Financial Services

Ninth Edition

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Preface to the Ninth Edition

We are pleased to present to the readers the ninth thoroughly revised edition of our highly successful reference-cum-textbook: **Financial Services.** Like the earlier editions, the focus of this edition continues to be on presenting to the readers the current status of the financial services sector/industry in the country reflecting/updating the notable policy and operational developments since its publication in 2015. It comprehensively covers the significant developments till end-March 2017.

The specific policy/operational/regulatory developments pertaining to the individual financial services are incorporated in appropriate places in each chapter. They are too numerous to be listed. The chapter-wise notable features of the revision are highlighted below.

Chapter-wise Additions/Deletions

The chapter-wise additions/deletions are listed as under:

- **Chapter 1: (a)** Section 2 on NBFC-ND-SI/NBFC-D RBI Directions, completely rewritten to reflect the 2016 directions; **(b)** Section 3 on RBI NBFC-ND Directions, completely rewritten to reflect 2016 directions; **(c)** Section 4 on NBFC-MFI RBI Directions, deleted; **(d)** Section 6 on RBI CICs Directions completely rewritten to reflect 2016 directions; **(e)** Section on NBFC-IFD RBI Directions, deleted.
- **Chapter 5: (a)** Deletion of Directions to Auditors in Section on NHB Directions to NHB HFCs Directions; **(b)** Addition of Section on Auditor's Report Directions; **(c)** Addition of Section on HFCs Corporate Report Directions; **(d)** Section on Mortgage Guaranteed Companies rewritten completely.
- **Chapter 6:** Complete rewriting of IRDA regulations relating to: **(a)** Registration of Corporate Agents; **(b)** Appointment of Insurance Agents; **(c)** Registration of Indian Insurance Companies; **(d)** Health Regulations to reflect the 2016 regulations.
- **Chapter 11: (A)** Addition of SEBI regulations relating to: **(a)** Conditions/Manner of Providing Exit Opportunity to Dissenting Shareholders, **(b)** Listing on Institutional Trading Platform, **(c)** Listing of Securities on Stock Exchanges; **(B)** Deletion of SEBI Listing and Issue of Capital by Small and Medium Enterprises on Institutional Trading Platform without Initial Public Offering.

Website Material

Additional reading material listed below is available on the book's website:
http://www.mhhe.com/khanfs9e

Appendix	*Chapter*	
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1-B		Interest Rate Sensitivity
1-C		Statement of Structural Liquidity
1-D		Statement of Interest Rate Sensitivity
1-E		Statement of Short-term Liquidity
2-A	(2)	Leasing and Hire-Purchase Glossary
2-B		Contract Act
2-C		Comprehensive Case: ARQ Ltd.
2-D		Sale and Lease-back Transactions that Result in Operating Leases
4-A	(4)	Comprehensive Case: Smart Chip Hardware Company
5-A	(5)	Guidelines for Extending Equity Support to HFCs
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5-D		Reverse Mortgage Loan: Operational Guidelines
5-E		Guidelines on Fair Practices Code for Housing Finance Companies
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6-E		Contract Between Issuer, Principal/Chief/Special Agent(s)
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Pedagogical Features

The new edition retains the following reader-friendly pedagogical features of the earlier edition.

- **Learning Objectives** Every chapter begins with a number of learning objectives to ensure broad understanding of the chapter-contents.
- **Flow Chart Exhibits** At the beginning of each chapter, these provide to the readers an overview of the contents.
- **Margin Notes** Throughout the text, margin notes in shaded bars define the important concepts and key terms when they are first introduced in the text. They would enable the readers to reinforce their learning.

- **Recapitulation** The chapter-end comprehensive summaries would provide to the readers a bird's eyeview of the main points by way of recapitulation.
- **Review Questions** The review questions would help the readers to test their understanding of the concepts, theories, techniques and procedures.
- **Cases** The mini cases can be used by the readers to synthesise and apply the related concepts, theories, techniques and procedures. The Comprehensive Cases available on the website are additional resources for the same purpose.

Acknowledgements

The main sources of the revision material are the publications of the RBI, SEBI and IRDA. We gratefully record our deep debt of gratitude for the same.

A word of appreciation is due to Prof. P.K. Jain, Department of Management Studies, IIT-Delhi who has contributed to my endeavours in innumerable ways.

The unstinted cooperation and support from editorial and production teams of McGraw Hill Education (India) has in no small measure contributed to the speedy and excellent publication of the book. I thank them all.

Suggestions from readers for improvement are welcome.

M Y KHAN

Preface to the First Edition

Fnancial Services is a complementary volume to my earlier book *Indian Financial System* published by Tata McGraw-Hill Publishing Company Ltd. A natural concomitant of the development of a sophisticated and matured financial system in the country, particularly since the early nineties, has been the emergence of an articulate financial services sector. In fact, the efficiency of the emerging financial system primarily depends upon the quality and range of the package of financial services largely provided by the non- banking financial companies. Although some of these services in India are at a nascent stage, they represent developments of considerable significance for the financial systems.

Financial services fall broadly into two groups: fund/asset-based and fee-based/advisory. This book covers both types of services. While the thrust of the book is on analytical framework, both from the point of view of the non-banking financial intermediaries/companies which provide the services as well as their users, the legal, procedural, tax, accounting and regulatory aspects are also comprehensively discussed. To aid and test the learning process, illustrative problems and review questions have also been included in the text. A unique feature of the book is that it provides a judicious mixture of theory and business practices of the contemporary Indian financial services sector. Its contents have been class-tested with my students in the Department of Financial Studies, University of Delhi, as well as in several executive development programmes.

The book is designed primarily for teachers and advanced students of finance, management, commerce and accounting. The practising professionals would find it extremely useful.

The book is divided into five parts, each part dealing with different segments of the financial services sector. Part one provides an overview of the non-banking financial companies (NBFCs) within the framework stipulated by the RBI (Reserve Bank of India) Act and the RBI directions.

The four chapters of Part two are concerned with lease financing as an asset-based financial service. The theoretical/conceptual and regulatory aspects of lease financing are described in Chapters 2 and 3 respectively. Chapter 4 presents the relevant aspects of taxation and financing of leasing companies. In view of the special nature of lease financing, the accounting and reporting framework in terms of IAS-17 (International Accounting Standard) and ICAI (Institute of Chartered Accountants of India) guidance notes is illustrated in Chapter 5. The evaluation of lease transactions/arrangements from the point of view of both the lessees and the lessors is the theme of Chapter 6.

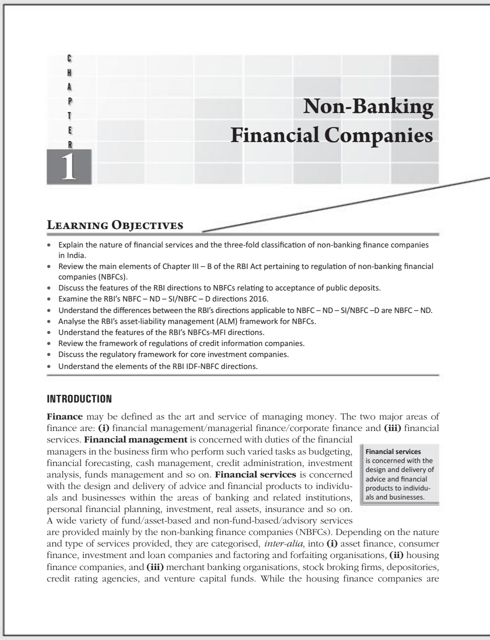
The other fund-based financial services is covered in Part three of the book. The legal, analytical and regulatory aspects of hire-purchase finance and consumer credit are examined in Chapter 7. While Chapter 8 evaluates the emerging factoring services in the country, bills discounting as a fund-based activity is covered in Chapter 9. Housing finance, insurance services and venture capital financing are comprehensively analysed in Chapters 10-12.

Apart from asset-based services, the emerging financial services sector in India also provides fee based/advisory services to corporate enterprises. Part four deals with merchant banking. Chapters 13 and 14 cover the entire gamut of the institutional and operational framework of merchant banking in India. The new issue management procedure is summarised in Chapter 15. One of the most popular merchant banking activities namely, mergers and acquisitions, is comprehensively analysed in Chapter 16.

The other advisory services constitute the subject-matter of Part five of the book. Stockbroking and credit rating are discussed in Chapters 17 and 18 respectively.

M Y Khan

Visual Walkthrough ····➜



C H A P T E R 1

Non-Banking Financial Companies

Learning Objectives

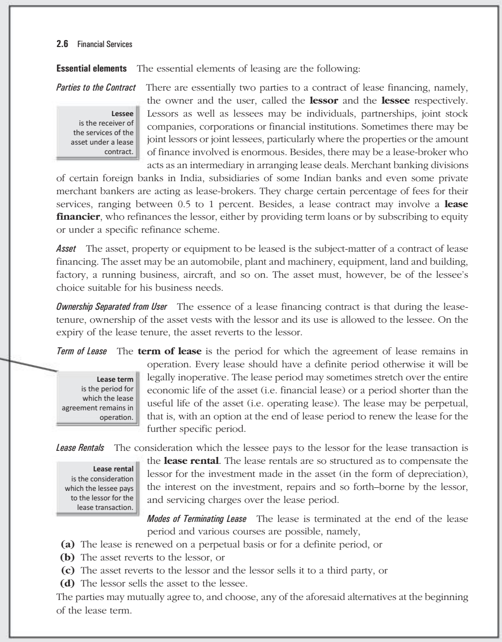
- Explain the nature of financial services and the three-fold classification of non-banking finance companies in India.
- Review the main elements of Chapter III – B of the RBI Act pertaining to regulation of non-banking financial companies (NBFCs).
- Discuss the features of the RBI directions to NBFCs relating to acceptance of public deposits.
- Examine the RBI's NBFC – ND – SI/NBFC – D directions 2016.
- Understand the differences between the RBI's directions applicable to NBFC – ND – SI/NBFC –D are NBFC – ND.
- Analyse the RBI's asset-liability management (ALM) framework for NBFCs.
- Understand the features of the RBI's NBFCs-MFI directions.
- Review the framework of regulations of credit information companies.
- Discuss the regulatory framework for core investment companies.
- Understand the elements of the RBI IDF-NBFC directions.

INTRODUCTION

Finance may be defined as the art and service of managing money. The two major areas of finance are: **(i)** financial management/managerial finance/corporate finance and **(iii)** financial services. **Financial management** is concerned with duties of the financial managers in the business firm who perform such varied tasks as budgeting, financial forecasting, cash management, credit administration, investment analysis, funds management and so on. **Financial services** is concerned with the design and delivery of advice and financial products to individuals and businesses within the areas of banking and related institutions, personal financial planning, investment, real assets, insurance and so on. A wide variety of fund/asset-based and non-fund-based/advisory services are provided mainly by the non-banking finance companies (NBFCs). Depending on the nature and type of services provided, they are categorised, *inter-alia*, into **(i)** asset finance, consumer finance, investment and loan companies and factoring and forfaiting organisations, **(ii)** housing finance companies, and **(iii)** merchant banking organisations, stock broking firms, depositories, credit rating agencies, and venture capital funds. While the housing finance companies are

Financial services is concerned with the design and delivery of advice and financial products to individuals and businesses.

