.

Some of these risks are :

- Delay in transfer of shares.
- Possibility of forgery on various documents leading to bad deliveries, legal disputes etc.
- Possibility of theft of share certificates.
- Prevalence of fake certificates in the market.
- Mutilation or loss of share certificates in transit.
- The physical form of holding and trading in securities also acts as a bottleneck for broking community in capital market operations.

The introduction of NSE and BOLT has increased the reach of capital market manifolds. The increase in

number of investors participating in the capital market has increased the possibility of being hit by a bad delivery. The cost and time spent by the brokers for rectification of these bad deliveries tends to be higher with the geographical spread of the clients. The increase in trade volumes lead to exponential rise in the back office operations thus limiting the growth potential of the broking members. The inconvenience faced by investors (in areas that are far flung and away from the main metros) in settlement of trade also limits the opportunity for such investors, especially in participating in auction trading. This has made the investors as well as broker wary of Indian capital market. In this scenario dematerialized trading is certainly a welcome move.

What is Dematerialization?

Dematerialization or "Demat" is a process whereby your securities like shares, debentures etc, are converted into electronic data and stored in computers by a Depository. Securities registered in your name are surrendered to depository participant (DP) and these are sent to the respective companies who will cancel them after "Dematerialization" and credit your depository account with the DP. The securities on Dematerialization appear as balances in your depository account. These balances are transferable like physical shares. If at a later date, you wish to have these "demat" securities converted back into paper certificates, the Depository helps you to do this.

Depository

Depository functions like a securities bank, where the dematerialized physical securities are traded and held in custody. This facilitates faster, risk free and low cost settlement. Depository is much like a bank and perform many activities that are similar to a bank.

NSDL and CDS

At present there are two depositories in India, National Securities Depository Limited (NSDL) and Central Depository Services (CDS). NSDL is the first Indian depository, it was inaugurated in November 1996. NSDL was set up with an initial capital of US$28mn, promoted by Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchange of India Ltd. (NSEIL). Later, State Bank of India (SBI) also became a shareholder.

The other depository is Central Depository Services (CDS). It is still in the process of linking with the stock exchanges. It has registered around 20 DPs and has signed up with 40 companies. It had received a certificate of commencement of business from Sebi on February 8, 1999.

These depositories have appointed different Depository Participants (DP) for them. An investor can open an account with any of the depositories' DP. But transfers arising out of trades on the stock exchanges can take place only amongst account-holders with NSDL's DPs. This is because only NSDL is linked to the stock exchanges (nine of them including the main ones-National Stock Exchange and Bombay Stock Exchange).

In order to facilitate transfers between investors having accounts in the two existing depositories in the country the Securities and Exchange Board of India has asked all stock exchanges to link up with the depositories. Sebi has also directed the companies' registrar and transfer agents to effect change of registered ownership in its books within two hours of receiving a transfer request from the depositories. Once connected to both the depositories the stock exchanges have also to ensure that inter-depository transfers take place smoothly. It also involves the two depositories connecting with each other. The NSDL and CDS have signed an agreement for inter-depository connectivity.

Depository Participant

NSDL carries out its activities through various functionaries called business partners who include Depository Participants (DPs), Issuing corporates and their Registrars and Transfer Agents, Clearing corporations/ Clearing Houses etc. NSDL is electronically linked to each of these business partners via a satellite link

through Very Small Aperture Terminals (VSATs). The entire integrated system (including the VSAT linkups and the software at NSDL and each business partner's end) has been named as the "NEST" (National Electronic Settlement & Transfer) system.

The investor interacts with the depository through a depository participant of NSDL. A DP can be a bank, financial institution, a custodian or a broker. Just as one opens a bank account in order to avail of the services of a bank, an investor opens a depository account with a depository participant in order to avail of depository facilities.

Benefits of demat:
Transacting the depository way has several advantages over the traditional system of transacting using share certificates. Some of the benefits are:

- Trading in demat segment completely eliminates the risk of bad deliveries, which in turn eliminates all cost and wastage of time associated with follow up for rectification. This reduction in risk associated with bad delivery has lead to reduction in brokerage to the extent of 0.5% by quite a few brokerage firms.
- In case of transfer of electronic shares, you save 0.5% in stamp duty.
- You also avoid the cost of courier/ notarization/ the need for further follow-up with your broker for shares returned for company objection
- In case the certificates are lost in transit or when the share certificates become mutilated or misplaced, to obtain duplicate certificates, you may have to spend at least Rs500 for indemnity bond, newspaper advertisement etc, which can be completely eliminated in the demat form.
- You can also receive your bonuses and rights into your depository account as a direct credit, thus eliminating risk of loss in transit.
- You can also expect a lower interest charge for loans taken against demat shares as compared to the interest for loan against physical shares. This could result in a saving of about 0.25% to 1.5%. Some banks have already announced this.
- RBI has increased the limit of loans against dematerialized securities as collateral to Rs2mn per borrower as against Rs1mn per borrower in case of loans against physical securities.
- RBI has also reduced the minimum margin to 25% for loans against dematerialized securities as against 50% for loans against physical securities.

