5TH SEMESTER BBA

CALICUT UNIVERSITY

FINANCIAL MARKETS AND INSTITUTIONS

Prepared by

ALIAKBAR.M.K

Assistant professor

Department Of Management

CPA College of Global Studies Puthanathani

Syllabus

University of Calicut

Bachelor of Business Administration

BBVI B12 Financial markets and institutions

Time: 5hours per week **Credits: 4**

***Objectives**: To give a detailed idea about the Indian financial system and its broad components*

Unit 1

Indian financial system– an overview. Money market- call money market-commercial paper market- commercial bill market- certificates of deposits-treasury bill market –guilt edged securities market. Capital market- an overview- capital market instruments - capital market reforms-primary markets- methods of raising funds from primary market- public issue- emerging trends

Unit 2

Financial services- nature- characteristics- role of financial services in economic development – Relevance of the study of financial services- factors influencing the growth and development of financial services industry – types of financial services.

Unit 3

Merchant banking – historical perspective- nature of services provided by merchant bankers- structure of merchant banking firm- setting up and managing a merchant bank- SEBI regulations on merchant banks – underwriting- stock broking- depositories- tax planning services- portfolio management services- factoring services and practices- card business- credit cards and debit cards

Unit 4

Credit rating: approaches and process of rating – credit rating agencies – CRISIL and ICRA, CARE ratings for financial instruments –n methodology of rating. Leasing: concepts and classification of leasing – preset legislative framework of leasing

Unit 5

Stock exchange business and practices – insurance – role of insurance in financial frame work – general insurance – life insurance – marine insurance and others.

INTRODUCTION TO INDIAN FINANCIAL SYSTEM

The economic development of any country depends on the financial system of that country. Financial system of the country should be efficient. Financial system acts as the intermediary for inflow and outflow of funds. Efficiency of financial system is determined on the basis of the flow of funds in the economy and channelization of these funds in to productive activity for the development of nation. Financial system includes financial markets, financial institutions, financial intermediaries, and financial instruments. Major institutions or establishments in the financial system of India are follows:-

- **RBI** (Reserve Bank of India)
- **IFCI** (Industrial finance corporation of India)
- **SBI** (State Bank Of India)
- **ICICI** (Industrial Credit And Investment Corporation Of India)
- **LIC** (Life Insurance Corporation)
- **IDBI** (Industrial Development Bank Of India)
- **UTI** (Unit Trust Of India)
- **NABARD** (National Bank For Agriculture And Rural Development)
- **EXIM Bank** (Export And Import Bank)
- **NHB** (National Housing Bank)
- **CRISIL** (Credit Rating Information Services Of India Limited)
- **SIDBI** (Small Industries Development Bank Of India)
- **SEBI** (Securities And Exchange Board Of India)
- **DFHI** (Discount And Finance House Of India Limited)
- **NSE** (National Stock Exchange)

Major legislative measures

- ***Banking Companies Act*** *(1947) - renamed as* ***Banking Regulation Act*** *(1949)*
- ***Indian Companies Act*** *(1956)*
- ***Securities Contracts (Regulations) Act***

- ***Securities And Exchange Board Of India Act (1992)***
- ***Monopolies and restrictive trade practices act (1969***) *renamed* **Competition Act 2002**

Functions of financial system

- Financial system brings the savers and borrowers to a common platform through financial intermediation and financial disintermediation.
- Financial system provides a payment mechanism for the exchange of goods and services.
- Financial system assists capital formation of a country and result in economic growth.
- Financial system provides liquidity to financial assets. (Financial assets mean equity shares, debentures, mutual funds...)
- Financial system serves as an intermediary between the saver and the investor.
- Financial system provides detailed information to those who are to be informed.
- Financial system helps in lowering the cost of transactions and increasing returns
- Financial system provides a mechanism for the transfer of resources across geographic boundaries.

Components of Indian Financial System

Financial Institutions	Financial Markets	Financial Assets	Financial Services

Weakness of Indian financial system

- Lack of institutional investors
- Lack of coordination between different financial intermediaries
- Lack of emergence of financial corporations
- Dominance of monopolies
- Dominance of development banks
- Dominance of public sector firms
- Lack of integration of the segments of the financial system
- Market irregularities
- Neglect for small and new enterprises

COMPOSITION OF INDIAN FINANCIAL SYSTEM

It can be divided in to two parts:-

- Capital market
- Money market

Indian money market

RBI Defines money market as **"**The center for dealing, mainly of short term character, in monetary assets, it meets the short term requirements of borrowers and provides liquidity or cash the lenders". In case of money market there is specific place set aside where money is borrowed or loaned. Money market refers to institutional arrangements, which deals with short term funds. Money market deals with near substitutes for money or near money like trade bills, promissory notes and government papers drawn for a short period not exceeding one year.

Features of a money market

- Market for short term funds
- Deals with financial assets having maturity period of one year(near money)
- Borrowers in the money market are traders, manufactures, speculators and government institutions.
- It have several sub markets like call money market, trade bills markets etc having close inter relationship and free movement of funds
- A market for following instruments: call money, notice money, repos, term money, treasury bills, commercial bills, certificate of deposit, commercial papers etc.
- It have no particular place to meet
- Important components of money markets are central bank, commercial bank, non-banking financial institutions, discount houses, acceptance houses
- It not dealing with money but in near money.

<u>Features of a developed money market</u>

- Well organized banking system
- Existence of a central bank
- Availability of proper credit instruments
- Proper coordination of different sectors
- Lack of diversity in money rates of interest
- Presence of bills market

- Sufficient resources
- Existence of secondary market
- Ample supply of funds
- Other factors

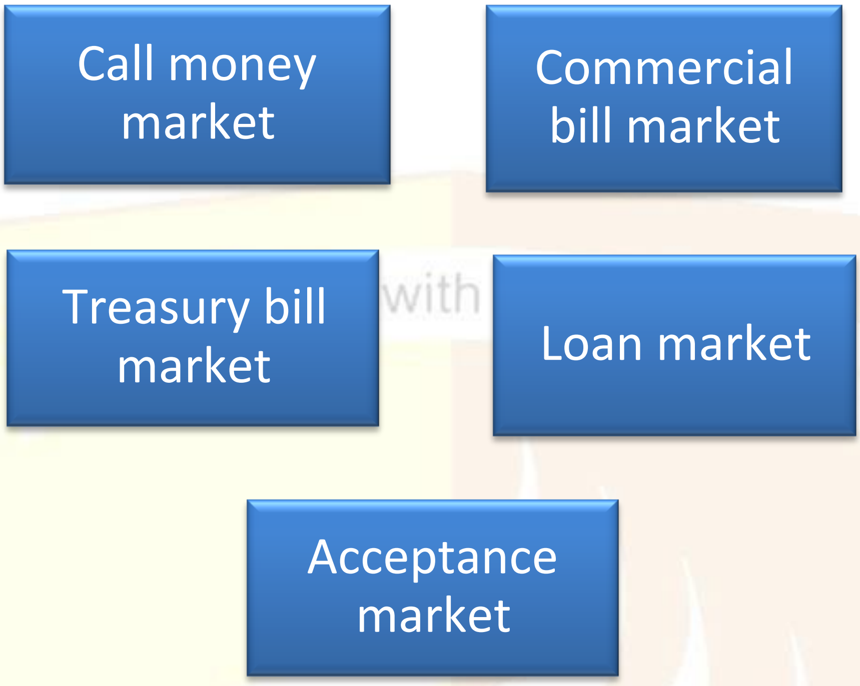
Components of Indian Money Market

Organized money market	Unorganized money market
(Regulated by RBI)	(Indigenous bankers, Money lenders

Importance of money market

- Development of capital market
- Financing industry
- Helps commercial banks
- Helps central bank
- Guide and help to government
- Encourages savings and investment

CONSTITUENTS OF INDIAN MONEY MARKET



1. CALL MONEY MARKET

Call money market is the market for very short term fund. It is sometimes referred as "**loans or money at call and short notice**". These are very short term loans. It may be grated for an overnight use or a maximum of 7 days use. The rate at which funds are borrowed or lend in this market is called **call money rate**. Ordinarily collateral securities are not insisted for these loans.

Features

- It enables the banks and institutions to even out their **day-to-day** deficits and surplus of money.
- Commercial banks, cooperative banks, primary dealers are allowed to borrow and lend in this market
- Financial institutions, mutual funds and all banking institutions are allowed to access this market. And non-banking entities not allowed accessing the same.
- Interest rate is determined by market.
- Borrowers and lenders are required to maintain a current account with RBI.
- The borrowers and lenders contacting each other through a telephone in the call market.

Merits

- Profitability
- High liquidity
- Safe
- Helps the central bank
- Helps to maintain statutory reserve requirements

Demerits

- Confined to big cities
- Lack of integration
- Call money rate volatile in nature
- Small size

2. COMMERCIAL BILLS MARKET OR DISCOUNT MARKET

This market helps to meet the short term financial requirements of the individuals firms and government. Commercial banks can invest their surplus funds in these bills profitably. Many types of bills are in circulation in this market like documentary bills, clean bills, inland and foreign bills, export and import bills, indigenous bills, accommodation bills etc. generally this market is divided in to two **Discount markets** and **Acceptance market.**

DISCOUNT MARKET:

It specializes in discounting of short term commercial bills. The establishment of DFHI has been an important step towards the development of active discount market in India.

3. ACCEPTANCE MARKET

It is a market where the financial intermediaries accept genuine trade bills. There are no such houses in India. But the commercial banks are accepting the bills to some extent. A trader‟s bill with acceptance of a bank acquires good reputation and it is easy to raise money by discounting it.

Importance of commercial bill market

- High liquidity
- Certainty in payment
- Self-liquidating in character
- Ideal for investment
- Quick yield
- Control
- More elastic monetary system

Limitations

- Lack of bill culture
- No rediscounting between banks
- Absence of secondary markets
- No proper development of foreign trade
- Domination of indigenous banks
- Commercial banks attitude
- Absence of specialized institutions

4. LOAN MARKET (INTERBANK TERM DEPOSIT)

These are the loans between the banks. It is like call money market. But the period of this type of loan is over 14 days and generally up to 90 days without any collateral security. The lenders cannot recall this type of loan lend before the maturity. DFHI plays an important role in this market to regulate the same.

5. TREASURY BILL MARKET

Treasury bill market deals with treasury bills. Treasury bills are the short term promissory note issued by the reserve bank of India for central government. Generally it is issued as 14, 91,182 and 364- day treasury bills. T- Bills are available for a minimum amount of Rs. 25000. It is generally issued at a discount and redeemed at a par. Participants in Treasury bill market include RBI, SEBI, Commercial banks, state government, DFHI, STCI, Financial institutions and public.

- RBI issued 14-day T-Bill in June 1977, having a maturity of 14 days. Its auction is on every Friday of every week.
- 91-day T-Bills are the traditional instruments, having a maturity of 91 days. Its auction is on every Friday of every week.
- 182-day T-Bills were variable interest bills, which are sold through public auctions having a maturity of 182 days. Its auction is on every alternative Wednesday.
- 364-day Y-Bills sold by fortnightly auctions. Auctions done by every alternative Wednesdays.

Advantages of T-Bills

- Safe
- Liquidity
- Suitable short-term investment
- Helpful to effective fund management
- Helpful to meet statutory requirements
- Source of short-term funds to government
- Prevaricate facility
- Helps to control inflation

Types of treasury bills

i. **Adhoc T-Bills: -** It is issued by state governments, semi governments departments and foreign banks. These are not marketable and are not sold to banks and general public by RBI.

ii. **Regular T-Bills: -** It can be sold to general public and banks by RBI.

MONEY MARKET INSTRUMENTS

1. Treasury bills
2. Call / Notice money
3. Commercial bills
4. Certificate of deposits
5. Commercial papers
6. Interbank participant certificates
7. Money market mutual funds
8. Repos

➢ **CALL OR NOTICE MONEY**

It is an amount borrowed or lent on demand for a very short period. If the period is more than one day and up to 14 days it is called „***notice money'*** otherwise the amount is known as „***call money'***. No collateral security is required to cover these transactions.

➢ **CERTIFICATE OF DEPOSITS (CD)**

It is the next lowest risk category investment option after treasury bills. Banks and financial institutions issue the CD. It is a negotiable money market instrument and issued in dematerialized form for a specified time period. It is governed by various directives issued by RBI.

Features of CDs

- It is a short term instrument issued by banks and financial institutions to raise large amount of money.
- Its maturity ranging from 7 days to 1 year.
- It is issued by banks in the multiples of Rs 100000, subject to a minimum issue of Rs 100000 to a single investor.
- They are issued at a discount to face value. Discount rate determined by market conditions.
- It is repayable on a fixed date without grace days.
- Banks are not permitted to grant loans on CD.

➢ **COMMERCIAL PAPER**

It is an unsecured money market instrument issued in the form of promissory notes. It is an instrument used to finance the working capital needs of corporate enterprises. It is issued by nationally reputed credit worthy and highly rated large corporations. It is an unsecured one. They are negotiable by endorsement and delivery. Any public and private company can issue CP.

Features of CP

- It is a short term money market instrument
- It Comprise usance promissory note with a fixed maturity
- It is issued at discount to face value
- It consist of a promise
- No assets are pledged for this purpose
- A company can issue CP directly to investors or through merchant bankers or banks
- CP can be issued only in a dematerialized form through any of the depositories approved by SEBI

Types of CP

1. Direct Papers: it is issued directly by the company to the investors without any intermediary.

2. Dealer Paper: A dealer or merchant banker on behalf of a client issues these types of CP

3. Master Note: it is generally issued by finance companies to bank trust departments and other permanent money market investors. The investing firm notifies the issuing company, the amount of paper and the issuing company then issues a paper on the agreed amount.

4. Medium Term Notes: these are unsecured obligations with a maturity period of 9-10 months investment corporations issue these notes at a particular rates of interest.

- **INTERBANK PARTICIPATION CERTIFICATE (PC)**

The basic idea behind this scheme was to even out the excess surplus funds with the banking system. The issuing bank is required to repay the amount of the certificate on the due date to the purchaser of PC. It is an additional instrument for level out short term liquidity with in the boundary of the banking system. It is mainly confined to scheduled commercial banks only and the period of participation is restricted to a minimum 91 days and a maximum of 180 days. Generally 2 types of participation is allowed namely with risk and without risk to the lender.

- **MONEY MARKET MUTUAL FUNDS (MMMFS)**

It is to provide additional short term avenues through which the small scale investor could actively take part in the money market. It is also known as liquidity fund. These are mutual funds which invest primarily in the money market instruments of very high quality and very short maturity.