Learning Objectives: To acquaint the readers with the contents of the chapter, so that they are aware of what all they should expect to know at the end of it.



2.6 Financial Services

Essential elements The essential elements of leasing are the following:

Parties to the Contract There are essentially two parties to a contract of lease financing, namely, the owner and the user, called the **lessor** and the **lessee** respectively. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial institutions. Sometimes there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous. Besides, there may be a lease-broker who acts as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and even some private merchant bankers are acting as lease-brokers. They charge certain percentage of fees for their services, ranging between 0.5 to 1 percent. Besides, a lease contract may involve a **lease financier**, who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

Lessee is the receiver of the services of the asset under a lease contract.

Asset The asset, property or equipment to be leased is the subject-matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft, and so on. The asset must, however, be of the lessee's choice suitable for his business needs.

Ownership Separated from User The essence of a lease financing contract is that during the lease-tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

Term of Lease The **term of lease** is the period for which the agreement of lease remains in operation. Every lease should have a definite period otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e. financial lease) or a period shorter than the useful life of the asset (i.e. operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further specific period.

Lease term is the period for which the lease agreement remains in operation.

Lease Rentals The consideration which the lessee pays to the lessor for the lease transaction is the **lease rental**. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the interest on the investment, repairs and so forth–borne by the lessor, and servicing charges over the lease period.

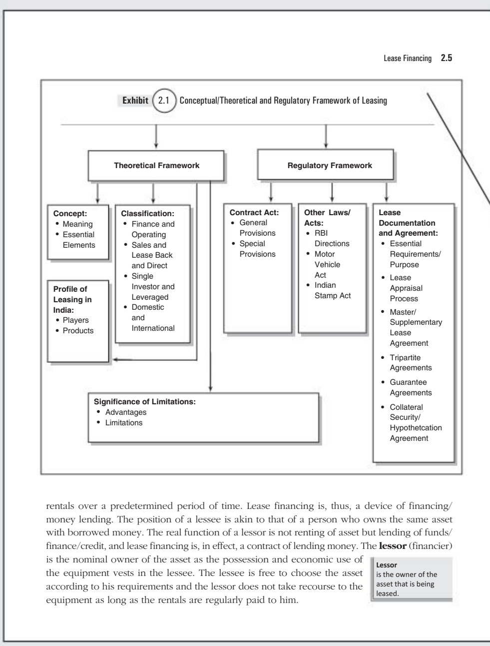
Lease rental is the consideration which the lessee pays to the lessor for the lease transaction.

Modes of Terminating Lease The lease is terminated at the end of the lease period and various courses are possible, namely,

(a) The lease is renewed on a perpetual basis or for a definite period, or
(b) The asset reverts to the lessor, or
(c) The asset reverts to the lessor and the lessor sells it to a third party, or
(d) The lessor sells the asset to the lessee.

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

Margin Notes: Brief notes in the text margins, these are definitions of important concepts and key terms, to enable the readers to reinforce their learning.



Lease Financing 2.5

Exhibit 2.1 Conceptual/Theoretical and Regulatory Framework of Leasing

Theoretical Framework
Regulatory Framework
Concept:
• Meaning
• Essential Elements
Classification:
• Finance and Operating
• Sales and Lease Back and Direct
• Single Investor and Leveraged
• Domestic and International
Profile of Leasing in India:
• Players
• Products
Significance of Limitations:
• Advantages
• Limitations
Contract Act:
• General Provisions
• Special Provisions
Other Laws/ Acts:
• RBI Directions
• Motor Vehicle Act
• Indian Stamp Act
Lease Documentation and Agreement:
• Essential Requirements/ Purpose
• Lease Appraisal Process
• Master/ Supplementary Lease Agreement
• Tripartite Agreements
• Guarantee Agreements
• Collateral Security/ Hypothetcation Agreement

rentals over a predetermined period of time. Lease financing is, thus, a device of financing/money lending. The position of a lessee is akin to that of a person who owns the same asset with borrowed money. The real function of a lessor is not renting of asset but lending of funds/finance/credit, and lease financing is, in effect, a contract of lending money. The **lessor** (financier) is the nominal owner of the asset as the possession and economic use of the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor does not take recourse to the equipment as long as the rentals are regularly paid to him.

Lessor is the owner of the asset that is being leased.

Exhibits (Flow Charts): Impact making visual representations of contents to make them crystal clear to the reader.

Illustrations: To elaborate on a concept, to make them clearer and easier to understand; specially useful in case of the more difficult portions of the subject.

hire-asset stock-in trade or as receivables. Secondly, the hirer should be entitled to the depreciation claim. Finally, the hire charges, like the lease rental in a financial lease, have two components: **(i)** interest/finance charge, **(ii)** recovery of principal. But there is no accounting standard/ guidelines note for accounting treatment of hire-purchase in India. There is also no specific law/ regulation to govern hire-purchase contracts. The issues/aspects which have a bearing on the accounting and reporting of hire-purchase deals are the timings of the capitalisation of the asset **(inception *vs* conclusion of the deal)**, the price, the depreciation charge and the treatment of hire-charges. This Section highlights the prevalent accounting practices relating to hire-purchase transactions in the books of the hirer as well as the hire-vendor.

In the Books of the Hirer

The cash purchase price of the asset is capitalised and the capital content of the hire-purchase installment, that is, the cash purchase price less down payment, if any, is recorded as a liability. The depreciation is based on the cash purchase price of the asset in conformity with the policy regarding similar owned assets. The total charge for credit (unmatured finance charge at the inception of the hire-purchase transaction/deal) is allocated over the hire-period, using one of the several alternative methods, namely, effective rate of interest method, sum-of-the-years-digits method and straightline method. The mechanisms of accounting and reporting is shown in Illustration 3.1.

Illustration 3.1

Under a hire-purchase deal structured by the Hypothetical Finance Ltd (HFL) for the Hypothetical Industries Ltd (HIL), the HFL has offered to finance the purchase of an equipment costing ₹150 lakh. The (flat) rate of interest would be 13 per cent. The amount would have to be repaid in 48 equated monthly installments in advance. The HIL is required to make a cash down payment of 25 per cent. It uses WDV method of depreciation @ 30 per cent on similar assets.

From the foregoing information, you are required to show: **(A)** the allocation of total charge for credit (finance charge), on the basis of **(1)** effective rate of interest (ERI)/annual percentage rate (APR) method, **(ii)** sum-of-year's-digits (SOYD) method and **(iii)** straight line method (SLM) of depreciation; **(B)** how the deal will be recorded in the financial statements (profit and loss account and balance sheet) of the hirer (HIL) in the first two years. You can make, if necessary, your assumptions.

Solution

(A) (i) Allocation of Total Charge for Credit: ERI/APR Method *(₹ lakh)*

Year	*Outstanding amount at the beginning*	*Interest content*	*Capital content/ recovery*	*Annual installment (3.5625 × 12)*
1	112.50	23.54	19.21	42.75
2	93.29	18.52	24.22	42.75
3	69.06	12.20	30.55	42.75
4	38.52	4.22	38.53	42.75

- The provisions of the RBI NBFC – SI – ND/NBFC – D directions aply to the NBFC-Factor. Some additional provisions are also applicable to them: **(i)** registration, **(ii)** not owned fund, **(iii)** principal business, **(iv)** conduct of business, **(v)** asset classification, **(vi)** risk management, and **(vii)** import-export factoring.
- NBFC-Factors, intending to deal in forex through export/import factoring, should seek necessary authorisation to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA/rules/regulations/ notifications/directions/orders.
- For an NBFC-Factor, such certificate should indicate the requirement of holding the certificate under the Factoring Act. The certificate should also indicate the percentage of factoring assets and income, the compliance that it fulfils all conditions stipulated under the FRA to be classified as an NBFC-Factor and compliance to minimum capitalisation norms, if FDI has been received. Non-compliance to the provisions of these directions would invite penal action under the Factoring Regulation Act.
- Factoring deals in India encounter serious obstacles which stand in the way of the growth of such services: **(1)** lack of specialised credit information agency/bureau, **(2)** funding limitations and **(3)** limited coverage. If factoring is to grow, a solution to these problems is urgently called for.

SOLVED PROBLEMS

P.4.1 The turnover of R Ltd is ₹60 lakh of which 80 per cent is on credit. Debtors are allowed one month to clear off the dues. A factor is willing to advance 90 per cent of the bills raised on credit for a fee of 2 per cent a month plus a commission of 4 per cent on the total amount of debts. R. Ltd as a result of this arrangement is likely to save ₹21,600 annually in management costs and avoid bad debts at 1 per cent on the credit sales.

A bank has come forward to make an advance equal to 90 per cent of the debts at an annual interest rate of 18 per cent. However, its processing fee will be at 2 per cent on the debts. Would you accept factoring or the offer from the bank?

Solution

Cost of factoring:		
Fee (0.02 × 0.90 × ₹4,00,000)@		₹7,200
Commission (0.04 × ₹4,00,000)		16,000
		23,200
Less: Savings in cost:		
Management costs (₹21,600 ÷ 12)	₹1,800	
Savings in bad debts (0.01 × ₹4,00,000)	4,000	5,800
Net cost of factoring		17,400
Cost of bank advance:		
Interest (0.18 × 1/12 × 0.90 × ₹4,00,000)		5,400
Processing fee (0.02 × ₹4,00,000)		8,000
Bad debts (0.01 × ₹4,00,000)		4,000
		17,400

@(Annual credit sales ₹48 lakh ÷ 12 months)

Note: It is assumed that R Ltd will continue to incur management costs.

Since the costs of both the alternatives are equal, R Ltd is likely to be indifferent between factoring and bank advance.

Solved Problems: A guide and aid to solving problems, will aid readers by suggesting suitable methodologies for tackling tough questions.

Recapitulation: At the end of all chapters, a brief recap of all the important points and salient features of every topic.

RECAPITULATION

- Credit rating is essentially a symbolic indicator of the relative grading of the investment/credit qualities of financial instruments and reflects the relative ability of the issuers of such instruments to meet the servicing obligations as and when they arise. It is neither a general purpose evaluation nor an over-all assessment of the credit risk associated with all the obligations of the issuers/corporates. A rating is specific to an instrument. It does not amount to any recommendations to buy, hold or sell an instrument.
- As a fee-based advisory financial service, credit-rating is of comparatively recent origin in India, the first institution having been set up in 1988.
- The increasing recognition to credit rating in the country marks a major transition from a corporate culture where names mattered to one where abstract gradings count.