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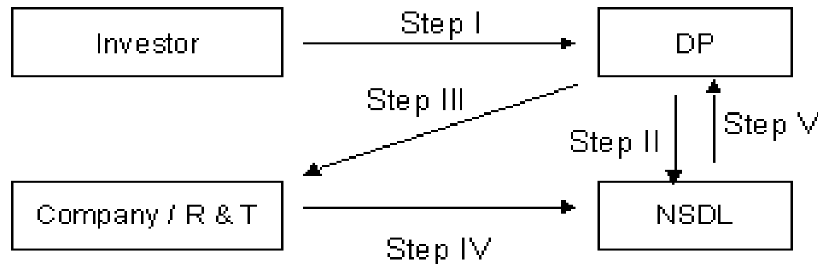
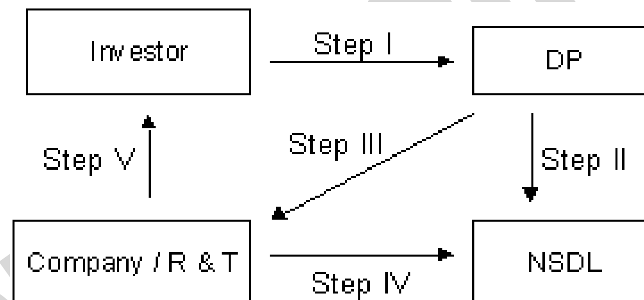
6. Process of Dematerialization:

DEMATERIALISATION PROCESS



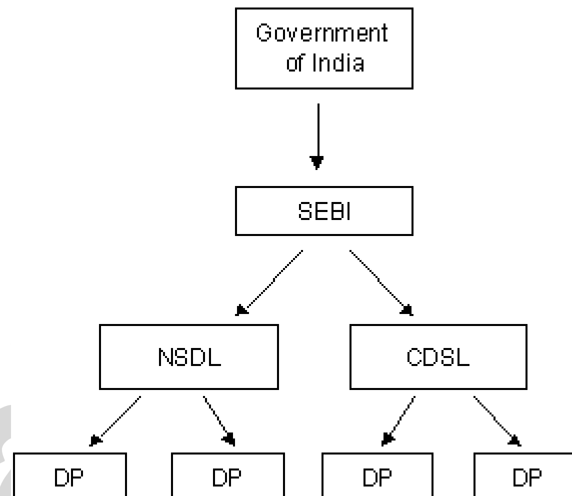
- Step I: Investor surrenders the share certificates to a DP.
- Step II: DP generates an electronic request to NSDL.
- Step III: DP forwards the physical certificate to the Company/RT.
- Step IV: Company/RT cancels the certificates and forwards the credits in demat form to NSDL.
- Step V: NSDL releases the credit to the investor's account with the DP.

Process of Rematerialization:



- Step I: Investor forwards a physical remat request to his DP.
- Step II: DP will generate an electronic request to NSDL.
- Step III: DP will forward the physical remat request to the Company/RT.
- Step IV: NSDL will confirm the company/RT about the change and nullifies the security electronically.
- Step V: On receipt of the confirmation from NSDL, company/RT will print new certificate and forward it directly to the investor.

7. NSDL



The Government of India enacted the Depositories Act, in August 1996, paving the way for setting up of depositories in India. Thus, pioneering the concept of depositories and ushering in an era of paperless settlement of securities, National Securities Depository Ltd. (NSDL) was inaugurated as the first depository in India on November 1996. Trading in dematerialized securities on the National Stock Exchange (NSE) commenced on December 26, 1996. The Stock Exchange, Mumbai (BSE) also extended the facility of trading in dematerialized securities from December 29, 1997.