- **Repurchase Agreement (Repos)/Ready Forward Transactions**

It is a transaction in which 2 parties agrees to sell and repurchase the same security. Here seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and a price. Similarly the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date and price. Such a transaction is called repo when viewed from the view of seller and reverse repo viewed from the view of supplier of funds. The rate of interest agreed among buyer and seller is called **Repo Rate.**

DEFECTS OF INDIAN MONEY MARKETS

- Existence of unorganized money market
- Non-coordination of organized and unorganized sector
- Multiplicity in rates of interest
- Seasonal stringency of funds
- Absence of bills market
- Inadequate banking facilities
- Absence of well-organized banking system
- Absences of specialized financial institutions
- Absence of movement of funds
- Absence of sufficient sub markets

Emerging trends in Indian money market

- Integration of organized and unorganized money market
- Enlargement of call money market
- Establishment of DFHI
- STCI (Security trading corporation of India)
- Offers market rates of interest
- Setting up of credit rating agencies
- Agenda for further actions
- Liquidity adjustment facility
- Introduction of interest rate swaps
- Electronic dealing system
- Strengthening of payment system
- Introduction of new instruments

➢ T-Bills

➢ **Derivative usance promissory notes**

With the intention of reducing paper movements and facilitate multiple rediscounting, RBI introduced this instrument the bank that originally discount the bills only draws DUPN. These are sold to investors in convenient lots of maturities (from 15 days up to 90 days).

➢ Repos

➢ MMMF

➢ Collateralized borrowing and lending obligation

INTRODUCTION TO CAPITAL MARKET

It is the market for long term capital. It refers to all the facilities and institutional arrangements for borrowing and lending „term funds" (medium term, long term). The major fund coming to capital market is from individual investors, corporate savers, commercial banks, insurance companies, PPF etc. it operates as a switching mechanism for transfer of funds to meet the long term needs of the private and public enterprises. It is the market that deals in financial assets, which have a long or indefinite maturity. Capital market generally deals with long term securities.

Features of capital market

- It deals with long term and medium term funds.
- It channelizes the flow of funds from the undesirable activities in to desirable activities.
- It trades both securitized and un-securitized funds. Securitized fund means equity shares, preference shares, convertible debentures, non-convertible debentures, etc. the un-securitized funds means bank deposit, provident fund, life insurance etc.
- The funds rose from capital market generally used for acquisition of land and building, plant and machinery and other fixed assets.
- Capital market composed of new and primary market, secondary market, government securities market, long term loans market.
- Banks, commercial institutions, cooperative institutions and financial institutions are the intermediaries in this market.
- It provides liquidity
- Securities dealt in capital market are transferable and marketable.
- Capital market regulated and controlled by the government of that country.

Functions of capital market

1. Investment function

It consists of capital formation and promotion of investment. The investment function of securities market can be viewed from various angles:-

- **From view point of issuers**

  Here fund raised from capital market is a source of finance for long term capital investment and for working capital.

- **From view point of investors**

  It is an income or return to their investment.

- **From view point of nation**

  It helps to mobilize the savings for the investment and capital formation in the country.

- **From view point of financial intermediaries**

  It he issues made in the capital market is the source of income to them. They place the issues to public.

2. Acts as link between investors and savers

It transfers the financial resources from wasteful areas to productive areas.

Scope and importance of capital market

- Mobilization of savings
- Capital formation
- Offers incentives
- Economic development
- Integrate different parts of the financial system
- Maintain liquidity in investments
- Innovation
- Latest technology

Classification of capital market

1. **Industrial Securities Market** 2. **Government Securities Market** 3. **Long Term Loan Market**

Primary Market

Secondary Market

Industrial Securities Market

It is the market for industrial securities. Industrial securities deals here are equity shares, preference shares, debenture, bonds etc. it is a market where industrial organizations raise their funds by issuing these securities. It is classified in to primary markets and securities.

Primary markets

It is also known as new issues market. It is the market in which newly created organizations or existing ones offer their issues for the first time. It is deals with those securities which are issued to the public for the first time.

Secondary market

It is market for existing or old securities. It means securities which are already issued through the primary market are traded in this market. These markets are generally confined to the stock exchanges. Secondary markets have physical existence. In India NSE, BSE OTCEI etc. are the major components of secondary markets.

Government securities market

The government securities comprise dated securities issued by the government of India and state government. The date of maturity is specified in the securities. There for it is known as dated government securities. Government borrows fund through the issue of long term dated securities the lowest risk category instruments in the economy. These securities are issued through auctions conducted by RBI, where the central bank decides the coupon or discount rate based on the response received. Most of these securities are issued as fixed interest bearing securities through the government sometimes issues zero coupon instruments and floating rate securities also. Investors in government securities are mainly banks, foreign investors, insurance companies, provident funds and trusts. These securities are open to all types of investors including individuals and there is an active secondary market.

Gilt edged security market

Gilts are bonds issued by certain national governments. These are very high grade investments with very low risk. These are issued by blue chip Company they are well established and financially stable. Government securities are also considered as guilt edged securities. The guilt edged market refers to the market for government and semi government securities backed by RBI. The term guilt edged means „of the best quality‟. This is because government securities do not suffer from risk of default and are highly liquid.

Long term loan market

Generally development banks and commercial banks supply long term loans to corporate investors. This market can be classified in to term loans market, mortgages market, financial guarantee markets.

CAPITAL MARKET INSTRUMENTS

1. Equity shares
2. Preference shares
3. Debentures
4. Bonds
5. Innovative debt instrument

Equity shares

These are the ordinary shares. These shares do not carry any preferential right in respect of dividend or repayment of capital. Dividend on equity shares is paid after the payment of a fixed rate of dividend to preference shareholders. The rate of dividend on equity shares is not fixed. Dividend varies according to the profit earned by the company. If the company has earned no profit equity shareholder will not get any dividend. In the event of winding up equity shareholders is paid at last. That means they get balance if any after payment of all other liabilities. Equity shareholders are the ultimate owners of the company. They are risk bears. It can be classified as follows:

- **Blue chip shares**: well reputed, matured and well established companies which have good track record of earnings are known as blue chip companies. These companies are financially sound. Shares issued by these companies are called blue chip shares. Price of such shares is normally high.
- **Growth shares:** these are the shares issued by growing companies these companies have wide scope for development. They expand their business by reinvesting their earning in profitable channels. Their performance is more than average.
- **Income shares:** certain companies are not going to reinvest their earnings for further expansion. And distribute their entire earnings as dividend. Such company‟s shares are known as income shares. Market price of such shares may stable.
- **Cyclical shares:** value of these shares are fluctuating due to cyclical fluctuations in the market such shares is known as cyclical shares. The yield of these companies is in between low to moderate. Shipping companies are treated as cyclical companies.
- **Defensive shares**: these are the shares of the companies engaged in food processing, beverage, drugs etc. Their income is moderate through the period.
- **Speculative shares:** These types of shares are very risky class of shares which requires special technical expertise and deep knowledge to deal them. Speculators deals with this type of shares. These are not well known and popular earners of dividend.
- **Stalwarts:** these are the shares issued by giant companies having ability to surpass the GDP of the country. They are not swift climbers
- **Fast growers:** these are the shares of small aggressive companies that grow at 20% to 25% in a year. The growth of these companies is equal to the growth rate of a country

- **Slow growers:** these are the shares of large and aging company. Their growth rate is slower than GDP of a country
- **Turn around:** these are the shares of companies having accumulated losses shows the signs of recovery.
- **Asset plays:** these are the shares of the companies which have valuable asset.

Preference shares

These are the shares having a preferential right in respect of payment of dividend and repayment of capital at liquidation of the company. The rate of dividend is fixed. This dividend is payable before any dividend is paid to equity shareholders. These are nonvoting shares and have no representation in the management of the company.

Types of preference shares

1. Cumulative preference shares: they have right to get arrears of dividend

2. Noncumulative preference shares: they have no right to get arrears of dividend

3. Participating preference shares: apart from the fixed rate of dividend these shareholders have a right to participate surplus profit if any

4. Nonparticipating preference shares: they have no right to participate in the excess profit of the company.

5. Redeemable preference shares: these are repayable after a fixed period.

6. Convertible preference shares: they have a right to convert preference shares to equity shares.

Debentures

It is a way of racing long term funds. The company borrows money from the public by way issue of debentures. A debenture is an acknowledgement of the debts due by a company issued under its common seal. It is a loan or borrowed capital of a company. The registered holder of the debenture is called as debenture holder. A debenture is a creditor ship security having no voting rights. Debenture holder gets a fixed rate of interest on the debenture. Interest paid annually or half yearly. Interest payment is a legal obligation in the case of debentures. Whether the company earns or not interest must be paid. Debentures and bonds are same. If it is issued by the govt then it is termed as bond and issued by private then it is termed as debenture.

Types of debentures

1. Registered debentures
2. Bearer debenture
3. Secured debenture (mortgage)
4. Unsecured debenture (naked)
5. Redeemable debentures
6. Irredeemable debentures (perpetual)
7. Convertible debentures

Features of debentures

- Debenture trustee
- Indenture: for the issue of debentures a legal agreement is made between company and trust.
- Security
- Payment of interest
- Payment of claim
- Coupon rate
- Maturity period
- Redemption
- Credit rating
- Exemption from payment of tax
- Voting rights
- Innovative instruments

Warrants

These are typically of a shorter duration. These are detachable from the securities from which they are issued and carry an exercise price, which requires a cash payment when used. Exercise price is the price at which the equity shares are to be issued. These are mainly two types detachable and non-detachable. Detachable warrants can be sold separately in the market and non-detachable can only sold in the market with the original security.

- Debentures with detachable warrants
- Non-convertible debentures with detachable equity warrants
- Equity shares with detachable warrants
- Preference shares with warrant

- **<u>Zero coupon bond:</u>**

No interest is paid on such bonds prior to maturity. Instead they are sold at discounts to their par value. It always issued at a lower price than nominal value and redeemed at nominal value after a fixed period

- **<u>Deep discount bond</u>**

It is sold at a large discount on their face value. They mature at par value. No interest is paid.

- **<u>Option bond</u>**

Its holder has an option whether bonds are to be cumulative or non-cumulative.

- **<u>Floating rate bond</u>**

Interest on bonds is varying according to the variation in the interest rates of term deposits

- **<u>Forward contracts</u>**

It is an agreement to buy or sell an asset on a specified date for a specified price. It is a financial contract obligating the buyer to buy and the seller to sell a given asset at a pre-determined price date in the future. Here each contract is customer designed.

- **<u>Futures contract</u>**

It is an agreement between two parties to buy or sell an asset at a certain time in future at a certain price. These contracts are traded on a future exchange. These are standardized contract.

Difference between future and forward contracts

Forward contract	Future contract
Personalized contract	Standardized contract
These are settled at start with a forward price	Settled at end on the last trading date of the contact
Clearly specifies who receives the delivery	Does not specify to whom the delivery of physical asset to be made
Traded over the counter	Traded on exchange
Not rigid in their stated terms and conditions	Rigid in their terms and conditions

- **Option contracts**

It is a contract which gives the right to the buyer but not the obligation to buy or sell an underlying asset at a specified date and price. The holder does not need to exercise the option necessarily. Option seller will get a premium in order to fulfill the contact if the buyer so chooses. It is two types:

Call option: contract giving the owner the right but not the obligation to buy a future contract

Put option: contract giving the owner the right but not the obligation to sell a future contract

- **Global deposit receipt (GDR)**

It is a financial instrument used by the private markets to raise capital denominated in either U.S. Dollars or Euros. It represents shares of the issuing company. The holder can convert the receipt in to specified number of shares, which can be traded in the domestic market. These shares traded as domestic shares, but are offered for sale globally through the various bank branches. The holders of GDR are entitled to receive dividend in multiple currency.

They have no voting rights. Prior permission of government is required to issue GDR. Investment in real estate and stock market is not permitted to issue GDR.

- **American depository receipt (ADR)**

ADR bought and sold on American market just like regular stocks. Here two banks are generally involved in maintaining an ADR on US exchange: an investment bank and a depository bank. Investment banks purchases the foreign shares and offers them for sale in the US. The depository banks handles the issuance and cancellation of ADR certificated according to the orders of investors.

- **Foreign currency convertible bonds (FCCB)**

It is an equity linked debt security. It can be converted in to equity or depository receipt within a specified period at a predetermined exchange rate. It carries a fixed rate of interest. The conversion is optional. The company is required to pay the interest in dollars up to the conversion date.

An overview of Indian capital market

- Stock market
- Stock exchanges
- Establishment of NSE(national stock exchange)
- Introduction of line trading
- Establishment of over the counter exchange of India (OTCEI)
- Listing of securities

- Shareholders
- Mutual funds
- Primary market
- SEBI
- Introduction of Screen based trading system
- Measures to curb insider trading
- Introduction of derivatives

Difference between capital markets and money markets

BASIS	MONEY MARKET	CAPITAL MARKET
funds	Short term fund	Long term funds
need	Sort term needs of government and business	Long term needs of business and government
Instruments	Bills of exchange, treasury bills, call money…	Share, debenture, bonds, GDR, ADR…
institutions	Central bank and commercial bank	Investment banks, insurance companies, finance houses…
Relation with central bank	Central bank and all other banks are working as a part of money market	No direct contract with central bank. It operates through money market
Regulation of the market	Commercial banks are closely regulated here	Institutions are not much regulated here
Degree of risk	Small risk	High risk.

PRIMARY MARKET

It is also known as new issue market. It is a market in which new securities or the new companies or the existing companies offer financial claims to the investor for the first time. Fresh capital can be raised from this market by companies, government and semi government body‟s etc. primary market includes all institutions, which are dealing in fresh claim. These claims are created by these institutions in the form of equity shares, preference shares, debenture, right issue, deposits etc.

Functions of primary markets

- **Origination:** the introduction of basic idea of issuing securities before the actual issue of securities is known as origination. A preliminary investigation should be carried by its sponsors of the new issue in respect of technical, economic and financial viability of the project. Generally this function is done by merchant bankers.
- **Propagation:** after origination the new shares issued should be propagated. The investors should be informed about the benefits of the investment opportunity. Information of new issue should be given to investors through appropriate media.
- **Underwriting:** it is a contract in which underwriter agrees to take over the shares, which are not taken over by the public. For this service he will get a commission called underwriting commission. The person or parties who are engaged in such activities are called underwriters. So underwriting is a form of insurance against the risk of new issues receiving a poor response. They ensure minimum subscription. If a part of the shares are unsold, the underwriter will buy that share. Underwriting is mandatory in India. An underwriting agreement may be in three forms:-
    - **Guaranteeing the issue**: here the underwriter promises the sale of a specified number of the shares within the specified period. If the shares not subscribed by the public, then the underwriter will subscribe them.
    - **Outright purchase**: here the underwriter purchase the whole shares and it will be sold in the market.
    - **Syndicate underwriting**: several underwriters form a syndicate. And syndicate makes agreement with the company.
- **Distribution:** it is the function of final sale of securities to prospective investors. Generally brokers and agents are doing the same.

Primary market and stock exchanges

Stock exchange is an organized market for free purchase and sale of industrial securities. It is a market for old securities. It provides a ready market for the securities. There is a strong relationship between stock exchange and primary market.

- When new shares are issued, it will be done through the new issue market. Subsequently it is disposed through stock exchange
- Stock exchange and primary market are the integral part of the whole financial system. If new issues are not promoted, there is no scope for the stock market.

- Listing of securities in a well-defined stock exchange helps the issuing company to enhance its credibility in the market. So stock exchange can exercise control over the new issues.
- New issue market is operating in an atmosphere of uncertainty. When securities are listed in stock exchange uncertainties will disappear.
- The success of the issue market depends upon the price movement in stock exchange and general economic outlook of them.