  There are four credit rating agencies in the country which rate corporate entities: CRISIL, ICRA, CARE, FITCH, and SMERA.
- CRISIL is the most important rating agency in the country. Its main business is rating services although it has diversified into information and advisory services. While it undertakes rating of mandated instruments, namely, debentures, deposits, commercial papers, LPG/kerosene dealers, its rating services also extend to preference shares, structured obligations, chit funds, real estate developers/builders, banks and states. The extensive compilation and analysis of data for rating business is also used by CRISIL to provide information services to corporate clients. It has leveraged its information base and expertise in credit rating to provide counselling to government, banks and financial institutions on aspects such as privatisation of PSUs, debt securitisation, credit evaluation and so on.
- ICRA focuses on rating of instruments for which credit rating is mandatory, namely, debentures/bonds, deposits, commercial papers, kerosene/LPG dealers. In addition, it rates banks. It has also ventured into EPRA for grading the primary market at the instance of the issuing companies and assessing the secondary market for the investors. It also provides credit assessment and general assessment services.
- CARE confines to normal rating business only and has not diversified its operations. The instruments credit-rated by CARE are debentures, deposits, commercial papers and structured obligations. It also undertakes general credit analysis of companies for the use of banks, other lenders and business enterprises.
- SMERA focuses exclusively on the rating of small and medium enterprises.
- Procedurally, credit rating is done in India at the instance of the issuers of the instruments. Unsolicited rating at the initiative of the rating agencies has still not emerged. The clients have, moreover, the option not to accept the ratings.
- Rating is a search for fundamentals and the possibilities of change in these in the long-term. All the credit agencies follow broadly the same analytical framework of rating methodology. It comprises of three broad sets of factors: **(i)** business analysis in terms of analysis of industry risk, market position, operating efficiency and legal position; **(ii)** financial analysis on the basis of consideration of accounting quality, earnings protection, adequacy of cash flows and financial flexibility and **(iii)** management evaluation. For finance companies, in addition, the assessment by the rating agencies lays emphasis on regulatory environment and fundamental analysis which includes liquidity management, asset quality, profitability and financial position and interest and tax sensitivity.

4.32 Financial Services

Decision Analysis: Cost Benefit of Non-recourse Factoring

	Amount (₹ lakh)
Benefits (savings of cost as per in-house management alternative)	35.25
Cost (of non-recourse factoring alternative)	49.86
Net loss	(14.61)

Recommendation: New Delhi Manufactures Ltd should not go for the factoring alternative.

Mini Case

4.C.1 (Factoring) Sunlight Industries Ltd manages its accounts receivables internally by its sales and credit department. The cost of sales ledger administration stands at ₹9 crore annually. It supplies chemicals to heavy industries. These chemicals are used as raw material for further use or are directly sold to industrial units for consumption. There is good demand for both the types of uses. For the direct consumers, the company has a credit policy of 2/10, net 30. Past experience of the company has been that on average 40 per cent of the customers avail of the discount while the balance of the receivables are collected on average 75 days after the invoice date. Sunlight Industries also has small dealer networks that sell the chemicals. Bad debts of the company are currently 1.5 per cent of total sales.

Sunlight Industries finances its investment in debtors through a mix of bank credit and own long-term funds in the ratio of 60:40. The current cost of bank credit and long-term funds are 12 per cent and 15 per cent respectively.

There has been a consistent rise in the sales of the company due to its proactive measures in cost reduction and maintaining good relations with dealers and customers. The projected sales for the next year are ₹800 crore, up 15 per cent from last year. Gross profits have been maintained at a healthy 22 per cent over the years and are expected to continue in future.

With escalating cost associated with the in-house management of debtors coupled with the need to unburden the management with the task so as to focus on sales promotion, the CEO of Sunlight Industries is examining the possibility of outsourcing its factoring service for managing its receivables. He assigns the responsibility to Anita Guha, the CFO of Sunlight. Two proposals, the details of which are given below, are available for Anita's consideration.

Proposal from Canbank Factors Ltd: The main elements of the proposal are: (i) Guaranteed payment within 30 days (i) Advance, 88 per cent and 84 per cent for the resource and non-recourse arrangements respectively (iii) Discount charge in advance, 21 per cent for with recourse and 22 per cent without recourse (iv) Commission, 4.5 per cent without recourse and 2.5 per cent with recourse.

Proposal from Indbank Factors: (i) Guaranteed payment within 30 days (ii) Advance, 84 per cent with recourse and 80 per cent without recourse (iii) Discount charge upfront, without recourse 21 per cent and with recourse, 20 per cent and (iv) Commission upfront, without recourse 3.6 per cent and with recourse 1.8 per cent.

The opinion of the Chief Marketing Manager is that in the context of the factoring arrangement, his staff would be able to exclusively focus on sales promotion which would result in additional sales of ₹75 crore.

Mini Cases: Elaborate upon the concepts taken up in a particular chapter and aid understanding by relating these concepts to real world examples.

Decision Analysis: Recourse Factoring (₹ *crore*)

Particulars	*Canbank*	*Indbank*
Benefits (₹57.2 – ₹12 Bad debts to be borne by company)	45.2	45.2
Costs	36.6	29.6
Net benefits	8.6	15.6

Decision Analysis: Non-Recourse Factoring (₹ *crore*)

Particulars	*Canbank*	*Indbank*
Benefits (₹57.2 + ₹1.1 Bad debts loss to be borne by factor)	58.3	58.3
Costs	54.5	45.8
Net benefits	3.8	12.5

Advice: My advice to the CFO of Sunlight Industries would be to accept the proposal of Indbank Factors for recourse factoring.

Comprehensive Case is available in Appendix 4-A on the website. The website address is **http://www.mhhe.com/khanfs9e.**

REVIEW QUESTIONS

4.1 Explain briefly the mechanism of factoring.
4.2 What are the functions of a factor?
4.3 Discuss briefly the various forms of factoring.
4.4 Write a brief note on the contents of a factoring agreement.
4.5 Compare and contrast factoring with forfaiting and bill discounting.
4.6 Discuss the main features of the recently codified legal framework relating to factoring in India in terms of the **(i)** Factoring Regulation Act, **(ii)** Registration of Assignment of Receivables (Government) Rules and **(iii)** RBI NBFC-Factors Directions.
4.7 Explain briefly the nature of factoring services in India. What are the operational obstacles encountered by factoring services in India?
4.8 The Udar Ltd sells all goods on credit. Its current annual credit sales (turnover) amount to ₹800 lakh. The variable cost ratio (ratio of variable costs to sales) is 0.80. The credit terms of the Udar Ltd are 2/10, net 30. On the current level of sales the bad debts are 0.75 per cent. The past experience has been that 50 per cent of the customers avail of the cash discount; the remaining customers pay on an average 45 days after the date of sale.

ANSWERS

4.8 Cost of non-recourse factoring alternative, ₹44.87 lakh; Cost of in-house management alterative, ₹39.59 lakh. Factoring alterative in recommended.
4.9 Continue with the in-house management of receivables : Net loss with non-recourse factoring (₹6.05 lakh); Net loss with recourse factoring (₹0.07 lakh).

Review Questions with Answers: Very useful for readers to test their understanding of the subject; the answers will help in confirming if they have understood correctly or not.

Appendices: Additional materials for readers who would like to go into further detailed study of the topics in the chapters. Apart from some Appendices in the book, a number of them have been given on the companion website.

Hire-Purchase Finance and Consumer Credit **3.25**

APPENDIX 3-A
Flat Rate vs Effective Rate of Interest/Annual Percentage Rate

The interest component of each hire-purchase installment is calculated on the basis of a flat rate of interest. But the original amount of the loan is repaid over the term of the loan in equated installments. To determine the interest component of each installment of the declining balance of the principal amount over a period of time, the equivalent effective rate of interest (invariably higher than the flat rate) is to be used. Thus, the effective rate of interest (ERI) is an important element of accounting and reporting of a hire-purchase transaction. It is also known as annual percentage rate (APR). The computation of APR depends on whether the hirer has to (a) make a down payment, or (b) invest in fixed deposit of the finance company. The APR also depends on the fact that the equated installments are paid in arrears or advance. The computation of APR/ERI is shown in **illustrations 3.A.1–3.A.2.**

Illustration 3-A.1 *(Cash Down Payment)*

Under a hire-purchase deal structured by the Hypothetical Finance Ltd (HFL) for the Hypothetical Industries Ltd (HIL), the (flat) rate of interest is 15 per cent. The HIL is required to make a cash down payment of 25 per cent and the repayment of the loan is to be made in 36 equated monthly installments. On the assumption of payment of installment in (a) advance (b) arrear, compute the ERI/APR for the plan.

Solution

The ERI/APR can be computed (i) by applying the trial and error approach or (ii) by using the approximation formula.

(A) Approximation Approach/Formula

(a) Computation of APR/ERI (Payment in Arrear)

$$I = \frac{N}{N+1} \times 2F$$

I = APR/ERIs

N = Number of repayments

F = Flat rate of interest per unit time

$$= \frac{36}{37} \times 2 \times 0.15 = 0.292 = 29.2 \text{ per cent}$$

(b) Computation of APR/ERI (Payment in Advance):

$$I = \frac{N}{N-1} \times 2F = \frac{36}{35} \times 2 \times 0.15 = 0.0309 = 30.9 \text{ per cent}$$

(B) Trial and Error Approach (Assumed Amount of ₹1,000)

(a) Computation of APR/ERI (Payment in Arrear):

Amount of loan (0.75 × ₹1,000) = ₹750

Total credit charge = ₹750 × 0.15 × 3 = ₹337.5

Corporate Restructuring **12.33**

Annexure 2 Demerger of DCM Ltd

DCM Ltd, promoted by Late Shri Ram in 1889, has become a conglomerate of 13 units with multifarious manufacturing activities in sugar, textile, chemicals, ryon tyre cord, fertilisers and so on. These units on their own being of the size of independent companies, the directors felt that greater focus on the operation of the various units of the company would result in substantial improvement in the results of their operations. The post-reorganisation slogan would be: "**The Trimmer We Are, The Faster We Are**".

On the basis of the various discussions, meetings, consultations between the members of the Board of Directors, financial institutions and consultants, it was decided to take appropriate steps to carry on the business of various units more effectively and efficiently in the larger interest of shareholders, debentureholders, creditors, employees and in the general public interest. To achieve the objective of carrying the business of DCM Ltd more smoothly and profitably, DCM Ltd was reorganised by dividing its business among four companies having shareholders with the same interest *inter-se* in DCM but to be managed and operated independently (Exhibit 1).

Exhibit 1 Division of DCM Ltd.

- **(i)** **DCM Ltd** comprising DCM Mills (DCM Estate) DCM Engineering Products, DCM Data Products, Hissar Textiles Mills, Shri Ram Fibres Ltd, and DCM Toyota Ltd.
- **(ii)** **DCM Shri Ram Industries Ltd** comprising Shri Ram Rayons, Daurala Sugar Works, and Hindon River Mills.
- **(iii)** **DCM Shri Ram Consolidated Ltd** comprising Shri Ram Fertilises and Chemicals Industries Ltd, Shri Ram Cement Works Ltd, Swatantra Bharat Mills Ltd, and DCM Silk Mils Ltd.
- **(iv)** **Shri Ram Industrial Enterprises Ltd** comprising Shri Ram Food and Fertilisers Ltd, and Mawana Sugar Works Ltd.

The division of DCM Ltd took place through the scheme of arrangement approved by the Delhi High Court on April 16, 1990 according to which three new companies were formed. The scheme of arrangement became effective from April 1, 1990. The four companies thereafter started operating independently, each with their respective Boards of Directors.