NSDL is promoted by Industrial Development Bank of India (the largest development financial institution in India) Unit Trust of India (the largest Mutual Fund in India), National Stock Exchange of India (the largest Stock Exchange in India), State Bank of India (the largest Commercial Bank in India), and the major other stake holders are Canara Bank, Citibank NA Dena Bank, Deutsche Bank AG, Global Trust Bank Limited, HDFC Bank Limited, Hongkong and Shanghai Banking Corporation Limited and Standard Chartered Bank.

8. CDSL

CDSL is promoted by Bombay Stock Exchange Limited (BSE) jointly with State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank.[5]. CDSL was set up in 1999.

Central Depository Services Limited (CDSL), is the second Indian central securities depository based in Mumbai. Its main function is the holding securities either in certificated or un-certificated (dematerialized) form, to enable book entry transfer of securities.

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UNIT-6
Security Brokerage

1.Meaning
2.Types
3.Difference between broker and jobber
4.SEBI Regulation related to brokerage business in India.

1. Meaning:

A **broker-dealer** is a term used in financial services regulations. It is a natural person, a company or other organization that trades securities for its own account or on behalf of its customers.

Although many broker-dealers are "independent" firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies.

When executing trade orders on behalf of a customer, the institution is said to be acting as a **broker**. When executing trades for its own account, the institution is said to be acting as a **dealer**. Securities bought from clients or other firms in the capacity of dealer may be sold to clients or other firms acting again in the capacity of dealer, or they may become a part of the firm's holdings.

2. Types:

Brokerage firms may be classified into three basic types: full-service, discount and limited products. There is also another sub-class of brokers known as online brokers.

Full-Service brokerage firm:

A full service brokerage firm can provide you with a complete package of investment services, including recommending securities, researching a particular issue, or providing individualized service through a salesperson. The firm receives its payment in the form of a commission that is calculated according to the type of security and the amount you are investing. A full-service firm is generally best for those who are new to the market or who do not have the time or the desire to do their own investment research.

Full Service Stock Brokers

A full service stock broker is there to provide you with advice, updates and everything you need to manage your investment. In some cases, you can tell full service stock brokers your investment goals and appetite for risk, and allow them free reign to manage your money.Full service brokers and financial advisors come with associated price tags that are obviously more expensive than a no frills broker or online stock broker. However, the cost can be largely negligible of a full service broker makes you more money in the long run.If you have larger amounts of investment capital and you want to reduce risk as much as possible, it makes sense to use a full service broker. With larger amounts of capital, brokerage charges will often be miniscule compared to overall potential gains and risk management advantages.

If you have small to mid amounts of capital to invest, a full service broker will probably cut into your bottom line profit more significantly. However, if you fail to manage your investment properly yourself, the losses may be greater still. If you have no experience in the stock market, or are not committed to spending a lot of time stock trading, you should at least consider consulting a financial advisor or stock broker before taking on financial commitments and risks. Remember, a full service brokerage house will probably have teams of professionals to monitor every aspect of the stock markets, and not many individual retail investors can keep up with that type of demand. Using full service stock brokers is no guarantee of future success, though, and a diligent investor will also complete their own research and monitor investments closely.

Discount brokerage firm:

While a discount brokerage also can provide you with a wide range of services, its salespersons are not allowed to give investment advice, to make recommendations or to provide research materials. For these reasons, a discount firm can offer substantially lower commissions than full-service brokers. Experienced investors capable of doing their own investment research typically use a discount firm.

Discount stock brokers offer stock broking services for lower fees than full-service stock brokers. Discount brokers may also be called non-advisory brokers, no-frills brokers or low-fee stock brokers. Many online stock brokers would be considered discount brokers. The name is fairly self-explanatory, but don't misjudge discount brokers just because they are cheap. Many discount brokers will provide general advice, market reports and even stock tips. The only difference is they leave a lot more of the final decision making up to you.

The amount you save on a discount stock broker can be crucial for smaller investors, especially if you're planning to trade a short to mid-term strategy. Brokerage rates of $100 will soon kill gains of a $5000-$10,000 investment, but with discount broker rates falling as low as $19.95, the potential advantages of discount brokers are clear. If you're thinking of using a discount broker, you should have done the appropriate research or even have prior experience stock trading. You must have a solid trading strategy and a clear idea of your financial goals, and you should also be able to assess and weigh risk according to any investment choices you make.

Mistakes could cost you your hard-earned investment money, so you must be sure when choosing to employ discount stock brokers.

Limited products firm:
These brokerage firms specialize in a limited number of securities products, such as mutual funds, limited partnerships or specific bonds.

