Block 1

FINANCIAL SERVICES – AN OVERVIEW

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COURSE INTRODUCTION

Financial Services are a very important component of a financial system. Financial services encompass a wide range of services such as banking, NBFCs, mutual funds, insurance, leasing, hire purchase, plastic cards, virtual money etc. The financial services industry also includes a number of innovative services such as credit rating, venture capital, factoring and forfaiting, securitization, etc. As these innovative services are expanding the scope of activities of this sector, there is also a similar need with regard to regulatory norms for effective functioning.

The coverage of financial services course has been designed to provide the learner an insight into the various types of financial services. The curriculum is segregated into 4 blocks comprising of 23 units.

Block-1**: **Financial Services- an Overview – The block introduces the scope of financial services, financial engineering, new products and services, sources of finance and regulatory environment of financial services and Credit rating. This block has four units.

Block- 2**: **Leasing and Hire Purchase – Leasing is a simple method of acquiring assets such as office premises, machineries, industrial and commercial equipment, and transport vehicles without buying it. This industry started in the western countries in the middle of the 20^{th} century. The block starts with an introduction to equipment leasing, leasing in Indian context, legal and tax aspects of leasing, lease evaluation from lessee and lessor angle, lease accounting and hire purchase. This block covers seven units from unit no. 5 till unit no 12.

***Block-3: Fund Based Services* -** This is the third block deals with fund based financial services. Fund based services is a financing method that is based on the assets of companies/organizations which can be debtors, inventories, receivables, fixed assets such as plant and machinery, etc. The block covers various concepts of consumer credit, bills discounting, housing finance, mortgages, real asset finance and securitization. This block contains seven units from unit 13 to unit 19.

Block- 4**: **Other Financial Services – The block covers those services which have not been covered in earlier three blocks such as insurance, plastic money, virtual money and venture capital. This block covers four units from unit nos. 20 to 23. Insurance provides protection over the economic value of assets and is a fast growing industry in our country. Plastic money is another important dimension in financial markets and is growing rapidly in India especially after the demonetization step taken by the Government in November 2016. One important development due to technology is the creation of virtual currencies, some financial transactions are taking place in some of the countries and across borders, though it is not legal tender in India. Venture capital provides seed capital for start-up and first stage financing especially in innovative form of ventures. The block extensively covers these four types of financial services for the benefit of the students.

This edition has added a large number of contemporary examples and deleted old examples and exhibits.

BLOCK 1: FINANCIAL SERVICES - AN OVERVIEW

The economy comprises many sectors and financial services is the most influential. This sector is made up of a various financial firms which comprises of banks, investment companies, finance companies, venture capital and insurance companies. This industry the most important sector of the economy, leading the world in terms of earnings and market capitalization and the greatest employer in terms of numbers and the most important sector that one should learn.

Block 1: Financial Services - An Overview – The block covers introduction to financial services, financial engineering, new products and services, sources of finance and regulatory environment of financial services and credit rating.

This is the first block on financial services that introduces the concept of financial services and its classification.

The block covers various concepts of leasing and hire purchase, consumer finance, other financial services, innovative financial instruments, financial engineering to provide insight into the latest products in the financial service sector. This block contains four units.

Unit 1: This unit provides an *Introduction to financial services* and its classification, structure of financial system it's concepts, discusses the role of financial services in economic development. An introduction to fund /Asset-based services and fee-based services is introduced. This unit is the basis for further study on financial services and hence a good understanding of the contents of this unit will enable the learner to grasp the intricacies of the individual topics in the course which follows in the next four blocks. The unit also covers the financial reforms and emerging challenges for financial services. It is also devoted for preventive vigilance and fraud management in financial services and importance of professional ethics in financial services. The unit also covers briefly on the insolvency and bankruptcy code, 2016.

Unit 2: This unit deals with *Financial Engineering: New Products and Services*. The financial services sector has to meet the business requirements of the client base. This is a dynamic situation where the client requires financial instruments and strategies to meet his business requirements. Knowledge of Financial engineering facilitates the financial services industry to innovate new products and services. Financial engineering is a process which uses analytical tools of knowledge from the fields of mathematics, computer science, statistics and economics to provide creative financial products. Innovative financial instruments are divided into fixed income securities, debt market instruments and equity instruments. The nature and scope of financial engineering and analyzing the risks in financial engineering with current developments in financial engineering have been discussed in this unit. The unit also covers concerns and issues and current developments and trends in financial engineering.

Unit 3: This unit is titled *Sources of Finance and Regulatory Environment of Financial Services*. Financial regulators form an important component of the financial sector and play an important role to ensure the proper functioning of the financial system. There are many financial institutions in India and hence the need for a regulators for each type of financial institutions. One should have a good knowledge and understanding of the regulators and their role in effective functioning of financial institutions. This unit discusses with various aspects of Indian regulatory environment. Indian financial system is regulated by various institutions such as RBI for banking and NBFC's, SEBI for capital markets, IRDA for insurance and PDRA for pensions in India. These regulators enforce safety standards, and protect consumers in markets. This unit discusses the regulatory framework within which the financial services sector has to operate. A detailed coverage on the various rules regulating NBFC's covers the major part of the unit. The various regulatory norms such as income recognition, provisions and capital adequacy for NBFC's is covered in detail.

Unit 4: Risk is an inherent part of business and more so in financial services. Hence is essential for the financial institutions to analyze the risk involved in lending to a client. The lending institution must be aware of the standing of the prospective client on various parameters like his creditworthiness, repayment capacity, integrity and other parameters related to risk. Here comes the role of credit rating agencies. Credit rating is the analysis of the possible credit risks associated to an individual or a company and the Credit rating agency (CRA) evaluates and assesses an individual's or a company's creditworthiness. This unit covers various concepts of *credit rating*. The unit covers credit rating agencies and its regulatory frame work as well.

Unit 1

Introduction to Financial Services

Structure

"When money realizes that it is in good hands, it wants to stay and multiply in those hands."

- Idowu Koyenikan, African Author

1.1 Introduction

Firms operating in financial services sector need to mobilize and allocate savings in order to transform savings into investment so as to multiply the wealth of the organization.

Financial services mean all those kinds of services provided in financial terms, where money is the essential commodity. These services include leasing, hire purchase, consumer credit, investment banking, commercial banking, venture capital, insurance, credit rating, bill discounting, mutual funds, stock broking, housing finance, vehicle finance, mortgages, loans, factoring, etc. Non-banking finance companies, commercial banks and merchant banks provide these services. Any discussion on financial services in India cannot be done at one go. Financial services in India are too vast and varied to have evolved at one place and at one time. To trace the origin of all these services and to dwell comprehensively on the evolution of each of these services is too voluminous to be covered in this unit. Hence, a brief description on each of the activities is covered in this unit.

One of the main entities that offer financial services in India is non-banking finance companies or NBFCs in short.

[1]In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial company can commence or carry on business of a non-banking financial institution without a) obtaining a certificate of registration from the Bank and without having a Net Owned Funds of ₹ 25 lakhs (₹ Two crore since April 1999).

[2]NBFCs are companies registered under the companies Act, 2013 (or earstwhile Companies Act 1956). They are engaged in the business of loans and advances, acquisition of shares/stocks/ bonds/debentures/ securities issued by government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business. They also receive deposits in one lump sum or in installments. These NBFCs, registered with the Reserve Bank of India, mainly provide fund-based services to customers and are regulated by RBI.

Some of the NBFCs are regulated by other regulators and are exempted from the requirement of registration with RBI.

Venture capital fund/merchant banking companies/stock broking companies are registered with SEBI, insurance company by IRDA, chit companies under chit funds Act. 1982, Housing Finance Companies (HFC) by national housing bank. (As per the guidelines of government, with effect from August 2019, HFC’s will be regulated by RBI).

In addition to fund-based services, NBFCs also provide some fee-based services. The fund-based services of NBFCs include: leasing, hire-purchase and other asset-based services, whereas fee-based services of NBFCs include bill discounting, portfolio management and other advisory services. NBFCs used to provide merchant banking services also. For better regulation, the RBI has ordered for division of merchant banking outfits of NBFCs into separate units. Henceforth, NBFCs cannot be said to be performing the role of a merchant banker and vice-versa.

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[1] https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92#:~:text=In%20terms%20of%20Section%2045, Two%20crore%20since%20April%201999).FAQ updated Jan10th 2017

[2] https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92

As the world is fast turning into a global village with the advent of satellite communications, the new developments taking place every day are making life more and more simple and easy. If the Internet has drastically changed, the definition of knowledge and communications, its byproduct e-commerce is virtually threatening the existence of every conventional business. Unless these businesses fast mend themselves into the changing scenario, their very survival will be jeopardized. And banks could be one of the first casualties if they do not go with the trend. If the growing number of web-users and online traders is anything to go by, it is certain that e-commerce will be the buzzword of the new millennium. Although some parts of the world, including Europe, are relatively slow in catching up with this phenomenon, it is a mistake to assume that it is a US-related issue. Consumer loans and mortgage loans via Internet, web-enabled kiosks for instant home loan and car loan applications, Modex-enabled screen telephones that enable customers to immediately download electronic cash onto a smartcard, etc., are only a few e-commerce related financial applications to name. Thus, adapting to the internet has become a matter of survival for banks.[3]

India's financial sector is well diversified, expanding, and the asset management industry is among the fastest growing markets in the world. In addition to the commercial banks, insurance companies, non-banking financial companies, pension funds, and mutual funds, payments banks have contributed to the growth of the financial sector. Further, the digital revolution and demonetization effect has increased this sector's utility tremendously thereby reducing the cash transactions.[4]

Example: Empowering Small Businesses with Affordable and Fast Credit

In 2021, FlexiLoans.com, an Indian MSME focused on digital lending platform collaborated with Google Pay to offer fast and flexible loans to their customers. This partnership filled up the credit gap by way of giving instant loans to small traders and entrepreneurs across India who were not able to get formal credit.

Source: https://bfsi.economictimes.indiatimes.com/news/fintech/flexiloans-and-google-pay-partner-to-offer-loans-to-merchants-via-gpay/84167482, July 06, 2021, accessed on June 1, 2022.

1.2 Objectives

After going through this unit, you will be able to:

- Discuss various concepts of leasing and hire purchase
- Describe the importance of consumer finance and other financial services such as insurance, mutual funds, venture capital, etc.

[3] Source: *Financial Services*, ICFAI-Vision Series, Finance.

[4] https://www.ibef.org/industry/financial-services-india.aspx

- Analyze portfolio management schemes
- Discuss the importance of credit rating for investors
- Explain the steps adopted by corporates for raising funds

1.3 Financial Services – Concepts and Meaning

[5]In general, all types of activities, which are of financial in nature, could be brought under the term "financial services". The term "financial services" in a broader frame encompasses "mobilizing and allocating savings". Thus, it includes all activities that are involved in the transformation of savings into investment.

Example: HDB Financial Services

HDB Finance Services, a leading Non-Banking Financial Company (NBFC) addressed the increasing needs of both Individual & Traders. HDB offered a lifestyle product loan to upgrade the lifestyle of an individual to a luxurious one. This loan helped customers to buy lifestyle products like high end furniture, cooking ranges, gadgets or even a designer watch. These loans were offered with attractive interest rates and no collateral to pledge against it.

Source: https://www.theceo.in/finance/top-10-financial-services-companies-in-india, 26th July, 21, accessed on June 1, 2022.

Financial services are offered by "financial intermediaries". Financial intermediation is a process by which funds are mobilized from savers and made available to those who are in need; mainly from trade, industry and retail consumers of the economy. The players include households, corporate, government and foreign sectors.

1.4 Structure of Financial System

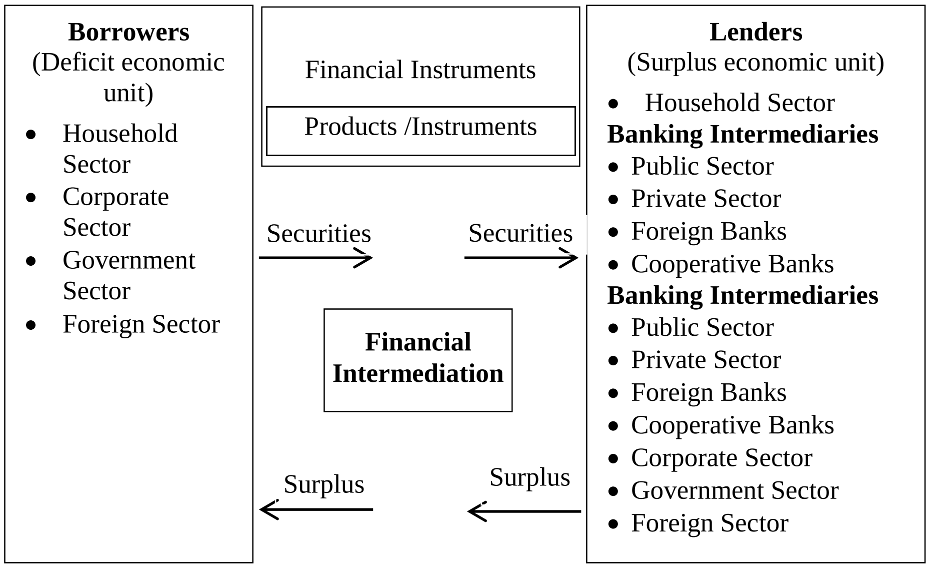
A financial system operates through financial institutions in the financial markets. The system uses various types of financial instruments. It is facilitated by financial services. A sound financial system allows smooth flow of the financial transactions and promotes healthy growth of the market.

The financial institutions, financial instruments, financial markets and financial services are all elements of the financial system. The main objective of the system is to channelize the surplus financial resources in the economy to deficit sectors of the economy. The products and services of the system create wealth in the economy through investment portfolios of savers/investors.

[5] https://www.imf.org/external/pubs/ft/fandd/2011/03/basics.htm

Figure 1.1 illustrates the process of financial intermediation.

Figure 1.1: Financial Intermediation Process

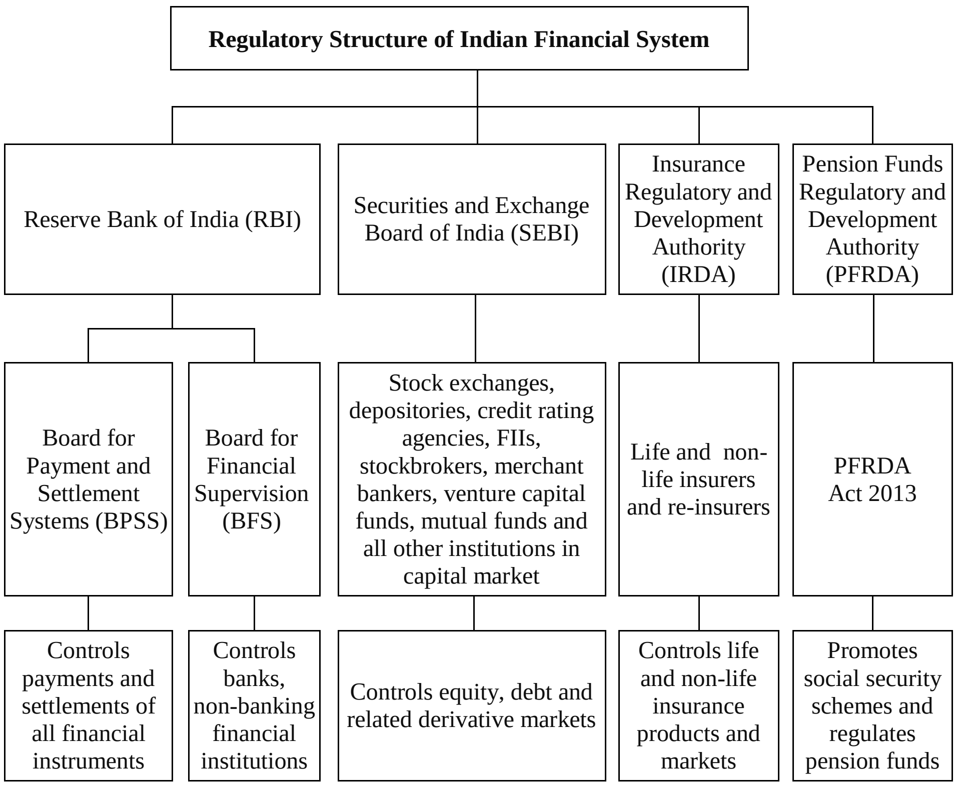


Source: ICFAI Research Center

The financial sector is regulated by various regulatory bodies.

The following Figure 1.2 will depict the regulatory system in India.

Figure 1.2: Regulatory Structure of Indian Financial System



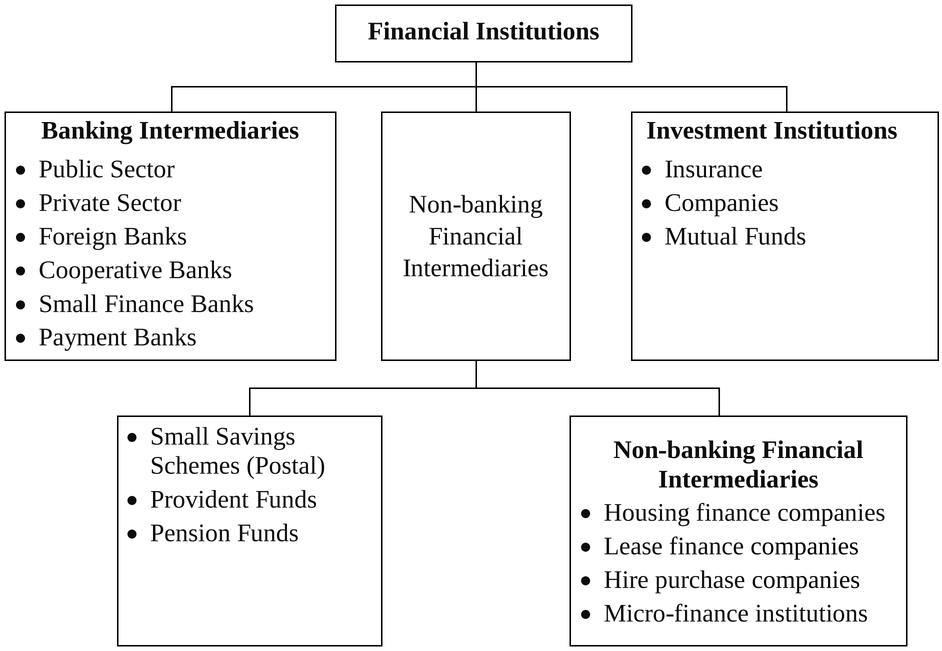
Source: ICFAI Research Center

1.4.1 Financial Institutions

Financial institutions are commercial organizations that act as mobilizers and depositories of savings, and purveyors of credit or finance. Financial institutions can be classified into two components: (a) banking & non-banking and (b) investment institutions. This classification is done on the basis of their primary activity or the degree of their specialization with relation to savers and investors. Banking institutions which have banking as primary activity, also offer other financial services.

Figure 1.3 illustrates the financial institutions in intermediation.

Figure 1.3: Financial Institutions in Intermediation



Source: ICFAI Research Center

1.4.2 Financial Instruments

Financial instruments are the means of exchange of financial claims that arise out of contractual relationships between two parties. Financial claims are also identified as financial assets and financial securities based on their nature of obligation. Financial assets include all claims which provide certainty of payment of principal and return, besides popular asset of cash. Financial securities are again divided into ownership securities (e.g. equity) and debt securities (e.g. debentures).

1.4.3 Financial Markets

Financial market is a place where dealing of financial claims takes place and prices are set depending upon supply and demand for the funds. Financial markets are classified further as (a) capital market (b) money market (c) forex market and (d) credit market.

Securities transactions are operated through subsets of capital market viz., primary (direct) and secondary (indirect) markets. The primary markets deal with new financial claims or new security issues whereas secondary markets deal in securities already issued or existing. Stock exchanges play an important role in capital market.

Money market is for short-term securities which have a life of less than one year.

1.4.4 Payment Banks & Small Finance Banks

Payment Banks: Payments banks are those which are set up with an objective to provide small savings accounts and payments or remittance services to low income households, small businesses, other unorganized sector entities and users. These banks can operate current accounts and saving accounts and can issue ATM or debit cards, Net Banking and Mobile Banking facilities, but they do not have the rights to provide lending services such as credit cards and issue loans facilities.

Small Finance Banks: The objective of these small banks is to increase financial inclusion by provision of savings vehicles to under-served and unserved sections of the population, supply of credit to small farmers, micro and small industries, and other unorganized sector entities through high technology-low cost operations. These banks are to provide a whole suite of basic banking products such as deposits and supply of credit, but in a limited area of operation. The small bank shall be registered, under the Companies Act, 2013, as a public limited company. These banks offer both deposits and loan products. They cannot set up subsidiaries to undertake non-banking financial services activities.

1.4.5 Financial Services

Financial services basically mean all those kinds of trading and advisory services which facilitate the exchange of financial claims and promotion of savings and investment through a wide range of financial instruments. The major services include: leasing, hire purchase, consumer credit, investment banking, mortgage financing, venture capital, insurance, credit rating, bill discounting, mutual funds, stock broking, factoring etc.

As banking and insurance are major sectors, the acronym popularly used is BFSI denoting Banking, Financial Services and Insurance.

Example: COVID-19 Benefit Insurance Policy to Reduce Financial Burden During the Pandemic

Financial services include all those kinds of trading and advisory services that facilitate the exchange of financial claims and promotion of savings and investment through financial instruments - mortgage financing, venture capital, insurance, credit rating etc.

Contd….

In 2020 April, Fintech unicorn Paytm collaborated with Reliance General Insurance and launched its COVID-19 Benefit Insurance Policy. The policy which had a validity period of one year was announced to reduce financial implications that people might experience due to the pandemic. The policy was specially designed to offer coverage against diagnosis for COVID, 14-day quarantine, loss of pay or jobs. In addition to this, the policy also covered a waiver up to 45 days travel exclusion as add-on.

Source: https://yourstory.com/socialstory/2020/07/fintech-unicorn-paytm-initiatives-covid-19/amp, August 7, 2020, accessed on June 1, 2022.

1.5 Role of Financial Services in Economic Development

Financial services are considered as drivers of economic growth as they enable businesses to start, expand, increase efficiency, and compete in local and international markets. Financial services can accelerate economic development through three routes: (i) funding technological needs (ii) funding capital requirements by promoting higher saving and investments and (iii) encouraging markets over space and time. Financial services also enhance the efficiency of the function of medium of exchange.

Example: Mobile Banking as a Component of Financial Services

In Kenya, Safaricom and Vodafone started mobile banking M-Pesa system. Utilizing the network of telecom subscribers, it permitted mobile payments, and gave banking access to the rural population where opening bank branches were expensive to operate. M-Pesa system resulted in well-established Mobile money transactions showing a surprised 44% of GDP till 2019. Mobile and agency banking model helped in spreading banking services very fast and efficiently. The socioeconomic impact of mobile banking was substantial in Kenya believing that M-Pesa alone has lifted 2% of the Kenyan household out of poverty.

Source: https://www.lazardassetmanagement.com/uk/en_uk/references/fundamental-focus/financial-inclusion, June 2021, accessed on June 1, 2022.

1.5.1 Economic Functions of Financial Services

Let us discuss on the economic functions of financial services:

- **Facilitate flow of funds:** Facilitates the flow of funds from surplus economic units to deficit economic units. The surplus economic units have an outlet for their funds. Thus, it would be able to store their wealth in financial instruments.
- **Efficient allocation of funds:** The financial intermediary, in this case bank, ensures that the available funds are allocated to the borrowers, who are expected to utilize the fund prudently, which in turn leads to an increase in economic activities.

Financial Intermediaries and Asymmetric Information

The financial intermediaries and asymmetric information is discussed as:

- Individuals may not access all the information on the company and the financial instrument (debt or equity) under reference for buying or selling. This may lead to adverse selection. Hence, they are dependent on financial intermediaries.
- There will be information asymmetry between the seller of the instrument and buyer of the instrument.
- When there is information asymmetry, there will be two types of risks that are present.
- Adverse selection, which is a risk exposure that exists before money is lent or invested, and
- Moral hazard, which is a risk after the financial transaction.

Example of Adverse Selection

A has a 2004 make car, which travelled 50,000 kilometers. It has been maintained properly in good condition.

B also has a 2004 make car of the same brand, which travelled more than 150000 kilometers. It has also been maintained properly in good condition. Both are kept for sale in second-hand car sales emporium in October 2022. The salesman knows about the usage of both the cars. He has to decide which price is to be quoted – average price or better price for the car owned by A, and lower price for the car owned by B. The intermediary has to make the transaction transparent, else will lead to adverse selection by buyer (investor).

Example of Moral Hazard

Moral hazard is the risk that the receiver of funds will not use the money as was intended or he may take unnecessary risks or not be vigilant in reducing risk.

One classic example is the scam of Wall Street in 2008. Investors invested their funds with Bernard Madoff, and lost most of their $65 billion because Madoff ran a Ponzi scheme without investing the money as the investors intended. The existing investors were paid from new investors and intended investment was not made. The fund ran for years. During the 2008 credit crisis, more money was withdrawn than was coming in. Hence, the money cycling hit a roadblock. The Ponzi scheme finally collapsed. The intermediary was not transparent in disseminating information.

- **Assistance in price discovery:** Price discovery is closely allied with efficient allocation of funds. Financial services dealing with primary market as well as secondary market influence pricing of securities as per the supply and demand of funds in the market.

- **Money creation and employment growth:** Money creation is allied with the efficient allocation of funds. Credit function of financial intermediaries creates money in the form of new deposits. Financial intermediaries ease the constraint of income on expenditure by enabling the consumer to spend in anticipation of income and the entrepreneur to acquire physical capital to pursue business opportunity. These activities are crucial in creating the supply and demand for goods and accelerating the employment growth.
- **Enhancing liquidity for investors:** Enhanced liquidity is created for the investor by the financial intermediary by providing online and offline trading.
- **Decreasing the price risk:** Financial service providers take on price risk and offer products that have little or zero price risk.
- **Taking over default risk:** Banks take over the default risk from depositors by assuring repayment of deposits, notwithstanding the default by borrowers.
- **Diversification of investments:** Small investors usually have a smaller wealth size. They can, therefore, only achieve limited diversification, compared to a financial intermediary that aggregates the small investments into pools. Thus, an individual has limited diversification possibilities. Therefore, he carries higher risk levels than financial intermediaries, who are able to hold a variety of investments.
- **Economies of scale:** Because of the sheer scale of size compared to individual participants, a number of economies are achieved by service providers. Two main economies are transaction costs and research costs. Grouping of activities and using technology to deliver helps in reduction of transaction costs. At the same time, financial intermediaries have expertise and resources to carry out research.
- **Payment systems:** Certain financial products serve only as a means of payments and purchases are settled efficiently with the help of clearing. These include: cheques, debit and credit cards.
- **Risk alleviation:** Certain financial services like insurance offer a range of products that reduce the economic loss against adverse occurrences such as death, accidents, health problems, damage to property and loss of income. This helps in alleviation of individual risk.
- **Implementation of Monetary policy:** The financial services provide the ideal mechanism for the implementation of government policy objectives of economic growth like stable employment growth, correcting balance of payments and lowering inflation. The monetary authorities exert a powerful influence on interest rates, in turn influencing consumption and investment, the demand for loans/credit and so on.

1.6 Classification of Financial Services

[6]Financial services can be categorized as fund-based services, fee-based services and non-fund-based services.

Let us understand basics of these services.

1.6.1 Fund-based Activities

[7]Traditionally, financial services have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two categories viz. Fund-based and non-fund based or fee-based activities.

Fund-based activities are the activities that involve flow of funds:

- Equipment Leasing / Finance
- Hire Purchase and Consumer Credit
- Housing Finance
- Factoring & Forfaiting
- Bill Discounting
- Securitization
- Insurance
- Venture Capital
  - Primary Market Activities
  - Secondary Market Activities

In all the above activities, the financial intermediary provides funding to the beneficiary.

1.6.2 Non-fund based or Fee-based Activities

Fee-based activities are advisory in nature without any outflow of funds.

The institutions earn good income without any outflow of funds by the following:

- Plastic Money
- Asset Management Services
- Portfolio Management Services
- Capital Issue management (Primary market operations Issue Management/ underwriting-merchant banking activities)
- Demat Services
- Project Advisory Services including funds arrangement from financial institutions to meet the project cost and working capital/ loan syndication

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[6] https://www.researchgate.net/publication/314747820_Analysis_of_Non-fund_Based_Financial_Services_Some_Insights_from_India

[7] Financial services by M Y Khan- 10th edition- McGraw Hill, 2019

- Foreign advisory services
- Credit rating services
- Support services for mergers and acquisitions by corporates
- Stock-broking

Modern activities involve managerial and advisory services for corporates, which are fee-based. Some of the non-fund-based activities are given below:

- Project counseling services, preparation of project reports
- Acting as trustees to debenture holders
- Rehabilitation and reconstruction report preparation for sick companies
- Asset-liability management
- Undertaking risk management services
- Undertaking specialized services, depository services, clearing services, custodial services, etc.

1.7 Fund-based / Asset-Based Services

In all the fund-based activities, the financial intermediary facilitates asset creation.

Let us go into some of the details of these activities.

1.7.1 Leasing

Leasing as financial service is a contractual arrangement where the owner (lessor) of equipment transfers the right to use the equipment to the user (lessee) for an agreed period of time in return for a rental. At the end of the lease period, the asset reverts to the lessor unless there is a provision for the contract renewal or a provision for transfer of ownership to the lessee. If, there is any such provision for transfer of ownership, the deal was treated as hire-purchase.

Example: Ministry of Defence Offered Fund Based Services to Fill the Urgent Operational Gaps

In 2020, Ministry of Defence, India introduced a new Defence Procurement Procedure (DPP) 2020 wherein "leasing" provision was added as a new category for acquisition to existing 'buy and make' categories. Subsequently, in 2021, the India Army, were in the process of concluding the lease of four advanced Heron Mark-II medium-altitude long-endurance UAVs (unmanned aerial vehicles) from Israel. The move was due to the reason that there was a constant delay in implementing the long-delayed ₹ 21,000 crore ‘Make in India’ project (included supplying 11 naval utility helicopters with foreign collaboration). This new option gave opportunity to replace the existing fleet of obsolete single-engine Chetak choppers that operate from warships.

Source: https://timesofindia.indiatimes.com/india/cash-crunch-forces-military-to-take-equipment-on-lease/articleshow/82563292.cms, May 12, 2021, accessed on 2nd June, 2022.

Leasing is extended in types - Operating Lease and Finance Lease.

In an operating lease the lessor, as owner, will retain legal ownership of an asset but allows the lessee to enjoy the economic use of the asset for a predetermined period before returning the asset to the lessor. At the end of the lease period, the asset continues to be owned by the lessor.

In a finance lease, the lessor is the owner of the asset; but at the end of the lease period, ownership is transferred to the lessee on the payment of a residual value price of the asset which is usually pegged at 10% of the original asset cost, or less.

Leasing was also prevalent during the ancient Sumerian and Greek civilizations where leasing of land, agricultural implements, animals, mines and ships took place. The practice of 'equipment leasing' came into being sometime in the latter half of the 19th century where the railroad manufacturers in the USA resorted to leasing of rail cars and locomotives. The spectacular performance of the railroad companies brought into sharp focus the role of equipment leasing in prompting capital formation. After the World War II, the railroad companies in Europe resorted to the practice of equipment leasing in a big way. By the early 60's, equipment leasing came into popular use in many industries in the USA, and in Europe.

Today, equipment leasing includes leasing of plant and machinery, office equipment (including computers), automobiles, ships, and aircraft. In fact, the global trend in the 80's has been towards leasing of large-scale manufacturing facilities, power projects and large construction projects. Put in differently, leasing industry in the 80's graduated from 'equipment leasing' to 'project leasing'. The wide range of business assets that are leased today have naturally led to several innovations in the practice of leasing in order to cater to the varied requirements of the end-users.

Evolution of Indian Leasing Industry

The equipment leasing industry came into being in 1973, when the first leasing company, appropriately named as the First Leasing Company of India (FLCI), was incorporated in Chennai. This industry, however, remained relegated to the background until the early 80's, because the need for this financial service was not strongly felt. The public sector financial institutions like IFCI, ICICI, IDBI and State Financial Corporations (SFCs), used to provide bulk of the term loans. The commercial banks provided working capital finance required by the manufacturing sector on relatively soft terms. Given the easy availability of funds at reasonable cost, there was no need to look for alternative means of financing. Therefore, the second leasing company – Twentieth Century Leasing Limited – commenced operations only in 1979.

[8]The scenario of the 70's underwent a change in the early 80's. The credit squeeze announced by the RBI coupled with the strict implementation of the Tandon & Chore Committee norms on Maximum Permissible Bank Finance (MPBF) for working capital forced the manufacturing companies to divert a portion of their long-term funds for working capital. The LIC–Escorts Limited episode conveyed a clear message that the financial institutions and the investment institutions cannot be taken for granted as passive investors. These factors forced the manufacturing companies to look for alternative means of funding their capital expenditure programs. They found equipment leasing a viable alternative because of its inherent advantages like: (a) easy documentation; (b) fewer restrictive covenants; (c) no convertibility clause that can result in dilution of ownership and control; and (d) availability of 100 per cent finance.

The sudden spurt in the demand for equipment leasing resulted in a spectacular performance of the few leasing companies that were in existence, and created an active investor following for equity stocks of these companies. The supply-demand imbalance and the easy availability of funds from the capital market encouraged the spawning of a number of leasing companies.

[9]The demand for leasing also encouraged the financial institutions and commercial banks to enter this industry. In 1983, the Industrial Credit and Investment Corporation of India (ICICI) entered the leasing industry. This was followed by the entry of the Industrial Reconstruction Bank of India (IRBI), Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), and a number of state-level financial institutions.

As of 2022, the term lending institutions, IDBI and ICICI after lot of corporate restructuring and reverse mergers, have become commercial banks rather than term lending institutions. With a view to converting the institution into a full-fledged development financial institution, IRBI was incorporated under the Companies Act 1956, as Industrial Investment Bank of India Ltd. (IIBI) in March 1997. Due to various administrative issues, the bank's closure was announced in the Budget 2012.

In 1983, the Banking Regulation Act, 1949 was amended, whereby commercial banks were permitted to promote subsidiaries specializing in equipment leasing and financial services other than hire purchase. The first commercial bank to set up a financial services subsidiary was the State Bank of India (SBI), which became operational in 1986 under the name of SBI Capital Markets Limited. This was followed by the Canara Bank setting up the Canbank Financial Services Limited, the Punjab National Bank promoting the PNB Financial Services Limited and so on. Some of the commercial banks promoted subsidiaries with

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[8] https://www.ifc.org/wps/wcm/connect/098d9d0e-a553-4d2a-9b46-bf1701b19bf4/Evolution+of+Leasing+in+India_Aug+30+2019.pdf?MOD=AJPERES&CVID=mQ-Gi0B

[9] http://vinodkothari.com/indo1/

equity participation from financial institutions. One such finance company, The Infrastructure Leasing and Financial Services (ILFS) Limited, was jointly promoted by the Central Bank of India, Housing Development Finance Corporation and the Unit Trust of India.

The early 80's witnessed the entry of the International Finance Corporation, Washington DC., and a number of multinational banks into the industry through the co-promoter route. IFC promoted two leasing companies jointly with the commercial banks and finance companies in the private sector – the India Equipment Leasing Limited (IEL) at Chennai with equal equity participation from State Bank of India and Sundaram Finance, and the Leasing Corporation of India at Mumbai with equal equity participation from Bank of India and Twentieth Century Finance Corporation Limited.

Standard Chartered Bank was the first foreign bank to participate in the equity of a leasing company. It promoted the Cholamandalam Investment and Finance Company at Chennai jointly with Tube Investments of India Limited. Many foreign banks started offering the service of lease broking to their corporate clientele.

As expected, the large-scale entry of private-sector companies, financial institutions and commercial banks into an industry with no entry barriers created tough competition and resulted in a steep fall in the lease rates. By the end of 1985-86, the lease rate on a five-year non-cancelable lease had declined from ₹ 32 ptpm (per thousand rupees per month) to ₹ 25 ptpm. The profit margins came under tremendous pressure with an increase in the cost of funding leases. This was further compounded with the governments of several states imposing sales tax on lease rentals. These developments forced several small leasing companies in the private sector to either close or diversify. Among the companies which chose the diversification route, some companies went in for concentric diversification by adding related activities like bill discounting and consumer finance to their portfolio. Others diversified into unrelated areas like manufacturing (conglomerate diversification). As of date, the dominant players in this industry are the Indian Railway Finance Corporation (IRFC), a dedicated leasing entity for the Indian Railways and the bank-sponsored subsidiaries like SBI Capital Markets, Canbank Financial Services etc. IRFC extends financial leases exclusively dedicated to the railways. Operating leases are mostly offered by some NBFCs, and some Non-Banking Non-financial Companies (NBNCs) like Bajaj Finance, Mahindra & Mahindra Finance, Bajaj Finance Limited, Tata Capital Financial Services Ltd, Aditya Birla Finance Ltd, L & T Finance Limited, Muthoot Finance Ltd etc.