Some of the notable features of the scheme of reorganisation of the erstwhile DCM Ltd into four companies were:

- The total paid-up capital of ₹23 crore was divided equally.
- The allocation of various assets and liabilities among them was done as under:

	DCM Shri Ram Industries Ltd	*DCM Shri Ram Consolidated Ltd*	*Shri Ram Industrial Enterprises Ltd*	*DCM Ltd*
Fixed deposits	16%	33%	36%	15%
Debentures	16%	12%	36%	36%
Common assets/ liabilities/income/benefit	16.66%	16.66%	33.33%	33.33%
Expenses and cost of arrangement	16.66%	16.66%	33.33%	33.33%
Specific assets	(All at book value as on 1.4.1990 unit-wise)			

Annexures: Contain specific Indian inputs related to the concepts discussed in the chapter

Website: The companion website of this book (http://www.mhhe.com/khanfs9e) contains in several appendices, extra material for the interested reader. Additionally, it features powerpoint slides for the instructors.

Contents

PART

1

INTRODUCTION

The non-banking financial companies (NBFCs) constitute a significant element of the organisation of the Indian financial system. They broaden the range of financial services. These are partly fee-based/advisory and partly asset/fund-based. The important fund-based activities of the NBFCs are: equipment leasing, hire-purchase, bill discounting, loans/investments, venture capital, housing finance, factoring, and so on. Their fee-based activities include issue management, portfolio management, corporate counselling, loan/lease syndication, arranging foreign collaboration, merger and acquisition, capital restructuring, and so on. Part One of the book is devoted to the general framework of the operations of the NBFCs in India and provides the background for a more detailed examinations of the nature and level of the available financial services in the subsequent parts of the book. Chapter 1 sketches an overview of the Indian NBFCs with special reference to their regulatory framework.

CHAPTER 1

Non-Banking Financial Companies

Learning Objectives

- Explain the nature of financial services and the three-fold classification of non-banking finance companies in India.
- Review the main elements of Chapter III – B of the RBI Act pertaining to regulation of non-banking financial companies (NBFCs).
- Discuss the features of the RBI directions to NBFCs relating to acceptance of public deposits.
- Examine the RBI's NBFC – ND – SI/NBFC – D directions 2016.
- Understand the differences between the RBI's directions applicable to NBFC – ND – SI/NBFC –D are NBFC – ND.
- Analyse the RBI's asset-liability management (ALM) framework for NBFCs.
- Understand the features of the RBI's NBFCs-MFI directions.
- Review the framework of regulations of credit information companies.
- Discuss the regulatory framework for core investment companies.
- Understand the elements of the RBI IDF-NBFC directions.

INTRODUCTION

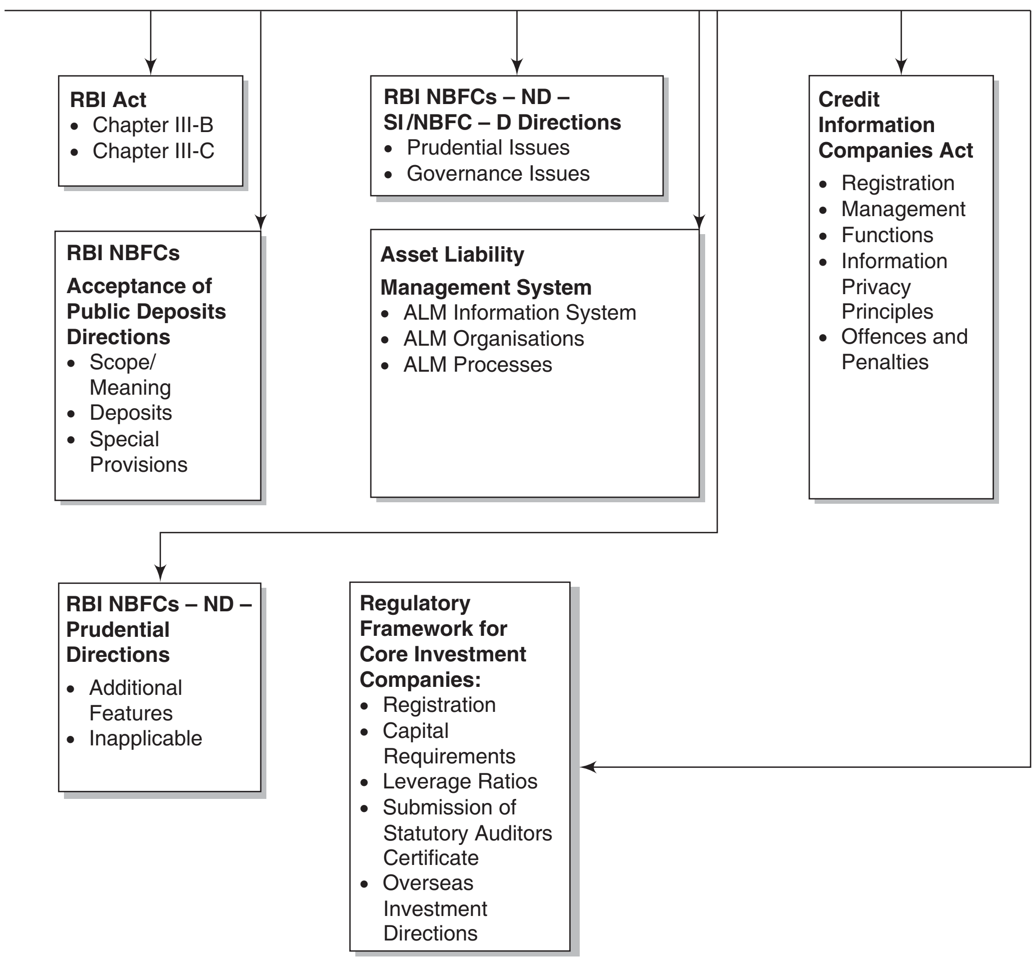
Finance may be defined as the art and service of managing money. The two major areas of finance are: **(i)** financial management/managerial finance/corporate finance and **(iii)** financial services. **Financial management** is concerned with duties of the financial managers in the business firm who perform such varied tasks as budgeting, financial forecasting, cash management, credit administration, investment analysis, funds management and so on. **Financial services** is concerned with the design and delivery of advice and financial products to individuals and businesses within the areas of banking and related institutions, personal financial planning, investment, real assets, insurance and so on. A wide variety of fund/asset-based and non-fund-based/advisory services are provided mainly by the non-banking finance companies (NBFCs). Depending on the nature and type of services provided, they are categorised, *inter-alia*, into **(i)** asset finance, consumer finance, investment and loan companies and factoring and forfaiting organisations, **(ii)** housing finance companies, and **(iii)** merchant banking organisations, stock broking firms, depositories, credit rating agencies, and venture capital funds. While the housing finance companies are

> **Financial services** is concerned with the design and delivery of advice and financial products to individuals and businesses.

regulated in India by the National Housing Bank (NHB), the third category of capital market intermediaries operate within the framework of SEBI regulations. The working and operations of asset finance, loan and investment category of NBFCs are regulated by the RBI. Such companies play a crucial role in broadening access to financial services, enhancing competition and diversification of financial sector. They are increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at the time of financial distress.

The purpose of this chapter is to outline the scheme/system of regulation of the working and operations of NBFCs regulated by the RBI. **It is portrayed in Exhibit 1.1.**

Exhibit 1.1 System of Regulation of Non-Banking Finance Companies



The provisions of the (amended) RBI Act and the RBI Acceptance of Public Deposit Direction to different categories of NBFCs are examined in Sections 1 and 2, respectively. Sections

3-4 describe the prudential norms applicable to the NBFCs accepting deposits and those not accepting deposits respectively. The Auditor's Reports Directions for NBFCs are discussed in Section 5. The RBI's Asset Liability Management (ALM) framework applicable to them is examined in Section 6. While the framework of regulation of credit information companies in terms of the Credit Information Companies Act, 2005 is outlined in Section 7, the guidelines on fair practices by NBFCs are outlined in Section 8. Section 9 discusses the regulatory framework for core investment companies. Some concluding observations are given in the last Section.

RBI ACT FRAMEWORK

The RBI regulates different types of NBFCs under the provisions of Chapter III-B and Chapter III-C of the RBI Act. It was amended in 1997 incorporating **(i)** amendment of the existing Sections (45I, 45MA, and 58B), **(ii)** insertion of new Sections (45A/B/C, 45JA, 45MB/C, 45NB/C, 45QA/B and 4/58G) and **(iii)** substitution by new Section (45S).

Salient Features of Chapter III-B

The chapter contains provisions relating to Non-Banking Institutions (NBIs) receiving deposits, and Financial Institutions (FIs).

Deposits The term deposit is defined in a broad sense to include any receipt of money by way of deposit or loan or in any other form. However, certain receipts are excluded:

(i) Amount received from banks,
(ii) Amount received from development finance corporations/State Financial Corporations or any other financial institution;
(iii) Amount received in the ordinary course of business, by way of security deposit, dealership deposit, earnest money, advance against order for goods/ properties/services;
(iv) Amount received from an individual/firm/association related to money lending;
(iv) Amount received by way of subscription in respect of a chit
(v) Loans from mutual funds.

Financial Institutions These mean any non-banking institutions/financial companies engaged in any of the following activities:

(i) Financing by way of loans, advances, and so on, any activity except its own;
(ii) Acquisition of shares/stocks/bonds/debentures/securities;
(iii) Hire-purchase;
(iv) Any class of insurance, stockbroking etc;
(v) Chit funds and
(vi) Collection of money by way of subscription/sale of units or other instruments/any other manner, and their disbursement.

Non-banking Financial Company (NBFC) It means **(i)** a financial institution that is a company, **(ii)** a non-banking institution that is a company whose principal business is the receiving of deposits under any scheme/arrangement/in any other manner or lending in any manner and **(iii)** such other non-banking institutions/class of institutions as the RBI may specify, with the prior approval of the Government and by notification in the official gazette.

> **NBFC**
> is a non-banking finance company whose principal business is the receiving of deposits.

Registration and Net Owned Funds (NOFs) With effect from January 1997, in order to commence (new company)/carry on (existing company) the business of a Non-Banking Financial Institution (NBFI), an NBFC must obtain a certificate of registration from the RBI. Moreover, its minimum net owned funds (NOFs) must be ₹25 lakh or such other amount not exceeding ₹200 lakh, as specified by the RBI. The **NOFs** mean **(a)** paid-up capital and free reserves, as per the latest balance sheet, minus the accumulated losses, if any, deferred revenue expenditure and other intangible assets and **(b) (i)** less investments in shares of subsidiaries/companies in the same group/all other NBFCs and **(ii)** the book value of debentures/bonds/outstanding loans and advances—including hire-purchase and lease finance made to, and deposits with, subsidiaries/companies in the same group—in excess of 10 per cent of (a) above.