Online Stock Brokers
Online stock brokers are an appealing choice for many investors. Using the power of the internet, online stock brokers provide cost effective brokerage services, up-to-date information and advanced stock trading platforms to suit a variety of investment strategies. Online stock brokers may also be called internet brokers, online brokers or online discount brokers.

Stock markets and share prices thrive and fail on information, and your ability to profit or loss can also depend on the speed and accuracy of the information you receive. The advantage of online brokers is they integrate stock trading and software into easy-to-understand platforms that can deliver stock market reports, stock tips and other useful information as you trade.

You can use this share trading software to set alerts, conditional orders (allowing you to buy or sell at a pre-determined price), view charts and analysis and a variety of other trading tools that were once only available to top-dollar traders. As mentioned, you get all this at usually at a competitive price.

Many of Australia's largest banks have developed online stock broking services, and there are many individual stock brokerage houses that have an online arm with various benefits. When choosing an online stock broker, make sure there is also a phone helpline or other service in case there are internet service problems. You don't want to be stuck without access to your shares at a critical trading point.
Using online brokers can often be so easy people forget they still need to do the appropriate amount of research and approach investing in the stock market with caution. If you are thinking of using an online stock broker, make sure you are confident in your trading strategy and research, and if in doubt contact a financial professional.

3. Difference between broker and jobber:
Broker
A stock broker buys and sells shares on behalf of clients. Say you want 1,000 shares of stock in XYZ Corp. You place your order through a brokerage, which then acts as your agent in locating a seller and obtaining the shares. You then typically pay a commission for the broker's services. The commission may be a percentage of the price you paid for the stock, or, as is common with online and discount brokerages, it could be a flat fee per trade, regardless of the size of your order.

Broker is a bonafide member of the stock exchange who deals outside the house for the purpose of bringing together his clients who cannot deal directly on the stock exchange. Broker thus transacts business in securities on behalf of his clients. He generally deals in a large variety of securities. He receives commission from his clients in exchange for his services. He is an experienced agent of the public. He renders important functions in regard to deal with skilled jobbers directly. 3. Minimum subscription. It is the minimum amount of shares subscribed by public before the directors can proceed to allotment. The amount of minimum subscription fixed by the Memorandum the Articles and named in the prospectus under the heading i.e. Preliminary expenses, underwriting commission, working capital and repayment whole of the capital offered for subscription must be subscribed by the public. This is intended to ensure that the company will not commence the business without adequate capital.
Broker is a retailer of stocks and shares. His customers are investors.

Jobber
"Jobber" is a British term for what in the United States is commonly called a "market maker." This is someone who maintains an inventory of shares in order to make trades possible. When you place your order for 1,000 shares of XYZ Corp., your broker doesn't have to call around trying to find someone with 1,000 shares to sell. Instead, he can simply go to a market maker, who keeps an inventory of XYZ stock, and buy the shares there. Likewise, if you decide you want to sell those 1,000 shares, your broker can sell them to the market maker. Jobbers typically post two prices for a stock: what they'll buy it for and what they'll sell it for. The sell price will be slightly higher, which is how jobbers make their money.

Jobber is the member of the stock exchange who performs important functions. He is an independent dealer in securities which are transacted in the market. He conducts the securities in his own name but they cannot deal directly with non members. In others words jobber has to deal with a broker or another jobber. He is a professional speculator who has complete information regarding the particular shares he deals in jobber does not transact for commission but transacts for profit which he gains from speculating activities. In brief he renders the valuable services by executing the public's orders that help to make the price fluctuations smooth.
A jobber is a wholesaler of stocks and shares. His customers are brokers.

4. SEBI Regulation related to brokerage business in India:
The stock markets in India are governed by the provisions of Securities and Exchange Board of India Act, 1992. The Securities Exchange Board of India constituted under SEBI Act, 1992 exercises overall superintendence over the stock exchanges under the Securities Contracts (Regulation) Act, 1956. SEBI was constituted on 21st February, 1992, with the twin objectives of regulation and development. The present broker regulations are by and large sufficient to protect the needs of the investors.

There are stock exchanges recognized under Securities Contract (Regulation) Act, 1956 which are the exclusive centres for trading of securities. Most of the stock exchanges in India are organized as mutuals which is considered beneficial in terms of tax benefits and matters of compliance. The trading members, who provide broking services also own, control and manage the exchanges. The trading platform of an

exchange is accessible only to brokers. Demutualised exchange allows free entry and exit of brokers. The broker enters into trades in exchanges either on his own account or on behalf of his clients.