In terms of the industry performance, the 80's witnessed a rapid growth in investment in leased assets. The annual investment in leased assets which was around ₹ 50 crore at the end of 1983 increased to ₹ 900 crore by the end of 1990, registering a compounded growth rate of more than 50% p.a. The industry expects this growth rate to be maintained in the '90s, thanks to the liberalization measures announced in the Industrial Policy 1991. For instance, the abolition of the investment limits under the MRTP Act and the provision to allow 51 per cent foreign equity in Indian companies are bound to accelerate the process of capital formation in the private sector. Equipment leasing has an important role to play in this process as a means of financing. However, by the late '90s till date, equipment leasing companies have been losing ground with the recessionary trends in the Indian economy. Many of the smaller players left the market, which is now mostly dominated by the leasing subsidiaries of the major MNCs that manufacture consumer durables. New schemes such as 0% interest on leasing have also come into the market.

In 1994, the RBI had permitted all commercial banks (excluding RRBs) to undertake equipment leasing and hire purchase financing activities directly without establishing subsidiaries. It is to be noted that in 1984, banks were allowed to provide hire purchase and leasing services through a subsidiary only.

The post-liberalization era was witnessing a slow but definite 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 interested in leasing in India. Previously, there were no entry barriers to leasing business. But the January 1997 amendments to the RBI Act, required any non-banking finance company to have a prior registration with the RBI and the conditions of registration virtually amount to RBI's authorization.

The leasing business can be classified broadly into financial and operational lease. The major difference between them is listed under Table 1.1 below.

Table 1.1: Differences between Financial and Operational Lease

Factor	**Finance leasing**	**Operating leasing**
Number of leases	Single	Several
Amortization cost	Fully recovered from one lessee	Recovered from many lessees
Maintenance of assets leased	Lessee	Lessor
Revocation of lease	Non-cancelable during the period of lease	Cancelable during the lease period
Period of lease	Long-term	Short-term

Source: https://www.ifc.org/wps/wcm/connect/098d9d0e-a553-4d2a-9b46-bf1701b19bf4/Evolution+of+Leasing+in+India_Aug+30+2019.pdf?MOD=AJPERES&CVID=mQ-Gi0B

1.7.2 Hire Purchase Services

A hire purchase is a contractual arrangement under which the owner lets his goods on hire to the hirer and offers an option to the hirer for purchasing the goods in accordance with the terms of contract. A hire purchase has two aspects: one, bailment of goods subject to the hire purchase agreement and two, element of sale when the option to buy the good is exercised by the user. It is to be noted that hire purchase is fundamentally different from leasing and installment purchase. Installment purchase allows the user to be the owner of the good immediately after the first installment is paid, whereas in hire purchase ownership of the equipment is transferred only after the user exercises his option to purchase it. The growth of hire purchase services in India has been contemporary with consumer credit and installment payment services in the financial services industry. Most of the companies which offer the services of leasing tend to offer hire purchase also and are therefore, seen as near relatives to leasing. In fact, the RBI in its classification of NBFCs has categorized those companies which offer leasing/hire purchase services into a single category of companies.

Hire purchase is available for a wide range of products and equipment. Products like televisions, audio systems, refrigerators, etc., are now being financed with the help of such credit. One of the most sought-after products through hire purchase system is automobiles. Automobiles like trucks, motor cars, two wheelers, and autos are sold on hire purchase to a wide range of borrowers. Users range from transport operators to individuals.

1.7.3 Consumer Credit and Installment Credit

Consumer Finance as distinguished from hire purchase activity, means providing the finance to the consumer for the sake of acquisition of a product or a service. That is, the ownership is transferred to the user immediately after the financing transaction takes place. It is generally between the finance company and the consumer directly. The consumer finance company provides finance to the consumer for the purpose of buying a product from the manufacturing company (which will be directly paid to the manufacturing company). Subsequently, the manufacturing company 'sells' the product to the consumer, for which the consumer pays back the money financed with interest to the finance company.

Installment credit essentially is between the consumer and the manufacturing company either directly or through a dealer network. The latter is more predominant. The ownership of a product is transferred to the user by the manufacturing company immediately after entering into agreement. The consumer pays back the cost of the product with interest in installments.

The growth of consumer finance has been in line with the boom in the white goods market witnessed in the late '80s. Consumers of these services normally are from middle-income and upper middle-income salaried groups who can afford to pay the installments (albeit with a decent interest) rather than gathering enough capital for the acquisition. The interest rates are normally charged on a flat rate basis and the installment paid includes repayment for the principal and the interest. There are quite a few finance companies which offer both hire purchase and consumer finance for the consumers. Companies like Ceat Finance specialize in office equipment whereas some companies such as Apple Credit, Countrywide, Sundaram Finance, Cholamandalam Finance, and Kotak Mahindra Finance specialize in automobile financing (either by hire purchase or consumer finance).

Changing Consumer Lifestyle - Growth of Consumer Lending

There has been a marked growth in consumer lending in India. One of the main reasons for the rise is the tendency to spend much more by the millennial group (age group of 18 to 35) than any other age group. The millennial group has higher disposable income and their spending pattern is driven more by "want" than "need". Further, the annual per capita income in India is growing. It is in a phase where consumers are more willing to spend and this trend is expected to continue, thereby driving the growth of consumer credit in the country. Many lending agencies and institutions have various loan schemes, and are offering incentives as well to attract new clients. Mortgages are the biggest contributors to consumer credit.

Check Your Progress - 1

1. Which of the following is not an advantage of equipment leasing?
   a. Easy documentation
   b. Fewer restrictive covenants
   c. No initial margin
   d. No convertibility clause that can result in dilution of ownership and control
   e. Availability of hundred percent finance
2. Name the first commercial bank that set up a financial services subsidiary.
   a. Canbank Financial Services
   b. SBI Capital Markets
   c. PNB Financial Services Ltd.
   d. Andhra Bank Financial Services Ltd.
   e. Central Bank of India Housing Development Financial Corporation
3. Which of the following is not the characteristic of hire purchasing schemes?
   a. Bailment of goods subject to the hire purchase agreement.
   b. Element of sale when the option to buy the good is exercised by the user.
   c. Ownership of the equipment is transferred only after the user exercises his option to purchase it.
   d. Ownership of the equipment is transferred automatically.
   e. Hire purchase and leasing are fundamentally different.

4. Which of the following is correct in the case of consumer finance transaction?
    a. Ownership of the asset is transferred to the user after the instalments are paid.
    b. Ownership of the asset is transferred to the user after 50% of the instalments are paid.
    c. Ownership of the asset is transferred to the user immediately after the transaction takes place.
    d. Ownership of the asset is transferred to the user after the margin money is paid.
    e. Ownership of the asset is transferred to the user after the first instalment is paid.
5. Interest rate on consumer finance is generally volatile and will be varying. What is the name given for such rate of interest?
    a. Flat rate
    b. Fixed rate
    c. Floating rate
    d. Based on RBI guidelines from time to time
    e. Based on the banks policies from time to time

1.7.4 Housing Finance - RERA

Housing finance constitutes providing funds for the purpose of constructing or buying of houses. Housing finance is generally given to all types of persons like companies, individuals, co-operative societies, government organizations, etc. Housing finance is provided by various governmental and non-governmental organizations in India. One such organization is HUDCO (Housing and Urban Development Corporation), established in 1970 to essentially provide long-term finance for construction of houses for residential purposes or to undertake housing and urban development programs in the country. Also, commercial banks are compulsorily made to lend certain amount of their total credit outlay for the purpose of constructing/buying of houses as a part of their priority sector lending requirements.

Being a priority sector deserving special attention and support, there has been continued governmental assistance for housing finance. Until the mid '80s, housing finance was in the hands of the government that has been providing finance for constructing or buying of houses to mainly lower- and middle-income groups. This was done through various state and central government supported organizations, co-operative societies and schemes. It was at this juncture that a need was felt for a more responsive entity to co-ordinate housing finance activity in the country. Hence, the birth of National Housing Bank (NHB). The National Housing Bank has been formed as a fully-owned subsidiary of the RBI. It has been overseeing private sector participation in the area of housing finance ever since. NHB refinances scheduled urban co-operative banks, housing finance companies and state-level apex co-operative housing finance societies to the extent of 100% of their direct loans to individuals up to ₹ 1 lakh for acquisition/construction of a housing unit with built-up area not exceeding 40 sq. mtr. or cost not exceeding ₹ 1.5 lakh including the cost of land. Today, there are around 350 housing finance companies in India, of which approximately 23 are registered with the National Housing Bank.[10]

Housing finance was one of the early attempts of the office of Housing and Urban Programs of USAID (United States Agency for International Development). It was in Latin America that the Regional Housing and Urban Development offices of the Housing supported the creation of Savings and Loan System in Honduras, Peru, Ecuador, Bolivia, Venezuela, Brazil, Chile, and Argentina to name a few. Today, the Savings and Loans systems in Latin America continue to bring resources into the shelter sector and have contributed to the overall development of the capital market in their respective countries. In India, USAID support for shelter programs was initially directed to the Housing Development Finance Corporation (HDFC), a fledging private sector institution at that time. HDFC is one of the leading providers of loan assistance for construction/buying of houses in India. Some of the other players in the Housing Finance are LIC Housing Finance, Can Fin Homes and SBI Housing Finance.

Housing finance segment has seen good growth over the last decade and the trend is intact. The affordable housing finance has excelled with a growth rate of nearly 30%. Most of the HFC's charge fixed rate of interest. However, some of them also charge variable rates such as HDFC, LIC Housing finance, Can Fin Homes, etc.

Real Estate Regulatory Authority

Real estate sector plays a very important role in Indian economy in housing and infrastructure areas.

According to real estate industry report (ibef.org), the industry is expected to record 19.5% CAGR (Compound Annual Growth Rate) for the period 2017 to 2028. The following Figure 1.4 depicts the growth projection. However, Indian real estate market was mostly unregulated.

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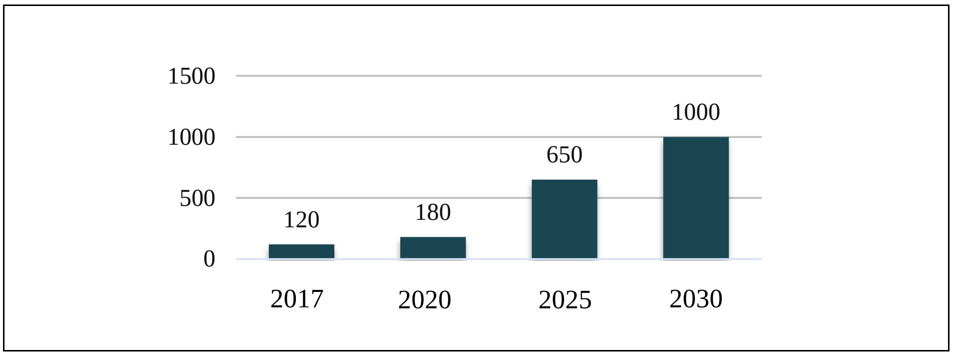
[10] Similar to the RBI ultimatum of registration of NBFCs recently, NHB is also considering such compulsory registration for Housing Finance Companies. Even with these numbers, around 15% to 20% of the total investments in the housing sector are being financed.

Figure 1.4: Growth Projection Real Estate



Source: KPMG, Report on Real Estate Sector in India –Corporate Catalyst India Pvt Ltd, CBRE, National Housing Bank – www.ibef.org

Though the Consumer Protection Act, 1986, is a forum to the property buyers, it was not adequate to address all the concerns of property buyers and promoters.

To protect the rights and interests of consumers and standardization of business practices and transactions in this sector, Parliament enacted the Real Estate (Regulation and Development) Act, 2016.

The government also strengthened regulatory framework with the following policy changes in real estate sector, namely:

- Real Estate Regulatory Act
- Benami Transactions Act
- Boost to affordable housing construction
- Interest subsidy to home buyers
- Change in arbitration norms
- Service tax exemption
- Dividend Distribution Tax (exemption)
- Goods and Services Tax
- PR (permanent residency status) for foreign investors

Real Estate Regulatory Authority (RERA)

The Act mandates establishment of RERA by every State Government and Union Territory for administering the real estate sector in their jurisdiction similar to Motor Vehicles Act, by May 1st 2017. Some states can have more than one RERA or two states can have one RERA. All the ongoing projects have to be registered by the property developer with RERA.

The Authority shall be a body corporate with the power (subject to the provisions of the Act), to acquire, hold and dispose of property (movable and immovable), to contract, to sue or to be sued. The Authority will be headed by chairperson and minimum of two whole-time members who will be appointed by the appropriate government. The concerned government in consultation with the Authority appoint officers and employees for the efficient discharge of their functions under the Act.

Functions of RERA for promoting real estate

RERA can make recommendations to the government of the competent authority. The broad coverage of the functions RERA are as under:

- Protection of interest of the allottees, promoter and real estate agent
- Ensuring time-bound project approvals and clearances for timely completion of the project
- Creation of a transparent grievance redressal mechanism
- RERA suggested the following measures to encourage investment in the real estate sector-
  - Increase financial assistance to affordable housing segment;
  - Encourage construction of environmentally sustainable and affordable housing;
  - Promote standardization and use of appropriate construction materials, fixtures, fittings and construction techniques;
  - Encourage grading of projects on various parameters of development;
  - Facilitate amicable conciliation of disputes between the promoters and the allottees through dispute settlement forums;
  - Facilitate digitization of land records;
  - Render advice to the government in matters relating to the development of real estate sector;
  - Any other issue that the authority may think necessary for the promotion of the real estate.

Other Functions of RERA

The following are the other functions of RERA:

- To register and regulate real estate projects and real estate agents registered under the Act.
- To publish and maintain a website of records, for public viewing, of all registered projects.
- To maintain a database, on its website, for public viewing, which includes:
  a. Names and photographs of real estate agents who have been registered under this Act,
  b. The names projects and photographs of promoters who are defaulters with reasons,

c. Projects which have been revoked or have been penalized under this Act,

d. Details of projects whose registration has been rejected or revoked,

e. Ensure compliance of the obligations cast upon the promoters, the allottees and agents,

f. Call for information, conduct investigation, issue interim orders and directions as deemed fit,

g. Perform such other functions as may be entrusted to the Authority from time to time under the provisions of the Act.

1.7.5 Factoring and Forfaiting – Content Addition on Forfaiting

Factoring involves sale of receivables by a firm to a financial intermediary who will perform the activity of maintenance of accounts, collection of debts and financing against receivables. Factoring is a source of financing of receivables and facilitates the process of their collection. Factoring as a financial service is of recent origin in India. It was in 1988, that Kalyan Sundaram Committee after examining the scope for offering factoring services in the country submitted its report in the subsequent year. This resulted in the entry of banks into the area of factoring with the amendment of the Banking Regulation Act. Some of the first ventures into this area are: SBI Factors & Commercial Services Limited and Canbank Factors Limited. Factoring in India is not vibrant due to the absence of distinct statute for factoring. Also, as factoring involves due evaluation of debtors of the client requiring judicious judgment on the risks associated, lack of specialized credit information agencies/bureaus is cited as one of the other reasons for the snail-paced growth of the industry.

Similar to factoring, forfaiting is also a method of trade finance wherein the exporters sell their receivables to obtain cash at a discount without recourse from forfaiter which is a financial service company. The forfaiter accepts the risk of non-payment. Unlike factors, forfaiter works with exporters who sell capital goods or involved in large projects. Thus, the credit period can be on long- term extending beyond seven years as well. Normally, the receivables are guaranteed by the importer's bank thereby mitigating the risk to the forfaiter.

Characteristics of Forfaiting

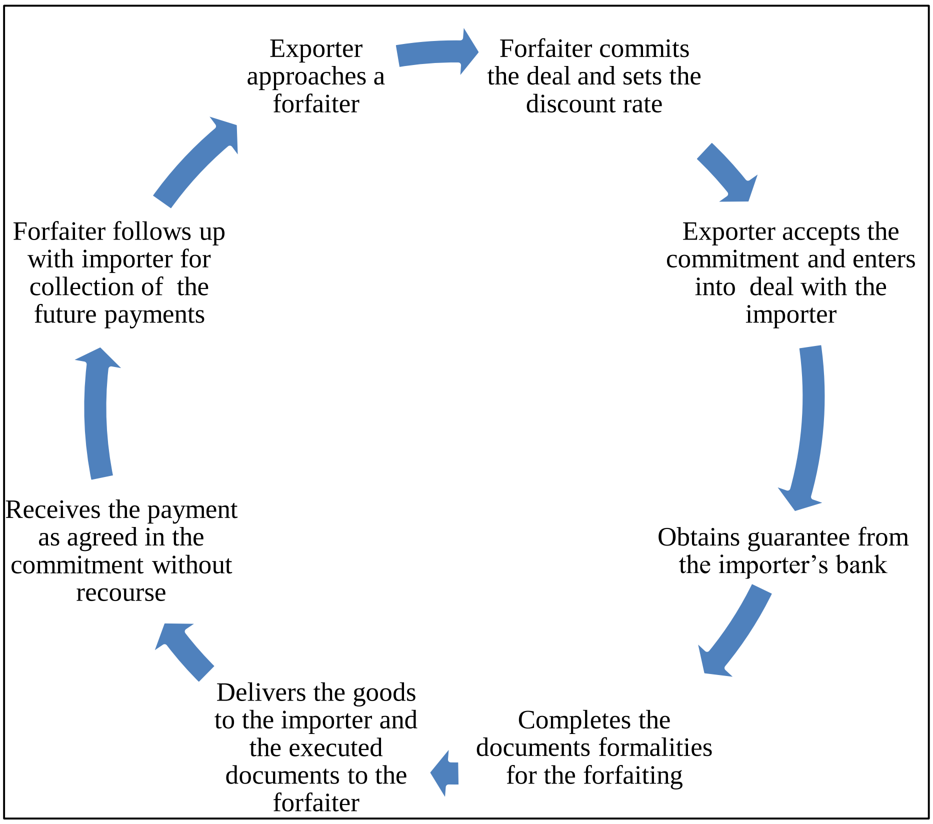
The characteristics of Forfaiting are:

- Forfaiting eliminates all risk to the exporter.
- It provides 100 per cent financing of contract value.
- It operates as a medium and long-term financing.
- Forfaiting is used by exporters of capital goods, commodities, and large projects.

Operation of forfaiting

[11]The following Figure 1.5 depicts the operation of forfaiting:

Figure 1.5: Operation of Forfaiting



Source: ICFAI Research Center

1.7.6 Bills Discounting

The buyers and sellers of trading in goods have conflicting expectations. The seller wishes to get paid immediately and the buyer wants a longer credit period. Bill discounting is the solution to the problem which places them in a win-win situation. The seller gets his major part of money immediately by discounting with his banker and is able to satisfy its customers by giving credit period. Thus, the bill discounting is an easy way of getting finance for the seller.

Discounting a bill means that the financial intermediary buys the bill (i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a prescribed discount amount is charged to the customer's account. The transaction is basically an advance against the security of the bill and the discount represents the interest charged upfront from the date of purchase of the bill until due date.

[11] https://www.export.gov/article?id=Trade-Finance-Guide-Chapter-11-Forfaiting

Generally, the following requirements of bank are to be fulfilled to become eligible for bill discounting:

- Where a usance bill is drawn at a fixed period, the bill must be accepted to establish the maturity. A usance bill must have been accepted and should bear at least two good signatures.
- The bank discounts only trade bills and accommodation bills without trade interest are not eligible for discounting.

1.7.7 Securitization

Securitization refers to the conversion of illiquid assets to liquid assets, by converting longer duration cash flows into shorter ones. Securitization denotes the process of selling assets by the person holding them, to an intermediary who, in turn, will break such assets into marketable securities. The assets may virtually be anything ranging from future sales of cinema tickets and airline tickets to hire purchase deals and Non-Performing Assets (NPAs).

The securitization of residential real estate in the United States began on the basis of the deeply ingrained principal, that the American family needs a home and will maintain that home over most other possessions. Hence, the concept of using mortgage loans to support investment-grade securities, or the process of securitization, originated. The statistical research also showed that the default rates on residential real estate loans were both minimal and predictable. Investment bankers saw this as an opportunity to generate liquidity. By ‘packaging’ hundreds of individual real estate mortgages into one large security, great confidence can be achieved in terms of the financial characteristics of the group. While it would be impossible to guess the probability and timing of the default of any individual mortgage, one could frame reliable predictions regarding average default for a group of mortgages on the basis of historical studies of other similar large pools of mortgage loans.

The definition as per RBI on securitization is reproduced hereunder.

Securitization is a process by which assets are sold to a bankruptcy remote Special Purpose Vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitization thus follows a two-stage process. In the first stage, there is sale of pool of assets to a 'bankruptcy remote' Special Purpose Vehicle (SPV) in return for an immediate cash payment. In the second stage, repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.[12]

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[12] https://rbi.org.in/Scripts/NotificationUser.aspx?Id=2723&Mode=0

The securitization process involves the following steps:

i. Transfer of assets by the originator (person holding the assets) to a person (company or a trust) specially created for the purpose called Special Purpose Vehicle (SPV). SPV is a separate entity formed exclusively for charting this deal and providing funds to the originator. SPV may be formed as a company under the Companies Act or as a trust formed under the Indian Trusts Act.

ii. The assets transferred should preferably be homogenous in nature in terms of the risk attached to them and/or maturity such that the pooling of such assets would be convenient. SPV divides this pool of assets transferred by the originator into marketable securities called Pay or Pass Through Certificates and resells them to various investors.

iii. Investors may either be a bank, mutual fund or state or central government. The investors may even be the parent company or the financier of the originator[13].

iv. The issue of securities is managed by a merchant banker who may underwrite the whole issue or it may be a syndicate of merchant bankers. The originator continues to administer the loan portfolio for some fee and he passes the collections to the trust which manages the securities.

1.7.8 Insurance

Insurance is an agreement where the insurer agrees to make good a loss suffered by the insured against a specific risk, in consideration for some specified amount. The insurer is generally an insurance company that pools all the risks of many such insured entities and provides insurance on the basis of probability. By pooling many such risks, insurance companies convert the uncertainty of individual loss into predictable expense. The insured has to forego a part of amount of money periodically in return for the assurance given by the insurer against any risk of loss and is known as premium. Insurance provides a sense of security for the insured which will allow him to perform normal business.

The importance of insurance as a financial service can never be underemphasized. Insurance companies play an important role in the financial system all over the world, and so also in India. Insurance companies hold substantial amount of assets and are capable of transferring funds quickly from one sector of the economy to another. In India, apart from being seen as a typical 'insurer' for covering of risk of loss, an insurance service is seen as a viable and safe investment alternative. Adequate tax breaks are also provided for the cause of furthering the attitude of saving through insurance in the general public.

Life insurance has been in existence in India since 1818, but it was only in 1956 that all 245 insurance companies were merged and nationalized to form the Life

[13] In India, mutual funds are allowed to invest not more than 5% of their total corpus in the securitized instruments. Also, unlike in the West, insurance companies are not allowed to invest in securitization deals. This, however, is expected to be relaxed with the entry of private insurance players.

Insurance Corporation of India. There were some companies that offered general insurance as their main business and they too were merged to form the General Insurance Corporation of India in 1972. General Insurance Corporation of India, National Insurance Co. Ltd., New India Assurance Co. Ltd., Oriental Insurance Co. Ltd., and United India Insurance Co. Ltd., offer general insurance business in India. Both the institutions are controlled by the government. The Insurance Regulatory and Development Authority was set up in 1999 as a regulator of insurance companies in India taking over from the Ministry of Finance. This authority is intended to oversee the smooth entry of private operators into the insurance industry and regulate the insurance schemes floated by them. Private players, most of them having tie-ups with foreign insurance giants, are slowly entering the market both in the life and general insurance sectors.

Thus, there is a huge opportunity for growth, which is explained in Exhibit 1.1.

Exhibit 1.1: Huge Potential for Growth of Insurance Industry in India

There is a huge opportunity in the Indian insurance market. At present, India's insurance industry is less than 1.5 per cent of the world's total insurance and about 2 per cent of the world's life insurance premiums. The country is the 15th largest insurance market in the world in terms of premium volume. It has the potential to grow exponentially in the coming years.

The country's insurance market is expected to quadruple in size over the next 10 years (i.e., by 2027) from its current size of US $60 billion (2017). During this period, the life insurance market is slated to cross US $160 billion. India's life insurance sector is the biggest in the world with about 360 million policies which are expected to increase at a CAGR (Compound Annual Growth Rate) of 12-15 per cent over the next five years. It has an excellent potential to grow by almost 200%. The overall growth for the period 2001-2016 was from US $ 10.5 billion to 27.5 billion.

Role of Government

The NDA government has been positive in pushing the insurance penetration in the country. The Pradhan Mantri Atal Bhima Yojna, Pradhan Mantra Jyothi Bhima Yojna, Pradhan Mantri Suraksha Bhima Yojna, and Pradhan Mantri Fasal Bhima Yojna (PMFBY) have been working towards providing social security to the common man. The Atal Bhima Yojna has been successful to the extent that 1.80 crore accounts were opened in the first phase. As part of PMFBY, ₹ 9,000 crore has been allocated for crop insurance in 2017-18. [14]The allocation increased to ₹ 16,000 crore in 2021-22.

Source: http://www.ibef.org/industry/insurance-sector-india.aspx (2022).

[14] https://static.pib.gov.in/WriteReadData/specificdocs/documents/2021/dec/doc2021122041.pdf

1.7.9 Venture Capital

Venture capital refers to financing of risky and untested ventures for the purpose of encouraging new and untried projects. Normally, venture capital is provided to newly-started companies for which capital is necessary for establishing infrastructure on location. Venture capital also extends to provide funds for the expansion of companies that have already demonstrated their business potential, but do not yet have access to public securities market or to credit-oriented institutional funding sources. Venture capital also finances management/ leveraged buyout financing.

Venture capital has contributed immensely to the growth of industry in the US. The computer and semi-conductor industry owe their success to the venture capitalists who came forward for investment in those times. In fact, the financing of expedition of Columbus is itself referred to as one of the first instances of venture capital. It was after the World War II that institutions were set up for venture capital. American Research and Development Corporation (ARDC) was the first formal venture capital firm to be established in 1946 by George Doriot that made investments in companies such as digital equipment corporation that went on to become one of the biggest companies in the USA. The venture capital industry in the USA has been growing ever since its inception with acceleration taking place in 1978 when capital gains tax was reduced from 49 per cent to 28 per cent. In Europe, venture capital started in the early ’80s with European Venture Capital Association (EVCA) founded in 1983. The concept of venture capital is widely known in countries like the UK, FRANCE and the Netherlands. In the later’ 80s, Europe witnessed a fast growth of venture capital due to changes in public policy and the economic conditions.

As in most other financial services, the venture capital industry in India is of recent origin. Before the actual advent, Development Finance Institutions (DFIs) had been partially playing the role of venture capitalists by providing assistance for direct equity participation to ventures that were in a nascent stage. Venture capital was conceptualized in the long-term fiscal policy presented in parliament by the ministry of finance in December 1985. A beginning was made in the budget for 1987-88 when a cess of up to 5 per cent was introduced on all technology import payments to create a pool of funds so as to assist venture capital undertakings. The venture fund that was created out of this cess was to be administered by the Industrial Development Bank of India (IDBI) and ICICI through Technology Development and Information Company of India (TDICI) for providing financial assistance to industrial concerns attempting commercial application of indigenous technology or adopting imported technology to wider domestic applications. In 1998, TDICI became a wholly owned subsidiary of ICICI Limited and was renamed ICICI Venture Funds Management Company Limited. (https://www.iciciventure.com) By 2022, ICICI Venture’s AUM/A reached $6 billion since inception across all strategies including the erstwhile VC strategy.

Indian venture capital industry has evolved over a period of time with the entry of venture capital funds promoted by banks, developmental financial institutions and private sector financial enterprises. Of these funds, the private sector venture capital funds have been most aggressive in providing assistance in the form of seed capital, early stage financing, expansion financing or acquisition financing. India has provided huge growth potential for the VC industry.

1.7.10 Primary Market Activities

To raise funds for business development, companies and government sell new issues of common and preferred stock, bonds on the primary market which are subscribed by general public or other corporates who invest and become shareholders.

Features of the primary market:

The features of the primary market are:

a. Primary market is that it is related with the new issues. Whenever a company wants to raise funds from public, it comes out with new issue either new shares or debentures through Initial Public Offer (IPO) or Further Public Offers (FPO).

b. There is no specific place or office called Primary market. It is only the activity to bringing in new issues.

c. Company raises funds in the primary market through various methods such as public issue, offer of sale, private placement, and rights issue.

   - **Public Issue -** In this method, the company issues a prospectus and invites the general public to purchase shares or debentures.
   - **Offer for Sale -** In this method, new securities are offered to an intermediary at a fixed price who in turn resell the same to the general public.
   - **Private Placement -** In this method, the company sells securities to the institutional investors or brokers instead of selling them to the general public who in turn sell these securities to the selected clients.
   - **Rights Issue -** In this method, the companies issue the new shares to its existing shareholders who have the option of either to accept or assign a part or all of his rights in favour of another person.
   - **Electronic Initial Public Issue (e-IPOs) -** In this method, companies issue shares through the electronic medium (i.e. internet) after entering into a contract with a Stock Exchange.

The companies which are going in for IPO or FPOs should appoint various intermediaries such as Registrar for the issue, Bankers for the issue, Merchant bankers, Brokers, Underwriters who help in making the issue a success by establishing contact with the stock exchanges or investors.

Players / Intermediaries in primary market

The players/intermediaries in primary market are:

- **Merchant bankers: Merchant bankers** play an important role at the time of IPO (Initial Public Offer). They act as issue managers, lead managers or co- managers.
- **Registrars to the issue: Registrars** undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue.
- **Bankers:** Bankers act as collecting agents or as co-ordinating bankers. Some bankers act as merchant bankers and some are brokers. They play an important role in transfer, transmission and safe custody of funds.
- **Brokers:** Brokers act as intermediaries in purchase and sale of securities. They have a network of sub brokers spread throughout the length and breadth of the country.
- **Underwriters:** Underwriters take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public. They may be financial institutions, banks, mutual funds, brokers etc.

1.7.11 Secondary market Activities

Once the IPO (Primary market activity) is done and the stock is listed, they are traded in the secondary market. In this market, the investor purchases the security from other investors who are ready to sell. The products which are traded in the secondary market are Equity shares, bonds, preference shares, debentures, etc. SEBI is the regulator of the same. These securities are traded through stock exchanges.

A stock exchange facilitates the transaction between traders of financial instruments and public who are the targeted buyers. Stock exchanges have to adhere to the guidelines, rules and regulations directed by Securities and Exchange Board of India (SEBI). SEBI is the regulator for the capital markets and functions to protect the interest of investors and aims to promote the stock market of India.

The major stock exchanges in India are Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) in addition to regional stock exchanges. BSE was established in 1875 in Mumbai at Dalal Street and is World’s 10th largest Stock Exchange’. National Stock Exchange (NSE) was established in 1992 in Mumbai and is accredited as the pioneer among the demutualized electronic stock exchange markets in India.

1.8 Fee-Based Services

Fee based services include plastic money, asset management services, portfolio management services, capital issue management (Primary market operations issue management/underwriting-merchant banking activities), demat services, project advisory services including funds arrangement from financial institutions to meet the project cost and working capital/ loan syndication, foreign advisory services, credit rating services, support services for mergers and acquisitions by corporates, stock-broking etc. Let us go into the details of some of these fee based services.

Example: Fee-based Services-Credit Card Utilisation

In 2022, in Quarter 3, FY22 results, HDFC Bank, a credit cards market leader, acknowledged that though spending was increasing, utilisation of limits remained a problem. The bank was strict on the credit limits. As the credit line usage was low and policy on credit limits was a little tighter, the fee income from payments products and credit cards for HDFC Bank dropped every year starting from December quarter. Additionally, the trend to revolve card balances also waned and HDFC Bank remained at 70-80% of the pre-Covid levels with respect to revolving balances on cards.

Source: https://www.financialexpress.com/industry/banking-finance/credit-card-utilisation-stays-lower-than-pre-covid-levels/2410796/, January 20, 2022, accessed on 30th May, 2022.

1.8.1 Plastic Money – Credit Cards

Plastic money refers to the mode of payment for goods and services bought where the payment is through use of specific cards made of plastic (hence, plastic money), which will substitute the usage of currency at the time of purchase/payment. The mode of payment is through the usage of ‘Plastic Cards’ which will identify the user enabling the payment. The payment by the card-holder for the goods or services is made before or after the purchase of the good depending on the type of card used. A credit card enables for payment after a lapse of certain period of time, subsequent to the purchase of the good, whereas a charge card enables the payment immediately after the purchase is reported to the card issuing authority. In case of debit card, the amount is deducted immediately at the place of buying of goods or services with the help of a special machine installed by the card issuer. Some other plastic cards exist which are normally linked to the commercial establishments or specific products. The facilities offered include in addition to providing a payment mechanism, discount on products and services, accident insurance, etc. One such card is the Health Card. The card asks for a payment upfront for a specific time period that will be the maturity of the card. It pays the amount back with interest after maturity. In the meantime, the card can be used for the purpose of seeking discount on the services or products offered. These cards will be discussed in detail later in the unit on Plastic Money.

The origin of Diners Card is attributed to a very affluent and well-respected businessman in a small town in the USA who forgot his money, but managed to pay for his dinner by his business card with "will pay next morning" scribbled behind. 'Eat now pay later' concept is considered as the genesis of plastic cards.

Credit cards were the first kind of plastic money introduced in India. Credit cards were first introduced as Diners card in 1962. Diners club membership grew over the years as its popularity has been increased; it had around 6.5 lakh memberships by 1990. In 1990, Citibank purchased the franchise of the Diners Club card, and at the same time, launched Master and Visa cards. Now, the main players in the market are ICICI Bank, HDFC Bank, HSBC, SBI, and American Express among others. Master and Visa actually enroll the member establishments (the place where the product/service is bought), and co-ordinate with the various providers of credit cards so as to expand the number of establishments which accept credit cards. Most of the credit cards offer the facility of withdrawing money from the respective bank's branches. American Express, a more prestigious card, came quite late to India. This card is quite exclusive and is aimed at the Indian 'cream' population. Membership is usually by invitation or recommendation.

[15]As per the Worldline report on digital payments, the total number of credit and debit cards in India stood at 1 billion by the end of second quarter 2022. The number of credit cards got increased by 25% to 78.7 million in June 2022 from 62.81 million in June 2021. While the number of debit cards got increased by 2% to 921.75 million in June 2022 from 906 million in June 2021.

In second quarter 2022, the number of transactions using credit cards at POS (Point-Of-Sale) stood at 358.35 million while e-commerce transactions touched 330.30 million. But, in terms of transactional value, POS stood at ₹1,22,629 crore while e-commerce stood at ₹ 2,05,366 crore. This is because of high ticket item transactions moving from physical space to digital space.

In second quarter 2022, the number of transactions using debit cards at POS (Point-Of-Sale) stood at 629.48 million while e-commerce transactions was 343.64 million. In terms of transactional value, POS stood at ₹ 1.28 trillion while e-commerce at ₹ 64,212 crore. This is because of small ticket item transactions are processed through debit card usage at physical touch points.

Activity 1.1

You are posted as development officer in the credit card division in your bank. Your manager has asked you to prepare a concept note on improving credit card business after studying the features offered by other cards. What steps will you suggest to your manager in the concept note?

[15] https://bfsi.economictimes.indiatimes.com/news/financial-services/cards-in-circulation-in-india-hit-1-billion-as-debit-cards-issuances-revive/94677163

Answer:

1.8.2 Asset Management Services

Asset Management deals with monitoring and maintaining the assets of business be it physical or financial. In the recent past, there are several banks and financial institutions that have started offering these services to customers for managing their investments. For instance, investment managers can manage the assets of a pension fund. Asset management in financial terms, thus, denotes investment management. The asset managers undertake a range of services from studying the client's assets to planning and looking after the investments. All things are looked after by the asset managers and recommendations are provided based on the financial health of each client.

1.8.3 Portfolio Management Services

Portfolio Management Services refer to the financial services provided by a stock broker, NBFC or a bank (referred as portfolio managers) to high net worth investors interested in reaping returns from the stock market. The portfolio managers invest in a range of financial instruments diversifying the risk involved thereby managing to get higher returns as compared to the inherent risk. Normally, investors are not directly involved in the investment process, and thereby, there is no ‘discretion’ in such constituted portfolio. Such arrangement is known as Discretionary Portfolio Management. In non-discretionary portfolio, the investor is directly involved in the selection of instruments for investment, and the role of portfolio manager is limited to servicing the client for the investment made. Regulations drafted under the purview of SEBI prohibit guarantee of returns on Portfolio Management Schemes.