While considering an application for registration, the RBI would consider that the NBFC fulfils the following conditions:

- The NBFC is/would be in a position to pay its present/future depositors in full, as and when their claims accrue.
- Its affairs are not being/likely to be conducted in a manner detrimental to the interests of its present/future depositors.
- The general character of the management/proposed management would not be prejudicial to the public interest/interest of the depositors.
- It has adequate capital structure and earning prospects.
- The public interest would be served by the grant of the certificate to commence/carry on business in India.
- The grant of the certificate would not be prejudicial to the operation/consolidation of the financial sector, consistent with the monetary stability and economic growth considering such other relevant factors specified by the RBI.
- Any other condition, the fulfillment of which, in the opinion of the RBI, would be necessary to ensure that the commencement/carrying on business in India would not be prejudicial to the public interest or the interest of the depositors.
- The RBI may impose conditions while granting registration. It may cancel a certificate of registration if the NBFC:
  - **(i)** Ceases to carry on the business in India;
  - **(ii)** Has failed to comply with any condition subject to which the certificate was issued;
  - **(iii)** At any time fails to fulfil any of the above conditions, which the RBI considered while granting registration;
  - **(iv)** Fails to **(a)** comply with any directions issued by the RBI under the provisions relating to registration, **(b)** maintains accounts in accordance with the requirements of any law/direction/order issued by the RBI under these provisions and **(c)** submit/offer for inspection its books of accounts/other relevant documents, when so demanded by an inspecting authority of the RBI and
  - **(v)** Has been prohibited from accepting deposits by an order of the RBI, under the provisions that have been in force for a period of at least three months.

Maintenance of Assets NBFCs are required to invest, in unencumbered approved Indian securities, at least 5 per cent or more of their outstanding deposits at the close of business on the last working day of the second preceding quarter as specified by the RBI from time to time. The RBI may, however, specify different percentages of investment in respect of different classes of NBFCs. Approved securities mean the securities of any State Government/Central Government and bonds unconditionally guaranteed by them as regards the payment of interest as well as the repayment of principal. Included in unencumbered approved securities are approved securities lodged by NBFCs with other institutions, for an advance/any other arrangement, to the extent to which such securities have not been drawn against or availed of or encumbered in any manner. The basis of valuation of such securities would be the cost or current market price. To ensure compliance of the maintenance of the percentage of assets, the NBFCs may be required to furnish a return in such form/manner and for such periods as specified by the RBI.

In case the amount invested at the close of business on any day falls below the specified rate, the NBFCs would have to pay the RBI, a penal interest at a rate of 3 per cent per annum above the bank rate to compensate the shortfall. If the shortfall continues in subsequent quarters, the rate of panel interest would be 5 per cent per annum above the bank rate. The penal interest must be paid within 14 days from the date of the issue or serving the payment notice by the RBI, failing which the RBI can approach an appropriate court for a direction for payment. The certificate/direction issued by the court would be enforceable like a decree in a suit. However, if the RBI is satisfied that the defaulting NBFC had sufficient cause for its failure, it may not demand the payment of the penal interest.

Reserve Fund Every NBFC must create a reserve fund to which at least 20 per cent of its net profits must be transferred before the declaration of any dividend. The reserve fund can be used/appropriated only for purposes specified by the RBI from time to time. Every appropriation should be reported to it within 21 days from the date of withdrawal. However, the RBI, for sufficient cause in any particular case, may extend the period or condone any delay. The Central Government may, on the recommendation of the RBI, exempt, by an order in writing, any NBFC for a specified period from the above requirements, taking into consideration the adequacy of its paid-up capital and reserves in relation to deposit liabilities. But such an exemption can be granted only if the reserve fund together with the share premium account of the NBFC is not less than its paid-up capital.

Power of Regulation/Prohibition The RBI can by general/special order regulate or prohibit the issue, by any Non-Banking Institution (NBI), of any prospectus or advertisement soliciting deposits of money from the public and also specify conditions subject to which they can be issued.

In public interest, to regulate the financial system or to prevent the affairs of a NBFC being conducted in a manner detrimental to the interests of the depositors, or prejudicial to the interest of the company, the RBI can determine policy and give directions to all or any of the NBFC(s) relating to: **(a)** income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off-balance sheet items and **(b)** deployment of funds. They would be bound to follow the policy determined/directions issued. In addition, the RBI may give directions to NBFC(s), in particular, regarding:

(i) The purpose for which advances/other funds-based/non-fund-based accommodation may not be made and

(ii) The maximum amount of advances/other financial accommodation/ investment in shares/ other securities, having taken into account the paid-up capital, reserves and deposits of the NBFC and other relevant considerations.

Power to Collect Information from NBIs The RBI can issue direction to the NBIs to furnish information relating to, or concerned with, deposits. The information may relate to aspects such as amount of deposits, its period and purpose, rates of interest and other terms and conditions on which deposits are received. It may also issue directions to the NBIs with respect to these matters. Non-compliance of these directions may lead to the prohibition of acceptance of deposits by the NBI. Any NBI can also be required to furnish depositors with a copy of its balance sheet, profit and loss account or other annual accounts.

Power to Call for Information from FIs and Issue Directions To regulate the credit system, the RBI can ask for information from the FIs relating to, as well as issue directions for the conduct of, their business. The information sought may cover matters such as paid-up capital, reserves or other liabilities, investments, persons/purpose and periods for which finance was provided, terms and conditions, including the rate of interest, and so on. While issuing directions, the RBI has to give due regard to the conditions in which and the objects for which the FI has been established, its statutory responsibilities and the effect its business would have on trends in the money and capital markets.

Duty of NBIs and Auditors It is mandatory for every NBI to furnish the statements/information/particulars called for and comply with any direction given by the RBI. The auditors of a NBI have an obligation to enquire into the status of compliance with the requirements relating to deposits and report it to the RBI. In public interest/in the interest of the depositors or for the purpose of assessment of the books of accounts, the RBI may issue directions to NBFCs/their auditors relating to balance sheet, profit and loss account, disclosure of liabilities in the books of accounts or any other related matter. The auditor should include in his statutory report, under the Companies Act, the contents of the report submitted to the RBI regarding the compliance status. The RBI can, in public interest/in the interest of the NBFC(s)/depositors, also order for a special audit of the accounts in relation to any specified transaction(s)/period(s). It can also appoint an auditor(s) to conduct the specific audit and report to it. The remuneration of the auditors, fixed by the RBI, having regard to the nature and volume of work involved, and the expenses incidental to the audit would be borne by the concerned NBFC.

A NBFC which violates any of the provisions or fails to comply with any direction(s), may be prohibited from accepting any deposit. If necessary, in public interest or in the interest of the depositors, the RBI may further direct such a company not to sell/transfer/create, charge, mortgage or deal in any manner with its properties/assets for a period not exceeding six months from the date of the order, without its prior written permission.

On being satisfied that the NBFC: **(a)** is unable to pay its debt, that is, has refused/failed to meet within five days any lawful demand, **(b)** has been disqualified to carry on business, **(c)** has been prohibited from receiving any deposit by order in force for not less than three months, **(d)** its continuance is detrimental to public interest or in the interest of the depositors. The RBI may file an application under the Companies Act for its winding-up, a copy of which must be sent to the Registrar of Companies. All the provisions of the Companies Act would be applicable to the winding-up process.

Inspection The RBI has the power to order inspection by its officers/employees or any other person (inspecting authority) of any NBI/FI **(a)** for the purpose of verifying the correctness/completeness of any statement/information/particulars furnished to it or obtaining any information/particulars which the NBI/FI has failed to furnish and **(b)** if it is necessary or expedient to inspect that NBI/FI. The management/ directors/ officers/employees of the NBI/FI must produce all books of accounts/documents and furnish all information/statements relating to its business to the inspection authority, which may also examine them on oath.

Soliciting Deposits, Disclosure of Information and Exemption Nobody is allowed to solicit deposits on behalf of NBFCs by publishing a prospectus or advertisement or through any other manner, unless he is authorised in writing to do so, and the advertisement/prospectus conforms to the RBI stipulations and the other provisions of law.

Any information relating to a NBFC, contained in any statement/return submitted by it/obtained through audit/inspection by the RBI, would be treated confidential and would not be disclosed. This restriction, however, does not apply to the following:

- Disclosures of information submitted by a NBFC with the previous permission of the RBI.
- Publication of any information collected by the RBI, in public interest, in a consolidated form, without disclosing the name of the NBFC or its borrowers.
- Disclosure/publication by the NBFC/RBI of any such information to another NBFC or in accordance with practice and usage, customary amongst such companies, or as permitted/required under any other law.

However, in public interest, or in the interest of the depositors/NBFC, or to prevent the affairs of the NBFC being conducted in a manner detrimental to the interest of the depositors, the RBI may, on its own or on request, furnish/communicate any information relating to the conduct of business of a NBFC to any authority constituted under any law. Nevertheless, no court/tribunal/authority can compel it to produce/give information or any statement/other material obtained by it from the NBFCs.

The RBI is empowered to exempt the NBIs/NBFCs from the application of any/all provision(s), either generally or for specified period, subject to any conditions/limitations/restrictions imposed by it.

Repayment of Deposit/Nomination by Depositors These provisions override all other laws in force. The deposits accepted by the NBFCs should be repaid in accordance with the relevant terms and conditions or renewed. If a NBFC fails to repay any deposit, the Company Law Board (CLB) is empowered to order the repayment of deposit immediately/within a specified time and subject to the specified conditions. The CLB would have to satisfy itself, either on its own motion or an application of the depositor(s), that it is necessary to do so to safeguard the interests of the company/depositors or the public.

The depositor(s) can nominate one person to whom, in the event of his/their death, the deposit money would be returned by the NBFC. The nominee-depositor would become entitled to all the rights of the depositor(s), unless the nomination is varied/cancelled in the prescribed manner. If the nominee is a minor, the depositor(s) can appoint any person to receive the amount of deposit in the event of his death, during the minority of the nominee. Payment to the nominee would constitute a full discharge, to the NBFC, of its liability, with respect to the deposit. The NBFC would neither receive any notice of claim from any person other than those in whose name(s) a deposit is held nor would it be bound by any such notice, even though expressly given to it. However, it would have to take note of any decree/order/certificate/other authority from a court of competent jurisdiction relating to such a deposit produced before it.

Penalties In case any prospectus/advertisement inviting deposit from the public, knowingly makes a false statement in any material particular knowing it to be false or omits to make a material statement, the person responsible would be punishable with imprisonment for a term up to three years and would also be liable to a fine. Failure by a person to produce any book/account/other document or to furnish any statement/information/particulars is punishable with fine up to ₹2,000 for each offence and refusal to comply or persistence in such failure with fine extending to ₹100 for every day after the first, during which the offence continues.

The penalties for the contravention of the provisions of the RBI Act are as listed below.

- Relating to the requirement of registration and net owned funds of NBFCs (Section 45IA), imprisonment for a term of not less than one year, but may extend up to five years; and fine of not less than ₹1 lakh, which may extend to ₹5 lakh.
- Failure of auditors to comply with any direction/order of the REI (Section 45MA), a fine not exceeding ₹5,000.
- Non-compliance with any order of the Company Law Board, relating to the repayment of deposit (Section 45QA), imprisonment for a term of up to three years and a fine of not less than ₹50 for every day during which non-compliance continues.

If any person, other than an auditor, receives any deposit in contravention of, or fails to comply with, any direction given/order made by the RBI under Chapter III-B, he can be punished with imprisonment up to three years and fine up to a maximum of twice the amount of deposit received.

In case of issue of any prospectus/advertisement by an unauthorised person or violation of orders pertaining to the condition, subject to which any prospectus/advertisement can be issued, the penalty would be imprisonment extending to three years and a fine that may extend to twice the amount of deposit called for.