Brokers deal with secondary markets for the sale and purchase of securities such as stocks and bonds. Trading is done in various ways such as it may occur on a continuous auction basis; it may involve brokers buying from and selling to dealers in stock markets. The stock exchanges differ from country to country in eligibility requirements and in the degree to which the govt. participates in their management.

'**Broker**' as defined in the Concise Law Dictionary means a middleman or agent who, for a commission on the value of the transmission, negotiates for others the purchase or sale of stocks, bonds, commodities or property of any kind, or who attends to the doing of something for another. Thus, brokers are the people who deal in shares and whose business includes the procuring of subscribers for shares. They are basically intermediaries in the secondary market and are middlemen between the investors and stock exchanges. They reflect the deal by transferring the stock and shares. They bring funds from investors to the stock exchanges. One category of intermediaries are stock brokers and sub brokers.

Securities Exchange Act, 1934 defines the term Broker as anyone, other than a bank, engaged in the business of effecting securities transactions for the account of others. In other words, brokers form a sub-class of dealers and include anyone who is in the business of effecting securities transactions as agents for others. Broker is an intermediary who is associated with securities market and is registered under Section 12 of the SEBI Act, 1992.

Unlike other brokers, stock broker is frequently entrusted with the possession of securities and may even take and transfer them without the name of the principal appearing in the transaction. He often pays the price in advance and then receives payment from the client. Thus, stock broker acts as a bailee as well as an agent. SEBI requires that the agreement between a stock broker and an investor is to be in writing and the agreement should be executed on stamp paper of atleast Rs.20. In K. Appa Rao v. Gopal Doss it was held by the Madras HC that when an agent is authorized to negotiate and complete a sale for a specified price within a particular time, it gives him an authority to enter into a contract for sale, whether for movable or immovable property.

Further, 'Brokerage' is a commission paid to a bank, stock-broker, or other marketing intermediary for placing shares on a best effort basis or for inducing a broker's clients or customers to subscribe for the company's shares or other securities and is lawful if reasonable in amount. In other words, brokerage is a fee or commission given to or charged by a broker. When the owner of the property employs a broker to find a purchaser and he agrees to compensate him therefor, the consideration is known as Brokerage Commission. The listed companies can only pay brokerage of 5% on private placement of capital. However, the expenses incurred by the broker for getting hold of subscribers would be borne by the share broker himself. Brokerage can only be paid for the services rendered under a contract with the company.

Stock Broker

Stock Broker is one who deals in stocks of monied corporations and other securities. He for a commission attends to the purchase and sale of stocks or shares, of the Government or other securities, on behalf of and for the accounts of their clients. He is a person who has either made an application for registration or is registered as a stock broker or sub broker, in accordance with the rules and regulations made under the SEBI Act, 1992. His functions are broader than the ordinary brokers, since he is entrusted with the possession of the property for which he acts and may even take and transfer it without the name of his principal appearing in the transactions. In India, there is no regulatory body for brokers.

In secondary market, brokers and sub brokers play a vital role. SEBI, as a regulator of the capital market has recognized their role and has thus permitted them to act as underwriters, without getting registered with SEBI pursuant to SEBI (Underwriters) Rules & Regulations, 1993. But this is subject to the condition that they hold a valid registration certificate from SEBI under SEBI (Stock Brokers and Sub Brokers) Rules & Regulations, 1992. However, he has to comply with all the obligations stipulated thereunder. He is also required to obtain the permission of the concerned Stock Exchange of which he is a member, so as to act as an underwriter for each and every issue.

Brokers send out regulatory newsletters to their clients giving them details of primary and secondary markets, particularly of new issues with their recommendation. Some of them undertake Portfolio Management for their valued clients. The brokers and sub brokers are even registered with leading merchant bankers, who handle large number of public issues.

A stock broker invests in the stock market for individuals or corporations. Only members of the stock exchange can conduct transactions, so whenever individuals or corporations want to buy or sell stocks they must go through a brokerage house. Stock brokers often advise and counsel their clients on appropriate investments. Brokers explain the workings of the stock exchange to their clients and gather information from them about their needs and financial ability, and then determine the best investments for them. The broker then sends the order out to the floor of the securities exchange by computer or by phone. When the transaction has been made, the broker supplies the client with the price. The buyer pays for the stock and the broker transfers the title of the stock to the client and performs clearing and settlement procedures.