According to the Securities and Exchange Board of India (SEBI), total (AUM) Assets under Management as on 31st October 2022 stood at ₹ 39,50,323 crore.

1.8.4 Capital Issue Management

Capital Issue Management refers to the professionalized activity performed by the merchant bankers involving management of a public issue on behalf of a corporate. Often referred to as Lead Managing, capital issue management may involve either or all of the following activities:

i. Seeking relevant approvals for the purpose of public issue.

ii. Helping in determining the issue price.

iii. Assisting in contracting with underwriters, printers, co-lead managers, registrars, brokers, etc.

iv. Arranging for marketing and placing of the issue.

v. Complying with allotment procedure and following other post-issue regulations.

Merchant banking, as is popularly known, grew in leaps and bounds in the post-liberalization era when the office of the Comptroller of Capital Issues was abolished and SEBI was formed ushering a free-pricing era. There were as many as 25,000 merchant bankers of all sizes and types at the time when the number of public issues had peaked in the middle of '90s. The industry had come a long way since the days of 1969 when the first merchant banking outfit was set up by ANZ Grindlays. However, the merchant banking industry began witnessing a shake-out following the occurrence of scams at regular intervals coupled with harsh fire-fighting regulations.

Most of the merchant bankers felt the heat when SEBI came out with the regulation segregating fee-based and fund-based activities of NBFCs. Also, merchant banking industry shrunk in size with SEBI stopping the renewal of merchant bankers other than Category I.

In terms of number of issues managed, SBI Caps is the leader in the industry. DSP Merrill Lynch and Kotak Mahindra Capital Company are some of the other important merchant banking outfits.

Another important player in the public issues market is the Registrar to the issue. Registrars to the issues work in close coordination with the merchant bankers and decide the allotment pattern, print the certificates (now mostly replaced by dematerialized entries with DPs), mail back refund orders, collect the balance money on calls, and later on provide services such as transfer of shares, dividend payment certificates, etc.

[16]Total no of merchant bankers registered with SEBI as on 23rd November 2022 are 222 and the [17]notable players in three verticals (public, private and foreign) are -

Support services of merchant bankers in M&A activities

Merchant bankers are advisers to corporate clients on amalgamations, mergers, acquisitions and takeovers. When a company proposes to acquire another company, the acquiring company will approach a merchant bank for advisory services in the matter of negotiations between the acquired and acquiring company. The merchant banker has to be involved in preparation of various documents in the area of finance, technical, marketing and completion of lengthy legal formalities.

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[16] https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=9

[17] https://moneymint.com/merchant-banking-in-india/; dated:13th August 2021 and accessed on 24.11.2022

One of the most important processes in an M&A deal is due diligence. This is an extensive process undertaken by an acquiring firm in order to thoroughly and completely assesses the target company's business, assets, capabilities, and financial performance. Some of the major due diligence areas are financial, intellectual, customer base, human resources, legal etc.

Further, the merchant banker will be involved in:

a. Preparation of project report
b. Valuation of the company proposed to be acquired
c. Raising funds to purchase the shares of the acquired company through loans and public issue
d. Underwriting issues in raising funds
e. Loan syndication post amalgamation

In a nutshell, the merchant banker will offer services from the stage of negotiation till completion of acquisition.

1.8.5 Dematerialization Services

[18]Dematerialization, also called as 'demat' is the process by which an investor can get physical certificates converted into electronic form / balances. These securities are in the form of bonds, government securities and mutual fund units, which are held by a registered Depository Participant (DP).

The investor intending to dematerialize the securities have to maintain and open a demat account with the Depository Participant (DP). A depository participant is a market intermediary through whom the depository services can be availed by the investors. These DPs are organizations involved in the business of providing financial services like banks, brokers, custodians and financial institutions. These investors can dematerialize only those share certificates that are already registered in their name and belong to the list of securities admitted for dematerialization at the depositories. A depository is an organization that is responsible for maintaining the investor's securities in the electronic form. Depositories in India include two organizations namely the National Securities Depository Limited (NSDL) and Central Securities Depository Limited (CDSL) registered and regulated by SEBI. This depository concept is similar to the banking system with the exception that banks handle funds, whereas a depository handles security of the investors.

[19]Dematerialization Procedure

The procedure for dematerialization is:

- After opening a demat account with the Depository Participant (DP), the investor will have to fill up the Dematerialization Request Form (DRF) and

[18] http://content.icicidirect.com/newsiteContent/Institute/equities/basics_on_stock_market_5.html?height=450&width=650

[19] https://nsdl.co.in/services/demat.php

submit it along with the share certificates for dematerialization. The investor also has to deface on each share certificate by writing 'Surrendered for Dematerialization'.

- The DP will process and verify this request along with the share certificates of the company and simultaneously with the Registrars and Transfer (R&T) agents through the depository.
- After the request is approved, the share certificates in physical form are destroyed and a confirmation for dematerialization will be sent to the depository.
- The depository will then confirm the dematerialization of shares to the DP where a credit in the holding of shares will get reflected in the investor's account electronically.
- This dematerialization request process will take around 15 to 30 days after the submission of DRF.
- In certain cases, the R&T may reject the dematerialization request by sending an objection memo to the DP, with or without DRF and share certificates depending upon the reason for rejection. In such a case, the DP or the investor has to remove the reasons for objection within 15 days from the date of receiving the objection memo. If the DP fails, the R&T agent may reject the request and return the DRF and accompanying share certificates to the DP.
- The DP may generate a new dematerialization request, if the investor so requires and will send the securities again to the R&T agent. The R& T agent will not generate any fresh requests for the same securities until it has been earlier rejected and been informed to the NSDL and the concerned DP about the reason for rejection.

Hence, dematerialization allows the investor to conveniently manage and trade in demat segment that completely eliminates the risk of bad deliveries. As the transactions are done electronically, there is no stamp duty charges levied, except for nominal holding charges that are levied at the time of opening a demat account with the depository participant.

1.8.6 Project Advisory Services

[20]Companies that implement growth plans or execute large capital projects do come across frequent cost over-runs and schedule delays. These projects are time-bound and comprise different stages such as planning, analysis, selection, implementation and review that are undertaken either for a profit or for a development motive. All these aspects require technical expertise, knowledge and skills where the merchant banks would offer the necessary expertise in the form

[20] https://books.google.co.in/books?id=1ktCZtI8emgC&pg=PA143&lpg=PA143&dq=project+advisory+services+meaning&source=bl&ots=HlVzXZxTEW&sig=l0OIZqbxzqbxnRb2T0XAUsXauZI&hl=en&sa=X&ved=0ahUKEwjCqND48vHUAhVKqI8KHQGlBx44ChDoAQhUMAk#v=onepage&q=project%20advisory%20services%20meaning&f=true

of services like conducting feasibility study, preparing project reports, or by conducting market surveys. Apart from banks, there are also other non-banking financial institutions and financing firms that offer a wide array of services by assisting in financing long-term infrastructural and commercial projects.[21]For instance, KPMG's advisory services in India include a Major Projects Advisory (MPA) team where it assists the clients in identifying and mitigating project risks throughout the project lifecycle. Their methodology encompasses both "Doing the right project" and "Doing the project right". KPMG's advisory services extends to include construction program evaluations, project risk and controls assessments, contract compliance analyses and cost investigations, as well as project support on complex and troubled projects. Firms giving project advisory services such as the KPMG bank on the strengths of industry knowledge, multi-disciplinary teams, and substantive experience in managing both the financial and technical aspects of major capital projects and programs. The team consists of professionals from diverse formal backgrounds including professional engineers, construction and project managers, certified public accountants, cost estimators, contract and procurement specialists, construction attorneys etc. There are also other financial firms that offer help to the companies in obtaining finance from banks by way of various means such as through overdraft limits, cash credit limits, working capital finance, term loans and letter of credit. Thus, it becomes significant for large and/or medium sized organizations to seek assistance from a project advisory firm to undertake their projects systematically, following a professional approach.

1.8.7 Forex Advisory Services

[22]Forex market or foreign exchange market is the most liquid market which deals with foreign currencies. Forex transactions very often lead to foreign exchange volatility which can impact an organisation in several ways, from creating near term cash flow and earnings volatility, to influencing competitive position and strategic opportunities over longer time horizons. Hence, it is imperative for firms conducting forex transactions to seek advice from dealers in forex markets. This is the genesis of the forex advisory services segment of financial services. Financial institutions are now-a-days offering a spectrum of foreign exchange services to clients. Forex advisory services assist the clients to understand the risk profile in and exposure to foreign exchange transactions. They guide the future course of action in the foreign exchange market. Forex advisory services usually comprise as:

- Providing information about the current exchange rates
- Reporting on the comparative rates for a specific exchange rate

[21] https://home.kpmg.com/xx/en/home/services/advisory/risk-consulting/forensic/major-projects-advisory.html

[22] http://www.forexcap.com/Service/service-details.aspx?page=forexadvisoryservice

- CLS (Continued Linked Settlement) support for settlement of all foreign exchange trades with reduced counter party risk
- Conduct of currency conversion of cash transactions
- Execution of both spot and forward transactions

1.8.8 Credit Rating Services

[23]Credit rating service is a fee-based financial service that involves giving a relative ranking of credit quality of debt instruments available in the market. It is a method of assessment and grading of the companies which borrow money from the market to make timely repayment of principal as well as interest on a particular type of debt instrument. Credit Rating agencies express the credit risk associated with a specific debt instrument. [24]These ratings are published, based on a detailed analysis by various credit rating agencies like Standard & Poor's, Moody's Investor service, ICRA etc. The credit rating services do not recommend buying, holding or selling an instrument as it does not take into consideration factors such as market prices, personal risk preferences, and any other considerations which may influence an investment decision. The primary objective of rating is to provide guidance to the investors and creditors in determining a credit risk, associated with a debt instrument and the credit obligation. [25]For instance, CARE (Credit Analysis and Research Limited), one of the leading credit rating agencies in India, opinion is considered as a highly valued credit risk opinion, which helps the investors to effectively monitor and manage investments based on their risk-return policies. It enables the corporates to access the capital markets for raising funds. It also enables the investors to take informed decisions based on the credit ratings given to the company.

Hence, the most significant requirement of any credit rating service is the credibility and independent structure and procedures which allow the investors to make informed decisions where there is a perceived default risk. The creation of active debt market becomes a crucial factor for credit rating agencies to provide their services.

In the recent past, credit rating ability and credibility has been a point of discussion across the globe as the rating allotted by them to the companies have slipped somewhere in the middle.

[26]SEBI, in order to strengthen the credit rating system, notifies standards (new/enhanced) at different periods of time. The latest one is on September 2022 that becomes applicable from 1st January 2023.

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[23] Financial Services in India: Concept and Application, BY Rajesh Kothari

[24] http://economictimes.indiatimes.com/definition/credit-rating

[25] http://www.careratings.com/about-us.aspx

[26] https://economictimes.indiatimes.com/markets/stocks/news/sebi-rolls-out-framework-for-credit-rating-agencies/articleshow/94520150.cms?from=mdr

Check Your Progress - 2

6. Which of the following enables the payment immediately after the purchase is reported to the card issuing authority?
   a. Credit card
   b. Debit card
   c. Charge card
   d. Diners card
   e. Visa/Master card
7. Which of the following is the basis for the insurer to provide insurance to the clients?
   a. Age of the insured
   b. Probability of the occurrence of the event
   c. Financial soundness of the insured
   d. Health of the insured
   e. The capability of the insured to pay the premium.
8. Which of the following entity provides seed capital finance?
   a. Banks
   b. Financial institutions
   c. Internal accruals
   d. Private venture capital
   e. IPO
9. Which of the following activities refer to the professionalized activity performed by the merchant bankers?
   a. Portfolio management
   b. Capital Issue Management
   c. Dematerialization
   d. Credit Rating
   e. Fund Management
10. Which of the following activities involves sale of receivables by a firm to a financial intermediary?
    a. Merchant banking
    b. Forfaiting
    c. Factoring
    d. Working capital financing
    e. Receivables management services

Activity 1.2
M/S ABC Pvt. Ltd., one of the clients of your bank. The company is planning is going for IPO. It has approached the Merchant Banking division of the bank to seek support of your bank. As Assistant Manager in the department, you have to discuss with the client on various support services you can offer. List them out. **Answer:**

1.8.9 Stock Broking Services

Stocks are bought and sold in the stock market through stock exchanges such as NES, BSE and other regional stock exchanges. A stock broker is a service provider who offers financial services to execute the trade for a client by buying and selling shares in the market on his behalf.

Stock brokers have to be members of BSE & NSE. He must obtain license to trade securities, and get registered under SEBI Act, 1982.

The fit and proper, criteria set by the SEBI.

He has to pay membership fees to the exchange. Further he has to meet certain deposit criteria as follows.

- He has to deposit ₹ 10 lakhs for doing proprietary trading without algorithm,
- ₹ 15 lakhs without algorithm, on behalf of clients,
- ₹ 25 lakhs for those doing both proprietary and client trading,
- ₹ 50 lakhs for doing algorithmic trading,
- A sub-broker may have to pay a one-time deposit amount ranging from ₹ 2,50,000 to 3,00,000.

The standard commission for full-service brokers is between 1% to 2% of a client's managed assets and is under the framework of SEBI and respective stock exchanges.

[27]The activities of stock broking services are governed by the SEBI Act, 1992, (Stock Brokers and Sub Brokers) Regulations 1992, Securities Contracts Regulation Act, 1956, Conduct Regulations, 1992, various rules and regulations and directives of SEBI.

[27] https://www.sebi.gov.in/legal/regulations/jul-2017/sebi-stock-brokers-and-sub-brokers-regulations-1992-last-amended-on-july-13-2017_35309.html#lir11

The further amendments of SEBI on stock broking services were done periodically.

Algorithmic trading is a process for executing orders by utilizing automated and pre-programmed trading instructions to account for variables such as price, timing and volume.

Algorithmic trading makes use of complex formulas, combined with mathematical models and human oversight, to make decisions to buy or sell financial securities on an exchange. In this type of a system, the need for a human trader's intervention is minimized and thus the decision making is very quick. Algorithmic trading enables a firm to make tens of thousands of trades per second. This is a highly technology driven system.

The deposit requirement was prescribed to be commensurate with the risks, other than market risk, that the broker may bring to the system. The various technological changes and the increased speeds of trading have brought to fore the greater quantum of risks arising during the course of execution of transactions. Hence, the deposit of algorithmic trading is higher.

The stock brokers provide primary market and secondary market operations.

Once the client opens demat account, clients can operate through broker/online trading.

The brokers provide services for equity trading /forex trading and debt trading. Commodity broking is different from stock broking.

Stockbrokers have an in-depth knowledge in the stock markets. They offer the best advice to their client on when to buy and sell. It is the responsibility of the stock broker to find clients the best prices possible.

After the advent of electronic trading platform, it is much easier for investors to execute trades themselves. However institutional investors often work with a broker as their volume of transactions is high and also in order to achieve specific outcomes. Even for smaller investors, brokers help in executing trades and provide expert advice on the markets.

In addition to buy sell activities of stocks, the stock broking companies have

a. Set up in-house research team that analyses the macro-economic scenario that impacts the stock market.

b. Technical analysts will provide market trends.

c. Assign a relationship manager to interact & advise the clients.

d. Help their clients to invest in other securities such as commodities, gold mutual fund products etc.

e. Help clients in investing in initial public offerings (IPO) of companies.

1.9 An Overview of Indian Financial Services Sector

India's diversified financial sector, which comprises commercial banks, insurance companies, non-banking financial companies, co-operatives, pension funds, mutual funds and other smaller financial entities, is undergoing rapid expansion.

Indian financial system has grown enormously since 1950s in terms of size, innovations, diversity, complexity and sophistication. Unlike in many other countries, in India, the household sector accounts for the major part of aggregate savings. The contribution of the public sector in facilitating savings is more dominating than private sector.

The Indian financial services industry has undergone a transformation since 1990. During the late 70's and 80's, the industry was dominated by commercial banks and other financial institutions which mostly catered to the requirement of the Indian industry. In fact, the capital market played a secondary role. A complete transformation in the Indian financial services industry was brought by the economic liberalization. Having been under excessive controls with minimum scope of innovation for a long period, the financial services sector in post liberalization became dynamic and vibrant by playing with new financial products and services rapidly.

Technology Revolution in BFSI Sector

Banking sector in India is experiencing rapid changes in the area of technology. Banks are offering numerous services over the internet resulting in the rapid growth of the sector. In the next couple of years, there will be revolution in customer service through technology beyond expectations. Some of the areas in BFSI in terms of technology revolution are summarized hereunder.

a. Innovation of digital solutions for the tech-savvy customers. Both financial institutions and insurance companies are experiencing the digital shift to stay competitive.

b. Mobile banking taking over the traditional banking systems. The mobile banking will be more efficient and effortless to meet the customer demands. One of the areas in Mobile banking services in future will be voice enabled services by acquisition of IoT (Internet of Things) and Voice-Enabled Payment Services.

c. UPI (United Payments Interface) which is a real-time payment system for instant inter-bank transactions with the use of a mobile platform will be widely used.

d. Block chain technology is the latest buzzword which works on the principles of computer science, data structures and cryptography will be the future of banking and financial services globally.

e. Adoption of chatbots or Artificial intelligence robots for assistance in customer support services.

f. Fintech companies with the use of financial technology will surpass the traditional methods of finance.

g. Paperless and branch less “Digital-only bank” are emerging in Indian BFSI scenario.

h. Cloud technology will be the future in BFSI sector in India. It will improve flexibility, scalability, efficiency, faster services and data security.

i. Biometric system with a combination of encryption technology and OTP (One Time Password), authentication will create a highly-secure database protecting it from leaks and hackers to ensure security to customers’ account and capital.

j. The smartwatch technology, will support in creating wearable for retail banking customers and provide more control and easy access to the data.

NASSCOM Cyber media Research (CMR) is of the view that there is a strong view in IT Industry that there is an urgent need for adopting Artificial Intelligence (AI) in the BFSI sector. Further, it is expected that the BFSI sector will deploy AI-based fraud detection and prevention tools and chatbots /voice bots for customer support very soon. Data science and AI will support in comprehending and utilizing the complex data in decision-making. Debjani Ghosh, President, NASSCOM (an Indian IT industry's apex body) is of the view that realizing this potential, organizations are prioritizing AI as an area to grow in BSFI sector. Based on the survey conducted by Cyber media Research, 74 per cent feel that there's a strong need for AI to achieve the following objectives in BFSI sector-

- To provide a more proactive and personal customer support.
- To automate back-end business processes to reduce human errors and improve the turnaround time.
- To track consumer behaviour in order to offer customized products.
- To use AI for marketing.
- To ensure security and compliance in business.

1.9.1 Features of evolution of financial system

Let us discuss on the features of evolution of financial system:

Conservatism to Dynamism

The Indian financial system evolved through a process of rapid transformation, particularly after the introduction of reforms in the financial sector. Introduction of more investor-friendly and encouraging polices, entry of numerous new financial intermediaries have brought in greater dynamism.

Emergence of Primary Equity Market

The capital markets which were very sluggish have become a popular source of raising finance with the emergence of many private sector financial intermediaries and increase in the number of stock exchanges.

Process of Globalization

Since the start of globalization by India, all obstacles that stood in the way of inflow of foreign capital and the introduction of innovative international financial products into Indian markets, have been removed. Moving in tandem with global exports of financial services,

Example: Strengthening Digital Platform to take Financial Services Offerings Closer to the Rural Customers in India

In July, 2022 Dvara Kshetriya Gramin Financial Services Pvt Ltd., an NBFC serving in remote rural areas of India, acquired 'TransactNow' digital platform, a tech start-up which provides digital financial services to India's unbanked and underserved population. KGFS Digital follows agent driven business model to offer an array of financial services to rural customers through Agent Touch Points located close to the villages in line with the Omni-Channel Strategy envisaged by Dvara KGFS. TransactNow facilitates retailers and Farmers Producers Organisations (FPOs) with CRM-based – Super point-of-sale (POS) which works on cloud computing to provide the banking digital services and commerce. It offers services like domestic money transfer, mobile recharge services, Aadhar Banking and micro-ATMs etc.

Source: https://www.thehindubusinessline.com/companies/dvara-kgfs-acquihires-digital-financial-services-platform-transactnow/article35582434.ece, July 28, 2021, accessed on 30th May, 2022.

1.10 Emerging Challenges for Financial Services

The financial services sector has been facing many challenges in its attempt to fulfil the ever growing financial demands of the economy.

Some of the important challenges are:

Qualified Personnel

The dearth of qualified and trained personnel is an important impediment in the growth of Indian ffinancial institutions.

Investor Awareness

The introduction of some new financial products and instruments met with turmoil as investors were not aware of the advantages and limitations of the new and innovative products and instruments.

Multi-channel Communication

Technological advances have offered more options for customer communication. This has increased the security risks for the service providers.

Example: Rapid Changes in Technology Posing Challenges for Financial Services Firms

From the beginning of the digitisation of banking sector, increasing cyber-attacks posed challenges for financial services firms. In 2018 the incidents rose to 819 from with respect to 69 incidents in 2017. Many data breaches were also reported till 2020. For instance, on March 22-23, a hacker caught Capital One's consumer and small business credit card applications since 2005. As per Capital One, about 140,000 social security numbers and 80,000 linked bank account numbers were unfold in the U.S. Also around 1 million Canadian social insurance numbers were breached.

Source: https://linchpinseo.com/common-challenges-in-the-financial-services-industry/, March 30, 2022, accessed on 30th May, 2022.

Transparency

The whole financial system is undergoing a phenomenal change in line with the global standards. Hence, this sector had to opt for better level of transparency. In other words, the disclosure requirements and the accounting practices have become mandatory in line with the international standards.

Specialization

In the Indian context, each financial intermediary is acting as a financial super market delivering many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons or Solomon Brothers, specialize in one or two areas only. This helped them to achieve high levels of efficiency and excellence.

Regulatory Framework

With multiple regulators occupying over imposing operational areas, the regulatory frame-work is not able to address the internal and external risks of the system effectively.

Risk Management System

With the opening up of Indian economy to multi-nationals, the domestic financial institutions are exposed to exchange rate risk, interest rate risk, international economies risks, and political risks. Risk management continues to be a serious challenge as the sustenance of the system is at stake.

1.11 Financial Sector Reforms

The reform process was initiated in India, in 1991, with the aim of accelerating the pace of economic growth and poverty eradication. India's economic liberalization introduced many policy changes and it impacted significantly industry and trade. Foreign Direct Investment (FDI) being a vehicle for capital infusion and technology transfer, industry and services sector was thrown open for foreign investors. The reforms aimed at liberal policies and procedures have since been fine-tuned to attract foreign investments, much needed for economic development.

Example: Reforms to Ensure Benefits of Digital Banking Reach Every Corner of the Country

In 2022, on the completion of 75 years of independence, the government of India intended to set up 75 Digital Banking Units (DBUs) in 75 districts of the country through Scheduled Commercial Banks to offer the benefits of digital banking across the country. As part of it, all the 1.5 lakh post offices were expected shift to the core banking system promoting financial inclusion and access to accounts through mobile banking, 11 net banking, ATMs, and also allow online transfer of funds between post office accounts and bank accounts. This initiation anticipated to facilitate farmers and senior citizens in rural areas, empowering interoperability and financial inclusion.

Source: https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1794167, 01st February 2022, accessed on 30th May, 2022.

The main objectives of these reforms have been:

- To develop a competitive and globally integrated Indian Financial System
- To increase the operational efficiency
- To accelerate the rate of economic growth and creation of employment opportunities

The economic reforms initiated in 1991 introduced far-reaching measures, which changed the scenario of Indian economy. Some pertinent changes as part of Liberalization and Privatization policies have eliminated the past barriers to economic development through bold initiatives, such as.

- Ending the dominance of public sector in the industrial and services sectors through disinvestment,
- Doing away with official discretionary controls on industrial investment and capacity expansion through abolition of number of licences, and
- Relaxing trade and exchange control regulations relating to imports and investments through foreign exchange management legislation and a vibrant Exim policy.

The reforms have unlocked India’s enormous growth potential and unleashed powerful entrepreneurial impetus. Since 1991, successive governments cutting across political parties have successfully carried forward the country’s economic reforms agenda.

Financial sector reforms are regarded as an integral part of the overall economic reforms that aim to improve the efficiency of resource mobilization and allocation in the economy and for the overall economic stability in the country. India has recognized that major reforms are imperative for increasing the stability.

The reforms have been driven by the thrust towards liberalization and autonomy for financial institutions. Several initiatives such as liberalization in the interest rates and reserve requirements have been taken on this front. During the last 15 years, the Indian financial system was de-regulated and exposed to international financial markets along with the introduction of new financial instruments and products.

At the same time, the government has focused on the stronger regulation aimed at strengthening prudential norms relating to capital adequacy and asset quality, transparency through disclosures to mitigate the systemic risks. Today, the Indian financial system is inherently strong, functionally diverse, efficient and globally competitive with good regulatory cover.

1.12 Preventive Vigilance and Fraud Management in Financial Services

Dictionary meaning of vigilance is keeping careful watch over possible dangers and difficulties. According to World Bank, corruption is use of public office for private gains. To identify, overcome and avoid corruption to perpetuate, vigilance is practice.

Example: Regaining Public Trust and Promoting Accountability through Preventive Vigilance

In collaboration with Ayasdi, an AI platform provider, HSBC initiated AI-based anti-money laundering with anomaly detection technology to detect suspicious and potentially fraudulent payments. HSBC could reduce false positive investigations by 20% with this initiation. In addition, with Ayasdi, HSBC also implemented Global Social Network Analytics (GSNA) platform, a centralized anti-money laundering platform which captures several data from both internal and external sources, facilitates investigators with a contextual, comprehensive view of customer activities and relationships.

Sources: i) https://www.aidataanalytics.network/data-governance/articles/ai-at-hsbc-part-1-can-ai-be-used-to-promote-trust-accountability, 08/31/2021, accessed on 1st June, 2022.

ii) https://financialservices.gov.in/about-us/public-grievances-redressal-mechanism, accessed on 1st June, 2022.

Vigilance is of three types – preventive, participative and punitive.

Preventive vigilance includes studying the organization, its policies and its people – stakeholders, implementing effective measures so that they are not exposed to or become vulnerable to corruption.

Participative vigilance involves participation of all stakeholders and well - wishers within the organization and from outside, whistleblower policy and RTI Act. This is purely voluntary in nature and do not cast any obligation for participation.

Punitive vigilance comes into picture when corruption has already been indulged in, committed and punishment is granted to have deterrent effect on others.

Fraud is a generic term embracing all the multifarious means which human ingenuity can devise and are resorted to by one individual to gain an advantage over another by false suggestions or by suppression of the truth.

Banks and financial institutions fall prey to fraudsters. As long as banks and financial institutions handle huge sums of money as financial intermediaries, they will always be the target of ingenious fraudsters trying to relieve them of the money.

The bank frauds are primarily deposit-related, advances-related and services-related. Of these, the deposit-related frauds, which used to be big in number though not in size, have been on the wane, thanks to the improvements in cheque and payment processing, usage of technology and tightening the provisions of the Negotiable Instruments Act. The advances-related frauds continue to be the major concern for banks, especially because of their size and far reaching implications to their financial soundness and integrity. A special variety of frauds, which are increasing in number and in terms of speed, are cyber frauds. Yet another special type relates to trade or documentary credit-related, special because of cross border implications.

The root cause of financial frauds can be reduced to one single phenomenon - failure to Know Its Somebody - i.e. failure to Know Its Customer, or failure to Know Its Employee, or failure to Know Its Partner / Vendor.

The Reserve Bank, from time to time, has been issuing instructions on the preventive and corrective measures that banks should adopt. One set of such instructions relate to information sharing. The importance that the Reserve Bank had always attached to is information sharing among banks, which has been again reinforced and made an integral part of the monitoring of potential frauds. Another initiative is the List of Wilful Defaulters. Fraudsters are included in this list. With this List in hand, the banks get not only cautioned about the fraudsters, they can also bring in certain deterrent action against them.

In the context of increasing incidence of frauds in general and in loan portfolios in particular, a framework for dealing with frauds has been put in place by Reserve Bank of India. The objective of this framework is to direct the focus of banks on the aspects relating to prevention, early detection, prompt reporting to the RBI (for system level aggregation, monitoring & dissemination) and the investigative agencies (for instituting criminal proceedings against the fraudulent borrowers) and timely initiation of the staff accountability proceedings (for determining negligence or connivance, if any) while ensuring that the normal conduct of business of the banks and their risk taking ability is not adversely impacted and no new and onerous responsibilities are placed on the banks. In order to achieve this objective, the framework also seeks to stipulate time lines with the action incumbent on a bank. The time lines / stage wise actions in the loan life-cycle are expected to compress the total time taken by a bank to identify a fraud and aid more effective action by the law enforcement agencies. The early detection of Fraud and the necessary corrective action are important to reduce the quantum of loss which the continuance of the Fraud may entail. The government is separately looking into the issue of more timely and coordinated action by the law enforcement agencies.

1.12.1 Consumer Grievance Redressal Mechanism

A prime motivation of all financial regulation is to protect consumers. The relationship between financial firms and their customers is one where, many times, the outcomes may harm customers. These problems are not sporadic or accidental. But are often rooted in basic problems of information and incentives and will not be alleviated through financial literacy campaigns. The central purpose of financial regulation is to intervene in the relationship between financial firms and their customers, and address market failures. This requires a comprehensive consumer protection framework that covers both the problem of prevention (interventions that induce financial firms towards fair play) and cure (addressing consumer grievances).

The rapid increase in the variety and nature of financial services has highlighted the need for robust regulation as well as consumer education to protect and empower consumers. The need to extend provision of banking services to underserved sections of the population whose financial literacy is low, combined with the growing complexity of financial products and the use of technology can increase the risk of mis-selling. Financial consumer protection should be reinforced and integrated with other financial inclusion and financial education policies. If such protection is absent, the benefits to economic growth of expanded financial inclusion may be severely undermined. Financial consumer protection also contributes to strengthening financial stability. Taking these factors into account, Reserve Bank has recently articulated its Core Purpose, Values and Vision as its commitment to the nation to include regulating markets and institutions under its ambit to ensure financial system stability and consumer protection.

The Financial Sector Legislative Reforms Commission (FSLRC) has come out with a draft Code to establish certain basic rights for all financial consumers. In addition, the Code defines what an unsophisticated consumer is, and an additional set of protections are defined for these consumers. The proposed basic protections are: a) Financial service providers must act with professional diligence; b) Protection against unfair contract terms; c) Protection against unfair conduct; d) Protection of personal information; e) Requirement of fair disclosure; f) Redress of complaints by financial service providers.

In addition, unsophisticated consumers will have three additional protections: a) The right to receive suitable advice; b) Protection from conflicts of interest of advisors; c) Access to the redress agency for redressal of grievances.

In USA, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Consumer Financial Protection Bureau (CFPB) to protect consumers by carrying out federal consumer financial laws. The CFPB is authorized to exercise its authority to ensure that:

(1) Consumers are provided with timely and understandable information to make responsible decisions about transactions involving consumer financial products and services;

(2) Consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;

(3) Outdated, unnecessary, or unduly burdensome regulations concerning consumer financial products and services are regularly identified and addressed in order to reduce unwarranted regulatory burdens;

(4) Federal consumer financial law is enforced consistently, without regard to (service providers') status as depository institutions, in order to promote fair competition; and

(5) Markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

In UK, the Financial Services Act of 2012, set up the Financial Conduct Authority (FCA) which is responsible for regulating the consumer credit industry from 1 April 2014, taking over the role from the Office of Fair Trading. The FCA supervises banks to ensure they treat customers fairly, and encourages innovation and healthy competition. The authority has significant powers, including the power to regulate conduct related to the marketing of financial products. It is able to specify minimum standards and to place requirements on products. In addition, the FCA is able to ban financial products for up to a year while considering an indefinite ban; it will have the power to instruct firms to immediately retract or modify promotions which it finds to be misleading, and to publish such decisions.

In the European Union, the European Banking Authority (EBA) promotes a transparent, simple and fair internal market for consumers in financial products and services. The EBA seeks to foster consumer protection in financial services across the EU by identifying and addressing detriments consumers may experience, or are at risk of experiencing, in their dealings with financial firms. The role and tasks of the EBA related to consumer protection and financial activities include: collecting, analysing and reporting on consumer trends in the EU; reviewing and coordinating financial literacy and education initiatives; developing training standards for the industry; contributing to the development of common disclosure rules; monitoring existing and new financial activities; issuing warnings if a financial activity poses a serious threat to the EBA's objectives as set out in the its funding Regulation; and temporarily prohibiting or restraining certain financial activities, provided certain conditions are met. The market is governed by various directives issued by the EU such as the Directives on Consumer Credit.

In Hong Kong, the industry-established Code of Banking Practice (CoBP) promotes good banking practices by setting out the minimum standards which financial institutions should follow in their dealings with customers. The Code is a non-statutory one issued by the financial industry associations for voluntary compliance by financial institutions. The Hong Kong Monetary Authority (HKMA) expects financial institutions in Hong Kong to comply with the CoBP and will monitor compliance as part of its regular supervision. There are also examples of international voluntary codes.

In India, consumer protection has been an on-going effort of Reserve Bank. For greater effectiveness and a more focused approach, several committees were appointed on aspects of customer service in banks from time to time, including the Talwar Committee (1975), the Goiporia Committee (1990), the Tarapore Committee (2004), the Sadasivan Working Group (2006), and the Damodaran Committee on Customer Service (2010). The importance of consumer protection was also highlighted in the Committee on Financial Sector Reform chaired by Dr Raghuram Rajan. The RBI had set up the Banking Ombudsman Scheme to act as a visible and credible dispute resolution agency for common persons utilizing banking services and to ensure redress of grievances of users of banking services in an inexpensive, expeditious and fair manner that provides impetus to improve customer services in the banking sector on a continuous basis.

1.13 Professional Ethics in Financial Services

At the core of finance, there are people who claim that the financial system, at its heart, is about trust. Nowhere is this more true than in banking. The word ‘credit’ derives from the Latin word ‘credere’, meaning to believe. Without broad-based trust and presumption of honest behaviour, it would not have been possible for the financial sector to grow to its present size and importance.

Example: Encouraging Employees to do the Right Things Always

In 2016, Wells Fargo employees illegally created millions of fake customer accounts to meet the sales quotas, without the knowledge of its customers'. Employees falsified signatures of their customers and opened fake records that generated billions of dollars in revenue. In 2020, Wells Fargo paid a settlement of $3 billion as a corporate penalty. In October 2019, when Charlie Scharf took the role of CEO at Wells Fargo, he acknowledged for the misconduct which was inexcusable and brought some fundamental changes for the business to move forward. He announced regulatory requirements as the company's top priority and created a culture of accountability and operational excellence with more clear responsibilities and authorities for the employees. Scharf also constituted a leadership team consisting executives from inside and outside the company with rich financial services experience and have turned around the financial institutions which were in troubles

Source: https://stories.wf.com/wells-fargos-new-ceo-will-get-done/, November 30, 2020, accessed on 1st June, 2022.

At the other extreme are people who say ethics and finance are poles apart. They contend that at a fundamental level, finance is all about making money, never mind how it is made. Status and recognition are accorded by how much profit is made regardless of how it is made. It is argued that even as the millions of foot soldiers may be innocent, people who rise to positions of top management and leadership in the financial sector could not have done so without compromising on scruples.

John Stuart Mill said that if we make men honest, good and decent, then they will make themselves honest, good and decent engineers, doctors and teachers, and we may add, financial sector professionals. The financial sector is a reflection of the society in which it operates. So, the approach to bringing ethical values into finance has to begin not by special efforts to enforce or regulate ethical standards in finance, but by fostering a value system in society at large.

The importance of ethical behavior in financial markets, is not just from a moral point of view, but equally from a point of view of economic efficiency. In an industry where the conclusion and enforcement of contracts is based on trust - trust from the provider of capital that he is fairly rewarded for the risk of potentially losing some of his assets; trust from the borrower that he is charged a fair price for his access to capital - any breakdown in that confidence can quickly lead to incorrect pricing and in turn, improper allocation of resources. Lack of confidence in the financial system in general typically means rising counterparty risks, and prompts lenders of capital to require a higher risk premium in their investment returns, raising the overall cost of capital in the economy.

Yet, the developments of recent years illustrate the challenges that the industry is facing. The Libor scandal of 2012, when several banks were found guilty of colluding to misprice benchmark rates, illustrates the potential ramifications of unethical behavior in one segment of the market. Yet, the manipulation of Libor was only one example of improper practices. While several global banks were fined for their involvement in the manipulation of the Libor and Euribor reference rates, others ended up paying hefty fines for infringements as diverse as inadequate underwriting and improper sales practices in the sub-prime mortgage market, material non-disclosure, illegal involvement with counterparties under US sanctions, or illegal credit card practices.