Power of RBI to Impose Fine Where the above contraventions/defaults are committed by a NBFC, the RBI is authorised to impose:

(i) A penalty not exceeding ₹5,000 and

(ii) Where the contravention relates to the requirement of registration and net owned funds or receipts of any deposit/compliance with any direction given/order made, a penalty of ₹5 lakh or twice the amount involved in such contravention/default. In case of continuation of the violation, a further penalty up to ₹25,000 for every day, after the first, during which the default continues.

The penalty imposed by the RBI is payable within 30 days from the date on which the notice demanding payment is served on the NBFC. In the event of the non-payment, the RBI may obtain a direction from a court specifying, in a certificate, the sum payable by the NBFC. The certificate would be enforceable in the same manner as if it were a decree made by the court in a civil suit.

Provisions of Chapter III-C

Subject to the provisions of Chapter III-B, non-corporates are not permitted to accept deposits after April 1, 1997. However, individuals can accept deposits from: **(i)** relatives, **(ii)** any other individual, for his personal use but not for lending or business purposes. Non-corporate entities that hold deposits should repay it immediately after such deposit becomes due for repayment or within two years from the date of such commencement, whichever is earlier. They are prohibited from issuing, or causing to be used, any advertisement, in any form, for soliciting deposit.

If certain documents related to the acceptance of deposits, in contravention of the requirements, are secreted in any place, a court, on application by an authorised officer of the RBI/

State Government, may issue a warrant to search for the documents. Such warrants would have the same effect as one issued under the Code of Criminal Procedure.

If a person contravenes any of the above provisions, he wold be punishable with imprisonment for a term that may extend to two years or with a fine up to twice the amount of deposit received or ₹2,000, whichever is more, or with both. Generally, the imprisonment and the fine would not be less than one year and ₹1,000, respectively. A fine exceeding ₹2,000 may be imposed in special circumstances.

RBI NBFCs ACCEPTANCE OF PUBLIC DEPOSITS DIRECTIONS, 2016

In pursuance of its powers, under the provisions of Chapters III-B and III-C, the RBI has issued directions to regulate acceptance of deposits by NBIs/FIs. These directions contain provisions regulating the amount/period of deposits, rates of interest, brokerage and so on. They also exempt from their purview certain types of borrowings/money received by these companies. The directions issued by the RBI so far are: **(i)** NBFCs Directions, 1977, **(ii)** MNBCs Directions, 1977 and **(iii)** RNBCs Directions, 1987. They also pertain to advertisement, namely, NBFCs/MNBCs/RNBCs Advertisement Rules, 1977. In the public interest and to regulate the credit system to the advantage of the country, exercising the powers conferred by Section 45J/K/L/MA of the amended RBI Act, the RBI issued the NBFC's Acceptance of Public Deposits (RBI) Directions, 1998, in place of NBFC Directions, 1977. The main elements of RBI Directions, 2016 are discussed below.

Scope and Meaning of NBFCs/MNBCs/RNBCs

Meaning of NBFCs The directions supply to a NBFC which means only the non-banking institution, which is any asset finance, investment, loan or mutual benefit financial company but excludes an insurance company/stock exchange/stockbroking company/merchant banking company. A mutual benefit company/financial company is not covered. The directions are also not applicable to NBFCs that do not accept/hold public deposits. Such NBFCs have to pass a resolution in a meeting of the Board of Directors, within 30 days of the commencement of the financial year, to the effect that they have neither accepted nor would accept any public deposit during the year. Investment companies that have acquired shares/securities of their own group/holding/subsidiary companies only—of not less than 90 per cent of their total assets—do not trade in these shares/securities and do not accept/hold public deposits are also exempt from these directions. For this purpose, their Board of Directors have to pass a resolution within 30 days of the commencement of each financial year.

The RBI can grant, to avoid any hardship for any just and sufficient reason, extension of time to comply with or exempt any NBFC/class of NBFCs from all or any of these directions, either generally or for any specified period, subject to such conditions as it may impose.

The term company refers to a public/private Indian/foreign company. The NBFCs, for the purpose of these directions, are classified into the following categories.

> **Asset finance company** means any company carrying on as its principal business the financing of physical assets supporting productions/economic activity.

Asset Finance Company (AFC) This means any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. The principal business means that the aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60 per cent of its total assets and total income respectively.

Investment Company (IC) A company that is a financial institution carrying on, as its principal business, the acquisition of securities.

Investment company is a financial institution carrying on, as its principal business, the acquisition of securities.

Loan Company (LC) This means any company that is a financial institution whose principle business is providing finance, whether by making loans or advances or otherwise for any activity other than its own, but does not include an asset finance company.

Mutual Benefit Company (MBC)/Mutual Benefit Finance Company (MBFC) A MBC is a company which is a financial institution that is not notified by the Central Government under Section 620-A of the Companies Act, 1956, but has at least ₹10 net owned funds and preferential share capital and complies with the requirements contained in the relevant provisions of the Directions issued under Section 637-A of the Companies Act to Nidhi Companies by the Government. A MBFC is a financial institution notified by the Government under Section 620-A of the Companies Act.

The question as to whether a company is a financial institution or not would be decided by the RBI in consultation with the Government. Moreover, the question as to whether a financial institution is a company in any of the foregoing five categories would be decided by the RBI, considering the principal business of the company and other relevant factors. The principal business of a financial company engaged in hire-purchase financing and equipment leasing activities will be decided by the RBI, after taking together the volume of both types of business and other related factors. Only such companies as have been specifically notified under Section 620-A of the Companies Act by the Government will be classified as Nidhi Companies.

Meaning of MNBCs A MNBC means a company or a financial institution carrying on all or any of the following types of business:

(a) Collection of money in one lump sum/instalments, by way of **(i)** contributions/subscriptions, **(ii)** sale of units/certificates/other instruments, **(iii)** in any other manner, **(iv)** as membership/admission fee, **(v)** service charges to/or with respect to any savings, mutual benefits, thrift or any other scheme/arrangement and utilisation of the collected money or the income accruing from investment for all/any of the following purposes:
   1. To give/award to subscribers by a draw of lots prizes/gifts in cash/kind.
   2. To refund to the subscribers the subscriptions/contributions/other money collected with/without any bonus/premium/interest rate on the termination of the scheme/arrangement or on/after the expiry of the stipulated period.

(b) Manage/conduct/supervise transaction/arrangement relating to an agreement with the subscribers, each one of whom subscribes a certain sum in instalments over a definite period, and is entitled to a prize amount on the basis of draw of lots or by auction/tender.

(c) Conduct any other form of chit/kuri.

(d) Undertake/carry on/engage in/execute any other business similar to those referred to above.

Meaning of RNBCs The RBI directions, 1987, define RNBCs as companies that are a non-banking institution receiving deposits under any scheme/arrangement in one lump sum/instalments by way of contributions/subscriptions or by sale of units/certificates/other instruments or in any other manner. NBFCs and MNBCs are excluded from the category of RNBCs. In other words, all non-banking companies other than NBFCs and MNBCs fall into the category of RNBCs.

Acceptance of Deposits

The Directions regulate the acceptance of public deposits, as defined under Section 45I(bb) of the RBI Act, excluding the amount received from the following.

- Received from or guaranteed by the Central/State government, local authority, foreign government/citizen, authority or person.
- Received from IDBI/LIC/GIC/SIDBI/UTI/NABARD/Electricity Boards/TIIC/ NIDC/ICICI/IFCI/IIBI/STC/REC/MMTC/SIDCs/ADB/IFC/ any institution specified by the RBI.
- Received from any other company.
- Received by way of subscription to shares/stock/bonds debentures, or by way of calls in advance on shares.
- Received from directors/shareholders, provided the amount is not given out of borrowed/acquired funds from others. However, in the case of joint shareholders of a private company, money received from or in the name of the joint shareholders, except the first named shareholder, would not be eligible to be treated as a receipt of money from the shareholders of the company.
- Raised by issue of convertible bonds/secured debentures not exceeding the market value of the security.
- Brought in by promoters by way of unsecured loan—in pursuance of stipulations of lending institutions, in fulfillment of their obligations—provided the loan is brought in by promoters or their relatives, but not from friends/business associates, till the repayment of the institutional loan.
- Received from mutual funds.
- Received as hybrid debt/subordinated debt, with a minimum maturity period of 60 months without option for recall by the issuer.
- Received from a relative of a director of a NBFC.
- Received by issuance of commercial papers.
- Received by a systematically important non-deposit taking NBFC by issuance of perpetual debt instruments.
- Raised by issue of infrastructure bonds by an infrastructure finance company.

Restrictions on Mutual Benefit Financial Companies (MBFCs)/Mutual Benefit Companies (MBCs) Such companies can accept/renew deposits only from their shareholders, provided they are not in the nature of current account deposits. However, they cannot issue advertisements in any form and in any media for inviting deposits from them. They are also not permitted to pay any brokerage/commission/incentive or any other benefit to any person for collecting deposits. The other provisions of these directions are not applicable to MBFCs/MBCs, with the exception of the ceiling on the rate of interest on deposits (specified subsequently).

Restrictions on Non-Banking Financial Companies (NBFCs) ***Minimum Credit Rating*** NBFCs that have minimum net owned funds (NOF) of ₹25 lakh can accept public deposits, provided they obtain minimum investment grade or other specified credit rating for their fixed deposits from one of the approved rating agencies, at least once a year. A copy of the rating must be sent to the RBI along with the return, on prudential norms. However, these stipulations do not apply to an asset finance company. The RBI must also be informed, in writing, within 15 days of the upgradation/downgrading of the ratings, if any. The stipulated minimum credit rating from the various credit rating agencies are as specified below:

	Credit Rating Agency	*Minimum Rating*
1.	Credit Rating Information Services of India Ltd (CRISIL)	FA-(FA Minus)
2.	Investment Information and Credit Rating Agency of India Ltd. (ICRA)	MA-(MA Minus)
3.	Credit Analysis & Research Ltd (CARE)	CARE BBB (FD) (Triple B)
4.	FTICH Rating India Private Ltd	[t_A-(ind) (FD)]
5.	Brickwork Rating India Pvt. Ltd. (Brickwork)	[(BWR) (FA)]
6.	SME Rating Agency of India Ltd (SMERA)	SMERA (A)

Periods of Deposits NBFCs cannot accept deposits payable on demand. They can accept/renew deposits for a minimum period of 12 months to a maximum period of 60 months from the date of acceptance/renewal.

Ceiling on Quantum of Deposit An asset finance/loan/investment company/factor having RBI stipulated NOF and complying with all prudential norms can accept/renew deposits upto one and one-half times of its NOF.

Down Grading of Credit Rating In the event of downgrading of credit rating below the minimum specified investment grade, their excess deposit should be regularised in the manner specified. They must immediately stop accepting deposits and report the position within 15 working days to the RBI. All existing deposits should run-off maturity.

Ceiling on the Rate of Interest There is a ceiling on the rate of interest on deposits. It may be paid or compounded at rests not shorter than monthly rests. The ceiling is currently 12.5 per cent.

Payment of Brokerage The permissible brokerage, commission, incentive or any other benefit on deposits with all NBFCs is 2 per cent of the deposit. The expenses, by way of reimbursement on the basis of related vouchers/bills produced, up to 0.5 per cent of the deposits are also permitted.