<u>Difference between primary market and stock exchange</u>

Basis	Primary market	Stock exchange
Function	Deals with new securities offered to investors for the first time.	Deals with securities which are already listed.
Organization	It has no administrative organizational set up.	It is a well-established organization
Service	It renders services to the lenders and borrowers of funds at the time of any particular operation.	It has its own rules and laws to conduct business. Daily prices and details of new companies are supplied to members.
Capital contribution	It provides industrial finance directly.	It provides capital indirectly.
Market	It is a newly created market for the new securities.	It is ready market for the securities.

Methods of raising funds from the primary market

1. Public issues
2. Private Placement
3. Bought Out Deals
4. Right issue
5. Bonus issue
6. ESOP

I. PUBLIC ISSUE

It can be further classified in to initial public offering and further public offering.

1. Initial public offering:

It is done when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. It is done in two ways

a) **Through prospectus**: it is the most common form of raising capital. Here a fixed number of shares at a stated price are offered to the public by the issuing company through a document named prospectus. A prospectus is an invitation to public to subscribe shares of a company. It is issue to inform about the formation of a new company and to induce investors to invest in their securities.

Merits

- Large number of investors in a wide area can be covered
- It is a direct method
- It helps to restrict the concentration of power in few hands.

Demerits

- It is costly.
- This method is only suitable for large issues.

b) **Offer of sale:** Here securities are issued to an issue house or intermediaries like brokers through a "**letter of offer**". The issue house or intermediaries subscribe these securities at a negotiated price and sell them to public at a higher price. The difference in the purchase and sale price is called turn or spread. It the profit to the intermediary. The advertisement given by intermediaries become a deemed prospectus.

II. PRIVATE PLACEMENT

In this method, securities are selling privately to friends, relatives and financial institution with or without the help of intermediaries. Here shares are sold to their own client. Here prospectus is not needed and an investment agreement is only needed. As per this method only limited amount of capital can be raised. The main limitation of this method is that the securities are not distributed in a wide geographical area. This method is not popular in India.

III. BOUGHT OUT DEALS

It is similar to private placement. It is a process of investment, by which a sponsor or a syndicate of investors make direct investment in the company. The company issues whole of its shares to a sponsor or syndicate at a negotiated price. The sponsors issue these shares after a certain period for a premium. The existing SEBI guidelines not promoting bought out deals.

Merits

- Cost of issue is less
- The sponsors get profit by issuing securities

Demerits

- There is possibility of loss of control in the management of the company.
- The price at which shares are offered to the public by the sponsors may be abnormally high.
- Here is scope for manipulation, insider trading and rigging which cannot be easily detected.

IV. RIGHT ISSUE

The issue of shares by a company to its existing shareholders is known as right issue. When the company wants to increase its share capital by issue of further shares, such shares must be issued first to the existing shareholders in proportion of their existing shareholding. These shares are called right shares. The existing shareholders can accept the shares or reject it and also can sell them to another person. If shareholders are neither subscribed nor transfer there right then the company can sell shares to public. If the market prices of shares are more than issue price then share holder get an advantage, the money value of such an advantage is called value of right.

Merits

- Cost of issue is less
- It helps to distribute shares equitably to existing shareholders
- It prohibits insider trading.

V. BONUS SHARES

When the accumulated reserve is more than its requirement, then the company distributes whole or portion of it to existing shareholders. It is known as bonus. It is not a source of financing because it does not bring additional cash reserve to the company. It is simply conversion of reserve in to share capital. It is gift shares issued to existing shareholders.

Merits

- Shareholders get additional shares without paying cash
- No tax is required
- Bonus shares can be converted in to cash by offering them to market
- Even if rate of dividend falls, shareholder will get more because number of shares is more
- Company is able to distribute profit without affecting its working capital

Demerits

- Dividend per share is reduced
- Decline in dividend rate will reduce market price of shares
- Issue of bonus shares will enhance speculation

EMPLOYEE STOCK OPTION SCHEME (ESOP)

It was introduces in 1985. Here employees of a public company are allowed to participate in the equity capital of a company in a phased manner. The permanent employee can joint in this scheme. He is required to pay an initial contribution and deposit of a fixed annual contribution in successive four years. The company allows employee a non-transferable convertible debenture then the employee can convert it to shares after 5 years. He cannot transfer that share for a period of 3 years.

Emerging trends in primary market

- Raising of capital
- Revival of primary market
- Domination

Factors contributed to the growth of primary market

- Industrial growth
- Buoyancy of secondary market
- Fiscal incentives
- Tightening of norms

Reasons for poor performance

- Manifestation of real economy
- Failure to mobilize the household savings
- Passive situation
- Gap in the primary market
- Introduction of economic reforms
- Data to investors
- Developments in the international markets

Measure taken by SEBI to strengthen primary market

- The capital issues (control) Act 1947 were abolished and SEBI was setup.
- SEBI appointed Malegam committee under the chairmanship of Y.H. Malegam. As per the recommendations of this committee, SEBI strengthen the norms for public issue related to disclosure and eligibility in order to enhance the level of investor protection.
- SEBI made a formal and informal consultation with the market participants, advisory committee, practitioners and experts, AMBI (Association of merchant bankers of India) etc. and adopted some measures. Its objectives are follows:
  - To simplify issue procedures to facilitate capital formation
  - To enhance level of investor confidence
  - To avoid fraud in public offering

SECONDARY MARKET

Secondary markets are also referred as stock market. The Secondary market deals with the sale and purchase of already issued equity and debt securities of the corporate and others. The securities dealt in secondary market include securities of government, semi government or other public bodies and public issue done by companies. The company lists their securities in stock exchanges for trading. The SEBI, the Company Law Board and the respective stock exchanges are regulating the secondary market. SEBI formulates the rules, regulations and the procedure to be followed for trading in the secondary market.

Functions of secondary market

- Capital formation
- Security price formation
- Creation of market place

DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKETS

Primary markets	**Secondary markets**
New securities	Already issued securities
Deals with issuing of securities	Deals with buying and selling of securities.
It has no tangible form of organization set up.	It has physical existence
Primary market for a security exists only for a limited period	It has long and continuous existence.
It is a source of fund to a new or existing company.	It is not a source of fund to a new or existing company.

FINANCIAL SERVICES

Financial services are regarded as the fourth element of the financial system. The term Financial Services in a broad sense means and allocating savings. Includes all activities involved in the transformation of savings into investment. The financial services can also be called financial intermediation. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Financial services include banking, broking, mutual fund etc. Which are regarded as sub segments of financial services. The role of financial intermediation is to channel funds from lenders to borrowers by intermediating between them.

Characteristics of financial services

- Customer specific
- Intangibility
- inseparability
- Perishability
- People based service
- Market dynamics
- Concomitant

Importance/ Role of financial services

- Cater to the needs of financial institutions
- Capital formation
- Risk management
- Fund pooling
- Economic growth
- Remittance and money transfer services
- Powerful economic force
- Promotion of savings
- Provision of liquidity
- Financial intermediation
- Contribution to GNP creation of employment opportunities

Objectives of financial services

- Fund raising
- Fund deployment
- Specialized services
- Regulation
- Economic growth

Relevance of the study of financial services

- Helps to balance family budgets
- The need for financial education and awareness is increasing
- Helps to know what are the avenues for investment
- Helps to know what are the ways for transferring money
- Helps to know how an account is to be opened
- Helps to know who will help in taking financial decision
- Helps to know how investment can be made etc.

Factors influencing the growth and development of financial services industry

- Economic policy of the government
- Type of economy
- Government reforms
- Stage of development
- Macro-economic shocks
- Severe business cycles
- Political pressures
- Social factors
- Incentives for innovation
- Legal and regulatory constraints
- Financial infrastructure
- Access to global capital
- Fiscal and exchange rate regimes
- Technology improvements
- Changing customer demographics
- Changing customer needs
- Revolution in banking sector

Types of financial services

1. Fee/ based advisory services

2. Fund/ asset based services

Fee based/ advisory services

It includes Merchant banking, Stock broking, Credit rating

Fund based services

Hire purchase financing, Lease financing, Housing financing, Venture capital financing, Factoring, Forfeiting, Mutual fund, Insurance services and Bills discounting.

1. HIRE PURCHASE FINANCING

Hire purchase means purchase of goods on installment basis. Hire purchase credit or installment credit refers to the term loans provided for the purchase of consumer goods or services and sometimes producer goods. In India hire purchase finance is provided by retail and wholesale traders specialized hire purchase companies commercial banks and financial institutions.

Guidelines

- Maximum limit for bank lending
- Maximum permissible bank finance
- Nature of facility
- Credit authorization forms
- Supervision and follow up

2. LEASE FINANCING

It is a form of financing employed to acquire the use of asset. Leasing or lease refer of an immovable property by the owners (lessor) to the ten and (lessee) on a specified rent for a specified period on terms that may be mutually agreed upon. Through lease firms can attain the economic use of asset for a stated period without owning them. There are two types of leases: *operating lease* and *financial lease.* In operating lease the producer of the capital equipment offers his product for lease it is a short term lease which can be cancelled by giving proper notice at the option of the lessee. In finance leasing there are three parties a) producer of the capital equipment b) the buyer of the capital equipment (who is the investor) and a leasing company. Lease financing refers to the method of financing equipment and machinery purchase. The prospective lessee identifies the equipment quality size quantity that he wants to acquire and he locates a supplier.

The lessee negotiates the price with the supplier and obtains quotation. Then the lessee locates a lesser (a leasing company). Lesser and lessee enter an agreement related with the payment. The lesser pays the amount of equipment to supplier and lessee get the equipment. As per the leasing agreement the ownership of the property vests with the lessor and the lessee is required to pay rental to the user during the lease period.

3. HOUSING FINANCE

It is included in the priority sector by government. The RBI directed the commercial banks to provide funds for housing.

Housing loan under priority sector

Direct Finance

- Loan up to rupees 200000 for construction of house granted all categories of borrowers
- Loan up to rupees 25000 for repairs to damaged house granted to all categories of borrowers.

Indirect Finance

Assistance to any government agency for the purpose of constructing houses were the loan amount does not exceed rupees 200000 for housing unit.

Institutions for house financing

- Housing Development Corporation(HUDCO)
- Housing Development Finance Corporation (HDFC)
- National Housing Bank
- Housing Finance Companies

Housing loan schemes of commercial banks

- Eligibility norms
- Margin requirements
  Loan amount
- Security and repayment

4. MERCHANT BANKING

Merchant banking involves rendering services of non-banking nature to the industrial and business houses. It's a wide range of services under one roof like a financial technical managerial extra which are ordinarily available through a widely spread non-banking agencies and professionals. A merchant banker shall undertake only those activities which are related to securities market.

Services

- They manage market and underwrite new issues
- Provide project promotion services and project finance
- Organization credit and other facilities
- Leasing including project leasing
- Provide corporate services
- Investment advisory services
- Provide venture capital
- Provide mutual funds and offshore funds
- Investment management
- Assistance for technical and financial collaboration and joint ventures
- Provide investment services to non-resident Indians

5. STOCK BROKING

Stock brokers are the members of the recognized stock exchanges. They buy sell or deal in securities. It emerged as professional advisory service in India. They have to work within the prescribed framework.

6. VENTURE CAPITAL FINANCING

It is the financing of new ideas and Technology. The term venture capital is normally defined as an equity investment in high risk project related to some innovations for new technological development by a company. Venture capital assistance is given to those enterprises where the risk element is comparatively high due to the involvement of a relatively new technology.

Guidelines

Form of assistants

- Equity support
- Conventional loan
- Conditional loan

Eligibility to obtain venture capital finance

1. The project is related with a novel idea or new invention or improved technology or skill
2. It should be capable of commercial exploitation and operation
3. With a new product which has good demand prospective
4. I have attained the pre-production stage

Stages of venture capital financing

1. Early stage
    - Seed
    - Startup
    - First stage
2. Expansion stage
    - Second stage
    - Third stage
    - Bridge stage
3. Turn around stage

Institution in the field of venture capital finance

- Venture fund of IDBI
- Venture fund of SIDBI
- Venture capital fund of technology development
- Other venture capital fund

7. FACTORING SERVICE

Factor is a financial institution which manages the collection of accounts receivables of the business firm and bears the credit to risk associated with it. Factoring involves provision of specialized services relating to credit investigation sales ledger management purchase and collection of depth and creditor protection. In factoring there are three main parties such as client (seller) the customer (buyer) and factor. Here the client enters into a formal agreement with a factor to create a legal relationship of buyer and seller. The seller sends good to the buyer and send the bill and invoice copies to the factor. The factor makes prepayment to the client up to a specified percentage of the eligible debt the factor thereafter takes over the collection function on behalf of the seller. Factor undertakes the risk of bad on behalf of the client.

8. FORFAITING

It is an established a method of providing fixed rate trade finance for export transactions. Forfaiting is the purchase of a series of credit instruments such as draft drawn under time letter of credit, bills of exchange and promissory notes or other freely negotiable instruments on a non-recourse basis (non-recourse means that there is no come back of the exporter if the importer does not pay). The forfeiter detects interest at an agreed rate for the full credit period covered by the notes. Instruments are drawn by the exporter accepted by the important and will be here an *aval* or unconditional guarantee. This process is known as avalisation. The guarantee will normally be issued by the importance bank but some strong cooperative can be accepted without a bank guarantee.

9. INSURANCE SERVICES

It is a fund based financial services performed by different insurance companies. Company"s insurance services are mainly divided into two such as life insurance and general insurance.

10. CREDIT RATING

Credit rating is an opinion of the rating agency regarding their relative ability of the issue of a debt instrument to fulfill the debt obligations in respect of the interest and repayments as and when they arise. According to SEBI credit rating agency is a body corporate which is engage in or purpose to be engaged in the business of rating of securities offered by the way of public issue or right issue. Rating is an opinion regarding the securities expressed in the form of standard symbols or in any other standard manner assigned by the credit rating agencies and used by the issuer of such securities.

Types of credit rating

- Bond rating
- Equity rating
- Commercial paper rating

Benefits to credit rating

- It is encouraged the common man to invest his savings in securities of corporate bodies
- Enable the investor to get superior information at low cost
- Help the investor to take a calculated risk
- Facilitate the companies to enter capital market with greater confidence
- Facilitate foreign collaboration
- Facilitate the government to formulate policy guidelines in relation with investment

Credit rating agencies

- Credit Rating Information Services of India Limited (CRISIL)
- Information and Credit Rating Agency of India Limited (ICRA)
- Credit Analysis and Research Limited (CARE)
- Duffs and Phelps (India) Limited (DCR)
- Fitch rating India Pvt Limited

MERCHANT BANKING

A merchant bank is a financial institution which provides capital to companies in the form of share ownership instead of loans. A merchant bank also provides advices on corporate matters to the firm's they lend to. There is not precise definition about merchant banks because merchant banking is used differently in different countries. According to Finance Ministry, „a merchant banker is any person who is engaged in the business of issue management either by making arrangements regarding selling, buying, or subscribing to the securities as manager, consultant, advisor, or rendering corporate advisory services in relation to issue management.‟

- A merchant banker is one who is a critical link between a company and investors.
- Merchant banker is one underwrites corporate securities and advices clients on issues.
- Merchant banker may be in the form of a bank, a company, a firm or even a proprietary concern.
- Merchant banker understands the requirements of the business concern and arranges finance with the help of financial institutions, banks, stock exchanges and money market.