In the debate on ethics and finance hosted by the IMF, Bank of England Governor Mark Carney spoke of how finance, over time, became much more transactional rather than relational - in a word, the growing number of intermediaries tended to break the connection between the original service provider and the end-customer, which had earlier formed the basis of trust-building in the industry. Furthermore, as the number of intermediaries grew, so did the size of financial companies through the wave of mergers and acquisitions that followed the deregulation of the 1980s, resulting in what some have described as a "dilution of culture" in many institutions. An institution spanning many businesses, countries and continents, as per the "financial supermarket" model that increasingly prevailed from the mid-1990s, made the creation of a common culture and set of values difficult. In many instances, companies began operating "in silos" and even senior staff often lacked sufficient knowledge of the different businesses in which they were involved. Finally, one cannot ignore the issue of incentives in the financial industry, especially the system of employee compensation, which at some stage heavily rewarded sales volume and short-term profits at the expense of risk awareness and longer-term prudential analysis.

Since the global financial crisis, several pieces of legislation have strengthened prudential regulation and supervision of the industry.

In the United States, for instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave regulatory agencies increased powers of oversight towards systemically important institutions, while incorporating stricter rules on executive compensation and corporate governance. The Volcker Rule, introduced as an amendment to the Act, was specifically aimed at shielding bank customers from risky behavior by banks, by seeking separation of retail banking from investment banking and proprietary trading activities.

At the same time, financial institutions have themselves taken steps to avoid a repeat of past crises, including a comprehensive review of their corporate culture and practices, with greater emphasis on the need to prioritize customer service.

To conclude, a survey conducted by the Economist Intelligence Unit showed that nearly all of the respondents from Europe, Asia-Pacific and North America felt that ethical conduct was just as important as financial success to their firm, and that 67 per cent had taken steps to make staff more aware of the importance of ethical conduct. Furthermore, 63 per cent had introduced or strengthened a formal code for ethical conduct, and 43 per cent had introduced financial or career incentives for respecting that code of conduct.

[28]1.14 Insolvency and Bankruptcy Code-2016

Insolvency and Bankruptcy Code, 2016 (The Code), is a comprehensive insolvency legislation encompassing all companies, partnerships and individuals (other than financial firms). The Code creates a new institutional framework, consisting of a regulator, insolvency professionals, information utilities and adjudicatory mechanisms, that will facilitate a formal and time bound insolvency resolution process and liquidation.

Features of the Code

Insolvency process for corporate debtors- The default should be at least ₹ 100,000 which may be increased up to ₹ 10,000,000 by the government. The Code proposes two independent stages:

a. Insolvency Resolution Process, during which financial creditors assess whether the debtor's business is viable to continue and the options for its rescue and revival.

b. Liquidation, if the insolvency resolution process fails or financial creditors decide to wind down and distribute the assets of the debtor.

Insolvency Resolution Process for Individuals/Unlimited Partnerships- The default amount is ₹ 1000 and above (the government may later revise the minimum amount of default to a higher threshold). The Code envisages two distinct processes in case of insolvencies:

a. Under the automatic fresh start process, eligible debtors can apply to the Debt Recovery Tribunal **(**DRT**)** for discharge from certain debts not exceeding a specified threshold, allowing them to start afresh.

b. The insolvency resolution process consists of preparation of a repayment plan by the debtor, for approval of creditors. If approved, the DRT passes an order binding the debtor and creditors to the repayment plan. If the plan is rejected or fails, the debtor or creditors may apply for a bankruptcy order.

Institutional Infrastructure comprises the following:

(a) The Insolvency Regulator

(b) Insolvency Resolution Professionals

(c) Information Utilities

(d) Adjudicatory

[28] https://www.mondaq.com/india/insolvencybankruptcy/492318/the-insolvency-and-bankruptcy-code-2016--key-highlights

India ranks very low in the World Bank's index on the ease of resolving insolvencies. The Code aims to bring about far-reaching reforms with a thrust on creditor driven insolvency resolution. The Code also has provisions to address cross border insolvency through bilateral agreements and reciprocal arrangements with other countries.

The unified regime envisages a structured and time-bound process for insolvency resolution and liquidation, which should significantly improve debt recovery rates and revitalize the dormant Indian corporate bond markets and the Indian financial system.

Example: Amendments were made in IBC for the Survival and Development of MSMEs During Pandemic

In 2021, during COVID-19 outbreak, World Economy was expecting a survival kit as commercial operations stalled for many months. To protect the interests of MSME sector some changes were brought in the Insolvency and Bankruptcy Code, 2016 to help them the survival line. The change was as underlined:

"In exercise of the powers conferred by the proviso to section 4 of the Insolvency and Bankruptcy Code, 2016 (31 of 2016), the Central Government hereby specifies one crore rupees as the minimum amount of default for the purposes of the said section." Minimum default limit under Section 4 of the IBC, raised from One (1) Lakhs to One (1) Crore."

Source: https://taxguru.in/corporate-law/amendments-insolvency-bankruptcy-code-2016-short-homerun.html, | 12th June 2021, accessed on 30th May, 2022.

1.15 Latest Changes in Indian Financial Service Sector

Financial services sector is very dynamic and new services, instruments are introduced by various service providers. Some of the latest additions in the financial services are big data, financial inclusion, Pradhan Mantri Jan-Dhan Yojana, Atal Pension Yojana (APY), payments bank and small finance banks, RuPay cards[29], consolidation of banks through mergers etc. are the developments in the financial services sector. Let us discuss these issues briefly.

1.15.1 The Impact of Big Data on the Financial Services Sector

Big data is the latest buzz word in financial services industry today. It is nothing but customer analytics, real-time analytics. Financial services sector is the most data-intensive sector and the impact of big data on this sector is but natural. There are large amount of data on customers such as customers profile, KYC details, deposits, withdrawals through ATM, purchases at POS, payments done on line, transactions done on line.

[29] https://www.finextra.com/blogposting/17847/big-data-in-the-financial-services-industry---from-data-to-insights dated September 2019

Though the financial services industry has been spending lot of amount in data collection and processing technologies, such data is not fully utilized to increase the business. Further there is increasing and changing customer expectations. Thus the financial services sector has to exploit these data for the industry benefit and the clients benefit as well. They should leverage the existing data sets to maximize customer understanding and gain a competitive advantage. Some of the uses of big data are:

a. To understand the change in customer behaviour and expectations.

b. To face competition of Fintech players who are already using for their new financial services.

c. To meet the regulatory requirements by providing more diverse data to central banks and regulators.

d. The fraud-detection engine uses customer analytics to point out the irregularities in the user's behaviour.

e. To reduce operational costs, by improving business efficiency driven by the insights gained from Big Data.

1.15.2 Financial Inclusion

Financial inclusion is the key enabler to reduce poverty and boosting shared prosperity.

As per the World Bank's group Universal Financial Access 2020 initiative, access to useful and affordable financial products and services to meet the needs of individuals and business is financial inclusion. It is the delivery of financial services such as conducting transactions (people to store money and send and receive payments), savings, credit and insurance in a responsible and sustainable way. This is the first step towards a broader financial inclusion.[30]

As per Findex data, about 1.7 billion adults are still unbanked and they include women poor households in rural areas or out of the workforce. A major portion of this number is from India. Though the concept of financial inclusion was introduced in India in the year 2005 by RBI, the total implementation has not taken place.

National Strategy for Financial Inclusion (NSFI): 2019-2024[31]

Financial inclusion is increasingly being recognised as a key driver of economic growth and poverty alleviation world over. Access to formal finance can boost job creation, reduce vulnerability to economic shocks and increase investments in human capital. Seven of the United Nations Sustainable Development Goals (SDG) of 2030 view financial inclusion as a key enabler for achieving sustainable

[30] https://www.worldbank.org/en/topic/financialinclusion/overview

[31] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=49116 press release dated 10th Jan 2020

development worldwide. To achieve the above objectives in a coordinated and time-bound manner, preparation of a National Strategy for Financial Inclusion (NSFI) was initiated the process of formulation of National Strategy for Financial Inclusion (NSFI) for the period 2019-2024. NSFI has been finalized and approved by the Financial Stability Development Council (FSDC). The document was formally released by RBI on January 10, 2020. The NSFI sets forth the vision and key objectives of the Financial Inclusion policies in India to expand the reach and sustain the efforts through a broad convergence of action involving all the stakeholders in the financial sector.

Pradhan Mantri Jan-Dhan Yojana (PMJDY)[32]

Launched in the year 2014 by the Prime Minister Shri Narendra Modi, PMJDY is a National Mission for Financial Inclusion the main objective of this mission is to ensure access to financial services which includes opening of banking/savings & deposit accounts, remittance, credit, insurance, pension in an affordable manner. 37.87 crore accounts have been opened under this mission till date. To ensure that the transactions are conducted, the various subsidies that are extended to the poor are routed through the Jan Dhan accounts.

"Pradhan Mantri Jan-Dhan Yojana (PMJDY)" under the National Mission for Financial Inclusion was launched initially for a period of 4 years (in two phases) on 28th August 2014. It envisages universal access to banking facilities with at least one basic banking account for every household, financial literacy, access to credit, insurance and pension.

Pradhan Mantri Jan-Dhan Yojana (PMJDY) is National Mission for Financial Inclusion to ensure access to financial services, namely, a basic savings & deposit accounts, remittance, credit, insurance, pension in an affordable manner. Under the scheme, a basic savings bank deposit (BSBD) account can be opened in any bank branch or Business Correspondent (Bank Mitra) outlet, by persons not having any other account.

Benefits under PMJDY-

- One basic savings bank account is opened for unbanked person.
- There is no requirement to maintain any minimum balance in PMJDY accounts.
- Interest is earned on the deposit in PMJDY accounts.
- Rupay Debit card is provided to PMJDY account holder.
- Accident Insurance Cover of ₹ 1 lakh (enhanced to ₹ 2 lakh to new PMJDY accounts opened after 28.8.2018) is available with RuPay card issued to the PMJDY account holders.

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32 https://pmjdy.gov.in/about

- An overdraft (OD) facility up to ₹ 10,000 to eligible account holders is available.
- PMJDY accounts are eligible for Direct Benefit Transfer (DBT), Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY), Pradhan Mantri Suraksha Bima Yojana (PMSBY), Atal Pension Yojana (APY), and Micro Units Development & Refinance Agency Bank (MUDRA) scheme (Refer Table 1.2).

Table 1.2: Beneficiaries of PMYDY as on 03/03/2021

Bank Name / Type	Number of Beneficiaries at rural/semi urban centre bank branches	Number of Beneficiaries at urban metro centre bank branches	No Of Rural-Urban Female Beneficiaries	Number of Total Beneficiaries	Deposits in Accounts(In Crore)	Number of Rupay Debit Cards issued to beneficiaries
Public Sector Banks	20.37	12.84	18.21	33.21	108596.92	26.31
Regional Rural Banks	6.58	0.94	4.35	7.51	26855.83	3.42
Private Sector Banks	0.69	0.56	0.69	1.25	4215.49	1.12
Grand Total	27.63	14.34	23.25	41.97	139668.24	30.85

Source: https://pmjdy.gov.in/account

Atal Pension Yojana (APY)[33]

The government of India announced the introduction of universal social security schemes in the Insurance and Pension sectors for all Indians, specially the poor and the under-privileged, in the Budget for the year 2015-16. The Atal Pension Yojana (APY), which will provide a defined pension, depending on the contribution, and its period. The APY will be focused on all citizens in the unorganized sector, who join the National Pension System (NPS) administered by the Pension Fund Regulatory and Development Authority (PFRDA). Under the APY, the subscribers would receive the fixed minimum pension of ₹ 1000 per month, ₹ 2000 per month, ₹ 3000 per month, ₹ 4000 per month, ₹ 5000 per month, at the age of 60 years, depending on their contributions, which itself would be based on the age of joining the APY. The minimum age of joining APY is 18 years and maximum age is 40 years. The minimum period of contribution by any subscriber under APY would be 20 years or more. The benefit of fixed minimum pension would be guaranteed by the government. The APY was introduced from 1st June, 2015.

[33] https://www.npscra.nsdl.co.in/scheme-details.php

Payments bank

Based on the committee constituted by RBI in September 2013 headed by Dr. Nachiket Mor on the financial services for small businesses and low income households, Payment banks were established. The primary objective was for achieving financial inclusion, increased access to financial services, increase the spread of payment and financial services to small business, low-income households, migrant labour workforce through technology-driven environment.

A payments bank operates on a smaller scale without involving any credit risk. It can accept demand deposits (up to ₹ 1 lakh), offer remittance services, mobile payments / transfers /purchases and other banking services like ATM/debit cards, net banking and third party fund transfers. As on date there are six active payment banks namely Airtel Payments Bank, India Post Payments Bank, Fino Payments Bank, Jio Payments Bank, Paytm Payments Bank and NSDL Payments Bank. As per the latest guidelines of RBI, Payments banks can apply for conversion into small finance banks (SFBs) after five years of operation subject to meeting the eligibility criteria.

Small Finance banks (SFB)

To increase financial penetration in India and to ensure access to basic financial services for a large population who are still left out of financial inclusion, RBI in 2013, constituted a committee under the chairmanship of Dr. Nachiket Mor that recommended differential licensing in the form of payment bank and SFB.

SFB’s are new class of banking entity mainly aimed to cater to the diverse needs of the low income group. RBI awarded SFB licenses to 10 based on the government’s focus towards financial inclusion. The primary objective of SFB’s is to provide banking services to the underserved and unserved population through savings and providing credit to small business units, small and marginal farmers, micro and small industries and other unorganized sector.

One of the primary condition is that these SFB should open 25% of their branches in rural unbanked centers with population less than 10,000 within one year of commencement of operations. Six SFB’s are presently functional namely, Equitas SFB, ESAF SFB, Fincare SFB, Suryoday SFB, Utkarsh SFB and Jana SFB

RuPay cards

Prior to the launch of RuPay card, India had Visa debit card, the MasterCard debit card, the Maestro debit card and these cards belong to the international payment systems and the foreign cards dominated the market. Further international payment systems are not supported at the merchant establishments in the rural areas. Thus to increase the access of financial services across the country, prominently in rural areas, it was felt that there should be a domestic payment system. RBI then promoted the National Payment Corporation of India and initiated the RuPay card system in 2012 by the national payment Corporation and in a span of 7 years, it has become one of the most popular debit cards accepted all over the country having seen a massive growth in the last few years in particular. The card is accepted at ATMs, POS devices as well as the various e-commerce websites.

Introduction of IFRS

The International Financial Reporting Standards (IFRS) accounting guidelines developed by the International Accounting Standards Board (IASB) is to be adopted by Indian companies to prepare Balance Sheets and financial statements. These guidelines provide a common accounting language globally. Presently 123 countries across the globe have converged with IFRS and India being one of the fastest growing global economies is on the verge of converging with International Financial Reporting Standards (IFRS).

Merger of Banks in India

SBI and its associates

From first April 2017, the five associate banks of SBI namely State Bank of Bikaner and Jaipur (SBBJ), State Bank of Mysore (SBM), State Bank of Travancore (SBT), State Bank of Hyderabad (SBH) and State Bank of Patiala (SBP) merged with SBI. This merger has made SBI among the top 50 large banks of the world with the consolidated balance sheet of the merged entity at ₹ 32 trillion. The merged entity has 23,899 branches and an employee strength of 271,765.[34]

Merger of public sector banks

With effect from first April 2020, ten public sector banks have been amalgamated into four large banks. This is the biggest consolidation exercise in the banking space and the total number of public sector banks in India has been reduced to 12. The amalgamation of these 10 banks into four big banks with result in enhanced capacity to increase credit and bigger risk appetite, with national presence and global reach.

The details of the banks that are merged are:

1. Oriental Bank of Commerce (OBC) and United Bank of India is amalgamated into Punjab national bank (PNB).

   Post amalgamation, PNB is the second-largest public sector bank in the country, after State Bank of India (SBI).

2) Syndicate Bank was merged into Canara Bank making it the fourth-largest public sector bank.

3) Allahabad Bank was merged into Indian bank.

4) Andhra Bank and Corporation Bank were merged into Union Bank of India.

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[34] https://www.livemint.com/Industry/mf507dGEvv1gCGRknnY9GM/SBI-merger-with-five-associate-banks-from-1-April.html

1.16 Summary

- The term “financial services” broadly refers to the “mobilizing and allocating of savings” for efficient investment.
- A financial system is an integral frame-work of financial institutions, financial markets, financial instruments and financial services.
- The financial system in India is regulated by agencies such as RBI, SEBI, IRDA and PERDA.
- Financial services can accelerate economic development through three routes: They are:

  (i) Technical progress;

  (ii) Deciding the rate of capital formation; and

  (iii) Encouraging markets over space and time.
- The relationship between economic development and growth of financial services is thus symbiotic, i.e., (i) funding technological needs (ii) funding capital requirements by promoting higher saving and investments and (iii) encouraging markets over space and time.
- Financial services include (i) Leasing, (ii) Hire Purchase, (iii) Consumer Finance and Installment Credit, (iv) Plastic Money, (v) Insurance, (vi) Bill Financing, (vii) Housing Finance, (viii) Venture Capital, (ix) Securitization, (x) Portfolio Management, (xi) Credit Rating, (xii) Capital Issue Management, (xiii) Factoring and Forfaiting.
- Leasing and hire purchase have been the oldest kinds of financial services both in India and around the world. Some of the financial services in India such as venture capital and credit rating are relatively of recent origin.
- A few of the financial services such as insurance, housing finance are witnessing better times due to various factors. Some of the developments in the financial services sector are: (a) the insurance industry has been opened for private sector participation and Insurance Regulatory Authority has been given statutory powers and (b) housing finance will see increased importance due to changes in the National Housing Bank Act, and the changes in the tax treatment for housing loans.
- Indian financial system comprises commercial banks, insurance companies, non-banking financial companies, co-operatives, pension funds, mutual funds and other smaller financial entities.
- Financial sector reforms are regarded as an integral part of the overall economic reforms in India. India has recognized that major reforms are imperative for increasing the efficiency of resource mobilization and allocation in the economy and, for the overall micro-economic stability.

- The reforms have been driven by the thrust towards liberalization and autonomy for financial institutions. Several initiatives such as liberalization in the interest rates and reserve requirements have been taken on this front.
- The government has emphasized on the stronger regulation aimed at strengthening prudential norms, transparency and supervision to mitigate the systemic risks.

1.17 Glossary

Asset-Liability Management: Managing resources (liabilities) against uses (assets).

Borrowers: In financial services, borrowers are those who seek money for capital investments against which they are bound to pay return.

Dematerialization: Dematerialization, also called as ‘demat’, is the process by which an investor can get physical certificates converted into electronic form / balances. These securities are in the form of bonds, government securities and mutual fund units, which are held by a registered Depository Participant (DP).

Financial Services: Financial services are professional services involving investment, lending, and management of money and assets. It includes: tax preparation, insurance coverage, investment portfolios, mutual funds, investment management, merchant banking, etc.

Insurance: A contract (policy) in which policy-holder receives an assurance of compensation against losses, from an insurance company.

Lenders: In financial services, lenders are the people who make funds available to another with the expectation that the funds will be repaid with good return.

Non-Banking Finance Company (NBFC): An NBFC is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by the government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business.

Leasing: Lease can be defined as a right to use equipment or capital goods on payment of periodical amount. There are two principal parties to any lease transaction, the Lessor who is actual owner of equipment permitting use to the other party on payment of periodical amount and the Lessee who acquires the right to use the equipment on payment of periodical amount. Leasing is broadly classified into two types: financial leasing and operating leasing.

Hire Purchase: Hire purchase is almost similar to a lease transaction with the basic difference that the person using the asset on hire purchase basis is the owner of the asset and full title is transferred to him after he has paid the agreed instalments. The asset will be shown in his balance sheet and he can claim depreciation and other allowances on the asset for computation of tax during the currency of hire purchase agreement and thereafter.

Payment Mechanism: Financial system supporting transfer of funds from suppliers (savers) to the users (borrowers) and from payers to the payees through offline and online media.

Portfolio Management: Portfolio Management Services refer to the financial services provided by a stock broker, NBFC or a bank (referred as portfolio managers) to high net worth investors interested in reaping returns from the stock market.

Risk: An uncertainty which cannot be avoided but can be mitigated.

Uncertainty: Strictly (in financial terms), uncertainty is where there is more than one possible outcome to a course of action; the form of each possible outcome is known, but the probability of getting any one outcome is not known.

1.18 Self-Assessment Test

1. Explain the concept of leasing. What are the differences between financial and operating leasing?
2. Consumer financing is growing rapidly in India over other finances. Discuss.
3. Plastic money is going to play an important role in the Digital India initiative by Shri Narendra Modi Government. Explain.
4. There is a high-level of optimism in India over the growth opportunity of insurance industry. Discuss.
5. List out the various objectives of RERA Act 2016.

1.19 Suggested Readings/Reference Materials

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

1.20 Answers to Check Your Progress Questions

1. (c) No initial margin

The advantages of equipment leasing are easy documentation; fewer restrictive covenants; no convertibility clause that can result in dilution of ownership and control; and availability of 100 per cent finance. The lessee has to provide some percentage towards margin.

2. (b) SBI Capital Markets

The first commercial bank to set up a financial services subsidiary was the State Bank of India (SBI) which became operational in 1986 under the name of SBI Capital Markets Limited.

3. (d) Ownership of equipment is transferred automatically

Ownership of the equipment is transferred only after the user exercises his option to purchase it and not automatically.

4. (c) Ownership of the asset is transferred to the user immediately after the transaction takes place

In consumer finance, the ownership is transferred to the user immediately after the financing transaction takes place.

5. (a) Flat rate

The interest rates are normally charged on a flat rate basis and the instalment paid includes repayment for the principal and the interest.

6. (c) Charge card

A charge card enables the payment immediately after the purchase is reported to the card issuing authority.

7. (b) Probability of the occurrence of the event

The insurer provides insurance on the basis of probability.

8. (d) Private Venture Capital

The private sector venture capital funds have been most aggressive in providing assistance in the form of seed capital, early stage financing, expansion financing or acquisition financing.

9. (b) Capital Issue Management

Capital Issue Management refers to the professionalized activity performed by the merchant bankers involving management of a public issue on behalf of a corporate.

10. (c) Factoring

Factoring involves sale of receivables by a firm to a financial intermediary, who will perform the activity of maintenance of accounts, collection of debts and financing against receivables.

Unit 2

Financial Engineering: New Products and Services

Structure

"I think one problem we've had is that people who are smart and creative and innovative as engineers went into financial engineering."

- Walter Issacson - American Author, Journalist and Professor

2.1 Introduction

Financial engineering is as important as engineering for new products and services.

In the previous unit, we had a glimpse of Indian financial system and basic concepts on various activities in the financial services. This unit deals with financial engineering. Financial engineering is a process which uses analytical tools of knowledge from the fields of mathematics, computer science, statistics and economics to provide creative financial products. It either designs new products or repackages several independent but complementary products into a new product form.

As discussed in the previous unit, financial services are provided by financial intermediaries through financial markets, financial instruments. The dynamic changes in financial markets and the requirement of the stakeholders warrant innovation of new instruments and new risk management strategies. Hence, there is a basic need to understand the basics of financial engineering. This unit will focus on engineering of financial products to cater to the customer needs which ultimately results into new and innovative financial instruments. Emphasis is also given on financial regulators and its tools to safeguard consumers' (both lenders and borrowers) finances.

2.2 Objectives

After going through this unit, you should be able to:

- Discuss the nature and scope of financial engineering
- Describe the risks in financial engineering
- Develop familiarity with structured financial products
- Appreciate the utility of innovative financial instruments
- Explain the current developments in financial engineering

2.3 Financial Engineering: Need for Innovations

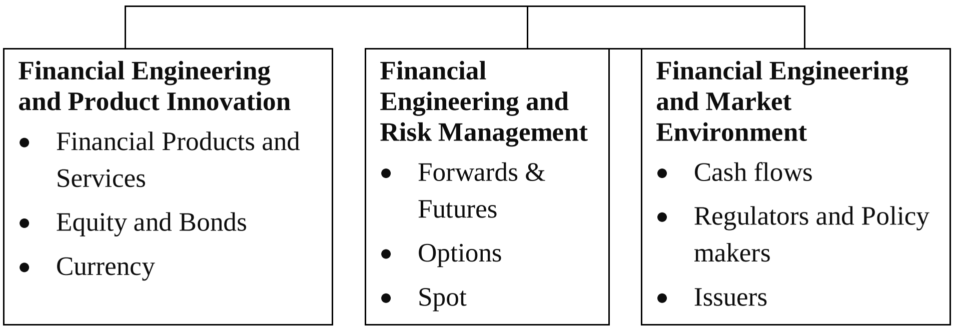
The dynamic situation of the financial markets necessitated more and more financial instruments and innovations to meet the business requirements of the markets. Financial engineering facilitates the business requirement.

2.3.1 Nature and Scope

Financial Engineering is a multi-disciplinary subject that utilizes financial theory, engineering, mathematics and computer programming.

Financial engineers design, create and implement new financial instruments, models, products and processes to solve the problems in investment and finance. They work for the improvement of an existing product or design a new product with the help of their expertise in corporate finance, economics and statistics. To take advantage of new business opportunities, great deal of research and innovation goes into the designing of models by executing in-depth analysis, simulations and risk analysis. Financial engineering mainly deals with three aspects of the market-product innovation, risk management and market environment as shown in the Figure 2.1.

Figure 2.1: Financial Engineering Components



Source: ICFAI Research Center

2.3.2 Risks in Financial Engineering

The need for financial risk management arises from the fact that a firm will be frequently prone to some type of risk due to fluctuations in interest rates, exchange rates, commodity prices etc. Mitigation of risks on account of price volatility and rapid economic changes has become an important challenge. Financial engineers create wide varieties of new instruments combining the features of options, forwards, futures and swaps.

The term “financial risk” is divided into two categories --- systematic risks and unsystematic risks.

There are certain events which may impact all firms simultaneously. These events are external to any one firm. Events such as inflation, war, and interest rates fluctuations influence the entire economy, not just a specific firm or industry. Systematic risk is that portion of risk which cannot be diversified and affects all securities but in different proportion. This risk is not rewarded.

Diversification cannot cure the risk of facing these events. Therefore, it is considered un-diversifiable risk. Unsystematic risk (also called diversifiable risk) is the risk that is specific to a company. This type of risk could include specific events such as a strike, or a fire, or declining sales. Two common sources of unsystematic risks are business risks and financial risks. Therefore, by diversifying, one can reduce this type of risk.

Systematic risks

- **Macro-economic risk:** This risk arises from macro-economic factors such as economic swings, de-regulations, and shift in demand due to seasonality.
- **Interest rate risk:** This risk arises due to change in interest rates which are dynamic and subject to policy changes.
- **Currency (or foreign exchange) risk:** This risk arises due to fluctuations in currency exchange rates in international markets.
- **Inflation risk:** It arises from inflation in the economy due to several external factors.
- **Political risk:** This risk may be due to domestic or external political instability.

Unsystematic risks

- **Price risks:** Specific to the company’s products.
- **Financing risk:** It arises from the raising of funds by the firm and available leverage.
- **Liquidity risk:** This risk arises when it is difficult to buy or sell the securities in the market at the determined price.

- **Operating risk:** This risk arises because of the firm's commitment to recover operating costs.
- **Default or credit risk:** It arises from the default of payment by the debtors of the firm.

To have a practical understanding of the various types of systematic and unsystematic risks, let us do an activity by identifying these risks from a situation given in the box.

Activity 2.1 **Read the information below and identify the various types of risks discussed:** Prior to the incidence of financial crisis of 2008, many customers borrowed loans for the purchase of residential property. These properties belonged to categories which the customers otherwise couldn't afford. These housing loans carried variable interest rate annuities. The interest rates differed with period of time. They were initially placed at a lower level and raised further. The record for the previous twenty years displayed increasing interest rates. But when these rose suddenly, home loan buyers encountered sudden increase in their monthly mortgage payments. Most of them defaulted. They were reassured that their investment would appreciate in value and they would be able to refinance it. The home loans were repackaged by the banks and sold off to other financial institutions across many countries in the form of complex investment vehicles. Though such investment appeared to be safe and beneficial in the beginning, they started breaking down slowly. When these investors who invested in the investment vehicles defaulted, the entire financial community realized there were no mechanics around to fix these vehicles. This resulted a major financial crisis.

2.3.3 Risk Management

Let us understand the risk management with the help of the two approaches that are discussed below-

- **Total risk approach:** Under this approach, the sum of systematic and unsystematic risks is taken into consideration by the firm.
- **Designing a suitable strategy:** Under this approach, there are three methods of managing the risk, they are: insurance, asset/liability management and hedging.

In highly volatile markets, financial engineering seeks to limit financial risk by creating financial instruments for hedging, speculation, arbitraging, and by fine-tuning portfolio adjustments. It also seeks to maximize profits quickly by making use of financial derivatives and securitization. Computer intelligence and human insight are combined to spot arbitrage opportunities, measure risks and react quickly and effectively.

2.3.4 Overview of Structured Financial Products

[35]US Securities Exchange Commission (SEC) defines structured securities as "securities whose cash flow characteristics depend upon one or more indices or that have imbedded forwards or options or securities where an investor's investment return and the issuer's payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows."

Structured products, generally known as market linked investment products, can be used as an alternative to a direct investment in the asset allocation process. They reduce the risk exposure of a portfolio in the current market.

[36]The following entities can issue the Structured Finance Instruments /Pass Through Certificates (PTCs):

- Banks
- Non-banking financial companies (NBFCs)
- Infrastructure entities
- Micro-finance institutions
- Urban local bodies

Features of structured financial instruments:

- Combining many features of traditional investments such as bonds with financial derivatives such as options.
- Return on investment is linked to pre-determined percentage up to which the investor will have share in the asset gain.
- Return on investments is linked to performance of underlying investments, such as individual securities, market indices, currencies, and commodities.
- Offers higher return than market coupons.
- Complex and best suited for sophisticated investors, but requires careful analysis before making investment.

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[35] https://www.sec.gov/rules/final/prosdel.txt

[36] https://www.crisil.com/en/home/our-businesses/ratings/rating-instruments-and-scales/pass-through-certificates-structured-finance.html

Example: Structured Product of Edelweiss

All Weather Equity (AWE) was one its kind structured product offered by Edelweiss, the popular non-banking financial services company in India. AWE was a principal protected and market linked debenture. As per the company's offering in September 2021, AWE offered an absolute return up to 53% and protection of principal amount equal to face value if retained till maturity.

Source: https://www.edelweiss.in/cas/microsite/RM-portal-new/assets/ECAP-Unlisted-AWE-3Yr-Sep-2021.pdf Accessed on June 22, 2022

Benefits of structured products:

- Based on the type of structured product, there is a protection of the principal amount.
- These products provided access to tax-efficient investments.
- Enhanced returns on an investment (depending on the type of structured product).
- Reduced volatility (or risk) within the investment (depending on the type of structured product).
- Such products enable investors to gain a positive return even in markets that give less return otherwise termed flat markets.

Disadvantages of structured products:

- The risk may include the loss or reduction of principal of reference asset on maturity.
- In cases where there is protection to the principal amount or the underlying security generates an interest rate which is more than the market, this investment product is not preferred. This is because it will restrict the participation in the underlying asset.
- The performance of derivative component of the instrument is linked to market movements of the reference security. Thus, it may result in loss of the principal amount. This makes the product unattractive to the investors who are looking at alternative investments.
- Lack of liquidity – The structured products are not liquid, as they are not easily marketable. They are not usually sold, once they are issued. So, anyone who wants to sell it may have to do so at huge discount. Structured notes are not designed to be liquid - they are intended to be held - up to maturity. While there may be a secondary market for structured products, issuers are under no obligation to maintain one.
- Selling before maturity carries with it the risks inherent in factors that can affect marketability - such as volatility of the underlying assets, interest rate swings and developments affecting the underlying securities.

- No daily pricing - structured products are priced on a matrix, not on net-asset-value. Matrix pricing is essentially a best-guess approach.
- Highly complex - the complexity of the return calculations makes it difficult to understand the performance of the instruments.

Check Your Progress - 1

1. Which of the following is the main objective of financial engineering?
   a. To structure financial system
   b. To innovate new financial products and services
   c. To design regulatory system
   d. To control finances in the system
   e. To calculate the financial implications of engineering projects
2. Which of the following statements is false with respect to structured financial products?
   a. They are created as a solution to the specific needs of the clients
   b. They can be used as an alternative to direct investment
   c. They are designed to facilitate highly customized risk-return objectives
   d. They can be issued by only infrastructure entities
   e. They combine the benefits of traditional investments with the new ones
3. Which of the following is not an advantage of structured financial products?
   a. Principal protection
   b. Tax-efficient
   c. No daily pricing
   d. Enhanced returns
   e. Positive yield in flat instruments
4. Which of the following statement is true in case of systematic risk?
   a. Can't be diversified
   b. Can be diversified
   c. Can't be controlled
   d. Can't be reduced
   e. Can be rewarded
5. Which of the following is not an example of systematic risk?
   a. Business risk
   b. Technology risk
   c. Inflation risk
   d. Default risk
   e. Price risk

Activity 2.2 Discuss the various types of risks faced by banks. **Answer**:

2.4 Innovative Financial Instruments

Financial engineering has contributed to the growth of innovative products and instruments through improved processes and strategies. In the recent years, innovation has been the growth driver behind the phenomenal success of many of the financial service companies. The innovative financial instruments can be broadly divided into the following three categories:

1. Fixed income securities
2. Debt market instruments
3. Equity instruments

1. Fixed Income Securities

These are the securities issued by private and public sector companies with the following features:

- Pay a fixed return periodically i.e., monthly, quarterly, half-yearly or yearly
- Pay a sum determined by a formula
- Guarantee a fixed sum as return upon maturity

Fixed income securities offer periodic income payments at an interest or dividend rate. This rate is known beforehand by the holder. The usual forms of fixed-income securities comprise government bonds, corporate debentures and, Fixed Deposits (FDs). Holders of government bonds and FDs receive a fixed interest over a specific period of time. Holders of preferred stock are entitled to a periodic fixed dividend specified by the issuing company as long as they own the shares.

Fixed income securities are preferred by low risk or risk averse investors who look for a regular source of income payments at regular intervals. Assume an investor holds a government bond with a face value of ₹ 2,00,000. The bill will give a return of 6%. So, the investor is guaranteed a payment of ₹ 12,000 each year for the life of the government bond. Similarly, an investor who holds preferred stock in company XYZ might be promised a quarterly dividend payment of ₹ 5 per share, which he can dependably receive as long as he holds the shares. But, the disadvantage for investors in fixed income securities is that along with low risk is the low level of return.

2. **Debt Market Instruments**

These instruments refer to any tradable debt issued by government or a corporation. The investor in the debt security will provide the money for purchase of security. The security gives the holder the right to receive periodical interest payments and at maturity, the principal. These are transferable instruments and traded in the market. In general, debt securities are less risky than stocks.

Features of debt securities

The following are the features of debt securities:

- **Coupon rate:** It is the rate at which the interest is computed on the amount of bond.
- **Yield:** It is the effective return paid on a bond.
- **Yield to maturity:** It is the rate of return that accrues on a bond or other fixed income security if the investor purchases and retains it till the date of maturity.
- **Tenor:** It is the period for which the instrument is issued, i.e. the time due for the repayment of a claim. It can be expressed in years, months, or days. The principal is repaid on maturity and interest is paid from the date of issue of the instrument to the date of maturity as per the terms of the contract.
- **Fixed and floating rates:** Debt instruments can be issued with fixed or floating rate of interest. The interest under fixed rate plan is fixed at the time of issue for the entire period of the instrument. The interest under floating rate plan is linked to some base rate which keeps on changing.
- **Call and Put Option:** The bonds / debenture instruments are issued with 'call' or 'put' option.

An investor can receive the invested amount in a bond / debenture before the maturity date if the debenture has the put option. Similarly, in call option, the investor decides to call the investment in bonds/ debentures back before its maturity date if the market rates are not favorable (lower), so that, they can re-borrow at a better rate. Thus, both the put and call option bonds/ debentures are beneficial to the investor.

Types of debt instruments:

The following are some of the types of debt instruments:

1. **Non-Convertible Debentures (NCDs):** These are simple debentures which are issued with specified coupon rate and time period. The repayment of the instrument is normally divided into one or more tranches. Besides, NCDs offer various other benefits to the owner such

as high liquidity through stock market listing, tax exemptions at source and safety. NCDs can be issued only by companies that enjoy a good credit rating. In India, they are issued for a minimum maturity period of 90 days. The following Exhibit 2.1 provides an illustration on this.

Exhibit 2.1: Tata Power: A Non-Convertible Debenture Issue

According to a report in the Economic Times on July 20th 2020, Coastal Gujarat Power Ltd (CGPL), wholly-owned subsidiary of the Tata Power has raised an amount of ₹ 350 crore NCDs on private placement basis for a tenor of 3 years, carrying a coupon of 8.55 % and guaranteed by TATA Power. The NCDs have been rated AA (CE) by India Ratings & Research.