Intimation of Maturing of Deposits It is obligatory for a NBFC to intimate the details of maturely of the deposit to the depositor at least two months before the date of its maturity

Renewal of Deposits NBFCs can permit existing depositors to renew their deposits before maturity to avail of the benefit of a higher rate of interest provided: **(i)** the deposit is renewed in accordance with the other provisions of these directions and for a longer duration than the remaining period of the original contract and **(ii)** the interest on the expired period of the deposit is reduced by 1 per cent from the rate that the NBFC would have ordinarily paid had the deposit been accepted for the period for which it has run; any interest paid earlier in excess of such reduced rate is recovered/adjusted. In this context, a depositor means any person who has made a deposit with a company; or a heir, legal representative, administrator or assignee of the depositor.

Payment of Interest on Overdue Deposits The directions permit NBFCs to pay interest, at their discretion, on overdue public deposits/or a portion of it from the date of maturity if:

(i) The total amount/part of the overdue deposit is renewed from the date of maturity till some future date according to the other relevant provisions of these directions and

(ii) The interest should be appropriate rate operative on the date of maturity of such overdue deposits, which would be payable only on the amount of renewed deposits.

If the NBFC fails to repay the deposit along with interest on maturity, following a claim made by the depositor, it would be liable to pay interest from the date of claim till the date of repayment, at the rate as applicable to the deposit.

In regard to the payment of interest on deposits which have been seized by the Government authorities/frozen till further clearance is received from them, the NFCs should follow the following procedure: **(i)** obtain a request letter from the customer on maturity for renewal including the term for renewal failing which the renewal may be for a term equal to the original terms; **(ii)** make a suitable note regarding renewal in the deposit ledger; **(iii)** advise by registered letter/speed post/courier service to the concerned Government department under advice to the depositor mentioning the rate of interest on renewal; and **(iv)** renewal may be done from the date of maturity in case the overdue period does not exceed 14 days on the date of the receipt of the request letter. For overdue period exceeding 14 days, any interest paid should be kept in a separate interest free sub-account and released together with the original deposit. However, the final repayment of the principal and the accrued interest should be made only after clearance from the respective Government agencies.

Joint Deposits Deposits may be accepted by the NBFCs in joint names with/without any of the clauses, that is, either or survivor, number one or survivor(s), anyone or survivor(s).

Particulars in Application Forms All NBFCs are required to accept/renew deposits only on a written application form, to be supplied by them to the depositors. The form should contain all particulars specified in the NBFCs/MNBCs Advertisement Rules, 1977. The application form should also contain the specific category of the deposits, that is, shareholder/director/promoter/member of public. The following additional information should also be included in them.

1. The credit rating assigned for its fixed deposit and the name of the credit rating agency or a statement from the management, if it is AFC that the quantum of public deposit held by it does not exceed 1.5 times of its NOF or not more than rupees ten crore, whichever is less.
2. In case of non-payment of the deposit/a part, as per the terms and condition of such deposits, the depositor may approach the Eastern/Western/ Northern/Southern Bench of the Company Law Board (specify full address) under whose jurisdiction the registered office of the NBFC is located.
3. In case of any deficiency of the NBFC in servicing its deposits, the depositor may approach the National/State/District Level Consumer Research Forum for relief.

4. A statement that the financial position of the NBFC, as disclosed, and the declarations made in the application form are true and correct and the NBFC and its Board of Directors are responsible for their correctness and veracity.
5. The financial activities of the NBFC are regulated by the RBI. It must, however, be distinctly understood that the **RBI does not undertake any responsibility for the financial soundness or for the correctness of any of the statements or the representation made or opinions expressed and for repayment of deposit/discharge of liabilities by the NBFC.**
6. At the end of application form, but before the signature of the depositor, the following verification clause by the depositor should be appended. **"I have gone through the financial and other statements/particulars/declarations made/furnished by the NBFC and after careful consideration I am making the deposit with the NBFC at my own risk and volition".**
7. The information relating to and the aggregate dues from the facilities, both fund and non-fund based, extended to and the aggregate dues from companies in the same group/other entities/business ventures in which directors/the NBFC are holding substantial interest, and the total amount of exposure to such entities.

Every NBFC should obtain proper introduction of new depositors before opening their accounts and accepting deposits and keep on its records the evidence it has relied upon for the purpose of such introduction.

Advertisement and Statement in Lieu of Advertisement All NBFCs have to mandatorily comply with the provisions of the NBFCs/MNBCs Advertisement Rules, 1977. They also should specify the following in every advertisement:

(i) Actual rate of return by way of interest, premium, bonus and other advantages to depositors;
(ii) Mode of repayment of deposit;
(iii) Maturity period of deposit;
(iv) Interest payable on deposits;
(v) Rate of interest payable on premature withdrawal of the deposits;
(vi) Terms and conditions for the renewal of deposits;
(vii) Any other special features relating to the terms and conditions for the acceptance/renewal of deposits and
(viii) Information relating to the aggregate dues (including the non-fund based facilities provided to) from companies in the same group or other entities/business ventures in which the Directors and/or the NBFC are holding substantial interest, and the total amount of exposure to such companies.
(ix) The deposits are not insured.

Where an NBFC displays any advertisement in electronic media, even without soliciting deposits, it should incorporate a caption/band in such advertisement indicating: **(i)** as regards deposits taking activity of the company, the viewers may refer to the newspaper/information furnished in the application form for soliciting public deposits, **(ii)** the company is having a valid certificate of registration from the RBI. However, the RBI does not accept any responsibility/guarantee about the present position as to the financial soundness of the company or for the correctness of any of the statements/representation made/opinions expressed by the company and for repayment of deposits/discharge for the liabilities by the company.

Where a NBFC intends to accept deposits without inviting such deposits, it has to file a statement in lieu of the advertisement with the RBI containing all the particulars specified above and duly signed in the specified manner. Such a statement is valid for six months. Fresh statements would have to be delivered in each succeeding year before accepting public deposit in that financial year.

General Provisions Regarding Repayment of Public Deposits The provisions are discussed below:

Lock-in Period An NBFC can not grant loan against, or make premature repayment of, a public deposit within the lock-in period of 3 months from the date of its acceptance. However, in the event of the death of a depositor, the NBFC may on request repay it prematurely even within the lock-in period on submission of satisfactory proof of death to the joint depositor/nominee/legal heir of the depositor.

Repayment of Deposits by a Non-Problem NBFC A non-problem NBFC may **(1)** permit premature repayment of a public deposit at its sole direction; it may repay prematurely after three months from the date of deposit at the request of the depositor, **(2)** grant a loan upto 75 per cent of the deposit after 3 months from the date of deposit at a rate of interest 2 percentage points above the rate of interest payable on the deposit.

Repayment by a Problem NBFC **A problem NBFC** means a NBFC which **(i)** has refused/failed to meet within 5 days any lawful demand for repayment of a matured deposit, or **(ii)** intimates the Company Law Board under Section 58-AA of the Companies Act about its default to a depositor in repayment of any deposit/a part of it/any interest on it, or **(iii)** approaches the RBI for withdrawal of liquid asset securities to meet deposit obligations, or for any relief/relaxation/exemption from the provisions of the RBI Public. Deposits Acceptance Prudential Norms Directions, or **(iv)** has been identified by the RBI to be a problem NBFC either **suo motu** or based on complaints from depositors/lenders about non-payment of public deposits/dues. Such a company may, to enable a depositor to meet expenses of an emergent nature, prematurely **(a)** repay a tiny deposit (i.e. aggregate amount not exceeding ₹10,000 in the name of the sole/first named depositor in all the branches of the NBFC) in entirety/upto ₹10,000 in case of any other deposit, **(b)** grant a loan of a similar amount at a rate of interest 2 percentage points above the rate of interest payable on the deposit.

> **Problem NBFC**
> is a NBFC which has refused/failed to meet any lawful demand for repayment of a matured deposit within five days.

For the purpose of premature repayment, all deposit accounts standing to the credit of sole/first named depositor should be clubbed and treated as one account. Where an NBFC prematurely repays a public deposit for any of the above reasons, it would pay interest at the following rates: **(a)** After 3 months but more than 6 months: not interest, **(b)** After 6 months but before maturity: 2 per cent lower than the interest applicable to a deposit for the period for which the concerned deposit has run. If no rate has been specified for that period, 3 per cent lower than the minimum rate at which public deposits are accepted by the NBFC.

Deposit Receipts All NBFCs/MNBCs/RNBCs have to furnish depositors/joint depositors or their agents with a receipt of the deposit, stating the date of deposit, name of the depositor(s), the amount of deposit (in words and figures), rate of interest and date of maturity. It must be signed by an officer who can act on behalf of the company in this regard.

Register of Deposits All NBFCs/MNBCs/RNBCs have to keep register(s) of deposits, containing each depositor's particular, as detailed below:

(a) Name and address,
(b) Date and amount of each deposit,
(c) Duration and due date of each deposit,
(d) Date and amount of accrued interest/premium on each deposit,
(e) Date of claim made by depositor,
(f) Date and amount of each repayment of principal/interest,
(g) Reason for delay in repayment beyond five working days and
(h) Any other particulars relating to the deposits.

The register of deposits should be kept at respective branches of the NBFC and, a consolidated register for all the branches at its registered office, for at least eight years following the financial year in which the latest entry is made for repayment/renewal of any deposit whose particulars are contained in the register.

Branches and Appointment of Agents to Collect Deposits An NBFC registered with the RBI/otherwise entitled to accept public deposits can open a branch or appoint agents to collect deposits **(i)** within the State where its registered office is situated, **(ii)** anywhere in India if its NOF is more than ₹50 crore with a credit rating above **AA**. The NBFC should notify the RBI of its intention to open the proposed branch. Within 30 days from the date of receipt of such notice/advice, if no advice of rejection of the proposal is communicated by the RBI, the NBFC may proceed with its proposal.

Closure of Branches An NBFC can close its branch(es)/office(s) after publishing its intention in one national level newspaper and in one vernacular newspaper in circulation in the relevant place, and advising the RBI 90 days before the proposed closure. Within 7 days of its publication, and intimation should be sent to the RBI.

Safe Custody of Liquid Assets/Collection of Interest on SLR Securities Every NBFC should open a Constituent's Subsidiary General Ledger (CSGL) account with a bank/Stock Holding Corporation of India (SHCIL) or a demat account with a depository to keep the unencumbered approved securities. It should also designate a bank as its designated banker to entrust in physical form its unencumbered term deposits which are not dematerialised. Such securities would be traded according to the specified procedure and the extent permitted. They can be used only for repayment to depositors with the RBI's prior approval.

Information to be Included in the Board's Report In every report of the Board of Directors of NBFCs under Section 217 of the Companies Act, the following particulars or information must be included:

(i) The total number of accounts of public deposit of the NBFC that have not been claimed by the depositors or not paid by the NBFC after the date on which the deposit became due for repayment and
(ii) The total amounts due to such accounts remaining unclaimed or unpaid beyond the due dates.