Types of merchant banking organizations

- Institutional based merchant banking organizations
- Banker based organizations
- Qualified brokers who provide skilled merchant banking services
- Private merchant banking organizations

Merchant bankers in India

I. Public sector merchant bankers

- SBI capital markets Ltd
- Punjab National Bank
- Bank of Maharashtra
- IFCI Financial Services Limited
- Karur vysya Bank Limited
- State Bank of Bikaner and Jaipur

II. **Private sector merchant bankers**

- ICICI Securities Limited
- Axis Bank Limited
- Bajaj Capital Limited
- Tata capital markets Limited
- ICC Bank limited
- Reliance Securities Limited
- Kotak Mahindra capital company limited
- Yes Bank Limited

III. **Foreign players in Merchant Banking**

- Goldman Sachs (India) Securities Pvt Ltd
- Morgan Stanley India Company Pvt Limited
- Barclays securities India Pvt Limited
- Bank of America
- Deutsche Bank
- Barclays Bank
- DSP Merrill Lynch Limited.

Nature of services provided by merchant bankers

- It helps in capital raising
- It is associated with the issue management, but the scope of activities extends beyond issue management.
- Serving every financial need of every client.
- Management of mutual fund, public issue and international fund.
- Project counseling, pre investment activities, feasibility study, project reports
- Design of capital structure
- Mobilization of funds from non-resident Indians.
- Helps in merger, amalgamation, takeover ,venture capital and buyback
- Financing of hire purchase transactions.
- Equipment leasing
- Financing local authorities

Functions of a merchant banker

- Management of debt and equity offerings
- Placement and distribution
- Corporate advisory services
- Financial structuring
- Refinancing alternative
- Rehabilitation and turnaround management
- Risk management
- Project advisory services
- Loan syndication
- Providing venture capital

Objectives of merchant bankers

- To carry on the business of merchant banking, assist in the capital formation, manage advice, underwrite, provide stand by assistance etc.
- Create secondary market for bills and discount or rediscount bills and act as an acceptance house.
- To step up and provide services for venture technology funds.
- To finance housing scheme for construction of the houses and buying land.
- Render services like foreign exchange, money exchange, authorize dealer etc.
- Invest in buying and selling of transfers hypothetical and deal with the debentures and security.

Role of merchant bankers

- He is always conscious to renew his skill and expertise to deal with emerging new problems.
- Merchant banker has to keep pace with the changing environment.
- Merchant banker has to think and device new instruments of financing industrial projects.
- He has to assume responsibilities of saving industrial unit from going sick.
- He has to guide Industries to set up industrially backward area to eliminate in regional imbalances in Industrial development of the country.
- He has to guide the wider sections of the community possessing surplus money to invest in corporate securities and other investments channels.

- He has to help the industry in different forms to ensure that it runs risk-free and avoid uncertainty.
- He has to watch the interest and win over the confidence of government.
- He must bridge the communication gap between different sections concerned with the business world.

The structure of organization of Merchant Banks

- A high proportion of professionals to total staff.
- A considerable delegation of decision making
- A short chain of command
- Rapid decision making
- Flexible organization structure
- Innovative approaches to problem solving
- High level of financial sophistication

Structure of merchant banking firm

The structure of Merchant banks consists of the following institution also because these institutions are performing the services of merchant bank in one way or other way.

1. Reserve Bank of India
2. The banking system

    I. Non-banking financial intermediaries
        - Post office savings bank
        - Provident fund
        - Insurance companies

    II. Unit Trust of India and mutual fund

    III. Miscellaneous non-banking financial intermediaries
        - Investment trust and Investment Corporation
        - Loan and Finance Companies
        - Mutual benefit Finance Companies or Chit Fund
        - Lease finance and hire purchase companies
        - Housing Finance Companies
        - Venture capital companies

    IV. State level financial institution

    V. Miscellaneous service organizations

    VI. Stock exchanges

Organization set up of merchant bankers in India

I. Institutional base
II. Banker base
III. Broker base
IV. Private base

Requirements for setting up a merchant banking unit as per SEBI guidelines

a) Formation of the business organization
   - Sole proprietorship
   - Partnership
   - Hindu undivided family
   - Corporate enterprises
   - Cooperative society
b) Adoption of a viable business plan
c) Registration of merchant bankers
   - Application for grant of certificate
   - Application to confirm to the requirements
   - Furnishing of information clarification and personal representation
   - Consideration of application

Registration of Merchant Bankers in India

- Procedure for registration
- Payment of fees and the consequence of failure to pay fees
- Renewal of certificate
- Procedure for registration is not granted
- Effect of refusal to grant certificate
- Payment of fees
- Regulations
  - Guidelines of SEBI and ministry of finance
  - Companies act 1956
  - Listing guidelines of stock exchanges
  - Securities contract (Regulation) Act 1956
- SEBI regulations on merchant banks
- Qualification
- Classification of merchant bankers
- Oversight
- Period of validity of certificate

Obligations and Responsibilities of Merchant Banker

Every merchant banker has to abide by the code of conduct as specified below:

- To protect the interest of investors.
- He has to observe high standard of integrity and fairness in all his dealings with his clients and other merchant bankers.
- To fulfill its obligation in a prompt, ethical and professional manner.
- To exercise due diligence, ensure proper care and exercise independent professional judgment.
- Merchant banker shall endeavor :
- To ensure that enquiries from investors are adequately dealt
- Grievances of investors are redressed
- When a complaint is not remedied properly, investor is advised of any further steps
- He should ensure that adequate disclosures are made to the investors in a timely manner.
- To ensure that the investors are provided with the true and adequate information without making any misleading or exaggerated claims.
- To ensure that copies of prospectus, offer document, letter of offer or any other related literature is made available to investors at the time of issue.
- He shall not discriminate among its clients.
- He shall not make any statement either oral or written which would misrepresent the services that the merchant banker is capable of performing for any client.
- Merchant banker shall avoid conflicts of interest and make adequate disclosures of interest.
- To make appropriate disclosure to the client.
- To render the best possible advice to clients.
- Merchant banker should not promote any unfair competition.
- Merchant banker should maintain arm‟s length relationship between merchant banking activities and any other activity.
- Merchant banker shall have internal control procedures and financial and operational capability which can expect to protect its operation, its clients and investors.
- Merchant banker shall not make untrue statement or suppress any material fact in any documents or information furnished to the board.
- Merchant banker should maintain an appropriate level of knowledge and competence.

- Merchant banker should ensure that the board is promptly informed about any action, legal proceedings etc.
- Merchant banker shall demarcate the responsibilities of the various intermediaries as to avoid any conflicts or confusion in their job description.
- A merchant banker shall provide an adequate freedom and powers to its complaints officer.
- A merchant bank shall develop its own internal code of conduct for governing its internal operation.
- A merchant banker shall ensure that a good corporate policies and corporate governance are in place.
- A merchant banker shall ensure that it has adequate resources to supervise the persons employed or appointed by it in the conduct of its business.
- A merchant banker shall be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

Services of Merchant banks

1) Corporate counseling
2) Project counseling and pre- investment studies
3) Credit syndication and project finance
4) Issue management
5) Underwriting
6) Portfolio management
7) Leasing
8) Nonresident investment counseling and management
9) Venture capital financing
10) Acceptance credit and bill discounting
11) Advising on mergers amalgamation and takeover
12) Arrangement of offshore finance
13) Fixed deposit broking.

Corporate counseling

Corporate counseling denotes the advice provided by the merchant banking to the co-operative units to ensure better corporate performance in terms of image building among investors, maintained steady growth, create better image, appreciation in market value of equity shares. Merchant bankers find out the problems of enterprise and suggest ways and means to solve those problems.

Project counseling

It is a part of corporate counseling and relates to project finance. It includes preparation of project report, designing the financing pattern to finance the cost of project and appraising the project report. Project reports are prepared mainly:

- To attain government approval of the project
- To getting financial assistance from financial institutions and banks
- For ensuring market for the proposed product
- For planning public issues

There are two sources of funds available to finance the project:

1. Internal source of fund
2. External source of fund

The finance mix is decided by merchant bankers. He has to decide between internal and external source of funds. The merchant bankers should help to:

- Identify potential investment avenues
- Providing general view of the project ideas or project profile.
- Advise on procedural aspects of project implementation
- Review the technical feasibility of the project
- Assist in the selection of TCS (Technical Consultancy Organization) for preparing project reports.
- Assist in the preparation of project report
- Assist in obtaining approval, license, grand, foreign collaborations from government.
- Helps in capital structuring
- Arrange and negotiate foreign collaborations and amalgamation, mergers and takeovers.
- Assist clients in preparing applications for financial assistance.
- Provide assistance to entrepreneurs coming to India.

Credit syndication

Credit syndication refers to obtaining of loan from single development finance institutions or a Syndicate or a consortium. Merchant banks help corporate clients to raise syndicated loans from commercial banks. For this purpose the merchant bankers follow certain steps before assisting the clients approach the appropriate financial institutions.

- Merchant banker makes an appraisal of the project to satisfy that it is viable.
- He ensures that the project adheres to the guidelines for financing industrial projects.
- It helps in designing capital structure.
- Merchant banker arranges for a preliminary meeting with Financial Institutions after verification of the project.
- If the financial institution agrees to consider the proposal the application is filled and submitted along with other documents.

Credit syndication includes the following:

- Estimate the total cost
- Draw a financing plan for the total project
- Prepare loan application for financial assistance
- Select the institutions and banks for participation in financing.
- Follow up of the term loan application
- Assist bridge finance
- Assist in completion of formalities for withdrawal of term finance sanctioned by institution.
- Assess the working capital requirement.

Stock Broking

Stock broker is a regulated professional broker who buys and sells shares and other securities through markets on behalf of investors. A stockbroker may be employed by a brokerage firm. Brokerage charges investment ideas and strategies shooting individual requirements and based on his objective of investment. Merchant bankers act as brokers in stock exchange. They conduct research on equity shares , advise their clients, they tracks and monitors the investment, changes or making reinvestment depending on the performance, generate reports etc. The end their process is known as ***Stock Broking***.

REGISTRATION OF STOCK BROKERS

Qualifications of stock brokers

- He should be an Indian citizen and has attained the age of 21
- He should not be adjudged as bankrupt
- He should not be added or proved to be insolvent and should not be convicted for fraud or cheating
- He should not be engage in any other business other than that of a broker in security
- He should not be a default of any stock exchange
- He should have 10 + 2 years educational qualification

Registration procedure

Registered brokers should submit an application to SEBI through the stock exchange on which he is a member. The stock exchange is required to forward the application within 30 days of receipt of the application. SEBI scrutinizes the application and may call for additional information or clarification regarding the dealing in security. SEBI may also request the applicant appear in front of the board for personal representation.

Eligibility to grant registration

- A stock broker should hold the membership of any stock exchange
- He should abide by the rules regulations and bylaws of the stock exchange.
- In case of any change in the status and the constitution the stock broker shall obtain prior permission of the board to continue to buy sell or deal in security.
- He shall pay the amount of fees for registration in the manner provided in the regulations.
- He shall take adequate steps for redressal of grievances of investors within one month of the date of the received of the complaint and keep the board informed about the same.

Eligibility criteria for registration as a stock broker

- Whether stock broker is eligible to be admitted as a member of a stock exchange
- Whether he has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities.
- Whether he has any past experience in the business of buying selling or dealing in securities.
- Whether he is not subjected to disciplinary proceedings under the rules regulations and bylaws of a stock exchange with respect to his business as a stockbroker.
- Whether he is fit for the job and proper person to act as a broker.

OBLIGATIONS OF STOCK BROKERS

Every stock broker should keeps and maintains the following books of accounts:

- Register of transactions
- Client ledger
- General ledger
- Journal
- Cash book
- Bank pass book
- Documents register which should include particulars of shares and securities received and deliver.
- Members contract book showing details of all contracts ended with other members of the same stock exchange
- Counter folios for duplicates of the contract notes issued to clients.
- Written consent of clients in respect of the contract entered into as principles.
- Margin deposit book
- Registers of accounts of sub brokers
- Agreement with sub brokers

Code of conduct for duties of stock brokers

1. **General**

- Integrity
- Act with the due care and skill manipulation
- Mall practices
- Compliance with the statutory requirements

2. **Duty to the investor**

- Execution of orders
- Issue of contract note
- Breach of trust
- Business and commission
- Business of defaulting client
- Fairness to client
- Investment advice
- Investment advice in publicly accessible media

3. **Corporation of stock brokers with other stock brokers**
    - Conduct of dealings
    - Protection of clients interest
    - Transaction with stock brokers
    - Advertisement and publicity
    - Inducement of clients
    - False or misleading return

KINDS OF BROKERS AND OTHER MEMBERS

- Commission brokers
- Floor brokers
- Jobber
- Tarawaniwalas
- Remisiers
- Arbitragers
- Budliwala
- Authorized clerk
- Security dealers
- Online brokers

Underwriting for public issue

Underwriting is a guarantee given by the underwriter that in the event of under subscription the amount underwritten would be subscribed by him. SEBI has permitted merchant banking companies to take up underwriting commitments up to 20 times their net worth.

An underwriter to the issue gets the following benefits:

- It earns commission for the commitment given
- It earns the right to be appointed as bankers of that issue
- It expands its clientele by underwriting more and more issues
- Bankers to the use.
- Act as a manager to the issue
- It has given underwriting commitments.
- The bank is a broker to the company.

Functions of underwriters

- Purchase of securities
- Distribution of securities
- Supplying information to companies
- Exchange in securities
- Services to the society
- Other services

Benefits of underwriting

- Assurance of adequate finance
- Benefits of expert advice
- Increase in goodwill of the company
- Geographical dispersion of securities
- Service to prospective buyers

Benefits to the company

- Reduces risk and uncertainty of marketing the securities
- Provide valuable advice to issuing company with their specialized in knowledge in the capital market
- Provide publicity services to the companies.
- Helps in financing of new enterprises and in the expansion of existing project
- Build up investors" confidence in the issue of securities
- Issuing company is assured of the availability of funds
- Facilitate the geographical dispersal of securities.

Types of underwriting

- Syndicate underwriting
- Sub underwriting
- Firm underwriting

Types of underwriters

- Development Banks like IFSC, ICICI and IDBI
- Institutional investors like LIC and Axis
- Financial and Development Corporations
- Investment and insurance companies and stock brokers

Issue management

It is the management of various types of instruments of corporate enterprises. As an issue manager the merchant bankers provides following functions:

Pre issue management

- To obtain SEBI's approval for the issue.
- To arrange underwriting for the proposed issue.
- To draft and finalize the prospectus.
- To draft and finalize other documents such as application forms, newspaper advertisement etc.
- Selection of Registrar to issue, printing press, advertising agencies, brokers and banks to the issue and finalization of fees and charges paid to them
- Finalization of underwriting
- Arrange press and investor‟s conference
- Coordinating printing, publicity and other work.