Source: https://economictimes.indiatimes.com/markets/stocks/news/tata-powers-arm-cgpl-raises-rs-350-cr-via-ncds/articleshow/77073275.cms?from=mdr, July 20, 2020

2. **Partly Convertible Debentures (PCDs):** These instruments contain two portions - first one is convertible portion and the second one is non-convertible portion. The convertible part is re-deemed into equity shares after a specified period as per the terms of issue. Non-convertible portion will be repaid on due date.

3. **Fully Convertible Debentures (FCDs):** These instruments are a type of debt security where the total value of the debenture is converted into equity shares as per the scheme of issue. Interest is paid on the debentures as per the scheme of issue until the date of conversion. Upon conversion, the investors enjoy the same status as ordinary share-holders of the company.

   Convertible debentures are issued normally by companies which has a high growth potential but suffer from low credit rating. These securities offer higher rate of returns to investors and provide growth potential for growth. These securities can be exchanged for common stock if there are fully or partially convertible. Though they carry some credit risk, they are generally, viewed as better option.

4. **Zero Coupon Bonds / Debentures (ZCBs):** Zero Coupon Bond is a bond that pays no interest (coupon) over its life and is issued at a significant discount to its face value.

Zero coupon bonds, as their name suggests, have no “coupon,” or periodic interest payments. At the time of issue, these bonds are issued at a discount. When they are being redeemed on maturity, the investor is paid the full principal amount. The difference between the issue price and the face value paid on maturity is the interest earned by the investor. The price of a zero-coupon bond can be calculated by using the following formula:

[37]Zero coupon bonds are long-term source of finance for the issuer. The business entities which raise the funds through this mode will use the funds for long-term investment purpose. They can plan the cash flows accordingly.

Similarly, these are long-term investment opportunities for the investor. Since long-term capital gains are exempted from tax, these investments are beneficial to the investor as the entire income forms part of cash flows. He can plan his investments in these securities to meet the future needs.

$P = M / (1+r)^n$

Where,

P = Price

M = Maturity value

r = Investor's required annual yield / 2 (Interest compounded half yearly)

n = Number of years until maturity x 2

For example, XYZ zero-coupon bond that has a ₹ 1,000 face value and matures in three years, @10% interest p.a., using the formula above purchase price is:

₹ 1, 000 / (1+0.05)6 = ₹ 746.22

When, the bond matures, face value of ₹1, 000 is payable.

A zero-coupon bond is alternatively called a deep discount bond. Due to the time value of money, the present value of a single sum of money increases over time as it reaches maturity.

3. **Equity instruments**

An equity instrument refers to a claim of the ownership right in a firm, like a share certificate. Equity instruments are issued to company share-holders.

Types of equity instruments issued in India:

- **Equity options:** Equity options include: call and put options on common stock and are often called as “stock options”.
- **Equity warrants:** Equity warrants are similar to call options on stock in the sense that they grant the holder the right without the obligation to buy the underlying stock from the warrant grantor.
- **Subscription rights:** This type of issue involves the company raising its capital from its existing shareholders only. When a listed company requires to raise additional funds, instead of going for a public issue, it can issue the shares to its existing shareholders only. The shares

[37] https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/zero-coupon-bond/

are issued in ratio to the shares already held by the shareholders. For example, a ratio of 1:2 rights issue means that an existing investor can be allotted one rights share for every two shares already held by him/her.

The rights issue is usually done at a price lower than the current market price of the share to attract the shareholders to subscribe to the rights issue.

- **Pooled investment vehicles:** Pooled investment vehicle is any arrangement by which assets are pooled and equity interests in the pool of assets are sold to investors. Mutual fund companies representing open-end investments are best known vehicles.
- **Alternative Investment Funds (AIFs):** In India, Alternative Investment Funds (AIFs) are defined in Regulation 2(1)(b) of Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. These are privately pooled investment funds. Indian or overseas sources can form them. They are constituted in the form of a trust or a joint stock company or a limited liability partnership.

  In India, the alternative investment funds are defined as those funds that do not come under the purview of any regulatory body. AIFs comprise venture capital funds, hedge funds, private equity funds, commodity funds, debt funds, infrastructure funds, etc. It does not include mutual funds or collective investment schemes, etc.
- **Index Futures and Index Options:** Futures is an agreement to buy or sell a particular asset on a specified future date at price agreed upon today. If the Futures, contract is based on an index i.e. the underlying asset is the index and it is known as Index Contract. For instance, a futures contract can be based on the NYSE Index. In such a case, the contract’s value is based on the changes occurring in the NYSE Index.

  When an index futures contract (go long) is bought, buyer agrees to buy the underlying index at particular date in the future. Profit /loss is dependent on the prevalent price of the future at expiry of the contract or at the time buyer closes out position (i.e. buy it back). When an index futures is sold for open opposition (go shorter), it means that the seller agrees to sell the index at a particular date in the future. Profit/loss is dependent on price that is prevalent on date of expiry. Index futures are leveraged products that allow to hedge, trade or gain exposure to an underlying index.

  Just like a futures contract, an option contract can also be done tracking an index.

- **Derivative contracts:** The eligibility of a stock / index for trading in derivatives segment is based upon the criteria laid down by SEBI through various circulars issued from time to time. Based on SEBI guidelines and as a surveillance measure, following criteria has been adopted by the exchange for selecting stocks and indices on which Futures & Options contracts would be introduced.

  - The stock shall be chosen from amongst the top 500 stocks in terms of average daily market capitalization and average daily traded value in the previous six months on a rolling basis.
  - [38]SEBI has advised that exchange may consider introducing derivative contracts on an index if the stocks contributing to 80% weightage of the index are individually eligible for derivative trading. However, no single ineligible stock in the index shall have a weightage of more than 5% in the index.

  Index contracts are not deliverable either on the maturity of the Index futures contracts or Index option contracts. Hence these contracts are primarily settled in cash on maturity.

In some of the financial instruments, especially certain options and futures, on the expiry or exercising the contract, the seller does not deliver the actual instrument which happens to be the underlying asset, but settles the amount in cash. The sellers of the instrument do not prefer to take the actual possession of the underlying asset and opt for cash settlement as it is more convenient. Thus, most of the derivative instruments such as options or futures based indices are cash settled.

However, it also introduces speculators and creates more liquidity in the market.

- **Foreign securities:** Global investment helps in diversification of the risk and increases the returns. Diversification across currencies and asset classes is important for all investors. Further, Indian investors who invest outside India will be in a position to have a cushion against downfall in the domestic market.

  Each country or region enjoys a distinct advantage in terms of resources or abilities that give it an edge over others. By investing in different overseas markets, an Indian investor can gain exposure to a variety of opportunities—technological innovations in the US, bountiful commodity reserves in Brazil or the rich mining fields in Australia, Africa, and Indonesia.

[38] https://www.sebi.gov.in/sebi_data/faqfiles/jan-2017/1485846339758.pdf dated January 2017

Example: US Securities Allowed into India

NSE owned International Financial Service Centre (IFSC) in Gujarat's GIFT city had allowed trading in eight US stocks including Alphabet, Amazon, Tesla, Microsoft and Netflix from March 3, 2022. This was part of the Government's initiative to slowly enable Indian investors to trade in foreign securities from India..

Source: https://www.business-standard.com/podcast/markets/indians-can-now-invest-in-international-stocks-through-nse-ifsc-122030800063_1.html Year 2022 Accessed on June 22, 2022

Investors who are prepared to take high risk can take part in the growth of some of the booming economies and benefit from the more stable developed economies. Investment in foreign securities is required to be made in terms of exchange control regulations prevailing in the country of investing company and Investee Company.

- **Hybrid securities:** Hybrid securities are a broad group of securities that combine the elements of the two broader groups of securities viz. debt and equity. Hybrid securities include:
  - Certain classes of preferred stock
  - Trust preferred securities
  - Convertible debt securities
  - Mandatorily convertible instruments
  - Capital notes are debt securities that have equity-like features attached

  Examples include:
  - Perpetual debt securities – They are debt instruments but unlike usual debt instruments, they do not have a specified maturity date. Thus, this kind of security combines the features of a debt security with the perpetuity associated with equity.
  - Subordinated debt securities – These debt instruments rank below other debt instruments with relation to payment of interest and repayment of debt.
  - Knockout debt securities - These are debt instruments which enable the issuer to enjoy the right to extinguish or cancel them if certain conditions are not met.

  A hybrid security is a blend of equity and debt security. Certain securities are fixed interest bearing securities, while others exhibit the features of the underlying shares into which they can be converted.

Carbon credit trading

Though these instruments are not traded by general public, due to the environment concerns, this instrument will gain prominence in future.

It is a tradable certificate that gives the holder of the credit, the right to emit one ton of carbon dioxide or any greenhouse gas. The main purpose of introducing this financial instrument is to reduce the effects of global warming.

This instrument was introduced as per Kyoto Protocol in the year 2005 and the Paris Agreement validates carbon credits as a financial instrument to reduce emissions of the greenhouse gases and facilitation of the carbon credits markets.

Background

Based on the Kyoto Protocol, governments or some other regulatory authorities have set the caps on greenhouse gas emissions on companies which are responsible for such emissions. Since immediate reduction of the emission is not possible or economically viable, these companies have been permitted to purchase carbon credits to comply with the emission cap. Similarly, companies which have been able to reducing the emissions of greenhouse gases are rewarded with additional carbon credits.

There are two types of the carbon credits, Voluntary Emissions Reduction (VER): and Certified Emissions Reduction (CER):

- VER is a carbon offset that is exchanged over-the-counter.
- CER is created through a regulatory framework with the purpose of offsetting a project’s emission.

Trading of Carbon Credits (CC)

The carbon credits can be traded in public and private markets. There can also be an international transfer of carbon credits. The price of carbon credits is based on the supply and demand in the markets and the prices of the carbon credits fluctuate.

In India the profits on carbon credits are taxed at the rate of 10 per cent, instead of regular tax of 30 per cent to encourage the trading in carbon credits.

[39]Collateralized Borrowing and Lending Obligation (CBLO)

This is a new money market instrument developed by Clearing Corporation of India Ltd. (CCIL) and introduced by RBI in the FY 2002-2003 for the benefit of those who do not have access to the call money market and those who hitherto were players in interbank call money market.

[39] https://www.ccilindia.com/Membership/ByLawsDocs/CBLO%20Regulations%202016%20-%20effective%2012th%20Sept%202016.pdf

CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days or up to one year. Clearing Corporation of India Ltd, (CCIL) provides the Dealing System Market participants can borrow and lend funds. The borrowers have to maintain securities in the form of margin with the Clearing Corporation.

Eligibility

Banks, financial institutions, insurance companies, mutual funds, primary dealers, NBFCs, non-government provident funds, Corporates etc. are eligible to borrow through CBLO.

Process

The Members are required to open Constituent Subsidiary General Ledger Account (CSGL) with CCIL.

The margin which is offered as collateral is in the form of securities and should be is deposited with CCIL.

The associate Members are required to open a current account with a Settlement Bank designated by CCIL for settlement of funds.

Eligible Securities

Eligible securities are central government securities including treasury bills.

[40]Inter-Bank Participation Certificates (IBPCs)

IBPC is a short-term money market instrument through which the scheduled commercial banks can raise money/deploy short-term surplus. The bank passes/sells on the loans and credit that it has in its book, for a temporary period, to the lending bank. Many a time this route is adopted by banks to reach the priority sector lending target. This instrument was introduced in the year 1990 by RBI.

[41]In August 2009, RBI permitted Regional Rural Banks (RRBs) also to issue IBPC of a tenor of 180 days on risk sharing basis to scheduled commercial banks against their priority sector advances in excess of 60% of their outstanding advances.

There are two types of IBPC. They are:

(i) With risk sharing

(ii) Without risk sharing

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[40] https://rbidocs.rbi.org.in/rdocs/content/pdfs/IBPC040809.pdf

[41] https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode =0&Id=5196#:~:text=2. of%20IBPCs % 20will%20remain%20unchanged.

Features of IBPC

The following are the features of IBPC-

- The minimum period of IBPC in case of non-risk bearing is 90 days. In case of risk bearing, it shall be 91 days and maximum period 180 days.
- The maximum participation in under IBPC would be 40% of the amount outstanding or the limit sanctioned whichever is lower.
- The participation should be in standard asset.
- The borrowing and issuing bank have to enter into participation contracts in the prescribed format and execute documents.
- Interest rates are determined between the issuing bank and the participating bank.
- IBPCs are not transferable and redeemable before due date.

Repayment

On the date of maturity, the issuing bank makes payment of the IBPC along with rate of interest to the participating bank.

In case where the risk has materialized, the issuing bank in consultation with the participating bank may share the recoveries proportionately.

In the case of non-risk sharing of IBPCs, the issuing bank will pay the amount to the participating bank irrespective of defaults.

Activity 2.3

A five-year zero-coupon bond is issued with a face value of ₹ 100 and a rate of 6% p.a. What would be the original price of the bond? If the interest rate is reduced, what would be the effect on the price?

Answer:

2.5 Financial Products and Services

Many financial intermediaries including banks have started expanding their activities in the financial services sector by offering a variety of new products. Some of them are as follows.

Asset/Fund-based Services

The following are the asset/fund-based services-

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

Hire-purchase and consumer credit: Hire-purchase is an alternative to leasing. Hire-purchase is a transaction where goods are purchased and sold on the condition that payment is made in instalments. The buyer gets only possession of goods. He gets ownership only after the payment of the last installment. If the buyer fails to pay any instalment, the seller can repossess the goods. Each installment includes interest also.

Venture capital: Venture capital refers to capital which is made available for funding the new business ventures. It is the investment in a highly risky project with the objective of earning a high rate of return when the unit starts making profits. In short, venture capital means long-term risk capital in the form of equity finance.

Housing finance: Housing finance refers to providing finance for house building. It emerged as a major financial service in India with the establishment of National Housing Bank (NHB), by the RBI in 1988 which supported the financial institutions with re-financing facilities. A number of specialized financial institutions have entered the field of housing finance. Some of the institutions are: HDFC, LIC Housing Finance and subsidiaries of several banks. This is also called as mortgage financing as house is mortgaged as security.

Reverse mortgage: In 2007-08, the National Housing Bank (NHB), and commercial banks have introduced this innovative new product to enable senior citizens to fetch value out of their property without selling it. In a reverse mortgage, the owner of the house property mortgages the property to a lender and raises money. The lender does not pay the entire amount at a time but pays out a regular sum each month for the agreed time. The owner and spouse can reside throughout their life. Usually, after the death of owner, the spouse can continue to use the property and in case, both die during the period of the reverse mortgage scheme, the lender will sell the property.

Reverse Mortgage Loan

The Reverse Mortgage Loan Scheme was introduced by banks/ housing loan companies and other NBFCs for supplementing the cash flow source of senior citizens in order to meet their financial needs.

Senior Citizen of India (with above 60 years of age) and the owner of residential property (house or flat) located in India in his/her own name is eligible for the scheme. Such a residential property should be fully self-occupied permanent residence.

Financial institutions may fix the maximum loan eligibility. They shall have the option to revise periodic annuity amount, if lump-sum payment is taken or at a frequency of five years based on valuation of the property.

The loan shall become due and payable when the last surviving borrower dies or would like to sell the home / permanently moves out of the home. The loan will, as such, become due for recovery and payable. Settlement of loan, along with accumulated interest, to be met by the proceeds received out of sale of residential property.

At the time of settlement of the mortgage, the right to settle is first given to the borrower. The borrower in such a case should settle the debt by repaying the borrowed amount along with any interest due. In the event of failure to do so, the mortgaged asset may be sold after the expiry of two months from the date the repayment is due.

Rate of interest is based on the markets rate structure. The property will be the primary security. A simple / equitable mortgage of the residential property is taken. The tenure will be fixed by the financial institution and may not exceed 15 years. The banks will cover adequate insurance.

Why reverse mortgage loan is not popular in India?

Reverse mortgage is not very popular in India. There are various reasons like-

i. Many senior citizens are not even aware of the product due to poor marketing by banks

ii. Many have not understood the concept itself

iii. Senior citizens are of the view that the product is more complex and may not suit them

iv. Owning a property is a sentiment and the parents/ grandparents would like to pass on the property earned to the next generation as their gift without any encumbrances.

Insurance services: Insurance is a contract between the insured and the insurer. Insured is the person whose risk is insured by the insurer. Insurer is the insurance company to whom risk is transferred by the insured.

It is a contract in which the insurance company undertakes to indemnify the insured on the happening of certain event for a payment of premium as consideration. The insurer assures insured to compensate him for the actual loss arising from the risk insured against. Thus, insurance is a pool by which a loss likely to be caused by an uncertain event is spread over a large number of persons who are exposed to it. The members of the pool with homogenous risk pay the premia to cover their risks. On occurrence of the event the affected members get paid out of the pool fund consisting of premia, surplus and returns on investments.

The contract which contains all the terms and conditions of insurance is called the ‘insurance policy’. The amount for which the insurance policy is taken is called ‘sum assured’. The consideration in return for which the insurer agrees to make good the loss is known as ‘insurance premium’. This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

Factoring: Factoring is short-term financing based on receivables of a business, where receivables are due within 180 days. Factoring is the process of purchasing accounts receivable, or invoices, from a business at a discount. Factors cater to the needs of mostly small and medium-sized enterprises that are short of working capital.

Factoring is often with recourse to the seller against default of his debtor. Under a recourse agreement, the seller has to repurchase or pay for any invoices the factor could not collect from the seller’s customers. The factor still agrees to advance money, take on the collection responsibility and earn a fee for it.

Bill discounting: Discounting of bill is a fund based financial service provided by the finance companies. In the case of usance bills (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer’s account. Thus, the bank purchases the bill and credits the customer’s account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer.

Forfaiting: Forfaiting (not forfeiting) is a form of financing of receivables relating to international trade. It involves a bank or any other financial institution purchasing receivables from the exporter. On the maturity date, the amount is received from the debtor by the forfaiting agency. In other words, it involves, the exporter transferring his right to receive payment from debtor, as he has already received from the forfaiting bank / financial institution.

Mutual fund: Mutual funds are a type of financial institutions that help small savers by mobilizing their small savings into a fund. The fund is then invested in viable opportunities on behalf of the savers. Mutual fund companies regularly manage the portfolio of investments to ensure that the investments are done in a combination of corporate and government securities that give the best returns with moderate risk. The mutual fund companies pass on the returns earned on the investments to the savers in the form of dividends or capital gains.

Non-Fund-based/Fee-based Financial Services

Merchant banking: According to SEBI (Merchant Bankers) Rules, 1992 merchant bankers are defined as follows: "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management". Merchant Banks are issue houses which manage new issues of the companies in the capital market.

Merchant bankers perform various functions such as:

(i) Loan syndication

(ii) Offering financial and management consultancy

(iii) Project counselling,

(iv) Portfolio management

(v) Developing revival schemes

(vi) Advices on foreign exchange dealings.

The procedure of 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 are discussed hereunder:

Spectrum of Merchant Banking Services:

- Equity Issue Management (Public/Rights)
- Debt Issue Management
- Structured Placements
- Project Appraisals
- Monitoring Agency Assignments
- IPO Handling
- Security Trustee Services
- Corporate Advisory Services
- Mergers and Acquisitions
- Buy-back Assignments
- Share Valuations
- Syndication
- ESOS Certification
- Debenture Trusteeship
- Demat Services
- Issuing & Paying Agent (IPA) for Commercial Paper Issues

Issue Management Services:

- Project appraisal
- Capital structuring
- DRHP/RHP- Compilation of Offer Document.
- Tie-ups (placement)
- Formalities with SEBI / Stock Exchange / ROC, etc.
- Underwriting
- Promotion /Marketing of Issues
- Collecting Banker / Banker to an issue
- Post-issue Management
- Refund Bankers
- Debenture Trusteeship
- Registrar & Transfer Agency (our Subsidiary)

Credit rating:

Credit rating is an expert analysis of the credit risks associated with a financial instrument issued by a financial institution such as CRISIL, ICRA, MOODY' S&P, etc.

It is a rating given to a particular instrument based on the credentials and the extent to which the financial statements of the entity are credible, in terms of borrowing history.

It is the financial capability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay.

Example: Credit Rating Upgrade for Vedanta

In February, 2022, CRISIL, the Indian credit rating agency, upgraded Vedanta's (an Indian multinational mineral ore mining company) rating to CRISIL AA from CRISIL A- considering the company's "long-term bank facilities and debt instruments". The new rating indicated superior financial position of the company with improved corporate structure, efficient capital allocation and balance sheet.

Source: https://www.cnbctv18.com/business/companies/crisil-upgrades-vedantas-credit-rating-outlook-revised-to-stable-12627932.htm Year 2022 Accessed on June 22, 2022.

It is an indication about a firm's financial and business credentials.

In short, credit rating means assessing the credit-worthiness of a company by an expert and independent agency, which helps ordinary investors to take an investment decision, as many investors may not be able to interpret the financial statements of issuer companies.

Usually, ratings are published in the form of abbreviations indicating the risks levels; such ratings are based on the financial history and critical information obtained from the financial institutions. It helps in assessment of the solvency of the particular entity. Some of the popular credit rating agencies are: Standard & Poor's, Moody's Investors Service, ICRA, and CRISIL. (Refer Table 2.1).

Table 2.1: Ratings and its Interpretation of Credit Rating Agencies in India

S. No	CRISIL	ICRA	CARE	Interpretation
1	AAA	LAAA	CARE AAA	Highest safety
2	AA	LAA	CARE AA	High safety
3	A	LAA	CARE A	Adequate safety
4	BBB	LBBB	CARE BBB	Moderate safety
5	BB	LBB	CARE BB	Inadequate safety
6	B	LB	CARE B	Risk prone
7	C	LC	CARE C	Substantial risk
8	D	LD	CARE D	Default

Source: ICFAI Research Centre

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

[42]**Custodial services:** "Custodial services" in relation to securities of a client or gold or gold related instruments held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund scheme in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 means, safekeeping of such securities or gold or gold related instruments or title deeds of real estate assets and providing services incidental thereto. These services include-

(i) Maintaining accounts of securities or gold or gold related instruments or title deeds of real estate assets of a client;

(ii) Undertaking activities as a domestic depository in terms of the Companies (Issue of Indian Depository Receipts) Rules, 2004; collecting the benefits or rights accruing to the client in respect of securities or gold or gold related instruments or title deeds of real estate assets;

(iii) Keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client; and

(iv) Maintaining and reconciling records of the services referred in the Securities and Exchange Board of India (Custodian Of Securities) Regulations, 1996.

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[42] Securities and Exchange Board of India (Custodian Of Securities) Regulations, 1996

Loan syndication: It is an arrangement of loans for a corporate from multiple institutions by an intermediary institution called arranger. An arranger is appointed by corporate to undertake the job for remuneration. Generally, the arranger is also a lender and lead banker. Loan syndication is preferred by financially sound corporates to gain competitive borrowing rates from the market. Important features are:

(i) Single borrower

(ii) Multiple lenders

(iii) Common loan documentation and security.

Securitization: Securitization is a process by which a company pools its different financial assets/debts and forms a consolidated financial instrument. This instrument is then sold or issued to investors. This process enhances liquidity for the company.

Corporate advisory services: Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. The services include regulatory, business operations, taxation, financial due diligence, marketing and research, and funds management.

Portfolio management: Portfolio management deals with management of investment portfolios of customers. Portfolio managers are involved in decision relating to arriving at an appropriate investment mix, allocation of assets and duly making optimum risk-return analysis.

Plastic money: Plastic money refers to the mode of payment for goods and services where the payment is through use of specific cards made of plastic (hence plastic money), which substitute the usage of currency at the time of purchase/payment. The mode of payment is through the usage of 'Plastic Cards' which will identify the user enabling the payment. Different types of plastic cards are credit cards, debit cards, smart cards, gift card, etc.

2.6 Financial Engineering -- Concerns and Issues

Financial engineering changed the investment trends by bringing innovation in designing the products and widening the scope of services. This change has also brought in increasing expectations from customers and rising safety concerns for the investing professionals. In this context, the investor and issuer concerns are discussed below:

Investor concerns:

- Investor is interested in a security which offers a stable and assured return whether it is fixed coupon rate or floating coupon rate.
- Whether the security is adequately rated by an accredited credit rating agency.
- Whether the security falls under the tax-free securities.

- Whether full and transparent information is available on risks and rewards for each instrument.
- Whether the issuer has permission from regulatory authority.
- Whether there is a secondary market for meeting liquidity needs.

Issuer concerns: The issuer takes the following points into consideration while issuing any securities.

- The issuer always looks for cost of debt which must be as low as possible.
- The debt instruments are issued at a fixed interest rate which provides better earnings for share-holders.
- The interest paid on borrowings could be allowed as a tax deductible expense.

Example: Key Issues Flagged at ETILC Conclave

In 2021, the Economic Times India Leadership Council (ETILC), the prestigious India Inc senior business leader network, in its conclave on finance industry highlighted some of the key issues and concerns of fintech. Particularly it noted that the RBI should come up with a licensing framework for NeoBanks and digital currencies to tackle data privacy issues. Secondly, it suggested safeguards on 'responsible lending practices' and revealing the risk profile of the companies.

Source: https://economictimes.indiatimes.com/industry/banking/finance/fintech-should-focus-on-inclusion-access-and-strengthening-the-ecosystem-etilc/articleshow/91176461.cms Year: 2022 Accessed on June 23, 2022.

2.7 Current Developments – Recent Trends in Financial Engineering

There are significant developments in the recent past in the area of financial engineering:

- Financial engineering is rapidly developing in providing solutions to the growing population of High Net worth Individuals (HNIs) in India.
- Pension funds and Sovereign funds are creating new challenges and opportunities for financial engineers to design new schemes.
- Developments of innovative and structured products are facing unpredictable interest fluctuations, and stock market volatility.
- The structured products developed by financial engineers in India have increased the efficiency in financial market by reducing the costs of funding. On the other hand, international financial crisis in European countries, regulatory failures in preventing the entry of fraudulent financial engineering products and rigging in the commodity markets have dented the investor confidence in derivatives market.

Technology is going to be the future of finance industry. Financial engineering has become an integral component of the financial industry. Hence the technological developments will provide a strong fillip to financial engineering.

Some of the world's largest global banks are of the view that they should think themselves as technologists. Some of the areas that have attracted technology in finance sector are:

- **Digitalization**

  The words digitization and digitalization have slight differences. According to Gartner's IT glossary, "Digitization is the process of changing from analog to digital form."

  "Digitalization is the process of moving to a digital business." In other words, it involves the use of digital technologies to upgrade a business model. It enables the business to secure revenue and value-producing opportunities.

- **Artificial intelligence and cyber:** Financial services risk managers will be thinking on protection of customer identities and their own production systems as technology outstrips humans' ability to manage it.

- **BigTechs:** Large technology companies are increasing their influence in the industry, specifically, in the area of cloud services. The services are provided to the industry by taking their core systems of record to the cloud, to offer new ways in storage of new forms of data. Many types of technology firms will be providing financial services themselves.

- **Industry convergence:** Many companies in other industries (tech, consumer, automotive) are entering into financial services as part of their value proposition[43].

Example: AI and Financial Engineering

AI was set to revolutionize the financial engineering landscape. The advent of predictive analytics detecting trends, patterns and correlations in the data enabling sales windows, cross-sell options, designing sequential investments etc. could go a long way facilitating financial engineering. Cybersecurity, robo advice and credit scoring could be impacted by AI.

Source: https://ibsintelligence.com/ibsi-news/5-applications-of-artificial-intelligence-in-banking/ Year: 2021 Accessed on June 23, 2022.

Check Your Progress - 2

6. Which of the following is not a debt instrument?
   a. Subscription rights
   b. Zero coupon bonds
   c. Partly convertible debentures
   d. Fully convertible debentures
   e. Non-convertible debentures

[43] https://www2.deloitte.com/us/en/pages/financial-services/articles/digital-future-of-financial-services-tech-and-beyond.html

7. Which of the following statements is true in respect of investment in foreign securities by Indian investors?
   a. Global investments entail diversification and increase in risk
   b. Indian investors believe investment in emerging economies will give fewer returns than in the Indian market
   c. Investors who are not prepared to take high risk can take part in the growth of some booming economies
   d. Investment in foreign securities is required to be made in terms of exchange control regulations prevailing in the country of investing company and Investee Company
   e. Foreign investments are not a cushion against downfall in the domestic market
8. Which of the following is an issuer concern?
   a. Low cost of debt
   b. High cost of debt
   c. Offering stable return
   d. Permission from regulatory authority
   e. Existence of secondary market for its securities
9. Rajesh has invested in a Deep Discount Bond (DDB), which has a maturity value of ₹ 5 lakh after 5 years @ 8 % interest rate. Which of the following is the purchase price of the bond?
   a. ₹ 3.64,574
   b. ₹ 3,57,143
   c. ₹ 3.78,156
   d. ₹ 3,23,457
   e. ₹ 3,33,157
10. Which of the following instruments enable the issuer to enjoy the right to cancel the security if certain conditions are met?
    a. Perpetual debt security
    b. Knock-out debt security
    c. Subordinate debt security
    d. Hybrid debt security
    e. Derivative contract

Activity 2.4

Relate the following financial instruments to the different markets: (1) money market, (2) capital market, (3) foreign exchange market, (4) government securities market and (5) credit market.

a. Commercial paper b. Certificate of deposit c. Equity shares

d. Debentures e. Global depository receipts f. Treasury bills

g. Forward exchange contract h. 10 year government bonds

i. Corporate bonds j. Housing loans/mortgages

Answer:

2.8 Summary

- Financial engineering is a process which uses knowledge from the fields of mathematics, computer science, statistics, and economics to study the current financial issues and provide solutions.
- Financial engineers create new products or financial products called as ‘structured products’ to meet the specific needs of the clients.
- Financial engineering encompasses the study of different types of risk i.e. systematic risk and unsystematic risk and suggests the measures to reduce such risks.
- Financial engineers helped in the growth of innovative products/instruments viz. fixed income securities, debt market securities, equity instruments, pooled investment vehicles, index futures and index options, foreign securities, and hybrid securities.
- The development of products needs to comply with the conditions of regulatory authorities. The products should also gain market acceptance from credit rating agencies.

2.9 Glossary

Annuity: A fixed amount of money to be received every year for a given period.

Bond: Promise by the issuer to pay a specified amount on due date with periodic interest payments at a fixed rate.

Broker: A person or agency who arranges the purchase and sale of an asset by acting as an intermediary between the purchaser and the seller.

Call Option: An option that gives its holder that right to buy an asset at a fixed price during a certain period without any obligation to buy.

Coupon Rate: The stated interest rate on a bond.

Debenture: An marketable instrument for raising debt.

Deep Market: A market in which there are always sufficient orders for buying and selling at both below and above the market price, with reference to stock markets.

Discount: The amount at which a bond or preferred stock sells below its par or face value.

Efficient Portfolio: A portfolio which has the largest expected return for a given level of risk or the smallest risk for a given level of expected return.

Forward Contract: An agreement between two parties to exchange an asset for cash at a pre-determined future date for a price that is specified today.

Hedge: Setting one investment purchased against another investment in order to counter any possible loss made by either.

Interest Rate Risk: The risk arising from a change in the price of a security resulting from a change in market interest rates.

Listed Securities: Securities which are admitted for trading on a recognized stock exchange.

Market Value: The market value of one share of stock is the current market price.

Matrix Price: Matrix prices are quoted prices for securities with same maturities and ratings rather than a fixed price for designated security.

Mortgages: Long-term liabilities collateralized by immovable properties.

Option Contract: An agreement that confers the right, without any obligation, to buy or sell an asset at a set price at some future date.

Par Value: The value of a security when it is issued at a price equal to the face value.

Portfolio: A set or group or combination of securities held by an investor, with a view to diversify the risk

Put Option: An option that gives its holder the right to sell, without any obligation, an asset at a fixed price during a certain period.

2.10 Self-Assessment Test

1. 'The products introduced by the financial engineers are expected to reduce the market risk'. -Justify.
2. Explain the nature of Index futures and Index options with reference to Indian context.

3. Explain the features of debt securities.
4. Discuss briefly some of the new financial products and services introduced in the Indian financial services sector.

2.11 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

2.12 Answers to Check Your Progress Questions

1. (b) To innovate new financial products and services

Financial engineering has contributed to the growth of innovative products, instruments through processes and strategies. In the recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing time and changing needs of customers.

2. (d) They can be issued by only infrastructure entities

It is a false statement as other institutions like banks, NBFCs, microfinance institutions also can issue structured products.

3. (c) No daily pricing

It is a disadvantage associated with structured financial products. Structured products are priced on a matrix, not net-asset-value. Matrix pricing is essentially a best-guess approach.

4. (a) Can’t be diversified

Systematic risk is that portion of risk which cannot be diversified away, and every institution is affected but in different proportion.

5. (c) Inflation risk

It is an unsystematic risk. With rise in inflation there is reduction of purchasing power.

6. **(a) Subscription rights**

   Subscription rights are equity instruments. A Rights Issue is a way by which a listed company can raise additional capital. However, instead of going to the public, the company gives its existing shareholders the right to subscribe to newly issued shares in proportion to their existing holdings.

7. **(d)** Investment in foreign securities is required to be made in terms of exchange control regulations prevailing in the country of investing company and Investee Company.

8. **(a) Low cost of debt**

   Low cost of debt is an issuer concern. All others are investor concerns

9. **(b) ₹ 3,57,143**

   The purchase price of a DDB is given by the formulae- $M/(1+r)^n$n where M=Maturity value, r = yield/2 and n = Maturity period x 2. Thus purchase price = 5,00,000 / (1+0.04)10= 5,00,000/1.4= ₹ 3,57,143

10. **(b) Knock-out debt security**

    These are debt instruments which enable the issuer to enjoy the right to extinguish or cancel them if certain conditions are met.

Unit 3

Sources of Finance and Regulatory Environment of Financial Services

Structure

"Regulation needs to catch up with innovation."

- Henry Paulson - American banker, financier and former United States Secretary of the treasury

3.1 Introduction

Regulations should be such that they advance at the speed of innovation so as to keep up with the changing business scenarios.

In the previous unit, we discussed the importance of financial engineering to facilitate the services sector for identifying and innovating new instruments and products. This unit discusses the regulatory framework within which the financial services sector has to operate. The Companies involved in providing financial services in India are many. One of the major segments is the NBFC sector. Non-Banking Finance Companies are regulated by the Reserve Bank of India. They perform various activities such as leasing, hire purchase, bill discounting, etc. Apart from NBFCs, banks and financial institutions do offer some of the financial services that the NBFCs offer, but a different set of guidelines and regulations specified by the RBI and the Ministry of Finance are in play for them. There are also Nidhi and Chit Fund Companies in India. The range of services offered by these entities makes an interesting study in itself considering the regulations and delivery in market norms for each of the activity of fundraising.

3.2 Learning Objectives

After going through this unit, you will be able to:

- Discuss the features of the fixed deposits offered by NBFCs
- State the classification of NBFCs
- List the rules and regulations for acceptance of deposits
- Discuss the income recognition, asset classification and provisioning norms of NBFCs
- State the capital adequacy norms of NBFCs
- Describe the regulatory framework within which NBFCs operate

3.3 Importance of Fixed Deposits

Each of the financial services activities is a source of income for the Company. Income from these activities is either in the form of fee-based activities or in the form of investment. Some of the fee-based services are merchant banking, underwriting and other advisory services. Some of the fund-based services are leasing, hire purchase and other services where the entity has to put in its own money. The fund-based and fee-based activities are regulated by both the Reserve Bank of India (which oversees fund-based activities), and by the Securities and Exchange Board of India (SEBI) (which oversees fee-based activities).

Example: Soft Interest Regime and Attractive Packages are attracting more FDs

In 2021, amidst the fall of interest rates on Fixed Deposits (FDs), Shriram City Union Finance Ltd (Shriram City), offered higher interest rates on FDs that were higher than that of commercial bank FDs. Shriram City observed healthy retail FD growth, collecting approximately ₹ 250 crore to 300 crore per month via various channels. It announced FDs with 7.75 percent interest rate and also offered 0.30 percent concession to senior citizens who deposited money. Customers who extended their FD period were given an additional rate of interest of 0.25 percent.

Source: https://www.cnbctv18.com/personal-finance/amid-falling-fixed-deposit-rates-this-nbfc-offers-up-to-775-fd-rates-11134672.htm, October 18, 2021, Accessed on 24/6/22

NBFCs, banks and financial institutions do take part in other forms of fundraising activities to provide funds for other operations. These include fixed deposits, bonds and private placement.

[44]3.3.1 Classification of NBFCs

[45]According to RBI, Non-Banking Financial Company (NBFC) is defined as a company registered under the Companies Act, 1956, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by government or local authority or other marketable securities of like leasing, hire-purchase, insurance business, chit business, but does not include any institution, whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services, and sale/purchase/construction of any immovable property.