The Central Government in India has enacted the law relating to Stock brokers under the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Rules, 1992 and the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992. The SEBI Rules define 'Stock Broker' as a member of the stock exchange. A stock broker acts as an agent of his client and deals with securities on behalf of his client. Though strictly, a stock broker is an agent, yet for the performance of the contract on his part both in the market and with the client, he is deemed as a principal. He holds a peculiar position of dual responsibility. He can charge commission from his client. He not only executes transactions on behalf of investors but also offers value management or services such as initial public offerings on line, asset allocation, portfolio management, financial planning, tax planning, insurance services. In the case of **Rajendra Prasad Bagaria v. Bhubaneshwar Stock Exchange Association Ltd.** Orissa High Court held that stock broker is governed by SEBI in matters relating to their registration, functioning and have to abide by the SEBI Regulations as well as bye-laws of the respective stock exchanges.

A person who is willing to operate as a stock broker can make an application for it under the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992. The stock broker has to get himself registered under the SEBI Act, 1992. He has to act as per the conditions of the certificate of registration obtained from the SEBI in accordance with regulations framed under the SEBI Act, 1992, otherwise he cannot deal with securities market and cannot even buy, sell or deal in securities. But he should be eligible as a member of the stock exchange, i.e., he should be a fit and proper person. This is based on an objective test, i.e., whether or not the person has been involved or has a pending enquiry against him for some malpractice in the stock exchange in any segment of the market. Persons who operate in the securities market are required to maintain high standards of integrity, promptitude and fairness in the conduct of the business dealings. People who indulge in manipulative, fraudulent and deceptive transactions or abet the carrying out of such transactions, which are fraudulent and unreliable, are not considered fit or proper persons to operate in the market.

There are certain conditions provided under Rule 4 of SEBI (Stock Brokers and Sub-Brokers) Rules, 1992, which are to be fulfilled before the grant of a certificate to a stock broker. The SEBI Act, 1992 prohibits stock broker from buying, selling and dealing in securities unless he holds a certificate granted by the Board under

the SEBI (Stock Brokers and Sub-Brokers) Rules and Regulations, 1992. Existing brokers of the concerned stock exchanges were allowed to continue their business, if they made an application for such registration within a period of 3 months from the establishment of the Board, till the disposal of the application. An interesting aspect of the relationship between a brokers and stock exchange is that the stock brokers are required to pay registration fees for the grant of certificate as prescribed by Schedule III. But if they fail to pay, then the Board may suspend the registration certificate, which implies that the stock broker shall cease to buy, sell or deal in securities as a stock broker.
In National Stock Exchange Members' Association v. UOI, the petitioner, which was an association of the trading members of the National Stock Exchange, dealt with the sale and purchase of the shares and securities in India. Upon payment of fee, the members were registered under SEBI (Stock Brokers and Sub Brokers) Regulations, 1992. A circular was issued by SEBI by way of clarification requiring separate registration fee to be paid for multiple registration with the SEBI.

Then a writ petition was filed by the petitioners where they contended that the methodology adopted by SEBI for charging multiple registration fees was contrary to Schedule III to the SEBI (Stock Brokers and Sub Brokers) Regulations, 1992. The Delhi High Court held that there was no concept of quid pro quo in view of the nature of regulatory functions performed and the mode and manner of levy of fee to be adopted by the SEBI. Once the power of SEBI was accepted, there could not be a challenge to the methodology adopted for quantification of the fee. The circular was intra vires the regulation and clarified the mode and manner of the calculation of the fee.

In **BSE Brokers Forum v. SEBI**, the validity of Regulation 10 read with Schedule III of the SEBI (Stock Brokers and Sub-Brokers) Regulation, 1992 was held intra vires the SEBI Act, 1992. But the imposition was held to be a fee and not a tax and was held not to be a condition precedent for the levy to constitute fee.

In due course, a number of brokers, proprietor firms and partnership firms have converted themselves into corporate. Out of 9,519 brokers registered with SEBI at the end of March, 2003, 3, 835 brokers accounting for nearly 40% of the total were corporate entities. At the end of March, 2003, there were 13,291 sub brokers registered with SEBI.

A stock broker is required to pay to SEBI a registration fee of Rs.5,000 for every financial year, if his annual turnover exceeds Rs.1 crore. If this is so, he has to pay Rs.5,000 plus one-hundredth of 1% of the turnover in excess of Rs.1 crore. after the expiry of 5 years from the date of initial registration as a broker, he has to pay Rs.5,000 for a block of 5 financial years. The a trading member can levy a maximum brokerage in respect of securities transactions is 2.5% of the contract price, exclusive of statutory levies like SEBI fee, service tax and stamp duty. Brokerage charges can be as low as 0.15% and maximum brokerage is inclusive of brokerage charged by the sub broker which shall not exceed 1.5% of the contract price.