Post issue management

- Collection of application money
- Write to the related stock exchanges regarding closure of subscription list.
  Send the complaints report to SEBI.
- Submission of record of 90 % subscription and bank certificate to regional stock exchange.
- Obtain approval of basis of allotment from stock exchange.
- Send a copy of the regional stock exchange to other stock exchange where listing permission is sought.
- Publish a copy of basis of allotment in two national dailies.
- Publish advertisement mentioning the various dates on which refund or allotment and listing were dispatched and sought respectively.
- Confirm the completion of listing formalities.
- To make arrangements to obtain permission for dealing in securities.

Portfolio Management Services

Portfolio refers to investment in different type of marketable securities such as shares, debentures, stocks, bonds etc. from different companies or Institutions held by individual firms or corporate unit. Portfolio management refers to managing efficiently the investment in the securities held by professional to others.

Objectives of Portfolio Management Services

- Keep the security safety of principal sum in both money as well as purchasing power.
- To maintain stability of the flow of income
- To attain capital growth
- Marketability of the securities
- Liquidity
- Diversification
- Favorable tax status

Advisory services related to mergers and takeovers

A merger refers to a combination of two or more equal companies. A takeover is referred to an actual distance in which one company purchases the controlling interest in other existing company. Merchant bankers act as a middleman in settling negotiations between the offered and the offeror.

Venture capital financing

It is the financing of new idea and technology. It is defined as an equity investment in a high risk project related to some innovations or new technological developments pondered by a company.

Working capital financing

It is the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities. It is provided depending upon their earning capacity in relation to the interest rate prevailing in the market.

Fixed deposit

Merchant bankers assist the companies to raise finance by the way of fixed deposit from public. However such companies should fulfill creditor rating requirements.

Leasing

This service includes arrangement for lease finance facilities for leasing company, legal documents and tax consultancy.

Nonresident investment

The merchant bankers provide investment advisory services to the NRI in terms of identification of investment, opportunities, selection of securities and portfolio management etc. They also take care of operational details like purchase and sale of securities.

<u>Acceptance credit and bill discounting</u>

These services are not currently provided by merchant bankers in India. The banking Commission 1972 recommended the establishment of acceptance and discount house in India following the development of Bill market

<u>Arranging Offshore Finance</u>

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

- Financing of exports and imports
- Long term foreign currency loans
- Joint venture abroad
- Foreign collaboration arrangement
- The assistance rendered as in the case of financial services

<u>Other services</u>

- Management of fixed deposit of companies
- Servicing of issues
- Small scale industry counseling

Depositaries

Depositary is an organization which holds securities of investors in electronic form at the request of the investor through a registered depository participant. It also provides services related to transactions in securities. The term depositary can be defined as "a central location for keeping securities on deposit".

It can also be defined as "an institution which transfers the ownership of securities in electronic mode on behalf of its members".

Features

- A depositary is an organization
- It keeps the securities of the investors under safe custody
- It keeps the security of a investor in electronic form
- It helps to transfer the ownership of securities in electronic mode.
- It transfers securities between accounts on the instruction of the account holder
- It leads the capital market towards scrip less system through immobilization and dematerialization of certificates.

Objectives

- To reduce the transfer time of security
- To reduce the cost transfer for the investor
- To avoid the risk of settlement of securities
- To enhance liquidity and efficiency
- To create a system for handling securities in electronic form
- To promote the country's competitiveness by completing the global standards
- To provide service infrastructure in the capital market

Activities of the depositories

- Accept deposit of securities for safe custody
- Create a computerized book entry for all transactions
- Provide facility for withdrawal of securities
- It undertakes to distribute dividend and bonus shares to its account holders.
- Monitoring all accounts of investors
- Redemption of securities on maturity

Interacting institutions

- The central depository
- Share registrar and transfer agent
- Clearing and settlement corporation

Depositary process

- Immobilization for dematerialization of shares
- Fresh issue

Rematerialisation

Investor can withdraw shares which are deposited with the depositary. This process is called rematerialisation. The process of rematerialisation is below:

- Investor makes a request for rematerialisation
- Depository Participant intimates depositary of the requested through the system
- Depositary confirm rematerialisation request to the registrar
- Registrar updates accounts and prints certificates
- Depositary updates accounts and downloads details to depository participants
- Registrar dispatches certificate to investors

Depository system in India

- SEBI Depositories and Participants Regulation Act
- Depositary
- Depository participants
- Registration and commencement of business
- Depositary eligible securities
- Transfer of securities
- Fungibility of the dematerialized receives
- No stamp duty
- Depositary record as legal evidence

Tax planning services

The principal objectives of corporate tax planning are follows:

- Reduction of tax liability
- Minimization of litigation
- Productive investment
- Healthy growth of an enterprise economics stability

Factoring services and practices

Factoring is a fund based financial services. Factoring is a method of financing where by a company sells its trade debts at a discount to financial institution. Factor is a financial institution which manages the collection of accounts receivables of the business firm and bears the credit risk associated with it.

According to V. A. Avadhani "factoring is a financial service of financial nature involving the conversion of credit bills into cash".

Features of a factoring

- It is a mode of financing as well as a financial service provided by the specialist companies called the factors
- Factoring is a continuous arrangement between the factor and the client firms
- Factoring is a contractual service arising out of the agreement between client and factor.
- Factoring enables the conversion of outstanding receivables into cash flows.
- Factoring involves an outright sale of book debts to the factor by client.
- Factor make an advance payment generally from (80% to 90%) against the invoices factored by the client firm.
- Factor may assume the credit risk
- Factor undertakes the services of credit collection, sales ledger maintenance etc.

Factoring agreement

There should be an agreement between the factor and client. Following are the main terms and conditions included in the agreement.

- Assignment of debt in favor of the factor.
- Selling limits for the clients
- Circumstances within which the factor will have recourse to the client in case of non-payment by the trade customer
- Situations under which the factor will have recourse in case of non-payment
- Details of payment to the factor for their services
- Interest to be given to the factor when the factor sanctioned credited to the supplier.
- Limit of overdraft facility and the rate of interest charges there on.

Functions

- Purchase and collection of debts
- Sales ledger management
- Credit investigation and undertaking credit risk
- Provision of finance against trade debts
- Rendering consultancy services

Types of factoring

- **Without recourse factoring or full service factoring.**

It is a continuous relationship between a factor and the claimed in which the factor purchases substantially all the trade debt of the client arising from such sale in a normal cause of doing business. It includes financing, debt administration, and collection of debt due, risk coverage in case of non-payment of debts. If the debtor fails to repay debts, the whole responsibility vests with the factor because he assumes credit risk also. So he cannot pass the responsibility to cleaned so this type of factoring is known as without recourse factoring.

- **Maturity factoring**

When financing is not required an arrangement is made which comprises full administration of sales ledger, collection from debtors and protection against bad debt, this service is called maturity factoring and can be defined as a full-service factoring without the financing element. Here the factor does not make immediate. The factor pays the client for the debt sold in one of the following ways:

- After a certain period from the date of invoicing this being known as the maturity period. The benefit of this method is that the client knows exactly when he gets paid.
- When every debtor pays his invoice or when the debtor is insolvable on the condition that the non-payment risk is insured.

- **Bulk factoring**

  It is a modern Financial Services. Here the factor gives finance after disclosing the fact of assignment of debt to debtors concerned. It is generally adopted when the factor is not sure about the financial position of the client. The factor simply collects the debt on behalf of the client.

- **Invoice factoring**

  Here the business sells the present accounts receivables that are unpaid to the factoring company. The sector simply provides finance against invoice without undertaking any other functions. This kind of invoice factoring will permit the business houses to get the fund needed on the anticipated money to be received by their clients.

- **Agency factoring**

  Here the factor and the client share the work between themselves such as providing finance and assuming credit by the factor and look after the sales ledger Administration and collection work by client.

- **International factoring**

  For many companies selling in an international marketplace is the ultimate challenge. International factoring provides solutions regardless of whether the exporter is a small organization or a major corporation. It helps to open account or documents against acceptance firm. Here factoring is done purely on the basis of invoice prepared by the exporter.

- **Financial factoring**

  Here the factor themselves provide advance to the firm selling its receivables immediate on the shipment of goods. It means that the company which is selling its receivables does not want to wait for cash till the date of maturity. The amount of advance varies in between 80% to 90%. As the factor advances money, ahead of the maturity date, before he collects the fund from the receivables, he charges for this for the period of the time from the date of advance.

- **Recourse factoring**

  A large number of the factoring companies do not offer complete factoring services being specialized in recourse factoring. In recourse factoring normally describes the services by which the factor provides finance for the client and carries of the functions of sales ledger administration and the collection but does not protect the client against bad debts.

Forfaiting

Forfaiting is the purchase of a series of credit instruments such as draft drawn under time letter of credit, bill of exchange, promissory note or other freely negotiable Instruments on non-recourse basis.

Forfaiting procedure

- The exporter requests the forfaiter to provide a written commitment to purchase the Debt from him at the time of shipment.
- The exporter and importer sign a commercial contract.
- The authorized dealer issues a forfaiting certificate.
- The goods are then dispatched to the importer along with the shipping documents.
- At the request of the importer, the importer's bank provides guarantee.
- The exporter assigns this guarantee in favor of the forfaiter and sends other documents related with forfaiting.
- After receiving complete document, the forfaiter makes payment to the exporter on a without recourse basis.
- On the date of maturity the forfaiter presents the document into the importer's bank for getting payment.
- The importer makes payment to hid guaranteeing bank.
- The importers bank guaranteeing the transaction makes the payment to the forfaiter on due date.

Benefits of forfaiting

- The exporter‟s receiver full export value from the forfaiter.
- The exporter is released of all the risks like in disaster risk, commercial risk, transfer risk etc.
- Improve liquidity of the exporter
- It enhances the competitive advantage of the exporter
- It relieves the exporter from the administration and a collection disturbance.

- The procedure involved in forfaiting is simple. So it enables the exporter to forfait transactions quickly and efficiently.
- It does not affect the banking limit of the exporter.
- Forfaiting provides a flexible, creative alternative to traditional international trade financing methods.

Difference between Forfaiting and Factoring

Forfaiting	**Factoring**
It is for export of capital goods on medium and long term credit	It is resorted to finance short term trade
It is 100% financing without recourse to exporter	It can be with recourse or without recourse
The complete ledge of the exporter is not transferred to the forfaiter	The factor handles the entire sales ledger at a pre-determined price.
The exporter sells the export bills to the forfaiter for cash	The factor undertakes to collect the debt assigned by exporters
The importers bank provides guarantee	Guarantee is not usually stipulated

CARD BUSINESS

CREDIT CARD

A credit card is a financial instrument which can be used more than once to borrow money or buy products and services on credit. It is a small plastic sheet bearing the name and number of the holder. It also contains the validity period and other important a particular. Each credit card bears the specimen signature of the holder.

Parties to the credit card

- Card issuer
- The card holder
- The merchants or service providers
- Credit limit
- Annual fee
- Revolving line of credit
- Personal identification number (PIN)
- Joint credit

Type of credit card

1. **Pure Credit Card**

   It is the most popular type of credit card which offers an option for revolving credit. A holder of this type of credit card need not settled his account at the end of every month; instead he is allowed to make partial payments every month subject to a minimum amount.

2. **Charge cards**

   It is also called travel and entertainment cards. These are a little different from credit card. One can usually charge as much as he wants, but he is required to pay off his entire balance when the bill arrives.

- ATM CARD

Automatic teller machines are generally installed at busy location away from the bank such as grocery store, airports, and bus and railway stations. Customers can access cash simply by inserting a plastic ATM card into the machine and entering their personal identification number. These cards allow withdrawal facilities even beyond banking hours. It operates 24 hours a day and on all days in a year.

Functions

- A card holder is able to withdraw money from his various accounts.
- A card holder is also get latest and the updated information about the cash balance in his account.
- It allows transferring fund between accounts.
- It is also possible to make deposits
- Payment of loans can be made through ATM
- Payment of bills to utility companies such as electricity and water can be made
- It provides the customers printed copy of transaction statement.

- DEBIT CARD

Debit cards are issued by the banks to their customers who have maintained an account in the bank with the sufficient credit balance. Each time when the customer makes a purchase an equal amount of the purchase is debited in his account. When using a debit card customers are drawing money in their account.

Types of debit cards

I. **Direct debit cards**

It allows only online transactions also called a point of sale. It is an immediate electronic transfer of money from customer‟s bank account into merchant's bank account.

II. **Deferred debit card**

It looks similar to a credit card bearing a visa or master card logo and can be used wherever you are card brand name is displayed. It is not a credit card rather this card allows offline transactions as well as online transactions. Offline purchases resemble a credit card transaction.

- SMART CARDS

These Smart cards combine both computer microchip technologies and personal credit cards. Here a tiny microchip is actually inserted into the body of the credit card to enable the card and the owner greater freedom and security for purchases both live and online. The microchips also contain information about the card owner as a precaution against identity, fraud/ theft. Cash from a personal bank account may be transferred and stored on the smart card account for travel and purchase convenience.

- CHEQUE GUARANTEE CARD

These cards provide the facility to a customer to encash his cheque at any branch of the same bank within the country. These credit cards are generally used by travellers and business people. It also provides a guarantee against dishonor of cheque.

- CORPORATE CARD

These cards are issued by companies to their employees to meet company expenses. The company issuing this credit card is responsible to pay the amount into the bank. Such cards are generally issued only to higher level officers of the company.

- PREPAID CARDS

These are pre-programmed cards which contain a fixed value. The cardholder goes on using this card till the stored value is fully exhausted. India telephone card is a good example for prepaid card.

Benefits of credit cards

Benefits to holders

- Convenience in shopping
- Readily available credit
- Delayed payment
- Freedom to use credit
- Safety
- Facilitates mail order shopping
- Record keeping

Benefits to merchants

- Increase in sales
- Easy to validate
- No risk

Benefits to banks

- Source of income
- Easy way of lending
- Wider market
- Marketing of new bank products

Other cards

- Master Card
- Visa card
- Standard card
- Classic card
- Gold card /executive card
- Platinum card
- Secured card
- Co-branded card
- Titanium card
- Cash card
- Traveller card
- Student credit card
- Private label card

- Affinity card
- Rupay' cards

Credit card operations of banks

1. Issue of card
2. Interest rates and other charges
3. Wrongful billing
4. Use of DSAs/ DMAs and other agents
5. Protection of customer rights
    - Right to privacy
    - Customer confidentiality
    - Fair practices in debt collection
6. Redressal of grievances
7. Internal control and monitoring systems
8. Right to impose penalty

CREDIT RATING

Credit rating is a fee based financial advisory services. It is an evaluation of the borrower's credit quality. This concept was originated in the USA. It can be defined as an assessment of the creditworthiness of individuals and corporations. Or it can be defined as an evolution of the financial trustworthiness of a company or individual particularly with regard to meeting its obligations.