An NBFC thus includes only non-banking institution that is any hire-purchase finance, investment, loan or mutual benefit financial company and an equipment leasing company. It excludes an insurance company/stock exchange/stock broking company/merchant banking company.

The classification of NBFCs is based on three parameters:

a) On the basis of types of liabilities they are classified into Deposit and Non-Deposit accepting NBFCs;

b) On the basis of their size – The Non-Deposit taking NBFCs are classified into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND); and

c) On the basis of the activities they conduct, the different types of NBFCs are as follows[46]:

I. **Asset Finance Company (AFC):** An AFC is a financial institution carrying on as its principal business, the financing of physical assets supporting productive/economic activity such as automobiles, tractors, lathe machines, generator sets, earthmoving and material handling equipment, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as the aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

II. **Investment Company (IC):** IC means any company, which is a financial institution carrying on as its principal business the acquisition of securities.

III. **Loan Company (LC):** LC means any company which is a financial institution carrying on as its principal business providing of finance whether as loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

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[44] www.rbi.org.in

[45] https://www.rbi.org.in/scripts/FS_FAQs.aspx?Id=92&fn=14

[46] https://www.rbi.org.in/Scripts

IV. **Infrastructure Finance Company (IFC):** IFC is a non-banking finance company which

a) Deploys at least 75 percent of its total assets in infrastructure loans,

b) Has minimum Net Owned Funds of 300 crores,

c) Has a minimum credit rating of 'A' or equivalent, and

d) Has a CRAR of 15%.

V. **Systemically Important Core Investment Company (CIC-ND-SI):** CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities, which satisfies certain conditions.

VI. **Infrastructure Debt Fund-Non-Banking Financial Company (IDF-NBFC):** IDF-NBFC is a company registered as NBFC to facilitate the flow of long-term debt into infrastructure projects. IDF-NBFC raises resources through issue of Rupee or Dollar denominated bonds of minimum 5-year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

VII. **Non-Banking Financial Company-Micro Finance Institution (NBFC-MFI):** NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets, which satisfy certain criteria.

VIII. **Non-Banking Financial Company-Factors (NBFC-Factors):** NBFC-Factor is a non-deposit taking NBFC engaged in factoring business. The financial assets in the factoring business should constitute at least 50 percent of its total assets, and its income derived from factoring business should not be less than 50 percent of its gross income.

IX. **Mortgage Guarantee Companies (MGC):** MGCs are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and the net owned fund is ₹ 100 crores.

X. **NBFC Non-Operative Financial Holding Company (NOFHC):** These are financial institutions through which promoters/promoter groups are allowed to start new banking institutions. NOFHC can hold the bank as well as all other financial services companies regulated by the RBI. Such holding is limited to the extent permissible under the applicable regulations.

The definition of systemically important non-deposit taking NBFCs (NBFC-ND-SI) was revised to entities with a total asset size of ₹ 500 crore and above (as against ₹ 100 crore earlier). Accordingly, the RBI categorized NBFCs into 3 broad groups as given below:

1. NBFC-D: NBFCs permitted to mobilize deposits
2. NBFC-ND: Non-Deposit accepting NBFCs with asset size of under ₹ 500 crore
3. NBFC-ND-SI: Non-Deposit accepting NBFCs with asset size of ₹ 500 crore and above

[47]RBI issue of scale based regulation (SBR)

The Reserve Bank of India notified the Scale Based Regulation (SBR). Accordingly, a revised regulatory framework for NBFCs was issued on October 22, 2021. The framework categorizes NBFCs in Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer (NBFC-TL). It specifies that Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank based on a set of parameters and scoring methodology as provided in the framework. The framework also envisages that top ten NBFCs in terms of their asset size shall always reside in the Upper Layer.

On 30th September 2022, RBI released the list of NBFCs in the upper layer (NBFC-UL) under the scale based regulation for NBFCs, as below:

NBFCs in the Upper Layer under Scale Based Regulation for NBFCs

Sl. No.	Name of the NBFC
1	LIC Housing Finance Limited
2	Bajaj Finance Limited
3	Shriram Transport Finance Company Limited
4	Tata Sons Private Limited
5	L & T Finance Limited
6	Indiabulls Housing Finance Limited
7	Piramal Capital & Housing Finance Limited
8	Cholamandalam Investment and Finance Company Limited
9	Shanghvi Finance Private Limited
10	Mahindra & Mahindra Financial Services Limited
11	PNB Housing Finance Limited
12	Tata Capital Financial Services Limited
13	Aditya Birla Finance Limited
14	HDB Financial Services Limited
15	Muthoot Finance Limited
16	Bajaj Housing Finance Limited

Source: https://www.rbi.org.in/scripts/FS_PressRelease.aspx?prid=54474&fn=14#:~:text=The%20Reserve%20Bank%20had%20issued, Layer%20(NBFC%2DTL).

Some of the important regulations relating to acceptance of deposits by NBFCs are as under:

i. The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and a maximum period of 60 months. They cannot accept deposits repayable on demand.

[47] https://www.rbi.org.in/scripts/FS_PressRelease.aspx?prid=54474&fn=14#:~:text=The%20Reserve%20Bank%20had%20issued,Layer%20(NBFC%2DTL).

ii. They cannot offer interest rates higher than the ceiling rate prescribed by the RBI from time to time. The present ceiling rate is 12.5 percent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.

iii. They cannot offer gifts/incentives or any other additional benefit to the depositors.

iv. They should have a minimum investment-grade credit rating.

v. The deposits with NBFCs are not insured.

vi. The repayment of deposits by NBFCs is not guaranteed by the RBI.

vii. Certain mandatory disclosures are to be made about the company in the Application Form issued by the company soliciting deposits.

3.3.2 Fixed Deposits by NBFCs

Fixed Deposits form the main source of funds for the NBFCs, financial institutions and banks. Such money is used in activities like hire purchase, leasing, etc. Fixed deposits are accepted by almost all the entities that are in the area of financial services. NBFCs, banks and financial institutions accept deposits. The acceptances of fixed deposits by companies are subject to the provisions of the Indian Companies Act, 2013, and the rules presented by the RBI from time to time. Section 73 to 76 of the Companies Act, 2013 read with the Companies Rules, 2014 regulate the invitation and acceptance of deposits except from the members through ordinary resolution or acceptance of deposits by an eligible company being a public company subject to rules based on net worth and turnover of the company.

[48]According to Section 2(31) of the Companies Act, 2013 “deposit” includes any receipt of money by way of deposit or loan or in any other form by a company and does not include such categories of amount as may be prescribed in consultation with the RBI.

The RBI, vide its master direction dated 25 August 2016, gave direction in respect of acceptance of public deposits by non-banking financial companies known as “Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions 2016”.

Non-banking finance companies are allowed to accept fixed deposits with maturities ranging from more than one year up to 5 years.

NBFCs were earlier allowed the freedom to offer the rate of interest on deposits based on whether the entities have attained the capital adequacy norms and/or whether they are credit rated or not. Any NBFC with Net Owned Fund (NOF) of ₹ 25 lakh and more cannot accept public deposits. However, it can do so only if it has secured a minimum investment grade or any other specified credit rating.

[48] https://www.mca.gov.in/SearchableActs/Section2.htm

Those AFCs (Asset Finance Companies) that do not get minimum investment grade by 31 March 2016 cannot renew existing deposits or accept fresh deposits thereafter. It is mandatory for an NBFC to have a minimum NOF of ₹ 200 lakh.

The Reserve Bank of India has specified ₹ 10 crores as net owned fund (NOF) required for the following categories of non-banking financial companies to commence or carry on the business of non-banking financial institutions from October 01, 2022:

1. Non-banking financial company –Investment and Credit Company (NBFC-ICC)
2. Non-banking financial company –Micro Finance Institution (NBFC-MFI)
3. Non-banking financial company –Factor (NBFC-Factor)

[49]An NBFC shall fulfill the following conditions before accepting fixed deposits:

- No non-banking financial company having Net Owned Fund (NOF) of less than 200 lakh shall accept public deposits unless it has obtained a minimum investment grade or any other specified credit rating for fixed deposits from any of the approved credit rating agencies at least once in a year, and a copy of the rating is sent to RBI along with return on prudential norms.
- No non-banking financial company shall accept any public deposit that is repayable on demand.
- An asset finance company holding public deposits in excess of the limit of one and half times its NOF shall not accept fresh deposits or renewal until such time it revises the limit.
- No non-banking company shall invite, accept or renew public deposit at a rate of interest exceeding twelve and a half percent per annum. Interest may be paid or compounded at rests that shall not be shorter than monthly rests.

Example: RBI is Tightening the Rules for NBFCs to Quickset the Financial Services System

In 2018, with the collapse of Infrastructure Leasing & Financial Services (IL&FS) and subsequent failures of leading NBFCs like Dewan Housing Finance Corp., Reliance Capital and SREI Infrastructure Finance Limited, the Reserve Bank of India (RBI) passed stringent rules for non-banking finance companies (NBFCs). The idea was to improve the supervision of NBFCs. The regulation passed by RBI stipulated that NBFCs cannot grow more than a size and should be within the limits of scope of activities. The RBI further said NBFCs which want to grow their business big, need to apply for bank permits.

Contd….

[49] www.rbi.org.in

Top Indian conglomerates like Tata, Birla, Piramal, and Bajaj Finance sought a banking licence. However, only one NBFC that was UAE Exchange and Finance Services, which was renamed as Unimoni, applied for such a licence.

Source: https://www.moneycontrol.com/news/business/banks/timeline-how-rbi-cut-the-arbitrage-of-nbfcs-and-moved-to-bank-like-regulations-8407561.html, April 25, 2022, accessed on 24/6/22

Activity 3.1

NBFCs are of different types. How you differentiate between them.

3.4 Various Rules and Regulations Concerning the Mobilization of Deposits

Credit rating of the company, adequacy of the capital base of the company, maximum size of the deposits a company can mobilize, etc. are the parameters one has to look into for company deposits. Let us understand the rules for mobilizing deposits by NBFC s are discussed as follows:

3.4.1 Minimum Credit Rating

(i) No non-banking financial company having Net Owned Fund (NOF) of ₹ 200 lakh or above shall accept public deposits unless it has obtained a minimum investment grade or any other specified credit rating for fixed deposits from any one of the approved credit rating agencies, at least once a year. A copy of the rating is sent to the RBI along with the return on prudential norms.

(ii) In the event of upgrading or downgrading of the credit rating of any non-banking financial company to any level from the level previously held by the non-banking financial company, it shall within fifteen working days of its being so rated, inform the RBI in writing, of such upgrading/ downgrading.

Example: Minimum credit rating - Credit Rating Agencies need to Adhere to the Rules and follow the Due Process while giving Ratings

In April, 2021, SEBI (Security Exchange Board of India) issued a show-cause notice to Brickwork Ratings India for the repeated lapses in the credit rating process.

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In the wake of annual inspection made by the SEBI and RBI jointly of credit rating agencies, it was noticed that in spite of several instructions given to Brickwork Ratings about the lapses and the corrections to be made, the agency had not addressed the issues that were pointed out by the regulator. Earlier, even the agency was imposed a penalty of ₹ 1 crore for lapses while giving credit ratings to NCDs of Essel Group and Great Eastern Energy.

Source: Read more at: https://economictimes.indiatimes.com/markets/stocks/news/sebi-issues-notice-to-brickwork-ratings-india-over-lapses/articleshow/82316678.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, April 30, 2021, (accessed on 24/6/22)

Approved Credit Rating Agencies and Minimum Investment Grade Credit Rating

The names of approved credit rating agencies and the minimum credit rating are in Exhibit 3.1 as follows:

Exhibit 3.1: Names of Approved Credit Rating Agencies

Name of the Agency	Minimum Investment Grade Rating
(a) Credit Analysis & Research Ltd. (CARE)	CARE BBB (FD)
(b) ICRA Limited	MA- (MA Minus)
(c) The Credit Rating Information Services of India Limited (CRISIL)	FA- (FA Minus)
(d) Fitch Ratings India Private Ltd.	tA-(ind)(FD)
(e) Brickwork Ratings India Pvt. Ltd. (Brickwork)	BWR FBBB
(f) SME Rating Agency of India Ltd. (SMERA)	SMERA A

Source: ICFAI Research Center

NBFCs should have a rating for fixed deposits that is at least up to ‘investment grade’. Those NBFCs that lacked requisite credit rating have been asked to stop accepting deposits.

This rule has been the center of much debate. The rules concerning advertisement for acceptance of deposits (which will be dwelt in detail later) stipulate that the advertisement should mandatorily display prominently the credit rating accorded by the credit rating agency approached by the NBFC. However, it should be noted that the credit rating would be accorded by the credit rating agency only if such a rating has been accepted by the NBFC. There may be a situation where a company finds that the credit rating it has been assigned is unreasonable or where the company possibly gets a better credit rating for itself from other credit rating agencies. Instead of accepting credit rating, the NBFC may approach other credit rating agencies, get the rating, compare and then accept the favorable one.

The controversies concerning Lloyds Finance over the acceptance of credit rating from ICRA and CARE are too well known.

In addition, the elevation of the credit rating agencies to the role of a quasi-regulator has been resented by the NBFCs. However, it should be noted that the credit rating is assigned only after a thorough analysis of the finances of the company and hence, would not be irrelevant in gauging the strength of the company.

[50]3.4.2 Limit for Public Deposits

An asset finance company or a loan company or a factor having minimum NOF as stipulated by the RBI and complying with all the prudential norms shall accept or renew public deposit together with the amounts remaining outstanding in the books of the company as on the date of acceptance or renewal of such deposit, not exceeding one and a half times of its NOF. An asset finance company holding public deposits in excess of the limit of one and a half times of its NOF shall not renew or accept fresh deposits till such time it reaches the revised limit. Further, no matured public deposit shall be renewed without express and voluntary consent of the depositor.

3.4.3 Procedure during Acceptance of Deposits

Every NBFC has to follow a set of procedures for accepting fixed deposits. The procedures have been put in place to ensure transparency in operations of the NBFC, and also to ensure easy supervision and genuineness of the operations.

Maintenance of Register**:** Every NBFC accepting fixed deposits has to maintain a set of registers in respect of all the deposits that contain specific details of each of the depositors. The details should include:

i. Name and address of the depositor

ii. Date and amount of each deposit

iii. Duration and the due date of each deposit

iv. Date and amount of accrued interest or premium on each deposit

v. Date of claim made by the depositor

vi. The reasons for delay in repayment beyond five working days

vii. Any other particulars relating to the deposit

These registers should be kept at the registered office of the company and should be maintained for the next eight calendar years following the financial year.

[51]***Advertisement for Deposits*****:** As mentioned above, regulations concerning the raising of deposits by NBFCs stipulate that these entities should not accept deposits without the issuance of advertisement inviting them in the first place.

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[50] www.rbi.org.in

[51] www.rbi.org

The advertisement must be issued in a leading English newspaper and one vernacular newspaper circulating in the state in which the registered office of the NBFC is situated, after approval from the RBI. Every non-banking financial company soliciting public deposit shall comply with the provisions of the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 and shall also specify in every advertisement to be issued there under the following:

(i) The actual rate of return by way of interest, premium, bonus and other advantages to the depositor;

(ii) The mode of repayment of the deposit;

(iii) Maturity period of the deposit;

(iv) The interest payable on the deposit;

(v) The rate of interest which will be payable to the depositor in case the depositor withdraws the deposit prematurely;

(vi) The terms and conditions subject to which a deposit will be renewed;

(vii) Any other special features relating to the terms and conditions subject to which the deposit is accepted/renewed;

(viii) Information relating to the aggregate dues (including the non-fund based facilities provided) from companies in the same group or other entities or business ventures in which, the directors and/or the NBFC are holding substantial interest and the total amount of exposure to such entities; and

(ix) That the deposits solicited by it are not insured.

Where an NBFC displays any advertisement in electronic media such as TV, even without soliciting deposits, it shall incorporate a caption/band in such advertisements indicating the following:

(i) As regards deposit taking activity of the company, the viewers may refer to the advertisement in the newspaper/information furnished in the application form for soliciting public deposits.

(ii) The company is having a valid Certificate of Registration with a date mentioned on the certificate issued by the Bank under section 45-IA of the RBI Act. However, the Reserve Bank of India does not accept any responsibility or guarantee about the present position as to the financial soundness of the company or for the correctness of any of the statements or representations made, or opinions expressed by the company and for repayment of deposits/discharge of the liabilities by the company.

(iii) Where a non-banking financial company intends to accept public deposit without inviting or allowing or causing any other person to invite such deposit, it shall, before accepting such deposit, deliver to the Bank for record, a statement in lieu of advertisement containing all the particulars required to be included in the advertisement pursuant to the Non-Banking

Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 as also the particulars stated in clause (1) hereinabove, duly signed in the manner provided in the aforesaid Rules.

***Nomination by Depositors*:** In terms of section 45QB of the RBI Act, the depositor/s of non-banking financial company may nominate, in the manner prescribed under the rules made by the Central Government under section 45ZA of the Banking Regulation Act, 1949 (B R Act) one person to whom, in the event of the death of the depositor/s, the amount of deposit shall be returned by the non-banking financial company. It has been decided in consultation with the government of India, that the Banking Companies (Nomination) Rules, 1985 are the relevant rules made under section 45ZA of the BR Act, 1949. Accordingly, the non-banking financial company shall accept nominations made by the depositors in the form similar to that specified under the said rules.

***Loans to Depositor*:** After 3 months from the date of deposit, NBFCs can grant the depositor loans up to 75% of the amount of public deposit kept by the depositor. Interest rate that can be charged by the NBFC can be 2% above the interest rate payable on the deposit.

Premature Renewal of Deposits: In a scenario where the interest rates are increasing, an NBFC may permit an existing depositor to renew his deposit before maturity. This is permitted if the depositor renews his deposit for a period longer than the remaining period of the original contract, and the interest on the expired period of deposit is reduced by one percentage point from the contracted rate and/or the excess interest so paid is recovered.

3.4.4 Premature Withdrawal of the Deposits

A fixed deposit cannot be withdrawn within 3 months from its acceptance. Subsequent to the 3-month period, the deposit can be allowed to be withdrawn before its maturity as shown in Exhibit 3.2 below:

Exhibit 3.2: Premature Withdrawal of the Fixed Deposits

After three (3) months but before 6 months	No interest is payable
After six (6) months but before the maturity date	The interest payable shall be 2 percent (%) lower than the interest rate applicable to a public deposit for the period for which the public deposit holds good. If no rate has been specified for that period, then 3 percent (%) lower than the minimum rate at which public deposits are accepted by the non-banking financial company (NBFC).

Source: ICFAI Research Center

In case, the NBFC on its own initiative (or statutory restrictions) wants a premature payment of a deposit, then it has to pay the contracted rate only. However, a depositor cannot refuse premature closure of his account that is being closed due to the regulators' dictate.

3.4.5 Brokerage

No NBFC shall pay to any broker on public deposit collected by or through him:

(i) Commission, brokerage, incentive or any other benefit by whatever name called, in excess of two percent of the deposit so collected; and

(ii) Expenses by way of reimbursement based on relative vouchers/bills produced by him, in excess of 0.5 percent of the deposit so collected.

3.4.6 Prudential Norms for NBFCs

Applicability of prudential norms: It is based on access to public funds and customer interface as shown in Exhibit 3.3.

Exhibit 3.3: Applicability of Prudential Norms

Activities	Limited Prudential Regulation	Conduct of Business Regulations (KYC, FPC, etc.)
No access to public funds & customer interface	No	No
No access to public funds but customer interface	No	Yes
Access to public funds but no customer interface	Yes	No
Access to public funds & customer interface	Yes	Yes

Source: ICFAI Research Center

For exemption from compliance with minimum CRAR requirement and credit concentration norms, NBFCs-ND should not exceed a leverage ratio (Tot. OL/OF) of 7.

Activity 3.2

Can you brief on the working of a credit rating agency and the purpose of it.

Check Your Progress - 1

1. Which of the following regulatory framework governs the acceptance of fixed deposits by limited companies?
   a. SEBI
   b. Rules of the individual companies
   c. Fixed deposit managers
   d. Companies Act 1956
   e. Companies Act, 2013
2. Which of the following is the maximum percentage of brokerage permissible to the broker who secured a deposit to NBFC in 2016?
   a. 1%
   b. 0.5%
   c. 2%
   d. 5%
   e. 8%.
3. Which of the following is minimum Net Owned Funds (NOF) for an NBFC?
   a. 10 lakhs
   b. 200 lakhs
   c. 15 lakhs
   d. 100 lakhs
   e. 150 lakhs
4. Which of the following statement is correct if NBFCs have to grant loans to the depositor after 3 months from the date of deposit?
   a. 25% of the amount of public deposit kept by the depositor
   b. 35% of the amount of public deposit kept by the depositor
   c. 95% of the amount of public deposit kept by the depositor
   d. 65% of the amount of public deposit kept by the depositor
   e. 75% of the amount of public deposit kept by the depositor
5. What is the maximum limit for an asset finance company to hold public deposits?
   a. Not exceeding 1.5 times of its NOF
   b. Not exceeding 2.5 times of its NOF
   c. Not exceeding 3.5 times of its NOF
   d. Not exceeding 5.5 times of its NOF
   e. Not exceeding 4.5 times of its NOF

3.5 Income Recognition Norms for NBFCs

In respect of NBFC-ND-SI and NBFC-D, the RBI proposes to align the asset classification norms with those of banks in a phased manner. Presently, NBFCs recognize exposures, which are overdue for 6/12 months as Non-Performing Assets.

The RBI has permitted a one-time adjustment of the repayment schedule on loans that would not be considered as restructuring.

Example: RBI Offered Deferment for Upgradation of NPA Accounts

In 2021, RBI had extended the roll-out of new bad loan norms for NBFCs by six months and NBFCs were informed that it was postponed to September, 2022. However, in April, 2022, the management of Bajaj Financial Services Limited announced that their asset quality was normal to levels of pre-Covid. Its gross non-performing assets (NPA) in terms of total assets percentage was at 1.6% in March, when compared to 31 December 2021 @ 1.73%. Bajaj Finance did not opt for the deferment plan given by Reserve Bank of India (RBI) (RBI allowed deferment plan till 30 September for upgradation of NPA accounts). Its loan losses and provisions also came down to 79% year on year to ₹ 702 crore in Quarter 4 Financial Year 2021. As on 31 March 2021, the liquidity buffer was at ₹10,110 crore.

Source: https://www.livemint.com/companies/companyi-results/bajaj-finance-sharpens-focus-on-payment-financial-services-biz-11651002528573.html, 27 April 2022, (accessed on 24/6/22)

3.5.1 Asset Classification

The leverage given to NBFCs on NPA norms was applicable to till September 30, 2022 only.

NBFCs should classify their loans, advances and any other forms of credit into four broad groups viz.

i. Standard assets

ii. Sub-standard assets

iii. Doubtful assets

iv. Loss assets

Broadly speaking, the credit classification should be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for the realization of dues. The following definitions should be kept in mind by the NBFCs while classifying the assets.

(I) Standard Assets:

Standard asset is one in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than the normal risk attached to the business. Such an asset is not an NPA.

(II) Sub-Standard Assets:

With effect from March 31, 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(III) Doubtful Assets:

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

(IV) Loss Assets:

Loss assets refer to those assets that have been identified as loss by the NBFC but the same has not yet been written off in the books either partially or completely. Such an asset may be identified either by the internal auditors or the external auditors. The loss so identified should be treated as an uncollectible amount even if the asset has some salvage value.

The revised asset classification guidelines are given in Exhibit 3.4 with time frame:

Exhibit 3.4: Revised Asset Classification Guidelines

Asset	Current Norms	31 March 2016	31 March 2017	31 March 2018
Lease rental and hire purchase - standard	12 months	9 months	6 months	3 months
All other assets	6 months	5 months	4 months	3 months
Movement into sub-standard	18 months	16 months	14 months	12 months
Sub-standard to doubtful	18 months	16 months	14 months	12 months

Source: ICFAI Research Center

In case of existing loans, a one-time adjustment of the repayment schedule is allowed provided it is not pertaining to restructuring.

Scale Based Regulation (SBR) for NBFCs

These guidelines were defined vide circular RBI/ 2021-22/112 in October 2021. The regulatory structure for NBFCs comprises four layers based on their size, activity, and perceived riskiness. The four classified layers were – base, middle, upper and top layers. These guidelines shall be effective from October 01, 2022.

Base Layer

The Base Layer shall comprise (a) non-deposit taking NBFCs below the asset size of ₹1000 crore and (b) NBFCs undertaking the following activities - (i) NBFC-Peer to Peer Lending Platform (NBFC-P2P), (ii) NBFC-Account Aggregator (NBFC-AA), (iii) Non-Operative Financial Holding Company (NOFHC) and (iv) NBFCs not availing public funds and not having any customer interface[1].

Middle Layer

The Middle Layer shall consist of (a) all deposit taking NBFCs (NBFC-Ds), irrespective of asset size, (b) non-deposit taking NBFCs with asset size of ₹1000 crore and above and (c) NBFCs undertaking the following activities: (i) Standalone Primary Dealers (SPDs), (ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), (iii) Core Investment Companies (CICs), (iv) Housing Finance Companies (HFCs) and (v) Infrastructure Finance Companies (NBFC-IFCs).

Upper Layer

The Upper Layer shall comprise those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology as provided in the Appendix to this circular. The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.

Top Layer

The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

NPA Classification - The extant NPA classification norm stands changed to the overdue period of **more than 90 days** for all categories of NBFCs. A glide path is provided to NBFCs in Base Layer to adhere to the 90 days NPA norm as under –

NPA Norms	Timeline
>150 days overdue	By March 31, 2024
>120 days overdue	By March 31, 2025
> 90 days	By March 31, 2026

3.6 Provisioning for Loans and Advances

The provisioning requirements, as given below, shall apply to every applicable NBFC (except NBFC-MFIs):

Every NBFC shall, after taking into account the time lag between an account becoming non-performing and its recognition as such and the realization of the security and the erosion over time in the value of the security charged, need to make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

(1) The provisioning requirement with respect to loans, advances and other credit facilities, including bills purchased and discounted, shall be as under:

(i) **Loss Assets:** The full asset should be written off. If, however, the asset is still shown in the books of accounts, the same should be provided with 100% provision.

(ii) **Doubtful Assets:** (a) In the case of the portion of the advance that is not covered by any security's realizable value, provision to the extent of 100% should be made. (b) In addition to the above provision, based on the period for which the asset was doubtful, a provision of the secured portion (i.e. estimated realizable value of the outstanding) to the extent of ~~20% to 50%~~ 25% to 100% should be as per the following:

100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	Provisioning requirement (%)
Up to one year	25
One to three years	40
More than three years	100

With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of ₹5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

(iii) **Sub-standard Assets:** In this category, a general provision of 10 percent of total outstanding needs to be made.

Example: Change in the norms of Provisioning for Loans and Advances had No Negative Impact on NPAs

Bajaj Financial Services Limited's Gross NPA and Net NPA stood at 1.73% and 0.78% respectively as of 31 December 2021, compared to 2.45% and 1.10% as on 31 September 2021. The Company catered the provisioning of coverage ratio at 56% for stage 3 assets. As on 31 December 2021, for stage 1 and 2 assets, it was 156 bps as. During the quarter, the Company altered its NPA classification criteria to Days Past Due approach from number of EMI outstanding as per the RBI circular released on 12 November 2021 - "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances - Clarifications". Bajaj Financial Services announced that the change in the norms had no negative impact on the Company's NPA.

Source: https://www.bajajfinserv.in/q3fy22-press-release-2022.pdf, 2022, (accessed on 28/6/22)

3.7 Provisioning for Lease and Hire Purchase Assets

The requirements of provisioning for hire purchase assets and leasing assets can be classified into basic provisioning and additional provisioning.

Provisions on Leased Assets

Substandard assets

(i) 15 percent of the sum of the net investment in the lease and the unrealized portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 Leases'.

(ii) Unsecured lease exposures, which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent.

Doubtful assets

100 percent of the extent to which the finance is not secured by the realisable value of the leased asset, should be provided for. Realizable value is to be estimated on a realistic basis. In addition to the above provision, provision at the following rates should be made on the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component of the secured portion, depending upon the period for which asset has been doubtful:

Period for which the advance has remained in 'doubtful' category	Provisioning requirement (%)
Up to one year	25
One to three years	40
More than three years	100

Loss assets

The entire asset should be written off, if for any reason, an asset is allowed to remain in books, 100 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component should be provided for.

3.7.1 Basic Provisioning for Hire Purchase Assets

The provisioning requirements pertaining to hire purchase assets shall be as follows:

(i) In respect of these assets, the total dues (i.e. Overdue and future installments taken together) as reduced by:

   (a) The finance charges not credited to the P&L A/c (profit and loss account), and carried forward (C/F) as un-matured finance charges; and

   (b) The depreciated value of the underlying asset shall be provided for.

Explanation: For the purpose of this paragraph-

1. The depreciated value of the asset shall be notionally computed, on a straight line method, as the original cost of the asset as reduced by depreciation at the rate of 20% per annum; and
2. In the case of second hand assets, the original cost shall be the actual cost incurred for the acquisition of such second hand assets.

3.7.2 Additional Provision for Hire Purchase and Leased Assets after the Last Due Date has passed

[52]The following Table 3.1 gives the details about the additional provisioning norms for hire purchase and lease assets after the last due date has passed:

Table 3.1: Additional Provision for Hire Purchase and Leased Asset after the Last Due Date has passed

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under: (a)	Where hire charges or lease rentals are overdue up to 12 months	Nil
(b)	Where hire charges or lease rentals are overdue for more than 12 months up to 24 months	10% of the net book value

Contd…..

[52] https://www.nhb.org.in/Regulation/

(c)	Where hire charges or lease rentals are overdue for more than 24 months but up to 36 months	40% of the net book value
(d)	Where hire charges or lease rentals are overdue for more than 36 months but up to 48 months	70% of the net book value
(e)	Where hire charges or lease rentals are overdue for more than 48 months	100% of the net book value

Source: https://www.nhb.org.in/Regulation/

Example: Requirements of IAS 16 Property, Plant and Equipment for Provision for Lease and Hire Purchase Assets

In March 2021, KPMG reported on the new normal for lease accounting. It stated that the depreciation value of the underlying asset has to be provided for and the details should be in accordance with the requirements of IAS 16 Property, Plant and Equipment. The depreciation charges to be calculated in a straight-line method. It is stipulated that the provision made should specify the ways and means of deriving future economic benefits when right-of –use assets are utilized.

Source: https://assets.kpmg/content/dam/kpmg/xx/pdf/2021/03/leases-overview.pdf, accessed on 28/6/22

3.8 Capital Adequacy of NBFCs

The introduction of capital adequacy of NBFCs was warranted because of a sharp rise in deposit base at the cost of banks. NBFCs with their high visibility and incentives managed to attract a sizable chunk of deposits. In addition, with the mushrooming of NBFCs (once upon a time there were about 60,000 of them) it became practically impossible for the RBI to monitor the activities of these intermediaries. Hence, to help the saver decide on the quality of assets in NBFCs, Capital Adequacy of NBFCs has been introduced after the A.C. Shah Committee Report recommended that these financial entities should be subjected to similar norms as applicable to banks. The committee advocated that the focus of NBFC-regulation be shifted from the liability side to the asset side of the NBFC balance sheet and was in favor of prescribing capital adequacy standard based on risk-weighted assets as prescribed for commercial banks.

The Narasimham Committee constituted by the RBI has broadly classified NBFCs into loan, investment, equipment leasing, hire purchase, mutual benefit finance companies, residuary non-banking companies, and housing finance companies.

In the light of the concerns that arise out of the divergent regulatory requirements for various aspects of the functioning of banks and NBFCs, and keeping in view the broad principles for the proposed revision in the regulatory framework, the following modifications are being made with immediate effect.

A. Regulatory Framework for Systemically Important NBFCs

RBI has suggested various guidelines for the NBFCs on some of the important aspects of the operational issues. The following are some of the important points

(i) Leverage Ratio

All NBFCs-ND with an asset size of ₹ 100 crore and more, are treated as systemically important NBFC-ND (SI-NBFC-ND) and shall be governed by a leverage ratio whereby they shall be able to raise borrowings only up to 10 times of their net owned funds. The net owned funds for this purpose shall be as per the last audited and published balance sheet.

(ii) Capital Adequacy Ratio for SI-NBFCs-ND

All SI-NBFCs-ND will be required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 10%. Those SI-NBFCs-ND which presently do not have a CRAR of 10% would have to approach the Reserve Bank (Department of Non-Banking Supervision, Central Office) with a clear indication of the timeframe within which they would be able to comply with the required CRAR. The present minimum CRAR stipulation at 12% or 15%, as the case may be, for NBFCs-D shall continue to be applicable.

(iii) Single/Group Exposure Norms for SI-NBFCs-ND

No SI-NBFCs-ND, as defined above, shall

a) Lend to:
   i) Any single borrower exceeding 15% of its owned funds; and
   ii) Any single group of borrowers exceeding 25% of its owned funds;
b) Invest in:
   i) The shares of another company exceeding 15% of its owned funds; and
   ii) The shares of a single group of companies exceeding 25 percent (%) of its owned funds; and
c) Lend and Invest (loans/investments taken together) exceeding:
   i) 25 percent (%) of its owned funds to a single party; &
   ii) 40 percent (%) of its owned funds to a single group of parties.

The above ceiling on the investment in shares of another company shall not be applicable to an NBFC in respect of investment in the equity capital of an insurance company up to the extent specifically permitted, in writing, by the Reserve Bank. Further, the SI-NBFCs-ND are advised to have a policy in respect of exposures to a single entity/group. The SI-NBFCs-ND which are holding companies, which do not access public funds, both directly and indirectly, and which invest only in the group entities may apply to the Reserve Bank for exemption from the above requirement.

Example: Meeting the Capital Adequacy Norms as per the Prudential Norms of RBI

In 2021, as per the key highlights from Q1 earnings of Shriram Transport's asset quality, it was observed that the company was well-capitalized at a tier-1 with the Capital Adequacy ratio of 21.1% as against the minimum criteria of 15% (As per the new Prudential Norms of RBI, the Deposit taking Non-Banking Financial Company (NBFC-D) and Systemically Important Non-Deposit taking Non-Banking Financial Company (NBFC-ND-SI) should have CRAR of at least 15%). With the promoters' warrant of ₹ 250 crore and with improved collection efficiency, the company could gain a comfortable capital position. Though the asset quality was a key overhang till the Covid-19 situation settles, the company made adequate provisions.

Source: https://www.indmoney.com/articles/shriram-transport-finance-higher-provisions-hit-bottomline?searchFilter=all, 05th August, 2021, (accessed on 28/6/22)

3.8.1 Capital Adequacy Norms – Risk-Weighted Capital Ratio

Tier 1 and 2 capitals are defined as under.

Common Equity Tier 1 – In order to enhance the quality of regulatory capital, NBFC-UL shall maintain Common Equity Tier 1 capital of at least 9 per cent of Risk Weighted Assets. This layer consists of permanent capital which carries a priority of common equity, such as PDI and CCPS (Perpetual Debt Instruments and Compulsorily Convertible Preference Shares).

Tier II capital shall consist of undisclosed reserves, revaluation reserves, general provisions and loss reserves, hybrid debt capital instruments, subordinated debt and investment reserve account.

According to an article published in [53]RBI Bulletin 18th August, 2022, the status of NBFCs as on December 2021 was given below.

As on January 31, 2022, there were 9,495 NBFCs registered with the Reserve Bank. Based on the liability structure, NBFCs are categorized into deposit-taking

[53] Source: A Steady Ship in Choppy Waters: An Analysis of the NBFC Sector in Recent Times RBI Bulletin 18th August 2022

NBFCs (NBFCs-D), which are allowed to raise term deposits and non-deposit taking NBFCs (NBFCs-ND). NBFCs-ND are further categorised as systemically important NBFCs (NBFCs-ND-SI) if their asset size exceeds ₹500 crore. Based on the kind of activity they undertake, NBFCs are classified into 12 categories.

Borrowings and reserves and surplus together constitute almost 88 per cent of the liability side of the balance sheet. At end-December 2021, the reserves and surplus grew at a robust pace owing to ploughing back of profits by NBFCs, which were aimed at bolstering their balance sheets. NBFCs rely heavily on bank and market borrowings to meet their funding requirements, except NBFCs-D, which have access to public deposits as well.