The brokers of the various stock exchanges filed writ petitions in various High Courts challenging the imposition of fees on turnover to be paid by the brokers under the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1990, which were subsequently transferred to the Supreme Court. The petitions were filed on the ground that it is a tax on the guise of the fee and is excessive or arbitrary. One of the case filed was of SEBI v. BSE Brokers Forum in which the validity of the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulation, 1992 was challenged. Supreme Court directed SEBI to amend the regulations following the recommendations of R. S. Bhatt Committee, which had given recommendations in respect of the computation of turnover of brokers under the regulations.

There are certain duties and responsibilities casted upon the stock broker who should maintain the books of accounts, records and documents. Every stock broker has a duty to intimate to SEBI, the place where the books of accounts, records and documents are maintained. Stock broker after the close of each accounting

period, shall furnish to SEBI a copy of the audited balance sheet and profit and loss account as soon as possible but not later than 6 months from the close of said period.[28] If it is not possible for the stock broker to furnish the documents required under Regulation 17 (1) of SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 within the required time, than he shall inform SEBI of the same along with reasons for delay and the time period by which such documents would be furnished. Stock broker has the responsibility of maintaining the books of accounts and other records for a minimum period of 5 years. There is an obligation casted upon the stock broker to allow the inspecting authority to have reasonable access to the premises occupied by the stock broker or any other person on his behalf. He shall extend reasonable facility for examining any books, records, documents and computer data which are in his possession. He shall provide copies of documents or other materials relevant to the inspecting authority.

A stock broker should follow code of conduct prescribed under SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992. As per code of conduct, he should maintain high standard of integrity. He should exercise due skill and care and should not indulge in manipulation or malpractices. He should execute the orders from his clients' at best possible price. The member brokers of the stock exchange should issue contract notes to their clients for the securities sold and purchased by them on behalf of the clients. The contract note should state that the rate of brokerage charged is not exceeding the official scale of the brokerage fixed by the stock exchange. He should maintain confidentially in respect of information about his client's transactions. He should not give advice to his clients unless he reasonably believes that the recommendation is suitable to his client.

A stock broker should not deal with any outside party which has failed to honour its business obligations with any other stock broker of any other stock exchange. So, the names of the defaulting clients should be reported by the member of the stock exchange authorities.

When the stock broker deals with his clients, he should observe certain precautions to avoid problems for the market as well as investors. This would protect the interests of the stock brokers, instill transparency and discipline in the dealings between the brokers and the clients and would contribute in the healthy working of the secondary capital market. These precautions are listed into two categories: (a) mandatory and (b) precautions by way of a guideline. SEBI is of the view that member brokers should strictly follow the mandatory precautions and the precautions by way of guidelines should be followed when circumstances demand. Complaints can also be reported against the stock brokers by the stock exchanges. The concerned stock exchange shall send a Monthly Status Report of Complaints against brokers, instead of sending replies on a case to case basis. Stock brokers sometimes trade on their own behalf as a principal. In such cases, the term broker makes little sense and the individuals or firms trading in a principal capacity sometimes call themselves dealers, stock traders or simply traders.

Sub-Broker

Sub Broker is any person, not being a member of a stock exchange. He acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers. He is further an agent of the broker and carries out actual transactions for the broker. He is one who has either made an application for registration or is registered as a sub broker under SEBI Act, 1992.

The members of the stock exchange who execute transactions of their clients through the members of other stock exchanges are treated as Sub Brokers. Any person who not being a member of a stock exchange, acts on behalf of a stock broker as an agent for assisting the investors in buying, selling or dealing in securities through such stock brokers is called as a sub broker. He is associated with securities market and should not buy, sell or deal in securities unless he has complied with the conditions of the certificate of registration obtained from SEBI issued in accordance with Rules and Regulations.[36] If he is associated with securities market before the establishment of the SEBI, then he may continue to do business but upon an application

made for registration within a period of 3 months from the establishment of SEBI, till the disposal of such application.

There are certain conditions provided in Rule 5 of SEBI (Stock Brokers and Sub-Brokers) Rules, 1992, which are to be fulfilled before the grant of a certificate to a sub-broker. If the stock broker/sub broker fails to comply with the conditions subject to which he is been granted registration, then he would be penalized and his registration would be suspended or cancelled.