According to CRISIL “Credit rating is an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy or sell and hold a particular security”.

Features of credit rating

- Credit rating is a fee based financial advisory services.
- It is an assessment of the borrower's credit quality.
- It is an evaluation of the capability of an issuer of debt security to pay interest and repay principal amount.
- Credit rating is done by an independent agency.
- It is neither a general purpose evaluation nor overall assessment of credit risk of a firm.

Approaches to credit rating

1. **Implicit judgmental approach**

This approach rates a security by considering a broad range of factors some of which may be quantified and others not quantified. It is not necessary that all the factors considered should be specified. The factors considered by capital market are divided into six categories:

- Promoters
- Project
- Prospects
- Government policy
- Security characteristics
- Miscellaneous

2. **Explicit judgmental approach**
   - Define a set of factors which are considered relevant for rating purposes.
   - The weights which are to be assigned to these factors are also explicitly specified.
   - For each of the factors a quantitative assessment of the entity to be rated is made.
   - The weights are applied to the quantitative assessment and a numerical credit score or index is arrived at.
3. **Statistical approach**

   The statistical approach in contrast uses a statistical method in selection of factors, the weights to be assigned to them and in the interpretation of scores. Following are the steps involved in statistical approach:
   - Define a set of factors which are considered to be relevant for rating purpose.
   - A sample of objects is taken and based on historical experience;
     "A priori" classification of these objects is made.
   - Using an objective statistical method, the credit rating model is developed.
   - The model which is developed is tested by scoring the sample of objects already gathered in order to determine the predicting power of the model.

Objectives of credit rating

- Provide superior information to the investors at a low cost.
- Provide a sound basis for proper risk-return structure.
  Subject borrowers to a healthy discipline.
- Assist in the framing of public policy guidelines for institutional investment.

Credit rating agencies

Credit ratings are determined by credit rating agencies. Credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government including non-public information obtained by the credit rating agencies analysts. Credit rating is not based on mathematical formulas. Instead credit rating agencies use their judgment and experience in determining what public and private information should be considered in giving a rating to a particular company or government.

Functions of a credit rating agency

- Provides unbiased opinion
- Provides quality and dependable information
- Provides information at low cost
- Provide easy to understand information

- Provide basis for investment
- Healthy discipline on corporate borrowers
- Formation of public policy

Advantages of credit rating

- Benefits to investors
- Helps in investment decision
- Assurance of safety
- Recognition of risk and return
- Freedom of investment decision
- Wider choice of investment
- Dependable credibility of issuer
- Easy understanding of investment proposals
- Relief from botheration to known company

Advantages of continuous monitoring

- Benefits of credit rating to company
- Improves corporate image
- Lowers cost of borrowings
- Easy to raise resource
- Wider audience for borrowing
- Good for non-popular companies
- Act as a marketing tool
- Helps in growth and expansion

Other advantages

- Easy understandability of investment proposal
- Choice of instruments
- Save investor's time and effort
- Benefits of rating reviews

Disadvantages of credit rating

- Non-disclosure of important information
- Possibility of existence of bias.
- Problems for new companies
- Stagnant study

- It is not a certificate of soundness
- Impact of changing environment
- Difference in rating
- Rating under adverse conditions
- Dissimilarity in rating grade
- Downgrading by rating agency

Process of credit rating

- Receipt of request
- Assignment to analytical team
- Obtaining information
- Plant visit and meeting with management
- Presentation of findings
- Rating committee meeting
- Communication of decision
- Distribution to public
- Surveillance

Rating methodology

1. **Business risk analysis**

The objective of business risk analysis is to analyses the industry risk, market position of the company, operating efficiency and legal position of the company.

➢ **Industry risk**

The industrial risk is evaluated by credit rating agencies by taking in to consideration various factors like strength of the industry prospect, nature and basis of competition, demand and supply position, structure of industry, pattern of business cycle etc.

➢ **Market position of the company**

Rating agencies assess the market standing of a company For this purpose the following factors are taken into account:

Proportion of market share, Competitive position within the industry, Marketing infrastructure, Competitive advantage, Product lives and competition, Degree of product diversification, Significance of research and development expenditure and new product development, Diversity of products, Quality improvement programs etc.

- **Operating efficiency**

  The operating efficiency of every company is affected by factors like favorable locational advantages, management and labor relationship, cost structure, availability of raw material, labor, complaint to pollution control programs, level of capital employed and technological advantages etc.

- **Legal position**

  The rating agency assesses legal position of a debt instrumental by letter of offer containing conditions of issue, trustees and their responsibilities, means of payment of interest and principal in time, provisions for protection against fraud etc.

- **Size of business**

  There are small and large companies. Smaller companies are more prone to risk due to business cycle changes as compared to larger companies. The operation of smaller companies is limited in terms of capital, product, geographical area and number of customers. But large companies have the benefits of diversification due to wide range of products, customers spread over large geographical area etc.

2. **Financial analysis**

   The objective of financial analysis is to determine the financial strength of the issuing company. It can be done with the help of ratio analysis, cash flow analysis and study of the existing capital structure. It includes an analysis of the following important factors such as:

   - Accounting quality
   - Earnings potential/profitability
   - Cash flow analysis
   - Financial flexibility

3. **Management evaluation**

   A company's performance is affected by the management goals, plans and strategies, capacity to overcome unfavorable conditions, staff own experience and skill, planning and control systems etc. The specific issues include:

- Record to date in financial terms
- Corporate goals and outlook
- Experience, Background, Credibility.
- Depth of Management
- Record compared with peers

4. **Geographical analysis**

   Geographical analysis is undertaken to determine the locational advantages enjoyed by the issuing company. If the issuing company enjoys some locational advantages then, it has a better credit rating.

5. **Regulatory and competitive environment**

   A country's financial system has a structure and regulatory framework. The credit rating agencies evaluate structure and regulatory framework of a financial system in which the company works.

6. **Fundamental analysis**

   It analyses the liquidity management, profitability and financial position, interest and tax rate sensitivity of company.

   - Liquidity management consists of a study of capital structure availability of liquid asset to pay the financial obligations and maturing deposits, corresponding of assets and liabilities.
   - Asset quality covers factors like quality of companies, credit risk management, disclosure to individual borrowers and management of credit related problems etc.
   - Profitability and financial position is indicated by use of funds, revenue on non-fund based activities, addition to reserve and the past profit.
   - Interest and tax sensitivity reveals what is the sensitivity of company if there are changes in tax law and interest rates.

Factors involved in credit rating

- Overall essentials and earnings capacity of the company
- Volatility of the earnings capacity
- Overall macro economics and business environment
- Liquidity position of the company
- Necessity of funds to meet irrevocable commitments
- Financial flexibility of the company to raise funds from outside sources to meet temporary financial needs.
- Guarantee or support from financially powerful outside bodies
- Level of existing leverage and financial risk

Credit rating agencies in India

1. Credit Rating Information Services of India Limited (CRISIL)
2. Investment Information and Credit Rating Agency of India Limited (ICRA)
3. Credit Analysis and Research in Equities (CARE)
4. Duff and Phelps

Credit rating information services of India Limited [CRISIL]

It is the oldest rating agency which was originally promoted by ICICI. It is a global analytical company providing ratings research and risk and policy advisory services. CRISIL was set up in 1987 by ICICI, UTI and other Financial Institutions. The major objectives are restoring the confidence of the investors in the capital market and provide unbiased evaluation of the creditworthiness of companies issuing debt instruments. CRISIL commenced its operation in January 1988 and released its first rating in March 1988. Instruments rated by CRISIL includes bonds, non-convertible debentures, convertible debentures, debenture portion of equity linked debentures, fixed deposits, preference shares and commercial papers. CRISIL has not taken up rating of equity shares. The main objective of CRISIL is to rate debt obligations of Indian companies.

Objectives

- To support the investors for making investment decisions in fixed interest securities
- To guide the investors for making timely payment of interest and principal on a particular debt instrument.
- To help companies to raise fund from a large number of investors at a lesser cost
- To create an awareness about credit rating
- To provide the regulations with a market-driven system in order to ensure discipline and a healthy growth of capital market.

Services or function

- Credit rating services
- Advisory services
- Research and information services
- CRISIL fund services
- The centre for economic research
- Investment research outsourcing

Grades

I. **High Investment Grades:**
   - **AAA (Triple A):** Highest safety - On timely payment of interest and principal.
   - **AA (Double A):** High safety (This symbol shows the minor variation from triple A)

II. **Investment Grades:**

   A: Adequate safety: This rating shows the adverse impact arising out of changed circumstances.

   BBB: Moderate safety: This rating shows the variations caused by changing circumstances weakening the capacity.

III. **Speculative Grades:**

   BB: Inadequate Safety - This rating shows the comparative uncertainty is faced by the issuer.

   B: High risk - This shows adverse business or economic conditions affecting the issuer.

   C: Substantial Risk - This rating shows unfavorable circumstances to develop as it can be default.

   D: This rating shows that such debentures are extremely speculative and return from them can be realized only on reorganization or liquidation.

CRISIL's rating for short term instruments

P - 1: Very strong. This rating shows the degree of safety regarding timely payment on the instrument is very strong.

P - 2: Strong

P - 3: Adequate

P - 4: Minimal. This rating shows adversity affected by short-term adversity or less favorable conditions

P - 5: Default. This rating indicates that the instrument is expected to be in the fault on maturity or is in default.

CRISIL Rating Process:

The rating process of CRISIL begins at the request of a company. An analytical team assigned the task of rating obtains and analysis information, meets the company's management and also interacts with a backup- team which would have collected industry information. The findings are submitted to a rating committee, comprising certain directors who were not connected with any CRISIL shareholder, decides on the rating which is communicated to the company. If company wishes to present some additional information it can do so at this stage. The issuer can also appeal against the rating and ask for a review. During the rating process strict confidentiality of client information is maintained. CRISIL considers the following key factors in its analysis:

- **Business analysis**
  - Industry risk
  - Market position of the company within the industry
  - Operating efficiency of the company
  - Legal position
- **Financial analysis**
  - Accounting quality
  - Earnings protection
  - Adequacy of cash flows
  - Financial flexibility
- **Management evaluation**
  - Track record of management
  - Evaluation of capacity to overcome adverse situations
  - Goals, philosophy and strategies.
- **Regulatory and competitive environment**
  - Structures and regulatory framework of the financial system
  - Trends in regulation, deregulation and their impact on the company.
- **Fundamental analysis**
  - Liquidity management
  - Asset quality
  - Profitability and financial position
  - Interest and tax sensitivity

Investment Information and Credit Rating Agency (ICRA)

It was set up in 1991 by leading financial/investment Institutions, commercial banks and financial services companies as an independent and professional investment information and credit rating agency. The factors that ICRA takes into consideration for rating depend upon the nature of borrowing entity. ICRA examining the natural protective factors, marketing strategy, competitive edge, competence and the effectiveness of management, human resource development, hedging of risk etc.. Besides determining the credit risk associated with a debt instrument ICRA formed a group under Earnings and Prospects and Risk Analysis. Its goal is to provide genuine information on the relative equality of the equity. This requires the examination of almost all parameters pertaining to the fundamentals of the company including relevant the sectoral prospective. ICRA's opinion helps the issuing companies to broaden the market for their equity.

Objectives of ICRA

- To access the credit instrument and reward it a grade consonant to the risk associated with such an instrument.
- To assist investors in making well informed investment decision.
- To assist a issuers in raising funds from a wider investor base.
- To enable banks, investment bankers and brokers in placing debt with investors by providing them with a marketing tool.
- To provide regulators with a market driven system to encourage healthy growth of the capital market.

Services of ICRA

- Rating services
- Credit assessment
- General assessment
- Helps to form an opinion about the risk involved in lending.
- Makes an assessment about the relative degree of capability of small and medium sized units to repay the principal and interest.
- Rating for insurance company claims.
- Information services
- Advisory services
- Grading services

ICRA's rating of financial instruments

ICRA's Long term rating scale

Long term rating scale is used in all bonds, NCDs and other debt instruments with original maturity exceeding one year.

[ICRA] AAA: 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.

[ICRA] AA: Instruments with this rating are considered to have a high degree of safety regarding timely servicing of financial obligation. Such instruments carry very low credit risk.

[ICRA]A: Instruments with this rating are considered to have a adequate degree of safety regarding timely servicing of financial obligation. Such instruments carry low credit risk.

[ICRA]BBB: Instruments with this rating are considered to have a moderate degree of safety regarding timely servicing of financial obligation. Such instruments carry moderate credit risk.

[ICRA]BB: Instruments with this rating are considered to have a moderate risk of default regarding timely servicing of financial obligations.

[ICRA]B: Instruments with this rating are considered to have a high risk of default regarding timely servicing of financial obligations.

[ICRA]C: Instruments with this are considered to have a very high risk of default regarding timely servicing of financial obligation.

[ICRA]D: Instruments with this rating are in default or are expected to be in the fault soon.

Medium - term Rating scale

Medium term rating scales is used for all public deposit programs.

MAAA: The highest accredited quality rating assigned by ICRA. The rated deposits program carries the lowest credit risk.

MAA: The highest credit quality rating is assigned by ICRA. The rated deposits programme carries low credit risk.

MA: Adequate credit quality rating assigned by ICRA. The rated deposits programme carries average credit risk.

MB: The inadequate credit quality rating assigned by ICRA. The rated deposits program carries high credit risk.

MC: Risk prone- credit- quality rating is assigned by ICRA. The rated deposits program carries very high credit risk.

MD: The lowest credit quality rating is assigned by ICRA. The rated instrument has very low prospects of recovery.

ICRA’s short term rating scale

Short term rating scale is used for all instruments with original maturity within one year.

[ICRA]A1: Such instruments carry lowest credit risk.

[ICRA]A2: Such instruments carry low credit risk.

[ICRA]A3: Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

[ICRA]A4: Such instruments carry very high credit risk and are susceptible to default.

[ICRA]D: Instruments with this rating are in default or expected to be default on maturity.

Credit Rating process

- Request
- Assigning a rating team
- Assemble information
- Plant visit
- Meeting key officials and the management team
- Preview meeting
- Rating committee meeting
- Communication
- Review

Credit Analysis and Research in Equity (CARE)

CARE is a credit rating information services company promoted by IDBI jointly with the investment Institutions, banks and finance companies. The company commenced its operation in October 1993. In January 1994 CARE commenced publication of CAREVIEW, a quarterly journal of care ratings.

CARE range of services

- Credit rating
- Information services
- Equity research
- Rating of parallel marketers of LPG and kerosene
- Other services
    - CARE Loan Rating (CLR)
    - Credit Analysis Rating (CAR)
    - Interest Rate Structure Model (IRSM)

Rating process

- Request for rating
- Submit information and detailed schedules
- Interact with team, responds the queries and provides additional data necessary for the analysis
- Assign rating team
- The team analysis the information
- Team interact with the client, undertakes site visits and analyses data submitted by the client
- Rating committee awards rating, rating letter and rational issued to the client.
- Publishes the information of rating in website if it is accepted by the client.

- **Credit rating of debt instruments - Symbols for long and medium term instruments**

CARE AAA: Such instruments carry minimal credit risk.