Consolidated Balance Sheet of NBFCs as on December 2021

(₹ crore)

	Amount outstanding at the end of			Y-o-Y growth (Per cent)	
	Dec-20	Mar-21	Dec-21	Dec 20 over Dec 19	Dec 21 over Dec 20
1. Share Capital	87,877	91,392	92,902	14.1	5.7
2. Reserves and Surplus	4,36,427	4,63,942	5,18,518	13.5	18.8
3. Public Deposits	52,524	56,426	63,510	27.4	20.9
4. Total Borrowings	19,63,017	21,01,027	22,08,431	10.9	12.5
5. Current Liabilities and Provisions	1,71,847	1,72,047	1,73,283	12.4	0.8
6. Other Liabilities	26,100	33,903	52,619	3.9	101.6
Total Liabilities/Assets	27,37,792	29,18,738	31,09,263	11.7	13.6
1. Loans and Advances	22,52,413	23,93,871	25,02,575	17.7	11.1
2. Investments	2,32,851	2,41,748	2,80,547	18.1	20.5
3. Cash and Bank Balances	1,16,197	1,31,857	1,40,814	47.7	21.2
4. Other Current Assets	78,129	74,707	80,916	2.5	3.6
5. Other Assets	58,203	76,555	1,04,411	-68.4	79.4

Notes:

1. Data are provisional.
2. Numbers may not add up as all components are not reported here.

Source: https://m.rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=21206

As per the extant regulations, every NBFC is required to maintain a minimum capital ratio of 15 per cent of its aggregate risk-weighted assets (including both on and off- balance sheet items). To further strengthen their capital position, the

PCA (Prompt Corrective Action) framework for NBFCs will be made effective from October 1, 2022. Any NBFC breaching the risk threshold, (defined by three parameters, namely CRAR, Tier-1 ratio and NNPAs) will be placed under PCA. According to the RBI paper, the NBFC sector looks comfortably poised to comply with these new regulations with an overall CRAR of 27.5 per cent at end-December 2021.

NBFCs remain at a disadvantage when compared with banks with respect to the capital requirement on the part of their retail lending books such as loans for construction equipment, home, gold, commercial vehicles, etc.

For example, banks are permitted to apply seventy-five percent (75%) risk weight for construction equipment or commercial vehicle loans, while Non-banking Financial Companies (NBFCs) have to apply hundred percent (100%) risk weight. Therefore, the capital requirement for banks would be 6% under Basel III, while NBFCs would have to maintain Tier I capital of 10% under the proposed norms. Similarly, for home loans, the amount of capital provided by banks would be 4% to 10% and in the case of gold loans up to 1.65%. NBFCs will need to keep a Tier I of 10% on these exposures.

In the case of NBFC-IFC, the regulatory minimum Tier I capital percentage is already 10% and therefore, the new regulations are unlikely to have an impact on such entities.

Capital will be divided into 2 tiers - Tier I and Tier II. Tier I capital is the core capital that provides the most permanent and readily available support against unexpected losses, Tier II capital consists of elements that are not permanent in nature or are not readily available.

Tier I capital consists of paid up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets, but not reserves created by asset revaluation. From the aggregate of these items, the accumulated loss and book value of intangible assets, if any, will be deducted to arrive at the owned fund. Investments in shares of other NBFCs and in shares, debentures of subsidiaries and group companies, and, loans and advances to and deposits with subsidiaries and companies in the same group, in excess of 10 percent of the owned fund mentioned above, will be deducted to arrive at the net owned fund, i.e., Tier I capital.

Tier II capital consists of:

Preference Shares

Preference shares have characteristics similar to equity capital in as much as the shareholders' funds are subordinated to the claims of creditors. These are also redeemed out of accumulated profits. Preference shares that are compulsorily convertible into equity will be included in Tier I capital and not Tier II capital.

Revaluation Reserves

Revaluation reserves serve as a cushion against unexpected losses, but they are less permanent in nature. Thus cannot be considered as 'core capital'. These are reserves created out of revaluation of assets such as land and buildings, marketable securities, etc. However, the usage of such reserves as an insulator for unexpected losses depends primarily on:

- The level of certainty associated with estimates of the assets' market values
- Subsequent deterioration in values under difficult market conditions or in a forced sale
- Potential for actual liquidation at those values
- Tax consequences of revaluation, etc.

Hence, it is better to take revaluation reserves at a discount of 55% (Fifty-five percent) when computing their value for inclusion in Tier II capital. These reserves have to be shown as revaluation reserves in the balance sheet.

General Provisions and Loss Reserves

If these are not attributable to the actual reduction (diminution) in the value or an identifiable potential loss in any specific asset or assets, and are available to meet unexpected loss, they can be included in the Tier II capital. Utmost care to be taken to see that the appropriate provisions are made to meet known losses and foreseeable potential losses. This should be done before considering the general provisions and loss reserves to be part of Tier II capital. General provisions and loss reserves that can be admitted are up to a maximum of 1.25 percent (%) of weighted risk assets.

Hybrid Debt Capital Instruments

Number of capital instruments that have a combination of certain characteristics of equity and certain characteristics of debt fall in this category. Each such instrument has a particular feature that is considered to affect its quality as capital. Where such instruments have close similarities to equity, they can be part of Tier II capital. This is only when they are able to support losses on an on-going basis without triggering liquidation.

Subordinated Debt

To be eligible for inclusion in Tier II capital, the instrument should be unsecured, fully paid-up, subordinated to the claims of other creditors, free of restrictive clauses and should be irredeemable at the initiative of the holder or without the consent of the Non-banking Financial Company's (NBFC's) supervisory authorities. These instruments often hold fixed maturity and, as they approach maturity, they should be subjected to progressive discount for inclusion in Tier II capital.

Subordinated debt instruments will be limited to 50% of Tier I capital.

3.8.2 Minimum Requirement of Capital Funds

As per Section 45-IA of the RBI Act, 1934, Non-banking Financial Companies (NBFCs) are required to obtain a Certificate of Registration (CoR) from the Reserve Bank of India (RBI) to commence or carry on the business of an NBFC.

[54]**Net Owned Fund –** Regulatory minimum Net Owned Fund (NOF): However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be ₹ 2 crore likely to be increased to ₹ 20 crores in a phased manner.

Regulatory minimum NOF for NBFCs – IDF (Infrastructure Debt Fund), IFC (Infrastructure Finance Companies) is ₹ 300 Crs., MGCs (Mortgage Guarantee Company) ₹ 100 Crs, HFC (Housing Finance Company) ₹ 20 crores, and SPD (stand alone primary dealers) core activity ₹ 150 crores and SPDs with noncore activity ₹ 250 crores.

[55]Further, the Reserve Bank of India has specified ₹ 10 crores as net owned fund (NOF) required for the following categories of non-banking financial companies to commence or carry on the business of non-banking financial institutions from October 01, 2022:

- Non-banking financial company –Investment and Credit Company (NBFC-ICC)
- Non-banking financial company –Micro Finance Institution (NBFC-MFI)
- Non-banking financial company –Factor (NBFC-Factor)

The time lines are given as under to achieve the NOF of the referred NBFCs.

NBFCs	Current NOF	By March 31, 2025	By March 31, 2027
NBFC-ICC	₹2 crore	₹5 crore	₹10 crore
NBFC-MFI	₹5 crore (₹2 crore in NE Region)	₹7 crore (₹5 crore in NE Region)	₹10 crore
NBFC-Factors	₹5 crore	₹7 crore	₹10 crore

Non-banking Financial Companies (NBFCs), whose net owned fund (NOF) currently falls below ₹ 200 lakh, require to submit a statutory auditor's certificate certifying compliance to the revised levels at the end of each of the two (2) financial years as given above.

Non-banking Financial Companies (NBFCs) failing to attain the specified ceiling within the stipulated period of time are not eligible to hold the Certificate of Registration (CoR) as NBFCs and the Reserve Bank of India (RBI) would initiate the process for cancellation of the CoR of such NBFCs.

[54] RBI/2021-22/112 DOR.CRE.REC.No.60/03.10.001/2021-22 issued 22nd October 2021

[55] https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92 FAQ on NBFCs updated as on 10th January 2017)

Explanations: On-Balance Sheet Assets

[56]In these directions, degrees of credit risk, expressed as percentage weightages, have been assigned to balance sheet assets. Hence, the value of each asset/item is multiplied by the relevant risk weights to arrive at the risk-adjusted value of assets. The aggregate shall be taken into account for calculating the minimum capital ratio. The risk-weighted asset shall be calculated as the weighted aggregate of funded items as detailed in Table 3.2:

Table 3.2: Weighted Risk Assets – On Balance Sheet Items and Percentage Weight

	Weighted Risk Assets – On-Balance Sheet Items	Percentage Weight
i.	Cash and bank balances including fixed deposits and certificates of deposits with banks	0
ii.	**Investments**	
	a. Approved securities	0
	b. Bonds of public sector banks and fixed deposits / certificates of deposits/bonds of public financial institutions	20
	c. Units of Unit Trust of India	20
	d. Shares of all companies and bonds / debentures / commercial papers of companies other than in (b) above / units of mutual funds other than in (c) above	100
iii.	**Investments**	
	a. Approved securities except (c) below	0
	b. Bonds of public sector banks	20
	c. Fixed deposits / certificates of deposits / bonds of public financial institutions	100
	d. Shares of all companies and bonds / debentures / commercial papers of all companies and units of all mutual funds	100
iv.	**Current Assets**	
	a. Stock on hire (net book value)	100
	b. Inter-corporate loans / deposits	100
	c. Loans and advances fully secured against deposits held by the company itself	0
	d. Loans to staff	0
	e. Other secured loans and advances considered good	100
	f. Bills purchased / discounted	100
	g. Others (to be specified)	100

Contd….

[56] https://www.nhb.org.in/Regulation

v.	**Fixed Assets** (net of depreciation)	
	a. Assets leased out (net book value)	100
	b. Premises	100
	c. Furniture & Fixtures	100
vi.	**Other Assets**	
	a. Income tax deducted at source (net of provision)	0
	b. Advance tax paid (net of provision)	0
	c. Interest due on government securities	0
	d. Others (to be specified)	100

Source: https://www.nhb.org.in/Regulation

Notes:

i. Netting may be done only in respect of assets where provisions for depreciation or bad and doubtful debts have been made.

ii. Assets that have been deducted from the owned funds to arrive at net owned fund shall have a weightage of 'zero'.

Non-Market Related Off-Balance Sheet Items

The credit equivalent amount, in relation to a non-market related off-balance sheet item, will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF). (Refer Table 3.3)

Table 3.3: Instruments with Credit Conversion Factor

Sl. No.	Instruments	Credit Conversion Factor
i.	Financial and other guarantees	100
ii.	Shares/debentures underwriting obligations	50
iii.	Partly-paid shares/debentures	100
iv.	Bills discounted/rediscounted	100
v.	Lease contracts entered into but yet to be executed	100
vi.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the NBFC	100
vii.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down	100

Contd….

viii.	Lending of NBFC securities or posting of securities as collateral by NBFC, including instances where these arise out of repo style transactions	100	
ix.	Other commitments (e.g. formal standby facilities and credit lines) with an original maturity of up to one year over one year	 20 50	
x.	[Similar commitments that are unconditionally cancellable by the NBFC at any time without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness]	0	
xi.	Take-out finance in the books of taking-over institution		
	(i)	Unconditional take-out finance	100
	(ii)	Conditional take-out finance	50
		Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by a government guarantee.	
xii.	Commitment to provide liquidity facility for securitization of standard asset transactions	100	
xiii.	Second loss credit enhancement for securitization of standard asset transactions provided by third party	100	
xiv.	Other contingent liabilities (to be specified)	50	

Notes:

i. Cash margins or deposits shall be deducted before applying the conversion factor.

ii. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance-sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of NBFC's on-balance- sheet credit exposure.

Check Your Progress - 2

6. For commercial vehicle or construction equipment loans, banks are permitted to apply 75% risk weight. What is the risk weight assigned for NBFCs in this category?
   a. 25%
   b. 75%
   c. 50%
   d. 100%
   e. 125%.
7. In case of subordinated debt to be included in Tier II capital, what is the discount to be allowed where the date of maturity of the instrument is beyond one year but does not exceed 2 years?
   a. 10%
   b. 25%
   c. 75%
   d. 90%
   e. 80%.
8. Which of the following does not constitute Tier I capital?
   a. Paid up capital
   b. Balance in share premium account
   c. Capital reserve
   d. Revaluation reserve
   e. Free reserves.
9. What is the minimum Tier I capital requirements for NBFC-ND-SI and NBFC-D?
   a. 7.5%
   b. 5%
   c. 2.5%
   d. 10%
   e. 12%.
10. Which of the following is the Credit risk expressed as a percentage of weightages in respect of bonds of public sector banks?
    a. 5%
    b. 0%
    c. 15%
    d. 10%
    e. 20%.

3.9 Regulatory Framework for NBFC's

World over, there is an acceptance and understanding, post the great financial crisis of 2008, about the existence, contribution, magnitude, significance and risks of the non-banking financial sector. From considerate neglect of or indifference to this sector, either by default or by deliberate choice, the world has now become anxious and seriously concerned about it. This awakening resulted in enhanced attention, monitoring and regulation of this sector.

Example: RBI strengthened its Regulations by Introducing Scale-Based Supervision for Top Ranked Banks

In 2021, the regulatory tightening of NBFCs paved way for the reverse merger of HDFC Ltd with the HDFC Bank. The scale-based supervision rules introduced by the RBI for non-banks, for strengthening the regulation especially for the top ranked banks accelerated the merger of Housing Development Finance Corp (HDFC) with HDFC Bank. The rules were introduced in view of the failure of large institutions like IL&FS, Reliance Capital and Dewan Housing etc. The new rules cut the cost of meeting reserve requirements for banks and challenged the arbitrage that mortgage financiers enjoyed as NBFCs.

Source: https://economictimes.indiatimes.com/industry/banking/finance/banking/hdfc-hdfc-bank-merger-regulatory-changes-pave-way-for-union/articleshow/90652355.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, April 05, 2022, Accessed on 13/9/22.

The objective of NBFC regulations during the twentieth century was to protect the interests of the depositors. However, as the NBFCs grew in size and their interconnectedness with the banking system was visible and raised concerns about their capacity to disturb systemic stability, the NBFCs were brought under prudential regulatory framework from 2006 onwards as detailed hereunder:

- In exercising the powers under the Reserve Bank of India Act, 1934 (RBI Act, 1934) and all the powers enabling it in that behalf, the RBI has specified ₹ 200 lakh as the NOF required for a NBFC to commence or carry on the business of the same.
- Provided that an NBFC, already holding a certificate of registration issued by the Reserve Bank of India, and having net owned funds of less than two hundred lakh rupees, may continue to carry on the business of the non-banking financial institution, if such company achieves net owned funds of one hundred lakh rupees before April 1, 2016 and two hundred lakh rupees before April 1, 2017.

- Provided that in case of an unrated asset finance company, it shall obtain the minimum investment grade or any other specified credit rating on or before 31st March, 2016. Those AFCs that do not get a minimum investment grade rating by 31st March, 2016 shall not renew existing deposits or accept fresh deposits thereafter. In the intervening period, i.e. until March 31, 2016, unrated AFCs or those with a sub-investment grade rating shall only renew the existing deposits on maturity, and shall not accept fresh deposits, until they obtain an investment grade rating.
- An asset finance company or a loan company or an investment company (a) having minimum NOF as stipulated by the Reserve Bank, and (b) complying with all the prudential norms, may accept or renew public deposit, together with the amounts remaining outstanding in the books of the company as on the date of acceptance or renewal of such deposit, not exceeding one and a half times of its NOF.
- Provided that an asset finance company holding public deposits in excess of the limit of one and a half times of its NOF shall not renew or accept fresh deposits till such time they reach the revised limit.
- In the event of downgrading of credit rating below the minimum specified investment grade as provided for in paragraph 4(1), a non-banking financial company, being an asset finance company or a loan company or an investment company, shall regularize the excess deposit as provided hereunder; with immediate effect, stop accepting fresh public deposits and renew existing deposits; all existing deposits should runoff to maturity, and report the position within fifteen working days to the concerned regional office of the Reserve Bank of India, where the NBFC is registered.
- Every NBFC (Non-banking Financial Company) shall maintain a minimum capital ratio consisting of Tier I and Tier II capital, which shall not be less than fifteen percent (15%) of its aggregate risk-weighted assets on balance sheet and of risk-adjusted value of off-balance sheet items.

3.10 Summary

- NBFCs are companies involved in providing financial services in India. They perform various activities like leasing, hire purchase, bill discounting, etc.
- The RBI has set-up certain rules for acceptance of deposits by NBFCs, including a minimum credit rating, limit for public deposits and the procedure for acceptance of public deposits.
- There are regulations for premature withdrawal of deposits, brokerage payments, etc.
- The income of an NBFC should be recognized as per guidelines issued by the RBI from time to time.

- Similarly, assets of an NBFC are classified as standard assets, substandard assets, doubtful assets, and loss assets.
- The capital adequacy norms for NBFCs depend on risk-weighted capital ratio, revaluation reserves, preference shares, general provisions and loss reserves, subordinated debt, hybrid capital instruments, minimum capital funds requirement and risk-weighted assets, and non-market related off-balance sheet items.
- The capital of the NBFC is divided as Tier I and Tier II capital.

3.11 Glossary

NBFC (Non-Banking Finance Company): NBFCs are regulated by the Reserve Bank of India. They perform various activities such as leasing, hire purchase, bill discounting, etc.

NPA: A Non-Performing Asset (NPA) refers to a classification for loans on the books of financial institutions that are in default or are in arrears on scheduled payments of principal or interest. In most cases, debt is classified as nonperforming when loan payments have not been made for a period of 90 days.

Off-Balance Sheet (OBS) Items: OBS items refer to assets or liabilities that do not appear on a company's balance sheet but that are nonetheless effectively assets or liabilities of the company. Assets or liabilities designated off-balance-sheet are typically ones that a company is not the recognized legal owner of, or in the case of a liability for which a company does not have direct legal responsibility.

NOF: NOF means net owned funds of an NBFC.

Tier I Capital: Tier I capital is the core capital which provides the most permanent and readily available support against unexpected losses.

Tier II Capital: Tier II Capital consists of elements that are not permanent in nature or are not readily available.

3.12 Self-Assessment Test

1. Discuss the guidelines pertaining to acceptance of deposits by a company under the Companies Act, 2013.
2. What norms of the RBI should an NBFC proposing to give gold loans, etc., comply with?
3. Compare the capital adequacy requirement of a commercial bank and an NBFC that specializes in giving gold loans.
4. Discuss the weightages assigned as a degree of credit risk expressed as a percentage to balance sheet assets of an NBFC.
5. How is credit risk determined in respect of off-balance-sheet items of an NBFC to compute capital requirement?

3.13 Suggested Reading/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

3.14 Answers to Check Your Progress Questions

1. (e) Companies Act, 2013

Presently, acceptance of fixed deposits by limited companies is governed by the directives of the Companies Act, 2013.

2. (c) 2%

Maximum percentage of brokerage permissible to the broker who secured a deposit to NBFC in 2016 was 2%.

3. (d) 100 lakhs

Minimum Net Owned Funds (NOF) for an NBFC as on 31 March 2016 as per RBI should be 100 lakhs.

4. (e) 75% of the amount of public deposit kept by the depositor

75% of the amount of public deposit kept by the depositor.

5. (a) Not exceeding 1.5 times of its NOF

Not exceeding one and a half times of its (NOF) net owned funds.

6. (d) 100%

For commercial vehicle or construction equipment loans, banks are permitted to apply seventy-five percent (75%) risk weight, while NBFCs have to apply a risk weight of hundred percent (100%).

7. (e) 80%

In case of subordinated debt to be included in Tier II capital, the discount to be allowed where the date of maturity of the instrument is beyond one year but does not exceed 2 years is 80%.

8. (d) Revaluation reserve

Revaluation reserves do not constitute Tier I capital.

9. (d) 10%

Minimum Tier I capital requirements for NBFC-ND-SI and NBFC-D at present is 10%.

10. (e) 20%

Credit risk expressed as a percentage of weightages in respect of bonds of public sector banks is 20%.

Unit 4

Credit Rating

Structure

"There are two things you will never be without: One is your reputation and the other is your credit rating."

- Larry Winget

4.1 Introduction

Importance of good credit rating need not be emphasized.

In the previous unit, we discussed the regulatory framework that monitors Non-Banking Finance Companies. The main source of finance for the NBFCs is fixed deposits. The previous unit discussed the features of fixed deposits.

One of the important aspects of NBFCs is their performance in the market. Are they credit worthy? Do the investors feel that their money is safe if they choose to invest in them?

The investors invest mainly with two aims, viz., safety and assured return. It becomes very difficult for them to choose the right investment options without any guidance as the data available is quite difficult to comprehend by many investors. A simple and objective opinion is sought by investors in this context. Credit rating helps such investors by providing an independent and expert opinion about the capability of the issuer of debt instruments to meet their financial obligations. Rating, in itself, is not a recommendation to buy or sell or hold a specific investment. Further, rating is one-time and has validity only for a particular reporting period.

This unit attempts to explain the concept and meaning of credit rating and, its features besides deliberating on the business application of rating.

4.2 Objectives

After going through this unit, you will be able to:

- Explain the concept, meaning and features of credit rating
- Describe the various types and functions of credit rating
- Discuss credit rating in India and its regulatory framework
- Describe the role of credit rating agencies in India
- Discuss the dimensions of credit rating methodology and process
- Distinguish the advantages and disadvantages of credit rating

4.3 Concept and Meaning

The concept and meaning of credit rating is discussed in the following paragraphs.

Why Credit Rating? Credit rating is a measuring tool that is used to assess an investment's risk and return. Ratings act as a yardstick to measure the intrinsic risk of an instrument. The need for credit ratings is well defined and it will be helpful to the issuers to price their debt instruments. The issuer's credit rating will help the investors in making investment decisions. Thus, the investor uses the credit rating of an instrument to assess the risk level and to compare the offered rate with the expected rate of return. This is to optimize the risk-return trade-off.

Credit rating is used by the regulators like Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI) to determine the eligibility norms for their instruments. For example, RBI's commercial papers stipulate minimum credit rating by an approved agency.

Usually, credit rating is expected to improve quality consciousness in the market. It establishes more meaningful relationship between yield and quality of debt over a time period. It delivers a valuable input in forming business relationships.

But, the credit rating by a credit rating agency should not be taken as a recommendation to purchase or sell a security. While making investments, investors usually follow security ratings. Credit ratings provide an objective evaluation on the borrower's default for the given instrument. Thus, credit rating is a professional opinion given after analyzing all inputs made available with the rating agency at a particular point of time. Such assessments for ratings may prove wrong in future with some subsequent developments.

The investor is free to agree / disagree to the rating agency's suggestion as there is no private contract between them. If the investor takes any decision based on the rating agency's suggestion and incur losses, the rating agency cannot be held responsible. So, credit rating is an investor service and the agency is supposed to maintain a logical proficiency and reliability while giving suggestions. In the long term, the rating agency's reliability has to be built steadily by providing quality services, by doing continuous research and through unswerving endeavors. Credit rating gained importance due to the rising levels of default which results from easy availability of finance. The other reasons are:

i. Growth of information technology (IT).

ii. Globalization of financial markets.

iii. Increasing role of capital and money markets.

iv. Lack of government safety measures.

v. Trend towards privatization.

vi. Debt securitization.

The following are the definitions from different rating agencies.

[57]**CARE Ratings:** CARE Ratings' for debt instruments, such as debentures, bonds, asset-backed securities, etc., is a highly-valued credit risk opinion. The credit ratings guide the investors to effectively monitor and manage their investments subject to their respective risk-return policies. CARE Rating is Credit Analysis and Research Ratings, one of the credit rating agencies in India.

Some of the important aspects of credit ratings are given below.

i. Credit rating is an unbiased and independent opinion of the rating agency on the capacity of an issuer of debt security. This is in regard to the principle payment with interest as per the terms of issue of debt.

ii. Even the new investors can understand the ratings which are indicated in code number.

iii. Credit rating is only a guideline to the investors. It is not a recommendation to a particular debt instrument.

iv. The important elements, in debt security, for investment decision making are: (a) yield to maturity, (b) risk tolerance to the investor and (c) credit risk of the security. The opinion of the credit rating agencies should be based upon one of said aspects.

v. Credit rating is an ongoing valuation. A rating is a one-time evaluation of credit risk. The changes in the dynamic business world may imply changes in the risk characteristics of the security.

[57] https://www.careratings.com/about-us.aspx

vi. A credit rating does not create a fiduciary relationship between the rating agency and the users of rating. Because there exists no legal basis for such relationship.

4.4 Utility of Credit Rating

Let us discuss the purpose of credit rating and how it industry and the institutions take advantage of the credit rating.

1. Provides superior Information

The credit rating agency provides superior information on credit risk for three reasons. They are:

i. Brokers, financial intermediaries, underwriters generally provide a biased opinion due to vested interest, but not an independent rating agency.

ii. As the staff members are well trained and thoroughly proficient in their areas, their capability to judge risk is better.

iii. Generally, the credit rating companies are accessible to a wide variety of information, which is not accessible to the general public.

2. Low-cost information

By collecting, analyzing, inferring, and summarizing the complex information, the rating firm, generally, makes it easily comprehensible and readily available to the investor. Most of the investors widely appreciate it as they find it hardly possible to do credit evaluation on their own, which is also very costly.

3. Basis for a proper risk and return trade-off

An instrument gets the benefit of higher confidence from investors, if it is rated by a credit rating agency. On the other hand, the investor becomes aware of the risks involved if he invests in that security.

4. Induces healthy discipline in corporate borrowers

Higher credit rating induces a healthy discipline in a company as it has a tendency to improve the corporate image and visibility.

5. Greater credence to financial and other representation

A credit rating agency always attempts to search for credible financial information of the target company as its own reputation is at stake, if the information rating a security proves incorrect. As the issue adheres to the demands of a credit rating agency on a regular footing, its fiscal and other representations gains better reliability.

6. Formation of public policy guidelines on institutional investment

The professional rating of debt securities enables formation of public policy guidelines. The guidelines on the type of securities eligible for inclusion in different types of institutional portfolios.

4.5 Types of Credit Rating

There are many credit rating agencies operating across the country. Each credit agency uses its own method and terminology to provide the credit ratings.

Ratings are broadly classified into two grades, the investment and speculative grade.

In the case of investment grade ratings, the investment is considered less risky by the credit rating agency as the issuer is likely to comply with the repayment terms and offer less returns. The speculative grade investments involve high risk and offer higher coupon rate.

The different kinds of credit ratings are: individual rating, mutual fund rating, insurance sector rating, infrastructure sector rating, issuer rating, financial sector rating, corporate governance rating, corporate debt rating, and bank loan credit rating. Few of the important types of credit rating are discussed hereunder:

4.5.1 Bond Rating

Bond rating deals with the grading of bonds or securities which are issued by a company, government or semi-government institution. It denotes the possibilities of payment on the maturity of the bond. In other words, it ascertains the level of risk associated with the debt securities. It is a view of a unit's capability and readiness to recognize its financial commitments with respect to a particular bond or other debt instrument. The ratings allocated to the debt issues of monetary establishments and corporate businesses can be either temporary or long-standing, depending on the tenor of the financial obligation. A short-term rating is allocated to debt instruments with maturity of up to one year.

4.5.2. Equity Rating

Rating of shares which are traded in capital market is called equity rating. Each stock is evaluated systematically by following four broad categories namely—fundamentals, valuation, momentum, and risk. This helps to gauge investor expectations.

4.5.3 Commercial Paper Rating

A company is statutorily bound to avail rating level from a rating agency before issuing commercial paper. It is known as commercial paper rating. In India, the rating of commercial papers issued by corporate bodies is mandatory.

4.5.4 Issuer Credit Ratings (for governments, financial institutions, banks, and corporates)

These summarize an entity's overall credit-worthiness and its ability and assigned to an entity are comparable across international borders. They vary in type which is assigned based on the financial strength of the sectors that includes the standalone financial health, bank support, long and short-term borrowable, as well as foreign currency ratings.

Example: Credit ratings for Dabur India's Instruments

On 2nd May 2022, Dabur India informed BSE and NSE in a regulatory filing that various instruments of the company had been rated by CRISIL as under:

Non-convertible debentures had been reaffirmed with rating of AAA/Stable up to an amount of ₹ 20 Crores.

Commercial paper had been reaffirmed with rating of A1+ up to an amount of ₹ 200 Crores.

Long term bank loan had been given AAA/Stable whereas short term bank loan has been given A1+. Overall bank loan had been rated up to an amount of ₹ 157.5 Crores.

Source: Statutory Filings - Credit Rating (dabur.com) 1294-Letter-Dated-02.05.2022.pdf (dabur.com) dated 2nd May, 2022 Accessed on 12th July, 2022

4.6 Credit Rating in India and its Regulatory Framework – CRA Guidelines

India was the first developing country to set up a credit rating institution named — "Credit Rating Information Services of India Limited (CRISIL)" — a joint venture of ICICI and UTI, established in the year 1988. Then came ICRA Limited (previously known as Investment Information and Credit Rating Agency of India) in 1991 and CARE (Credit Analysis and Research Limited) in 1994.

The function of credit rating agencies was institutionalized by the RBI on the issue of commercial papers, followed by SEBI which made rating mandatory for debt instruments and a few types of debentures. In June 1994, ratings for financial instruments of Non-Banking Financial Companies (NBFCs) were mandated by the RBI, while the credit ratings for instruments issued by Public Sector Undertakings (PSUs), and were made optional.

As stated above, credit rating agencies in India were regulated by SEBI. The main elements of its Credit Rating Agencies (CRA) Regulations are:

a. Registration

b. General obligations

c. Restrictions on the rating of securities

d. Procedure for inspection and investigation

e. Action in case of default

SEBI Guidelines 1999[58]

SEBI has framed guidelines to be followed by a credit rating agency-

1. The validity period for a rating agency shall be for three years.

[58] www.sebi.gov.in

2. Credit rating agencies shall not rate a security issued by its promoters, subsidiaries or associate concerns in which the agencies chairman or directors or employees have interest.
3. Debt securities over ₹ 100 crore issued either in the form of IPO or right issue should be rated by at least two agencies.
4. The companies which are going in for credit rating of their instruments should provide correct and factual information. They should incorporate an undertaking in their offer documents and a penal clause as well if it is proved to be not correct at a later stage. This is to protect the investor's interest.
5. Rating agencies can choose their methodology of operation in undertaking the rating process.
6. No chairman, director or employee of the promoters of the rated company shall be in the rating committee.

In 2010, the above guidelines were updated. The details are given below hereunder.

[59]Guidelines for Enhanced Disclosures by Credit Rating Agencies (CRAs)

Post ILFS crisis in September 2018, SEBI[60] has come out with guidelines on enhanced disclosures by CRAs.

The guidelines have been broadly classified into five action points:

1. Disclosures in the Press Release regarding Rating Actions by CRAs

A. In its earlier circular issued on 1st November 2016, SEBI has prescribed a standard format regarding rating action by CRAs in their press release. One important factor is that the CRAs should incorporate the relevant factors which were discussed in detailed notes considered by the rating committee for assigning the final rating on the matters of creditworthiness of an issuer and other rating drivers.

SEBI in its latest circular dated September 2018, has stated that, in order to enable investors to understand underlying rating drivers better and make more informed investment decisions, CRAs shall make the following specific disclosures in the section on "Analytical Approach" in the Press Release:

i. The funds support from a parent/group/government, towards timely debt servicing is available, the name of such supporting entities, along with rationale for such expectation of funds if needed, may be provided.
ii. When subsidiaries or group companies are consolidated to arrive at a rating, list of all such companies, along with the extent to which the issuer gets support (e.g. full, proportionate or moderate) and rationale of consolidation, may be provided.

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[59] *SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2018/ 140 November 13, 2018*

[60] SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2018/ 140 November 13, 2018

B. In the Press Release, the CRAs shall provide a specific section on "Liquidity". This section should highlight parameters like liquid investments or cash balances, access to unutilized credit lines, liquidity coverage ratio, and adequacy of cash flows for servicing the debt obligation on maturity, etc., by the issuer. Further, the press release by the CRAs should disclose any linkage of the issuer to external support for meeting near term maturing obligations.

2. Review of Rating Criteria

The procedure continues as suggested in Para 2 in Annexure A of SEBI Circular dated November 01, 2016. The following are the guidelines on the review criteria.

A. CRAs may review their rating criteria with regard to assessment of holding companies and subsidiaries in terms of their inter-linkages, holding company's liquidity, financial flexibility and support to the subsidiaries, etc.

B. While carrying out "Monitoring of Repayment Schedules", CRAs shall analyze the deterioration in the liquidity conditions of the issuer and also take into account any asset-liability mismatch.

C. While reviewing "Material Events", CRAs may treat sharp deviations in bond spreads of debt instruments vis-à-vis relevant benchmark yield as a material event.

3. Disclosure of Average Rating Transition Rates for long-term instruments

Transition studies are core to evaluating the performance of a CRA and provide an insight on the stability of ratings over a period of time. Thus, in disclosures of average transition, ratings have to be a part of press release.

A. In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA should publish information about the historical average rating transition rates across various rating categories, so that investors can understand the historical performance of the ratings assigned by the CRAs.

B. CRAs shall publish their average one-year rating transition rate over a 5-year period, on their respective websites, which shall be calculated as the weighted average of transitions for each rating category, across all static pools in the 5-year period. For the said purpose, the following terms shall have the meaning as under:

i. Static Pool: These are ratings outstanding for each category at the beginning of any financial year (excludes ratings that have been withdrawn or ratings of non-cooperative issuers during the financial year). Ratings downgraded to D shall be treated as default for the rest of the financial year. Ratings which are upgraded from D shall be considered as new rating for the relevant subsequent static pools.

ii. **Transition Rate**: The number of movements/transitions from each rating category to another, as at the end of the financial year, as a percentage of the total number of ratings in the static pool.

iii. **Averaging**: All averaging across static pools for transition rate computations must be based on the weighted average method where the weights are the number of issuers in each static period.

4. Disclosure of performance of CRAs on Stock Exchange and Depository website

Each CRA shall furnish data on sharp rating actions in investment grade rating category, as per the format specified in Annexure B, to Stock Exchanges and Depositories for disclosure on website on half-yearly basis, within 15 days from the end of the half-year (31st March/30th September).

5. Internal Audit of CRAs

Half-yearly internal audit, mandated under Regulation 22 of the SEBI (Credit Rating Agencies) Regulations 1999, shall also cover adherence to the prescribed methodology for calculation of transition rates, as specified in it, and default rates.

Regulations of CRA - under SEBI (Credit Rating Agencies) Regulations, 1999

SEBI is responsible to regulate Credit Rating agencies on the following areas:

- Registration of rating agencies
- Fit and proper criteria for rating agencies
- Rating process and methodology
- Records, transparency and disclosures, avoidance of conflict of interest, code of conduct, etc.

The Reserve Bank of India provides the accreditation after assessing the eligibility of the agencies based on Objectivity, Independence, International Access/Transparency, Disclosure, Resources, and Credibility. As on date, there are six C R agencies namely CRISIL, ICRA, CARE, India Ratings, Brickwork Ratings, and SMERA Ratings. **(**Detailed report on the regulations is provided in the Annexure**)**.

SEBI's Circulars on CRA Guidelines in 2022

SEBI has issued the following circulars on the various aspects relating to Credit Rating Agencies:

- Circular dated 31st October, 2022[61] has issued standardized rating symbols and their definitions to bring in standardization in rating scales used by different CRAs. These symbols and their definitions are as given below:

  AAA - Issuers with this rating are considered to have the highest degree of safety regarding timely servicing of debt obligations. Debt exposures to such issuers carry lowest credit risk.

[61] https://www.sebi.gov.in/legal/circulars/oct-2022/standardisation-of-rating-scales-used-by-credit-rating-agencies-cras-_64506.html

AA – Issuers with this rating are considered to have high degree of safety regarding timely servicing of debt obligations. Debt exposures to such issuers carry very low credit risk.

A - Issuers with this rating are considered to have adequate degree of safety regarding timely servicing of debt obligations. Debt exposures to such issuers carry low credit risk.

BBB – Issuers with this rating are considered to have moderate degree of safety regarding timely servicing of debt obligations. Debt exposures to such issuers carry moderate credit risk.

BB – Issuers with this rating are considered to have moderate risk of default regarding timely servicing of debt obligations.

B – Issuers with this rating are considered to have high risk of default regarding timely servicing of debt obligations.

C – Issuers with this rating are considered to have very high risk of default regarding timely servicing of debt obligations.

D - Issuers with this rating are in default or are expected to be in default soon.

- Circular dated 13th October, 2022 clarified the procedure for suspension, cancellation or surrender of certificate of Registration of a Credit Rating Agency. This was an outcome of SEBI's cancellation of the licence of Brickwork Ratings India. Because of this event, the Securities and Exchange Board of India came out with guidelines to facilitate orderly migration of credit ratings of debt securities following the cancellation of licence of a credit rating agency.
- Circular dated September 30, 2022 brought in amendment to guidelines and extension of timeline for implementation of standardized industry classification by Credit Rating Agencies (CRAs).