A sub broker should co-operate with his broker in the transactions. He should not knowingly and willfully deliver documents which constitute bad delivery. He should also co-operate with other contracting party for prompt replacement of the documents which are declared as bad delivery. Further, he should extend his full co-operation to his stock broker in protecting the interests of his clients regarding their rights to dividends, bonus rights, rights shares and any other right relatable to such securities.

Further, sub brokers, who act on behalf of their principal broker, are required to issue to their clients purchase or sale notes for all the transactions entered into by them on behalf of their clients. While performing this function, the sub brokers act as an agent of the principal broker.

He is also required to be registered with the concerned stock exchange. The business of the stock brokers and sub brokers is too much interlinked, so, for properly monitoring their activities separate registration procedure is provided. The sub broker owes obligations not only to the client but also to the stock broker. The sub broker enters into a tripartite agreement with the main broker and his client. He assists his clients in obtaining the contract note from the main broker. But he cannot issue the note or make payments through cheques directly, as that has to be done by the main broker.

Relation between Stock Broker And The Client

The relationship between a stock broker and a client is that of a principal and agent. SEBI requires that the agreement between the stock broker and an investor is to be in writing. It has to be executed on a stamp paper of Rs. 20. Due to the nature of trading activity at NSE and BSE, every stock broker can be considered as a del credere agent. There also exists a bailor-bailee relationship between the two. There relation is also held to be of fiduciary nature. Still the broker is bound to exercise his functions with due diligence as stated in SEBI Code of Conduct for Brokers. In Sharedeal Financial Consultants (P) Ltd. v. SEBI it was held that 'due diligence' required is not that of an ordinary or prudent person but that of a stock broker who would be required to perform his duties towards his client using his skill and reasonable care.

The investor has to deliver the shares to the stock broker so that he can sell them in the stock exchange. In case stock broker cannot sell them, then those shares have to be delivered back to the investor. Thus, a stock broker becomes a bailee and operates on certain responsibilities in that capacity. The relation between the stock broker and the investor is that of fiduciary nature, which is founded on trust, reliance, dependence or confidence rested by the investor in the reliability and faithfulness of the stock broker who is in a position of relative dominance and influence. In Kennedy v. Budd it was held by the court that when we consider the broker's duties as to the performance of the contract after the purchase has been made, he was bound to act solely for the benefit of his customer and bound to give his best judgment and to take no advantage of his customer, it was quite clear that to that extent he acts in a fiduciary capacity. Even in State ex rel. Paine Webber, Inc. v. Voorhees the Judge observed that the broker had an implicit obligation which arose in connection with his fiduciary duty to the customer, which was to disclose to the customer the material facts. This duty does not, however, include the obligation to discuss prominent written provisions with the competent party. When broker is disloyal and betrays the trust and confidence of his client/investor, than he could be held liable for damages. If a broker misrepresents or fails to provide information regarding an

investment or transaction, the client/investor may have a potential claim against that broker to recover losses.

When a client operates through a stock exchange, he has the right to receive the best price prevailing at that time for the trade, the money or shares on time, contract note from broker confirming the trade and indicating the necessary details of the trade, good delivery and right to insist on rectification of bad delivery.

The broker has a number of rights that he can claim over his clients. A broker who has carried out his instructions is entitled to full indemnity from his client against any losses or liability incurred by him for having entered into the transaction. He shall be at full liberty to close out the contract when the client fails to make payment to him within 2 days of issuance of contract note and sell or purchase the securities.

SEBI has issued mandatory guidelines to be followed by the stock brokers before they agree to act on behalf of their clients. An important duty of the stock broker towards his client is that of confidentiality. Under SEBI guidelines, the broker is not supposed to disclose either personal or financial details of his clients to anyone. The broker has a corresponding duty to ensure that he maintains separate accounts for his clients and pays them regularly the required amounts. The clients are also issued ID's in case they need to be traced if they fail to make payments.

Conclusion

To conclude, it is submitted that SEBI has modernized the stock exchanges. An active effort made by stock exchanges is that of making the clients aware of their rights and liabilities. Even today, the stock broker continues to command an immense power in the stock exchanges. A vast majority of securities transactions are handled by stock brokers or dealers who act as agents for principal willing to buy or sell securities. But technological developments in 21st century have greatly influenced the nature of trading. The increased access to internet and the proliferation of electronic communications networks altered the investment world. Through e-trading, the customer enters an order directly on-line and software automatically matches orders to achieve the best price available without the intervention of specialists or market makers or stock brokers. This has gradually reduced the need of intermediaries like stock brokers to deal between the client and the stock exchange.