CARE AA: Such instruments carry very low credit risk

CARE A: Such instruments carry low credit risk.

CARE BBB: Such instruments carry moderate credit risk

CARE BB: Such instruments carry High credit risk

CARE B: Such instruments are susceptible to default.

CARE C: Instruments with this rating are considered to be having very high likelihood of default in the payment of interest and principal.

CARE D: Instruments with this rating are of the lowest category. They are either in default or likely to be in defaulter soon.

- **Credit rating of debt instruments- symbols for short term instruments**

ent of short-term loan obligation and carry lowest credit risk.

PR-2: Loans with this rating would have a greater capacity for timely payment of short-term loan obligations and carry higher credit risk as compared to loans rated higher.

PR-3: Loans with this rating would have moderate capacity for timely repayment of short-term loan obligations at the time of rating and carry higher credit risk as compared to loans rated higher.

PR-4: Loans with this rating would have inadequate capacity for timely repayment of short term loans obligations and carry very high credit risk. Such loans are susceptible to default.

PR-5: The loan is in default or is likely to be in default on maturity.

Leasing

Leasing is a contract made between two parties a landlord and tenant where by the first conveys the right to use the property to the second payment of the rents for a certain time. Completed this period, the lessee has an option to purchase the leased property, paying price determined, return or renew the contract. According to James C. Van Horne, " lease is a contract where by the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset, usually for an agreed period of time in return for the payment of the rent".

Characteristics of lease

- A least transaction is a commercial arrangement whereby an equipment owner conveys to the equipment user the right to use equipment in return for a rental.
- Lease is a contract between the owner of an asset (lessor) and its user (lessee) for a right to use the asset during a specified period in return for a mutually agreed periodic payment (lease rentals).
- The title of the asset remains with the lessor.
- The important feature of a lease contract is separation of the ownership of the asset from its usage.
- Lease is a financial concept.
- It is an arrangement between two parties the leasing company or lessor and the user or lessee whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent.
- The lessee receives the right to total ownership for a spelled out period of time and conditions in return for payments.

Classification of leasing

- Financial lease
- Operating lease
- Leverage lease
- Cross border lease
- Sale and leaseback

Financial lease

Financial lease is also named as capital lease, long term lease, net lease and close lease. A financial lease is a lease that is primarily a method of raising finance to pay for assets rather than a genuine rental. It is a long term lease coinciding with the economic life of the asset and is non-cancellable. At the end of the lease period the lessee has the option to buy the asset. It operates as a long-term debt financing. According to The Institute of Chartered Accountants of India" A lease is classified as financial lease if it is secures for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term".

Financial lease includes the following elements:

- The lessor does not operate the asset he leases, he merely finances it.
- Financial lease put the lessee in the position of a virtual owner.
- The lease is non-cancellable.
- The entire risk incidental to the ownership of the asset and the benefits arising out of the use of the assets are transferred to the lessee. But the legal title may or may not be ultimately transferred.
- The lessor transfers the ownership of the assets or equipment to the lessee at the end of the lease period.
- The lessee has the option to purchase the asset or equipment at a price which is expected to be lower than fair value at the date of option.
- The lease period is for the major part of the economic life of the asset.
- At the beginning of the lease the present value of the minimum lease payment amounts to at least considerably all of the fair value of the leased asset.
- In financial leases the lessor's rate of return is fixed.

Operating lease

An operating lease commonly used to acquire equipment on a relatively short-term basis. Operating lease is a lease contract that allows the use of an asset but it does not convey rights similar to ownership of the asset. For example, a machine which has an economic life of 30 years may be leased to a company for 5 years on an operating lease.

The period of lease is short when compared to the useful life of the asset. As the lease period is short, the lessor can recover the cost of the asset from the multiple lessees. In the case of operating lease, the lessor is responsible for all kinds of maintenance, insurance and all other expenses related to leased asset.

Features of operating lease

- Operating leases may not allow the asset to be virtually exhausted by the same lessee.
- Operating leases do not put the lessee in the position of a virtual owner.
- The lessor does not take asset- based risks and asset-based rewards.
- The lease is either fully cancellable or partly non-cancellable and partly cancellable; meaning the lessee can return the asset and not pay the whole of the lessor's investment.
- Operating leases are non-full payout, meaning the full repayment of lessor's investment is not assured by the lessee.
- In an Operating lease, the lessor may provide any services relating to the asset such as maintenance or operations. In such case the lease is wet lease.
- The risk the lesser takes is asset based risks.
- The lessor's rate of return is dependent upon the asset value, performance or costs relating to the asset.

<u>Difference between operating lease and financial lease</u>

Financial lease	Operating lease
It is a long term arrangement between the lessee and the lessor.	It is a short term arrangement between the lessee and the lessor
All expenses are paid by lessee	All expenses are paid by the lessor
It covers entire economic life of the asset	It does not covers entire economic life of the asset
Lessee cannot terminate or end the lease unless otherwise provided in the contract	Lessee can end the contract any time before expiration date of lease.
Rent paid by the lessee is enough to fully amortize the asset.	Rent paid by the lessee is not enough to amortize the asset.
It is an agreement in which all risks and rewards incidental to ownership of the assets are transferred to lessee from the lessor.	It is an agreement in which all risks and reward associated with the assets are not transferred to lessee and stay with the lessor.
Lessee has to bear the risk of obsolescence	Lessor has to bear the risk of obsolescence
Here, aircrafts, land and building and heavy machines are leased.	Computers, office equipment, automobiles, truck are leased.

Leverage Lease

Under leverage leasing arrangement, a third party is involved besides the lessor and lessee. The lessee borrows a part of the purchase cost of the asset from the third party. A leveraged lease is a lease, in which the lessor puts up some of the money required to purchase the asset and borrowers the rest from a lender. The loan is generally secured by mortgage of the asset besides assignment the leased rental payment. The lessee makes payments to the lessor who makes a payment to the lender. The term may also refer to a lease agreement wherein the lessor, by borrowing funds from a lending institution, finances the purchase of the asset being leased. Here the value of the asset involved is extremely high under lease agreement.

Cross Border Lease

Cross-border leasing is a leasing arrangement where lessor and lessee are situated in different countries. It includes exports leasing. This presents a significant additional issues related to tax avoidance and tax shelters.

Sale and leaseback

A sale and leaseback allows a company to raise money from the sale of assets while retaining use of them but at the cost of increasing operational gearing. The money raised from selling assets may make the company financially stronger, but is commonly used at least in part to return capital to shareholders. It is an arrangement in which one party sells a property to a buyer and the buyer immediately leases the property back to the seller. This arrangement allows the initial buyer to make full use of the asset while not having capital tied up in the asset. Leaseback sometimes provides tax benefit. It is beneficial to both lessor and lessee.

Advantages of Lease

- Leasing provides 100% financing
- Protects against obsolescence
- Flexibility
- Eliminate disposal cost
- Leasing provides fixed rate financing
- Leasing balances usage and cost
- Leasing is convenient
- Leasing is tax-advantaged
- Leasing provide options
- Hedge against risk of obsolescence
- Inflation friendly

- Facilitates additional borrowings
- No large outlay
- Budgeting

Disadvantages of leasing

- No ownership
- Long term expense
- Maintenance
- Not suitable for project finance
- Cost of leasing would be higher than obtaining bank credit to a lessee
- If the lessee is not able to pay rentals regularly the lesser would suffer a loss
- Lease agreement main post some restrictions on the use of the equipment. Thereby making it an economical for the lessee.

Present legislative framework for leasing

- Contract Act
- Motor vehicles Act
- Indian stamp Act

Contract Act

Important elements of a contract:

1. A contract create legal obligation.
2. Each of the parties must give and take something which is legal and moral.
3. The contract should not be void under any law.
4. Parties eligible for leasing must be of 18 years of age and sound mind. There must not be any legal disqualification.
5. A contract may be discharged in different ways and these provisions are applicable to lease agreements.
6. Non-performance of a contract by a party provides for remedial measures in the Contract Act and these provisions are attracted in case of lease agreements also.
7. Payment of monetary compensation and damages, claim for specific performance, lodging a suit for injunction, indemnity and guarantee are all applicable to lease contract.

STOCK EXCHANGE BUSINESS AND PRACTICES

Stock exchange is a market place like any other centralized market for buyers and sellers can transact business in shares and securities at a given point of time in a convenient and the competitive manner at the fairest possible price. The business is done using screen based trading method through duly authorized members of the exchanges. The stock exchange is open to anyone, big or small with the money to invest or securities to sell. Stock exchange is an organized market for free purchase and sale of industrial securities. Secondary markets are also referred to as stock exchange. They are a part of capital market. They assist and control the buying and selling of security.

Features of stock exchanges

- It is a centralized marketplace to trade in securities, which is done through member brokers.
- They are the theatre of trading security.
- They assist to buy and sell security.
- Stock exchange is an auction market.
- It has its own rules and regulations.
- It has facility for genuine speculation
- It has government patronage and control

Functions of stock exchanges

- Provide ready market
- Liquidity and marketability of securities
- Fair price determination
- Safety of funds
- Source for long term funds
- Channelization of funds to profitable ones
- Helps in capital formation
- Reflect the general state of economy
- It induces companies to raise their standard of performance.
- Marketing of new issues.

Services of stock exchanges

Services to investors

- Provide ready market for purchase and sale of securities
- It help the investor to assess the value of investment
- Help in the investor to select the securities which are most profitable.
- It prevented the companies from intruding the rights of the shareholders by making rigid listing provisions.

Services to companies

- It helps to enhance credibility of the companies by listing their shares
- It helps the company in sensing market responses.
- It helps the companies to distribute its securities in a wide geographical area.
- Listing helps to have a higher price for their securities.

Services to community

- It helps to promote economic development of country
- It widens the market for securities and stabilizes the price of securities
- Helps in capital formation.

Organization of stock exchanges in India

Management

The management of the stock exchange is vested with a group of persons known as 'governing body' or committee of management. The governing body consists of elected member directors from stock broker members, public representatives, and the nominees of the government/SEBI. The government has powers to nominated president/ presidents and vice President of the stock exchange. The day-to-day administration of the exchange is vested with an executive director appointed by the government and the president elected by the governing body. The governing body is the supreme authority of exchange which we can make rules and the by-laws of the exchange in compliance with the government/SEBI guidelines. The administration of stock exchange and the regulation of trading are done through a number of working committee.

Membership

Stock exchange permits only its numbers to transact business in listed security. Stock exchange has its own rules relating to admission of members. A person should possess the following qualifications to become a member of the stock exchange:

- He should be a citizen of India
- He should be less than 21 years of age
- He should not have been adjudged bankrupt or insolvent and should not be convicted for fraud or dishonesty.
- He should not be engaged in any other business or employment, except as an agent of the broker.
- He should not have been expelled by any other stock exchange or declared as a defaulter by any other stock exchange.

Listing of securities

Listing means the enrollment of a name of company in an official list maintained in the stock exchanges. These securities are only allowed to be traded in stock exchanges. Unlisted securities are not traded in the recognized stock exchanges. Listing is compulsory in the case of companies which are intended to offer shares or debentures for public issue through the issue of prospectus. The SEBI insists public limited companies for listing while granting permission of new issues to them. Listed companies are required to submit themselves to the various regulatory measures of the stock exchanges concerned as well as SEBI.

Advantages of listing

- High liquidity
- Helps to know the performance
- Get regular information
- Tax advantages
- Facilitates buying and selling
- Helps to raise finance
- Protect the investors
- Fair price
- Good collateral security

Limitations

- Speculation
- No regular price quoting
- Large amount of listing fees
- Information to competitors

Delisting

It may be two types namely voluntary delisting and compulsory delisting. Voluntary delisting means delisting of securities of a body corporate voluntarily by a promoter or an acquirer or any other person other than the stock exchanges. A company may delist from stock exchanges where its securities are listed, provided that:-

- The securities of the company have been listed for a minimum period of 3 years on any stock exchange.
- An exit opportunity has been given to the investors for the purpose of which an exit price shall be determined in accordance with the "book building process"".

Procedure for voluntary delisting

- Obtain the prior approval of shareholders of the company by a special resolution
- Make a public announcement about the delisting
- Make an application to the delisting exchange in the form provided by the exchanges.
- Comply with such other additional conditions as may be specified by the concerned stock exchanges.

Compulsory delisting

Compulsory delisting means delisting of the securities of a company by a stock exchange. The stock exchanges may be listed companies which have been suspended for a minimum period of six months for non-compliance with their listing agreement. Before suspending the dealings in securities the company is given an opportunity of being heard by the stock exchange.

Trading in stock exchanges

- **Auction trading system**

  It is also known as order driven trading system. The trading in securities is done on the floor of the stock exchanges on the basis of auction. Hear customers buy or sell orders reach a central point where they are matched. This system allows the buyer and the seller to find a mutually agreeable price with no intervention from the broker-dealers. If the buyers and sellers quotations are matched, the transactions are to be carried out.

- **Quota driven system**

  Under this system transaction take place between a broker and dealer. The dealers compete with each other to provide the customer the best competitive price. It is a negotiated market.

  The market maker announces two way quotes continuously. One for buying price and other for selling price.

Listing procedure

Criteria for listing

- At least 60% of each class of securities issued must be offered to the public for subscription and the minimum capital issued should be rupees 3 crores.
- The minimum public offer for public subscription must be at least 25% of issued capital and it must be offered through advertisement in newspaper at least for a period of two days.
- The company should be a fair size having broad-based capital structure and public interest in it securities.
- There must be at least 10 public shareholders for every one lakh shares of fresh issue of capital and it is 20 in the case of subsequent issue of shares.
- If the issued capital exceeds 5 crores the company has to make arrangements to enlist the securities in one more stock exchanges.
- If the excess share application money not refunded within 10 weeks from the closure of subscription list the company must pay interest on the excess application received at the rates of ranging between 4% and 15%.
- The memorandum and articles of association of the company must contain prescribed for permissions.

Obligations

- Annual listing fees
- Notice of board meeting
- Publish of quarterly results
- Approval of unaudited quarterly results
- Preparation of the half yearly results
- Book closure notice
- Circulation of closure of registers
- Notice of general meetings
- Annual General Meeting
- Changes in directors/auditors/ management
- Details of holding and transfer of shares
- Certificate of issue of certificates
- Information of events.

Method of trading in stock exchanges

Manual trading

It involves the following steps: -

- Choose brokers
- Placing the order
    - At best order or market order
    - Limit order
    - Immediate/Cancel order/ Discretionary order
    - Limited discretionary order
    - Open order
    - Stop loss order
- Execution of orders
- Preparation of the contract notes
- Settlement of transactions
    - Sport delivery settlement
    - Hand delivery settlement
    - Clearing settlement
        - Special delivery settlement
        - T+2 settlement

Badla Mechanism

Badla session is conducted every Saturday in Mumbai, Delhi, and Ahmedabad and on Thursday at the Calcutta stock exchange. The outstanding positions of various stocks are listed along with the quantities outstanding. The carry forward rates are determined on the basis of the demand and supply of money. If the market is overbought, it results in vyaj badla. When the market is oversold or when in a particular stocks the short position is more, the Undha Badla is applied. Badla is normally done for a period of seven days. Hence the money could easily be pulled back within 15 days from the day of intimation, if required.