[62]Efficacy of Ratings Accountability & Transparency of Credit Rating Agencies

In India, the general responsibility of supervision and regulation of credit rating agencies is carried out by the SEBI under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. These regulations oversee the following aspects:

- Registration of rating agencies
- Fit and proper criteria for rating agencies
- Rating process and methodology
- Records, transparency and disclosures, avoidance of conflict of interest, code of conduct, etc.

[62] Growing NPAs in Banks: Efficacy of Ratings Accountability & Transparency of Credit Rating Agencies (Speech delivered by Shri R. Gandhi, Deputy Governor, Reserve Bank of India at the Conference conducted by ASSOCHAM on May 31, 2014, at Le-Meridian, New Delhi)

Though the rules were first applicable only to rating of debt securities, later, their coverage was expanded to all rating activities including bank ratings.

The Reserve Bank of India (RBI) examines and provides the accreditation required for a rating agency to be designated as an eligible External Credit Assessment Institution under Basel II framework.

The RBI gives such permission only after a thorough evaluating of the rating agency's capability to comply with the standards given as per Basel II framework. As of today, there are six such rating agencies—CRISIL, ICRA, CARE, India Ratings, Brickwork Ratings, and SMERA Ratings. While accrediting credit rating agencies, the Reserve Bank has been mindful of the need to have an optimum level of competition among the rating agencies.

Credit rating agencies' eligibility is assessed against various qualitative and quantitative parameters. These requirements are grouped into the following six criteria: objectivity, independence, international access/transparency, disclosure, resources, and credibility.

Objectivity: Basel regulations prescribe that the methodology for assigning credit ratings must be rigorous, systematic and subject to some form of validation (back testing, etc.) based on historical experience. Further, the ratings should be subjected to continuous surveillance.

The Reserve Bank assesses this criteria in terms of factors like credit rating agency's definition of default and action taken on default, historical default rates, order of default rates (i.e. the lower the rating, the higher the default probability), stability of the ratings (i.e. probability that a given rating remains unchanged during a given period), predictive ability of the ratings, improvement to the rating methodology to reflect current trends, etc. The Reserve Bank looks into the default studies, transition matrices, Gini Coefficient, etc., of credit rating agencies to conduct the above assessment.

To ensure standardization of default rates, the Reserve Bank of India has mandated that all rating agencies shall use a uniform definition of default as far as the bank loan ratings are concerned.

Independence: Basel norms state that a credit rating agency should be independent and not subjected to political or economic pressures while rating. The rating process should also be free from conflict of interest that may arise due to shareholding pattern or composition of board of directors.

To assess whether a rating agency is independent, the Reserve Bank of India evaluates the ownership and organization structure (presence of independent directors in the Board & rating committees), independence of individuals, i.e. conflict of interest between rating fee and quality of ratings, conflict of interest with shareholders, conflict of interest at rating committee level, separation of business development and rating activities, separation of rating business from other business activities.

International Access/Transparency: Under this parameter, the Reserve Bank gauges whether a credit rating agency makes necessary disclosures with regard to rating methodologies and rating rationales to both domestic as well as international users without any differentiation.

Disclosure: During the accreditation process, the Reserve Bank assesses whether a credit rating agency makes the following disclosures: rating methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each rating category; and the transitions of the rating. In addition, the Securities and Exchange Board of India has also mandated a detailed set of disclosures by credit rating agencies.

Resources: Access to sufficient resources is an important factor in determining a credit rating agency's ability to furnish quality ratings. The Reserve Bank makes an assessment as to whether a credit rating agency has sufficient capabilities in terms of human resources, i.e. number of employees, their qualifications and experience, etc. Further, the Reserve Bank also looks into the technological capabilities of the credit rating agencies before deciding upon their accreditation. In addition, the Reserve Bank requires credit rating agencies to have access to various sources of information on economy, sectors, companies, etc.

Credibility: Credibility of a rating agency is assessed based on the degree of acceptability of ratings of a rating agency by independent parties, viz. investors, insurers, trading partners, etc. The Reserve Bank also looks into the internal procedures put in place by the credit rating agencies to prevent misuse of confidential information acquired by them during their rating exercise. The credit rating agency's adherence to code of conduct prescribed by Securities and Exchange Board of India, International Organization of Securities Commissions (IOSCO) and Association of Credit Rating Agencies in Asia (ACRAA), are also analyzed to determine the credibility of a credit rating agency.

In addition to accrediting credit rating agencies, Basel II framework requires that the ratings assigned by credit rating agencies shall be mapped to appropriate risk weights available under the standardized risk weighting framework. Basel II framework requires that national regulators should decide which rating categories correspond to which risk weights. The mapping process should be objective and should result in a risk weight assignment consistent with the level of credit risk reflected in the ratings. In India, the Reserve Bank has prescribed uniform risk weights for all rating agencies. Such uniform risk weights are prescribed due to relatively low penetration of ratings and absence of sufficient historical default data.

In addition to the detailed assessment at the time of accreditation, the Reserve Bank of India also conducts an annual review of accreditation of credit rating agencies to assess their eligibility for continued accreditation under Basel II framework. During the review exercise, the Reserve Bank evaluates the processes as well as the outcomes. The cumulative default rates of rated portfolio of individual rating agency is evaluated in comparison with the benchmark cumulative default rates proposed under the Basel II framework. The cumulative default rates of the bank loan ratings in India are higher than the benchmarks provided by Basel II framework.

Example: 3 CRAs have been penalized by SEBI

SEBI imposed a fine of ₹ 25 lacs each on 3 CRAs – ICRA, CARE Ratings and India Ratings in December 2019 in the context of credit ratings provided to NCDs of IL&FS. On 22nd September 2020, SEBI increased the penalty amount to ₹1 crore on each of the three rating agencies, as they completely depended on the statements submitted by corporate IL&FS without proper verification of the statements. This excess dependence on the statements submitted by corporate IL&FS led to serious lapses in credit ratings assigned to NCDs of IL&FS.

Source: IL&FS: SEBI enhances penalty to ₹1 crore on 3 credit rating agencies | Mint (livemint.com) dated 23rd September, 2020 Accessed on 22nd August, 2022

Check Your Progress - 1

1. Which of the following terms depicts the independent opinion about the capability of the issuer of a financial instrument to meet the financial obligation?
   a. Analysis
   b. Credit rating
   c. Appraisal
   d. Assessment
   e. Evaluation
2. Which of the following is a part of guidelines given to CRAs?
   a. CRA should maintain records in support of each credit rating and, review and surveillance thereof.
   b. Maintain a summary of the discussions with the issuer, its management, bankers and auditors. This will have an impact on the credit rating.
   c. Decisions of the credit rating committee(s). This includes voting details and notes of dissent, if any, by any member of the rating committee.
   d. If a quantitative model is a substantial element of the credit rating process, then the rationale for any material difference between the credit rating implied by the model and the credit rating actually assigned is to be recorded.
   e. CRA has to ensure the issuer company conducts AGM regularly.

3. Which of the following is the first credit rating agency in India which was jointly promoted by ICICI and UTI?
   a. CRISIL
   b. CRA
   c. CARE
   d. ICRA
   e. UTI
4. Which of the following is/are the main element/s of the regulatory framework of credit rating agencies?
   a. General obligations
   b. Restrictions on the rating of securities
   c. Registration
   d. Procedure for inspection and investigation
   e. All the above
5. Which of the following depicts the rating of shares which are traded in capital market?
   a. Bond rating
   b. Commercial paper rating
   c. Equity rating
   d. Sovereign rating
   e. Currency rating

Activity 4.1

Many credit rating agencies reduced their ratings of Britain after it announced its withdrawal from EU (commonly known as Brexit). Standard and Poor downgraded it to “AA” from “AAA” followed by similar action from Fitch Ratings. What type of credit rating is referred to in the above example? Find any other instances of such downgrading by credit rating agencies.

Answer:

4.7 Credit Rating Agencies in India

[63]Over the period, the Indian credit rating industry has evolved. The Indian credit rating industry primarily consists of CARE, CRISIL, ICRA, ONICRA, SMERA, Ind-Ra, and Duff & Phelps Credit Rating India (DCR India). CRISIL has a market share of more than 60% and is the largest credit rating agency in India. CRISIL offers its services in manufacturing, service, financial, and SME sectors as it is a full service rating agency. SMERA is the rating agency specially launched for the rating of SMEs.

4.7.1 CRISIL

CRISIL is a global analytical company that provides services such as credit ratings, research, risk assessment and other policy advisory services. It is India's leading ratings agency. It is also the leading source of premium research to the world's major banks and chief corporations. With continuous competitive expansion arising from its dynamic brand, supreme reliability, and market control across businesses, and huge customer support, it provides analysis, observations and clarifications that make markets work better. CRISIL's vital trait is its capacity to switch data and information into professional judgment and foresee across an extensive range of fields, with profound knowledge and absolute neutrality. CRISIL's major share-holder is Standard and Poor's (S&P). S&P, a division of McGraw-Hill Financial (formerly The McGraw-Hill Companies) (NYSE:MHFI), is the world's leading contributor of credit ratings.

Client Base: CRISIL addresses a rich and globally diversified client base. In India, its customers vary from small business units to leading corporations and financial institutions. Outside India, its clients comprise the world's major banks and leading corporations. In addition to this, CRISIL works with policy-makers and governments in India and other upcoming markets in the infrastructure domain.

Services to Customers: CRISIL empowers its customers and the markets at large. CRISIL assists the lenders, borrowers, issuers, investors, regulators, and market intermediaries to make better informed investment and business decisions through independent analysis, tools and benchmarks. CRISIL contributions permit markets and their participants to become more clear and efficient by diminishing and managing risk, taking pricing judgments, creating more income, lowering time to market, and enhancing returns. By aiding shape public policy on infrastructure in promising markets, it assists in mobilizing economic expansion and development in these countries.

4.7.2 ICRA

Leading financial or investment institutions, commercial banks and financial services companies set up ICRA Limited (previously called as Investment

[63] https://download.oliveboard.in/pdf/CreditRatingAgenciesInIndia.pdf

Information and Credit Rating Agency of India Limited) in 1991, as a self-sufficient and professional investment Information and Credit Rating Agency. Together, ICRA and its ancillaries formed the ICRA Group of Companies. It is a public limited company, having its shares listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

The functioning areas of ICRA are rating services, grading services, industry research and consulting services, software development, analytics & business intelligence and engineering services.

Service to Customers: The following are ICRA's services to its customers:

(a) To give information and guidance to individual and institutional investors or creditors; (b) To improve the issuers or the borrowers ability to access the money and capital markets for tapping a larger quantity of resources from a wider range of the investing public; (c) To support the regulators in promoting the financial markets transparency; and (d) To provide intermediaries with a tool to improve efficiency in the fund-raising process.

4.7.3 ONICRA

Onida Individual Credit Rating Agency of India Ltd. (ONICRA) is one of India's leading credit and performance rating agencies. ONICRA provides rating services. It also provides risk assessment and analytical solutions to its clients such as individuals, micro, small and medium enterprises and corporates. It is a third party credit and performance rating and estimation and assists in creating "trust" between players in markets that build transactions.

The rating agency collects and analyzes the financial, operational, industry and market information. It synthesizes the information and provides autonomous, reliable assessments of an entity. This acts as an important source of input for the stake-holders to take better decisions.

Service to Customers: To realize its goal, it is committed to provide the stakeholders with objective, independent, timely and forward-looking credit and performance opinions. It rooted in several core principles like independence, integrity, neutrality, quality, and transparency.

4.7.4 SMERA (SME Rating Agency of India)

[64]SMERA is a full-fledged credit rating agency which has been primarily set up for rating of micro, small and medium enterprises (MSME) in India. A joint initiative of SIDBI, Dun and Bradstreet information service resulted in the creation of SMERA. SMERA provides ratings for micro, small and medium enterprises that enable them to avail bank loans at concessional interest rates. These ratings enable the MSME units to improve their credibility and promote their growth. The ratings are also a measure of self-evaluation and improvement.

[64] https://www.smeraonline.com/

SMERA MSME rating is an independent and comprehensive third-party evaluation of the MSME. The parameters considered for rating include financial performance, financial position and various qualitative parameters that impact the credit-worthiness of the MSME.

SMERA also provides Bank Loan Ratings. These are allotted to several short-term and long-term loan facilities such as project loans, working capital demand loans, cash credit facilities, etc. The banks based on SMERA ratings also extend other non-fund based facilities such as bank guarantee and letter of credit.

4.7.5 Ind-Ra–A Fitch Group Company

[65]India Ratings and Research (Ind-Ra), is India's one of the most sought-after credit rating agency devoted to offering the Indian credit markets with precise, well-timed and potential credit opinions. Developed on a base of independent thinking, thorough analytics, and an open and balanced approach towards credit research, Ind-Ra has developed quickly during the past decade gaining considerable market presence in India's fixed income market.

Customer Base: Ind-Ra presently caters to the needs of corporate issuers, financial institutions, i.e., banks and insurance companies.

Ind-Ra, a 100% owned subsidiary of the Fitch Group, is a global leader in financial information services, operating in more than 30 countries. Fitch Group comprises Fitch Ratings, Fitch Solutions, BMI Research, and Fitch Learning. BMI Research is an independent provider of country-risk and industry analysis, specialized in upcoming and frontier markets.

4.7.6 Brickwork Ratings (BWR)

BWR offers rating services on bank loans, NCD, commercial paper, fixed deposits, securitised paper, security receipts etc. Brickwork Ratings was founded by bankers, credit rating professionals, former regulators as well as professors, is committed to promoting financial literacy. Brickwork Ratings has Canara Bank, a leading Public Sector Bank, as its promoter and strategic partner.

4.7.7 Infomerics Valuation and Rating Pvt. Ltd.[66]

Infomerics Valuation and Rating Pvt. Ltd was conceived and instituted by a team of experienced professionals with rich experience in finance, banking and administrative service. The agency provides free & fair analysis and evaluation of credit worthiness & ratings of banks, NBFCs, large corporates and small and medium scale units (SMUs).

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[65] https://www.indiaratings.co.in/about-us/overview#:~:text=Ind%2DRa%20is%20recognised%20by,subsidiary%20of%20the%20Fitch%20Group.

[66] https://www.infomerics.com/service-cat

4.7.8 Structured Obligations

[67]A structured obligation is a different method to raise funds from the market which is done through a special purpose vehicle (SPV), normally a trust. The SPV organizes the securities such as existing assets, future receivables etc. and creates a special ownership rights on them called Pass Through Certificates (PTC) and markets them to the investors. These PTCs are rated by a CRA. The investors buy them basing upon their risk taking ability. Banks, financial institutions, infrastructure companies use this method to raise money.

Example: CRISIL to Provide Impact of ESG on Credit Profiles

CRISIL Ratings, in January 2022, announced that they would commence publishing effect of environmental, social and governance parameters separately while assigning credit ratings. ESG was a significant factor in investment decisions and while accessing capital also.

In the last few years ESG led investments gained importance with ESG assets standing at $37.8 trillion as of March 2021. It accounted for a third of global assets under management. In India also assets under management of ESG focused funds reached up to ₹ 12,000 crores as of December 2021.

Source: CRISIL Ratings to call out ESG impact on credit profiles dated 12th January 2022, Accessed on 23.08.2022

4.8 Dimensions of Credit Rating Methodology and Process

Credit rating provides a prospective investor a view on the credit-worthiness of an instrument of a company in which he invests. This rating is based on the perceived risk of the various aspects such as company’s business, financial profile, strength of the management, etc. The investor relies on the rating in order to ascertain the level of risk and the rate of return while taking a decision to go for an investment or not.

4.8.1 Credit Rating Process

[68]The key systems and procedures of ratings are as follows:

1. The rating process begins after receiving the mandate letter from the issuer company. CRA shall enter into a written agreement with each and every client whose securities it proposes to rate and every such agreement shall include the following provisions:
    a. The rights and liabilities of each party in respect of the securities’ rating shall be defined. The credit rating agency must specify the fee that is to be charged.

[67] https://unovest.co/2017/06/debt-funds-structured-obligations-risk/#:~:text=A%20structured%20obligation%20is%20a,or%20future%20receivables%20to%20it.

[68] http://www.psnacet.edu.in/courses/MBA/Financial%20services/17.pdf

b. The client must agree to a regular rating analysis by the CRA during the period of the rated instrument.

c. The client should provide the CRA with true, adequate and timely information. He should cooperate with the CRA so that the latter can arrive and maintain an authentic and accurate rating of the client's security.

d. Irrespective of whether the client accepts or rejects the rating, the credit rating agency shall disclose the client's securities rating in periodic and regular method of dissemination.

e. The client's offer document shall agree to disclose:

   - The past three years data regarding the rating assigned to the client's listed securities by any CRA.
   - The data pertaining to client's security rating given by any other CRA which has not been accepted by the client.

f. The agreement to the effect is to be made by the client, to obtain from a minimum of two agencies, for any issue of debt securities of the size not less than ₹ 100 crore.

   CRA shall, during the lifetime of securities rated by it, continuously monitor the rating of such securities.

2. Analytical teams are to be formed for drawing analytical and sector skills within the organization.
3. These analysts procure both qualitative and quantitative data related to credit history from secondary sources such as annual reports, regulatory filings, prospectus, etc.
4. Another source of information for the analysts is the meetings with the key managerial personnel. These meetings help them to obtain information on the company's financials, operations, history, etc. Such information will assist the analyst to evaluate the borrower's ability to generate cash flows from the debt granted.
5. After gathering information and making a thorough analysis of it, the analysts derive at a detailed report outlining the parameters for the assessment of rating.
6. The report is placed before a pre-view meeting after which it is tabled in the rating committee meeting, which should comprise members that ensure objectivity and impartiality.
7. The information, from which the report is generated, is kept confidential.
8. The whole process may involve a time span of two to four weeks. It may vary depending on the complexity of the issuer operations.

9. Once the review committee finalizes a rating, the same is then communicated to the issuer. The issuer, in turn, may approach the committee with a request to review the rating. However, such a request can be done only in cases where there are new facts or information emerging that validates the need for a revision.
10. In India, the issuer enjoys the privilege of not accepting the rating given by the rating agency. In such a case, the rating agency does not publicly disclose the rating.
11. However, if the issuer accepts the rating, the next step is, communicating the rating to the different credit markets. Such communication can take place either through press releases or through publications of the rating agency.
12. The rating agency annually conducts surveillance of the issuer's entity to study the changes that occurred and their impact on the rating given.

4.8.2 Credit Rating Methodology

In order to meet the benchmark standards of world leading rating agencies, the CRA employs methodologies and approaches during risk assessment. For different types of companies and their debt instruments, CRA experts use special ways to assess their credit-worthiness. The methodology of rating adopted by CRAs in India is more or less similar.

The common methodology includes the analysis of all the factors like business, industry parameters, operational efficiency, quality of management, issuer's commitment to new projects, financial positions, etc. - that affect the creditworthiness of an issuer. A detailed analysis of the past financial statements is to be made to assess the performance and to estimate future projections. An evaluation of the company's ability to serve the debt obligations over the tenure of the instrument being rated will be made. Thus, the rating is determined by the relative comfort level of the issuer to service the obligations.

The main factors that are to be analyzed, in detail by the CRA while assessing the instrument, are listed as: Business Risk Analysis, Financial Analysis, Management Evaluation, Geographical Analysis, Regulatory and Competitive Environment, and Fundamental Analysis. The same are discussed below:

1. **Business Risk Analysis**

   It aims at analyzing the industry risk, market and legal positions of a company, operating efficiency, etc. as discussed below:

   a. **Industry risk:** Several Factors like business cycle pattern, structure of industry, strength of industry prospect, position of demand and supply, nature and basis of competition, etc., will be taken into consideration by the rating agency before evaluating the industry risk. Price, quality of the product and distribution capabilities form the basis on which industries compete with each other. Stable growth in demand and flexibility in timing of the capital outlays will give the industry a better position for getting a better credit rating.

b. **Market position of the company:** Several factors like percentage (%) of market share, marketing infrastructure, competitive advantages, selling and distribution channel, diversity of products, customers base, research and development projects undertaken to identify obsolete products, quality improvement programs, etc. are taken into consideration by the rating agencies while evaluating the market standing of the company.

c. **Operating efficiency:** The operating efficiency of every issuer company and its credit rating are dependent on the factors like locational advantages, the relation between management and labor, availability of raw material, compliance to pollution control norms, cost structure, level of capital employed, technological advantages, etc.

d. **Legal position:** Assessment of the legal position of a debt instrument can be made with the help of the letter of offer. This letter contains the terms of issue, the responsibilities of the trustees, means of payment of principal and interest in time, provision made for protection against fraud, etc.

e. **Size of business:** While making the credit assessment of a company, the relevant factors are the size of business and geographical spread. Business cycle changes adversely affect smaller companies more as compared to bigger companies. Operations of smaller companies are limited in terms of products, number of customers and geographical area whereas, big companies enjoy the advantages of diversification, wide product range and customers spread over a wide geographical area.

2. **Financial Analysis**

The aim of the financial analysis is to determine the financial strength of the issuer company with the help of ratio analysis, cash flow analysis and existing capital structure. The four important factors involved in an analysis are: a) profitability/earning potential; b) quality of the accounting; c) cash flow analysis and d) financial flexibility. The future performance of the company is evaluated on the basis of both past and current performances. The important areas considered are explained below-

a. **Accounting quality:** The rating process starts with the analysis of audited financial statements and the study of accounting quality. For this purpose, the CRA verifies the aspects of: a) auditor's qualification,

b) understatement/overstatement of profits, c) valuation of stock, d) charging of depreciation on fixed assets and e) the methods adopted for income recognition.

b. **Earnings potential/profitability:** Rating is a forward looking exercise. Hence, the emphasis is more on the future earning capacity rather than on the issuer's past. The profits should ensure the ability of the company to meet its fixed interest obligation in time. To withstand any adverse conditions, a business should have stable earnings and also generate capital resources internally.

c. **Cash flow analysis:** To assess the debt, fixed and working capital requirements, cash flow analysis of the company is undertaken. It shows the extent of cash available for use in different purposes and for meeting fixed interest obligations. Cash flow analysis indicates the issuer's debt servicing capacity in a better way compared to reported earnings. It facilitates credit rating of a company.

d. **Financial flexibility:** A study of a company's existing capital structure is a pre-requisite to find debt/equity ratio, different modes of financing used to raise funds, ability to raise funds, potential of asset deployment, etc. The future debt claims on the issuer's and the issuer's ability to raise the capital is to be determined. The purpose is to know the issuer's financial flexibility.

3. **Management Evaluation**

Factors like management goals, strategies and plans, capacity to overcome the adverse conditions, skills and experience of staff, planning and control systems etc. affect significantly the company's performance. The rating of a debt instrument requires a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the management.

4. **Geographical Analysis**

This analysis is undertaken to determine the locational advantages enjoyed by an issuer company. An issuer company can get a better credit rating when its business is spread over a large geographical area and enjoys the benefits of diversification. On the other hand, when the company is located in a backward area, it can get subsidies from the government resulting in lower operational cost.

5. **Regulatory and Competitive Environment**

Credit rating agencies evaluate the structure and regulatory framework of the financial system in which they work. The CRAs evaluate the impact of regulation/deregulation on the issuer company before assigning the rating symbols.

6. Fundamental Analysis

The analysis of liquidity management, profitability and financial position, interest and tax rates, sensitivity of the company are included in the fundamental analysis of the company.

a. Liquidity management includes a study of capital structure, availability of liquid assets to meet the financial commitments and maturing deposits and matching of assets and liabilities.

b. Factors such as quality of company's credit risk management, management of problem credits and exposure to individual borrowers come under asset quality.

c. Profitability and financial position include factors like past profits, deployment of funds, revenue on non-fund based activities, addition to reserves, etc.

d. Interest and tax sensitivity reflect the sensitivity of a company following the changes in interest rates and tax laws. In order to provide rating for debt instruments, fundamental analysis is done.

Example: Bankers of Mcleod to Hire a Credit Rating Agency

Williamson Group company McLeod Russel was a defaulter to many banks. In February 2022, the bankers formed a committee for taking the services of a CRA so that it could assess the possible credit rating of the company.

Lenders to the company were ICICI Bank, HDFC Bank, IndusInd Bank, Axis Bank, Indian Bank, SBI, UCO Bank, SCB, Yes Bank and RBL. They had entrusted LSI Financial Services to revisit the viability and Earnings before Interest, Depreciation, Taxes and Amortization (EBIDTA) of operations of the company.

Source: http://timesofindia.indiatimes.com/articleshow/89577921.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst_dated 15th February, 2022 Accessed on 23rd August, 2022

4.9 Symbols of Rating and Grades

Credit rating provides an indicator that is symbolic of the relative grading of the investment/credit qualities of financial instruments. The grading also symbolizes the relative ability of the issuers of such instruments in complying with the financial obligation in the prescribed time and with reference to the instrument being rated. The opinion about the credit quality of the issuer of the security instrument can also be expressed by symbols. These symbols are in the form of alphabets for which the parameter for assigning the symbol is also given.

The rating agencies have different symbols/codes for symbolizing the rating for different instruments. But the number of grades and sub-grades is usually common. For example, for long-term debentures/bonds and fixed deposits, CRISIL has four main grades and a host of sub-grades. In decreasing order of quality, these are AAA, AA+, AA, AA-, A+, A, A-, BBB-, BBB, BBB+, BB+, BB, BB-, B+, B, B-, C and D. CARE, ICRA and Duff & Phelps have similar grading systems.

CRISIL assigns credit ratings in the following six categories, namely long-term, short-term, structured finance ratings, fixed deposits (FD), financial strength ratings, and corporate credit ratings as shown in Table 4.1 below:

Table 4.1: CRISIL Rating Scales

Long-Term	**Short-Term**		**Structured Finance**		**Corporate Credit**	**Fixed Deposit**	**Financial Strength**
Symbol	Symbol		Long-term	Short-term	Symbol	Symbol	Symbol
CRISIL AAA	CRISIL A1		CRISIL AAA	CRISIL A1	CCR AAA	FAAA	AAA
CRISIL AA	CRISIL A2		CRISIL AA	CRISIL A2	CCR AA	FAA	AA
CRISIL A	CRISIL A3		CRISIL A	CRISIL A3	CCR A	FA	A
CRISIL BBB	CRISIL A4		CRISIL BBB	CRISIL A4	CCR BBB	FB	BBB
CRISIL BB	CRISIL D		CRISIL BB	CRISIL D	CCR BB	FC	BB
CRISIL B			CRISIL B		CCR B	FD	B
CRISIL C			CRISIL C		CCR C		C
CRISIL D			CRISIL D		CCR D		D
					CCR SD		

Source: https://www.crisil.com/

The assignment of credit ratings to debt obligations by CRISIL is in three scales: 1) the long-term scale, 2) the short-term scale and 3) the fixed deposit scale. CRISIL's long-term credit rating scale and description associated with each category on the rating scale is given in Table 4.2 below.

Table 4.2: CRISIL's Rating Scale for Long-Term Instruments

CRISIL AAA (Highest Safety)	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
CRISIL AA (High Safety)	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

Contd….

CRISIL A (Adequate Safety)	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
CRISIL BBB (Moderate Safety)	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
CRISIL BB (Moderate Risk)	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
CRISIL B (High Risk)	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
CRISIL C (Very High Risk)	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
CRISIL D Default	Instruments with this rating are in default or are expected to be in default soon.

Source: http://www.crisil.com/ratings/credit-rating-scale.html

4.10 Advantages and Disadvantages of Credit Rating

The advantages and disadvantages of credit rating are:

4.10.1 Advantages of Credit Rating

1. Safeguards against bankruptcy: While making an investment decision, the investor looks for a credit rating of the instrument which gives the degree of the financial strength of the issuer. Investors get an assurance on the safety and minimum risk of bankruptcy of the instrument when the instrument is highly rated.
2. Recognition of risk: The credit rating provides rating symbols. These symbols are defined and carry information in an easily understandable manner. For example, CRISIL AAA. Instruments with this rating are considered to possess the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk. This enables the investor to perceive the risk involved in the investment. The worth of the issuing company can be easily perceived by the investor by having a glance at these symbols. They also throw light on the aspects of advantage and risk involved in the investment.
3. Credibility of the issuer: The rating company and Issuer Company are totally independent of each other. They will have no business or any other connection like common board of directors, etc. Thus, the total disconnect of the rater and the rated firm establishes the ground for the credibility of the rater and the ratings given.

4. Easy understandability of investment proposal: No special analytical knowledge is required for the investor to understand a rating symbol. Investment decisions can be made easily and quickly by the investor in any rated security basing on the rating symbols.
5. Saving of resources**:** By reposing confidence on the professionalism and expertise of the credit rating agency, the investor gets a lot of relief and can save time and resources in knowing the financial standing, fundamentals of the company, management, etc., and can take safe investment decisions.
6. Investment decision-making: The dependence on the advice of a financial intermediary becomes redundant for making investments in a rated instrument, since the symbol assigned to a particular rated instrument will give a complete picture about the creditworthiness and degree of risk involved in it.
7. Choice of investments: When the investor is faced with the scenario of the availability of different credit rated instruments in the capital market, he can make a wise choice based on their risk profile and the plan of diversification of fund.
8. Capital saving for a company: If a bank has high-quality assets (for example, if the majority of its assets are in the 'AAA' and 'AA' categories), it will save capital because of low credit risk; the difference is apparent in the illustration below (Exhibit 4.1).

Exhibit 4.1: Illustration of Capital-Saving Potential by Banks on a Loan of ₹ 1,000 Million

Rating	Basel I		Basel II		
	Risk weight	Capital required (₹ mn)	Risk weight	Capital required	Capital saved (₹ mn)
AAA	100%	90	20%	18	72
AA	100%	90	30%	27	63
A	100%	90	50%	45	45
BBB	100%	90	100%	90	0
BB and below	100%	90	150%	135	(45)

Source: www.crisil.com

4.10.2 Disadvantages of Credit Rating

[69]**Biased rating and misrepresentation:** In case of non-existent of standard quality credit rating, credit rating is a curse for the capital market industry. Some companies with a low grade rating do not advertise and apply rating besides raising funds from the public. As a consequence, the investor will have inadequate knowledge about the risk factor of the instrument and thereby incurs loss.

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[69] https://www.yourarticlelibrary.com/economics/8-main-disadvantages-of-credit-rating/1449

Static study: Static Rating is more a static study, based on the present and historic data of the company. Thus, prediction of a company's health, arrived at by rating methodology, is momentary and the rating symbols cannot guarantee the future performance of the company. Hence, the very objective of rating gets defeated. In a dynamic economic environment, the factors such as political situation, government policy, may directly affect the working of a company.

Concealment of material information: Often, the quality of rating suffers and becomes unreliable. This is due to the concealment of vital material information by the rating company from the investigating team of credit rating agency.

Rating is no guarantee for company soundness: Normally, credit rating is given to assess the credit risk of a particular instrument. It cannot be treated as a certification on the soundness of the company or the quality of its management. Users should have their independent views without relying on rating symbols.

Human bias: At times, the findings of the investigating team suffer from human bias due to unavoidable human weakness, failing which may affect the rating process.

Reflection of temporary adverse conditions: Sometimes, misleading conclusions are possible due to time factor. For example, due to a temporary adverse condition, a company may get a low rating which may affect the company adversely.

Downgrade: Credit rating agencies will review the performance of the company periodically. If the company is not able to maintain the working results, the rating agency may downgrade the company's rating which will adversely affect the company's image.

Difference in rating of two agencies: In several cases, the ratings given by two different agencies differ for the same instrument of the same issuing company. This is because of the value judgment differences on qualitative analysis aspects of the different agencies.

Check Your Progress - 2

6. Which of the following is the main objective of CRISIL, when it is rating Indian companies?
   a. Debt obligations
   b. Equity obligations
   c. Commercial papers
   d. Cash management
   e. None of the above

7. What should be focused upon on ICRA venturing into earning prospects risk analysis?
    a. Debt rating
    b. Sovereign rating
    c. Equity rating
    d. Commercial paper rating
    e. Currency rating
8. Which of the following is part of the profitability and financial position, analysis of liquidity management and interest and tax rates sensitivity of the company?
    a. Fundamental analysis
    b. Business analysis
    c. Geographic analysis
    d. Financial analysis
    e. Liquidity analysis
9. Which of the following entities/instruments do not require rating in India?
    a. Debt instruments
    b. Equity instruments
    c. Start-up company as a whole
    d. Government securities
    e. Insurance companies
10. Which of the following terms deals with analyzing the industry risk, operating efficiency, market and legal positions of the company?
    a. Financial analysis
    b. Business risk analysis
    c. Management evaluation
    d. Regulatory and competitive environment
    e. Fundamental analysis

Activity 4.2

The “Big Three” global credit rating agencies, US-based Standard and Poor’s (S&P), Moody’s, and Fitch Ratings, faced severe criticism in the aftermath of the global financial crisis. They were criticized on the ground that they were meant to provide investors with reliable information on the riskiness of different kinds of debt, which they failed to do. Instead, these agencies contributed to worsening the crisis by rendering favorable evaluations of insolvent financial institutions and approving extremely risky mortgage-

related securities. What disadvantages of credit rating can you identify from the above example? **Answer:**

4.11 Summary

- Credit rating provides superior low-cost information and proper base for risk-return trade-off to the investors.
- There are mainly four types of credit rating—bond rating, equity rating, commercial paper rating, and issuer credit rating.
- The function of credit rating was institutionalized when the RBI made it mandatory for the issue of commercial paper. And SEBI too, when it made credit rating compulsory for certain types of debentures and debt instruments. In June 1994, the RBI made it mandatory for Non-Banking Financial Companies (NBFCs) to be rated.
- Credit rating agencies (CRA) in India are regulated by SEBI. The main elements of CRA Regulations are registration, general obligations, and restrictions on the rating of securities, procedure for inspection and investigation and action in case of default.
- The Indian credit rating industry mainly comprises CRISIL, ICRA, CARE, ONICRA, SMERA, and Ind-Ra & DCR India. CRISIL is the largest credit rating agency in India, with a market share of greater than 60%.
- The rating process begins with the receipt of mandate letter from the issuer company. This is analyzed by the analytical team followed by meeting with management, preparation of report, preview in the rating meeting, and the completion time.
- The credit rating methodology includes an analysis of all the factors affecting the creditworthiness of an issuer company. For instance, business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issuer, commitment to new projects, etc.
- Each of the credit rating agencies has different codes / symbols for expressing the rating for different instruments. However, the number of grades and sub-grades are same.
- SEBI cancelled licence of Brickwork Ratings India, one of the rating agencies as the credit rating agency failed to follow proper rating process and exercise due diligence while providing ratings. This incident took place in October 2022.

4.12 Glossary

Bond Fund Rating: An opinion on the credit qualities of bond funds underlying portfolio holdings.

Claims Paying Ability: Ability of the concerned insurer to honor policy-holder's claim on time.

Corporate Governance Rating: An opinion to which an organization agrees and complies with codes and guidelines of corporate governance practices to the serve the stakeholders' interests.

Credit Assessment: Indicates a broad opinion as to the relative degree of capability of a company to meet obligation on lines of credit.

Credit Rating Agency (CRA): A corporate body engaged in the business of rating of securities.

General Assessment: Provides report on different aspects of the operation of management of a company for the use of bank.

Promoters: A person who holds at least 10% of shares of the CRA.

Rating: An opinion on securities, expressed in standard symbols or any other standardized form, assigned by a credit rating agency and used by the issuer of such securities.

4.13 Self-Assessment Test

1. What is credit rating? Explain its purpose and types.
2. Examine the role of regulatory framework of credit rating in India.
3. Write a note on credit rating agencies in India and their performance.
4. Describe the advantages and disadvantages of credit rating.

4.14 Suggested Readings/Reference Materials

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

4.15 Answers to Check Your Progress Questions

1. **(b) Credit rating**

   An independent opinion about the capability of the issuer to meet their financial obligation is credit rating.

2. **(e) CRA has to ensure the issuer company conducts AGM regularly**

   CRA has no role for conducting AGM of a company.

3. **(a) CRISIL**

   CRISIL is the first credit rating agency in India which was jointly promoted by ICICI and UTI.

4. **(d) Procedure for inspection and investigation**

   The main elements of regulatory framework of credit rating agencies are: Procedure for inspection and investigation.

5. **(c) Equity rating**

   The rating of shares which are traded in capital market is equity rating.

6. **(a) Debt obligations**

   CRISIL's main objective is to rate debt obligation of Indian companies.

7. **(c) Equity rating**

   ICRA has ventured into earning prospects risk analysis which focuses on equity rating.

8. **(a) Fundamental analysis**

   Fundamental analysis includes profitability and financial position, an analysis of liquidity management, interest and tax rates sensitivity of the company.

9. **(c) Start-up company as a whole**

   Rating is not normally done in India for a startup company as a whole.

10. **(b) Business risk analysis**

    Business risk analysis aims at analyzing industry risk, operating efficiency, market and legal positions of a company.

Financial Services

Course Structure

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Unit 19	Securitization
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Unit 21	Plastic Money
Unit 22	Virtual Money
Unit 23	Venture Capital