Contango

It is also known as „Seedha Badla" in Indian stock exchanges. When a bull buys in anticipation of an immediate rise in price, but finds at the end of the trading circle that the price has not risen, he may both pay for the shares and take delivery, or he may carry over his transactions to the next trading cycle by paying carry over charges or "Seedha Badla" to the seller. This Badla is financed by the Badliwalla.

Hawala Rates

Hawala rate is the prices at which buyers and sellers are settle their speculative transactions at the end of the settlement on any exchange. It becomes the basis to buy and sell for the investor opting for carry forward during the next settlement. This price is fixed by taking the weighted average of trades in the last half an hour of trading on the settlement day for securities in the carry forward list also known as the a group or a specified group.

Online Trading

Online trading is the mechanism of buying or selling securities through the internet. A number of transactions are involved in online trading. The client places an order why the net by logging onto this brokers site. The broker accepts and executes the orders and replaces it with the exchange.

Merits of online trading

- Ensures the best price for investors
- Offers liquidity
- Offers greater transparency
- Enables pester free trading
- Allows quick trading
- Reduces the settlement risk
- Access of information

Investors in stock market

Genuine investors: They are taking delivery of shares and give delivery without the intention of deal in carry forward transactions. Their main aim is to get long term gains. **Speculators:** They are not taking delivery or do not give shares. They deal in differences in the purchase and sale prices. Their main aim is to carry forward the transactions to the next settlement period to make a short term gain.

Types of speculators

- Bull/Tejiwallas
- Bear/Mandiwallas
- Badla financiers
- Stag
- Wolves
- Lame duck

Difference between speculators and genuine investors

Genuine investors	**Speculative investors**
Investors buy and sell securities occasionally	Buy and sell securities continuously
Investors deals in securities in expectation of a regular income.	Speculator aims to earn quick capital profit due to the fluctuation in the price of securities.
Investors look on the performance of the company to invest in securities.	They consider the market price fluctuations of the price of the securities
Investor does not like to bear a heavy risk	Speculators bear high risk
Investors gives and takes delivery of shares	Speculators do not take or give delivery of securities.

Speculative transactions

Speculation can be carried out on any one of the transactions: -

- Option dealings
    - Call option
    - Put option
    - Double option

Margin trading

Borrowing money from a bank or a broker to execute a securities transaction is referred to as using “margin”.

Cornering

The entire supply of a particular security is held by an individual or group of individuals. It indicates that the markets for the securities are cornered by them. This is called cornering. Due to its defects it is prohibited.

Rigging

It is a process of creating an artificial condition in the market to enhance the price of certain securities. Speculators purchase certain securities continuously to hike price of securities in the market.

Blank transfer

It is not a speculative transaction but it can be used for speculative purpose. The seller simply signs the transfer deed without mentioning the name of the transferee. So it can be transferred any number of time. It is called a blank transfer.

Wash sales

It is the sale of securities and immediate repurchase of the same for the purpose of realising more capital gain. The same securities bought from another broker at a high price. Due to this misleading picture, the price of the securities rises. He sells the securities now at a higher price and makes good profit.

INSURANCE

Insurance is a contract between two parties where by one party agrees to undertake the risk of another in exchange for consideration known as premium and promises to pay a fixed sum of money to the other party on happening of an uncertain event/death or after the expiry of a certain period in case of life insurance or to indemnify the other party on happening of an uncertain event in case of general insurance.

In the words of John Megi "insurance is a plan where in persons collectively share the losses of risk".

Parties of insurance

- Insured
- Insurer
- Insurance policy
- Premium
- Indemnity
- Beneficiary

Features of insurance

- Contract
- Consideration
- Cooperative endeavor
- Protection of monetary risks
- Good faith
- Contract of indemnity

Functions of insurance

- **Primary functions**
  - Providing protection
  - Collective risk bearing
  - Evaluating risks
  - Provide certainty
- **Secondary functions of insurance**
  - Preventing losses
  - Covering larger risk with small capital
  - Helps in the development of larger industries
  - Provides capital

- **Other functions of insurance**
    - It is a savings and investment tool
    - Medium of earning foreign exchange
    - Risk free trade

Purpose and need for insurance

- Spread the cost of losses
- Reduces the need for individual Insurance funds
- Provides investment capital for governments and industry
- Encourages loss prevention activities

Role of insurance in financial framework

- Investment for economic development
- Providing capital to infrastructure and other long term investment
- Benefit of Insurance to business and trade
- Companies are protected from the consequences of the loss
- Encourages the businessman to invest freely in business enterprises
- Routes for long term wealth creation
- Insurances services a number of valuable economic functions
- Insurance contributes positively to economic growth
- Strong complementarily between insurance and banking
- Insurance enables risk averse individuals and entrepreneurs to undertake higher risk

Elements of general contract

- Offer and acceptance
- Legal relationship
- Consensus ad idem
- Competency of parties
- Free consent
- Lawful consideration
- Legal objective

Basic principles of insurance

- **Insurable interest**

  Contract of insurance means that the insured must have an actual precautionary interest and not a mere anxiety or sentimental interest in the subject matter of the insurance. The insured has an insurable interest in the object or in the life of the insured person. A person is said to have an insurable interest in the property, if he is financially benefited by its existence and is biased the by its loss, destruction or nonexistence. No person can enter into a valid contract unless he has insurable interest in the subject matter of insurance.

- **Principle of utmost good faith**

  The contracts of insurance are contracts of Ubereimae fidei. It is essential that there must be utmost good faith and mutual confidence between the insured and the insurer. In a contract of insurance, the insured knows more about the subject matter of the contract than the insurer. So his duty is to disclose accurately all material facts and nothing should be withheld or concealed. However the following facts are not required to be disclosed by the insured: -

  - Facts that may tend to reduce the risk
  - Facts which the insurer knows already
  - Facts of public knowledge
  - Facts waived by the insurer
  - Facts governed by the conditions of the policy
  - Facts which could have been secondary from the information supplied by the insured.

- **Principles of indemnity**

  A contract of insurance is contained in a fire, marine, burglary or any other policy (except life assurance and personal accident and sickness) is a contract of indemnity. Here the insured in case of loss against which the policy has been issued shall be paid the actual amount of loss not exceeding the amount of the policy. The maximum amount of compensation does not exceed the amount of actual loss or the value of the policy whichever is less. The object of every contract of insurance is to place the insured in the same financial position as nearly as possible after the loss as if the loss had not taken place at all. It would be against public policy to allow an insured to make a profit out of his loss or damage. The principle of indemnity does not apply to life insurance and other personal accident insurance because loss of one individual life cannot be measured in terms of money.

Features of the principle of indemnity

- All contracts of insurance except the life insurance, personal accident insurance are contract of indemnity.
- The amount of indemnity should not exceed the amount of actual loss or the value of the policy whichever is lower
- The marine insurance is not a pure indemnity contract
- The doctrine of subrogation is applied after the settlement of the claims Valued policies accepted marine insurance are not covered under the scope of the principle of indemnity.

Conditions

- It is the duty of the insured to prove that he will suffer loss on the insured subject matter at the time of happening of event and the loss is actual monetary loss.
- Indemnification should do not be more than the amount insured.
- If the insured get more amount than the amount insured, then the insurer has the right to get back the excess amount paid.
- If the insured get an amount from third party after receiving the full amount of indemnity, then the insurer have the right to receive full amount paid by the third party.
- The principle of insurance is not applied in the case of personal and life insurance because the amount of loss cannot be calculated easily.

Method of indemnity

- Cash payment
- Repair
- Reinstatement
- Replacement

Principle of subrogation

"The doctrine of subrogation is corollary to the principle of indemnity and applies only to fire and marine insurance. It is also known as "doctrine of rights substitution". According to it, when an insured has received full indemnity in respect of his loss, all rights and remedies which he has against third person will pass on to the insurer and will be exercised for his benefit until insurer recoups the amount he has paid under the policy. It must be clarified here that the insurer's right of subrogation arises only when he has paid for the loss for which he is liable under the policy and this right extend only to the rights and remedies available to the insured in respect of the things to which the contract of insurance relates.

Features of subrogation

- It is an extension of the principle of indemnity
- It is applicable to all contracts of indemnity
- It arises only after the payment of the claim by the insurer to the insured.
- The rights of subrogation may arise even before indemnification of the insured except in the case of marine insurance.
- Here the insurer has the right to sue against third party.
- If the insured get any money as compensation after indemnification, the insured can hold that amount of compensation as a trustee for the insurer.
- Here insurer cannot recover anything more than the amount of indemnification paid to the insured.

Principle of Causa

The term Causa Proxima means nearest or proximate or immediate cause. It means that the cause of the loss must be proximate or immediate and not remote. If the real cause of the loss is insured, the insurer is liable to pay compensation. Otherwise the insurer is not liable to pay compensation. Proximate cause means the active, efficient cause that sets in a motion of events which bring about a result.

Principle of Mitigation of loss

The insured must take all necessary steps to mitigate or minimize the loss just as any prudent person would do in those circumstances. If he does not do so, the insurer can avoid the payment of loss attributable to his negligence. But it must be remembered that through the insured is bound to do his best for his insurer, he is not bound to do so at the risk of his life. Mitigation of loss means to minimize or reduce the severity of loss.

Principle of contribution

It is an outcome of the principle of indemnity. Where there are two or more insurance on one risk, the principle of contribution comes into play. The aim of contribution is to distribute the actual amount of loss among the different insurers who are liable for the same risk under different policies in respect of the same subject matter. Any one insurer may pay to the insured the full amount of the loss covered by the policy and then become entitled to contribution from his co- insurers in proportion to the amount which each has undertaken to pay in the case of loss of the same subject matter.

Warranty

A warranty in a contract of marine insurance is substantially the same as a condition in a contract of sale of goods. These are the conditions and promises in the insurance contract. It gives the aggrieved party the right to avoid the contract. Warranty is an important condition in the insurance contract which is to be fulfilled by the insured. There are two types of warranties. Expressed warranties and implied warranties.

Express warranties

An express warranty is one which is expressly stated in the policy of insurance it must be included in or written upon the policy. There is no limit to the number of express warranties.

Implied warranties

Implied warranties or conditions not incorporated in a policy but assumed to have been included in the policy by law, custom or general agreement. These warranties are: -

- Seaworthiness
- Legality of the voyage
- Non deviation

Reinsurance

In order to safeguard his own interest, he may insure the same risk, either wholly or partially with other insurers, thereby spreading the risk. This is called reinsurance. Re-insurance can be resorted to in all kinds of insurance and a contract of re-insurance is a also a contract of indemnity.

Double Insurance

When the insured insures the same risk with the two or more independent insurers and the total sum insured exceeds the value of the subject matter the insured is said to be over insured by double Insurance. Both double Insurance and over insurance are perfectly lawful unless the policy otherwise provides.

Auto Insurance

Auto insurance is designed to help to pay for repairs or replacement in the event of an accident. It may also cover medical cost for a driver or passengers or even those for individuals in other vehicle if the insured is deemed to be default. It also covers a vehicle in the event of theft or other forms of damage depending on the chosen policy.

Disability insurance

It may protect the insured from financial ruin if he is injured or disabled and can no longer work. This type of insurance is made to help with the monthly living expenses and health care expenses not covered by a health insurance policy.

Homeowner's insurance

It helps to cover losses of a home or property due to fire, natural disaster, faulty electrical work, bad plumbing and more. If the insured have a mortgage he will most likely to be required to carry some form of homeowner's insurance.

Motor vehicle insurance

Long-Term Care Insurance

It is designed for those diagnosed with chronic illness and the elderly. It may help to provide for nursing home or at home health care.

Miscellaneous or Liability insurance

It refers to contracts of insurance other than these of life, fire and marine insurance.

- Personal accident insurance
- Property insurance
- Liability insurance
    - Public liability insurance
    - Professional negligence insurance
    - Compulsory insurance
    - Employer's liability insurance
    - Guarantee insurance

Kinds of insurance

- Life insurance
- Fire insurance
- Medical insurance
- General insurance
- Marine insurance

Kinds of marine policies

- Voyage policy
- Time policy
- Mixed policy
- Valued policy
- Open or unvalued policy
- Floating policy

Module -5

DERIVATIVE

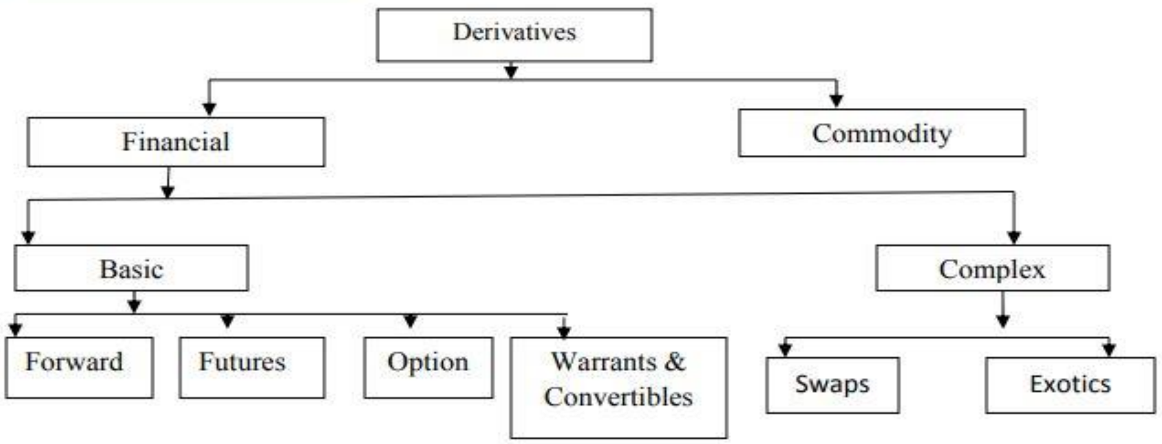
'Derivative' includes– Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security. A contract which derives its value from the prices, or index of prices of underlying securities. There are two types of derivatives. Commodity derivatives and financial derivatives. Firstly derivatives originated as a tool for managing risk in commodities markets. In commodity derivatives, the underlying asset is a commodity

Features of financial derivatives

1. It is a contract
2. Derives value from underlying asset
3. Specified obligation:
4. Direct or exchange traded
5. Related to notional amount:
6. Delivery of underlying asset not involved
7. May be used as deferred delivery:
8. Secondary market instruments
9. Exposure to risk

Types of financial derivatives

Derivatives are of two types: financial and commodities.



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

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

Options: Options are of two types– calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date.

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

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

The two commonly used swaps are:

•Interest rate swaps: These entail swapping only the interest related cash flows between the parties in the same currency

•Currency Swaps: These entail swapping both principal and interest on different currency than those in the opposite direction.

REFERENCE

1. ***Dr. K. VENUGOPALAN****, (2016), Indian financial system, Revised 1st edition, Calicut university central co-operative store ltd.*
2. ***Dr. C.K. FRANCIS, (2014),*** *Indian financial system , Revised second edition, Excel publishers.*