These particulars or information should be furnished with reference to the position as on the last day of the financial year to which the report relates and if the amounts remaining unclaimed or undisbursed exceed in the aggregate a sum of ₹5 lakh, the report should also contain a statement on the steps taken or proposed to be taken by the Board of Directors for the payment of the remaining unclaimed or undisbursed amounts due to the depositors.

Employees Security Deposit All NBFCs receiving any amount, in the ordinary course of their business, as security deposit from any of their employees, for due performance of their duties, should keep such amount in an account with a scheduled commercial bank or in the post office in the joint names of the employees and the NBFC on the condition that the amount would not be withdrawn without the written consent of the employee, and it is repayable to the employee along with the interest payable on such deposit account, unless such amount or any part of it is liable to be appropriated by the NBFC for failure on the part of the employee in the due performance of his duties.

Submission of Accounts All NBFCs accepting/holding public deposits have to deliver to the RBI—at the Regional Office of the Department of Non-Banking Supervision, within whose jurisdiction their registered offices are located—an audited balance sheet as on the last date of each financial year and an audited profit and loss account in respect of that year, as passed by the company in general meeting, together with a copy of the report of the Board of Directors, within 15 days of such meeting, as also a copy of the report and notes on the accounts furnished by its auditors.

Cover for Public Deposits To ensure protection of depositors interest, all NBFCs should ensure that there is full cover for all public deposits. They should create a registered floating charge on their statutory liquid assets in their favour through a Trust Deed.

On failure to repay a public deposit, NBFCs are prohibited from granting loan/other credit facility or making any investment creating any other asset as long as the default exists.

Restrictions on Investments The ceiling on investment in land/building, except for own use, by asset finance/loan/investment company is 10 per cent of owned fund. While AFCs can invest upto 10 per cent of owned fund in unquoted shares of a company, other than a subsidiary/same group company, the ceiling for a loan/investment company is 20 per cent. These restrictions would not apply to investment in equity capital of an insurance company.

Provision for Submitting Auditor's Certificate All NBFCs holding/accepting public deposits are required to furnish to the RBI, along with a copy of the audited balance sheet, a copy of the auditor's report to the Board of Directors and a certificate from its auditor to the effect that the full liabilities to the depositors of the company, including the interest payable, are properly reflected in the balance sheet and that the company is in a position to meet the amount of such liabilities to the depositors.

Information to RBI The NBFCs should also intimate to the RBI within one month from the occurrence of any of the following changes:

(i) The complete postal address, telephone number(s) and fax number(s) of the registered/corporate office;

(ii) The names and residential address of the directors of the company;

(iii) The names and the official designation of its principal officers;
(iv) The specimen signatures of the officers authorised to sign on behalf of the company and
(v) The names and office addresses of the auditors of the company.

NON-BANKING FINANCIAL COMPANY—SYSTEMICALLY IMPORTANT NON-DEPOSIT TAKING AND DEPOSIT TAKING COMPANY DIRECTIONS, 2016

The RBI **(i)** in public interest, **(ii)** to regulate the financial system to the advantages of the country and **(iii)** to prevent the affairs of any systematically important non-deposit taking non-banking financial company (**NBFC-ND-SI**) and deposit taking non-banking financial company (**NBFC-ND**) from being conducted in a manner detrimental to the interest of investors/depositors or in any manner prejudicial to the interest of the NBFCs, has been issuing directions in exercise of its powers under the RBI Act and the Factoring Regulation Act since 1998. These were comprehensively revised in 2016. The directions relating to the NBFC-ND-SI and NBFC-D are discussed in this Section. The provisions of the directions relating to the NBFC-Non-systematically important non-deposit taking companies (**NBFC-ND**) are covered in the next Section.

> **NBFC-ND-SI/NBFC-D** means a NBFC not accepting/holding public deposits and having maximum total assets of ₹500 crores.

The provisions of these Directions apply to the following: **(i)** systemically important non-deposit taking NBFCs, **(NBFC-ND-SI)**, **(ii)** deposit-taking NBFC **(NBFC-D)**, **(iii) NBFC-factor**, **(iv)** infrastructure debt fund – NBFC **(IDF-NBFC)**, **(v)** NBFC – micro finance institutions **(NBFC-MFIs)** and **(vi)** NBFC - infrastructure finance Company **(NBFC-IFC)** having an asset size of ₹500 crore and above. They are referred to as **applicable NBFCs**. The specific directions applicable to the specific categories of NBFCs registered as NBFC-Factors, IDF-NBFCs and NBFC-MFIs are also discussed in this Section.

A **systematically important** non-deposit taking NBFC means a NBFC not accepting/holding public deposits and having maximum total assets of ₹500 crores. The minimum net owned fund for a NBFC to commence/carry on business is ₹200 lakh, failing which it would not be eligible to hold certificate of registration (CoR) as NBFC from the RBI.

> **IDF-NBFC** has minimum NNOF of ₹300 crores and invest only in PPP and COD and is a party to a tripartite agreement.

Infrastructure Debt Fund-Non-Banking Financial Company (IDF-NBFC) An IDF-NBFC means a non-deposit taking NBFC that has minimum net owned fund of ₹300 crore or more and which invests only in public private partnerships (PPP) and post-commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a tripartite agreement.

> **NBFC-IFC** has: (a) a minimum of 75 per cent of its total assets deployed in "infrastructure loans"; (b) minimum net owned funds of `300 crore; (c) minimum credit rating `A' or equivalent; (d) CRAR of 15 per cen.

An **Infrastructure Finance Company (NBFC-IFC)** means a non-deposit taking NBFC that has: **(a)** a minimum of 75 per cent of its total assets deployed in "infrastructure loans"; **(b)** minimum net owned funds of ₹300 crore; **(c)** minimum credit rating '**A**' or equivalent; **(d)** CRAR of 15 per cent (with a minimum Tier-I capital of 10 per cent).

Infrastructure lending means a credit facility extended by NBFC to a borrower, by way of term/project loan, subscription to bonds/debentures/

preference shares/equity shares in a project company acquired as a part of the project finance package such that subscription amount to be "in the nature of advance" or any other form of long term funded facility for exposure in the following infrastructure sub-sectors, namely, transport, energy, water and sanitation, communication and social and commercial infrastructure.

A **Non-Banking Finance Company – Factor (NBFC-Factor)** means a non-banking financial company having at least 50 per cent of **(i)** its total assets in financial assets and **(ii)** gross income from factoring business.

A **Non-Banking Financial Company – Macro Finance Institution (NBFC-MFI)** means a non-deposit taking NBFC having minimum net owned funds of ₹5 crore and not less than 85 per cent of its net assets are in the nature of **qualifying assets**. **Net assets** mean total assets other than cash and bank balances and money market instruments. **Qualifying asset** means a loan which satisfies the following criteria: **(i)** loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹1,00,000 or urban and semi-urban household not exceeding ₹1,60,000; **(b)** loan amount does not exceed ₹60,000 in the first cycle and ₹1,00,000 in subsequent cycles; **(iii)** total indebtedness of the borrower does not exceed ₹1,00,000 and medical expenses should be included while arriving at the total indebtedness of a borrower; **(iv)** tenure of the loan to be not less than 24 months for loan amount in excess of ₹30,000 with prepayment without penalty; **(v)** loan to be extended without collateral; **(vi)** aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs; and **(vii)** loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower. A **Non-Operative Financial Holding Company (NOFHC)** means a non-deposit taking NBFC which holds the shares of the banking company and the shares of all other financial services companies in its group.

> **NBFC-Factor**
> has at least 50 per cent of (i) its total assets in financial assets and (ii) gross income from factoring business.
>
> **NBFC-MFI**
> has minimum net owned funds of ₹5 crore and not less than 85 per cent of its net assets are in the nature of qualifying assets.

> **NOFHC**
> means a non-deposit taking NBFC which holds the shares of the banking company and the shares of all other financial services companies in its group.

The main elements of the NBFC-ND-ST/NBFC-D directions: **(i)** prudential issues and **(ii)** governance issues are discussed below.

Prudential Issues

The prudential issues pertain to **(i)** capital requirements, **(ii)** prudential regulations, **(iii)** fair practices, **(iv)** specific directions applicable to NBFC-Factor, IDF-NBFC and NBFC-MFIs.

Capital Requirements Every applicable NBFC should maintain a minimum capital ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items. The minimum Tier-I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time should be 10 per cent. The NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 per cent or more of their financial assets) should maintain a minimum Tier-l capital of 12 per cent. Tier-I capital means **(a)** owned funds as reduced by investment in **(i)** shares of other NBFCs and **(ii)** shares/debentures/bonds/outstanding loans and advance including hire-purchase/lease finance made to, and deposits with, subsidiaries/companies in the same group in excess of 10 per cent of the owned fund and **(b)** perpetual debt instrument issued by the NBFC in each year upto the extent of 15 per cent of its aggregate Tier-I capital. Owned funds means paid-up capital, compulsorily convertible preference share, free reserves, balance in share premium account and capital reserves, excluding revaluation reserves, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure. Group company means an arrangement involving two/more related entities through any of the following relationships: **(i)** subsidiary-parent, **(ii)** joint venture, **(iii)** associate, **(iv)** promoter-promotee for listed companies, **(v)** related party, **(vi)** common brand name and **(vii)** minimum investment in equity shares of 20 per cent. Tier-II capital includes the following:**(a)** preference shares other than those which are compulsorily convertible into equity, **(b)** revaluation reserves at discounted rate of 55 per cent, **(c)** general provisions (including that for standard assets) and loss reserves to the extent not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of 1.25 per cent of risk weighted asset, **(d)** hybrid debt capital instruments (i.e. which passes certain qualities of debt as well equity), **(e)** subordinated debt; and **(f)** perpetual debt instruments in excess of what qualifies for Tier-I capital, to the extent the aggregate does not exceed Tier-I capital. Subordinated debt means an instrument, which is **(i)** fully paid up, **(ii)** unsecured, **(iii)** subordinated to the claims of other creditors and **(iv)** free from restrictive clauses and **(v)** not redeemable at the instance of the holder or without the consent of the supervisory authority of the NBFC. This book value would be subjected to discounting as shown below to the extent such discounted value does not exceed 50 per cent of Tier-I capital.

Remaining maturity of the instruments	*Rate of discount (%)*
(a) Upto one year	100
(b) More than 1 year but upto 2 years	80
(c) More than 2 years but upto 3 years	60
(d) More than 3 years but upto 4 years	40
(e) More than 4 years but upto 5 years	20

I. On-Balance Sheet Assets Degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weight to arrive at risk adjusted value of assets. The aggregate should be taken into account for reckoning the minimum capital ratio. The risk weighted asset should be calculated as the weighted aggregate of funded items as detailed below:

Weighted Risk Assets – On Balance Sheet Items	*Percentage weight*
(i) Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii) Investments	
(a) Approved securities [expected at **(c)** below]	0
(b) Bonds of public sector banks	20
(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
(d) Shares and debentures/bonds/commercial papers of all companies and units of all mutual funds	100

	(e) All assets covering PPP (public-private-partnership) and post-commercial operations date (COD) infrastructure projects in existence over a year of commercial operations	50
(iii)	Current assets	
	(a) Stock on hire (net book value)	100
	(b) Intercorporate loans/deposits	100
	(c) Loans and advances fully secured against deposits held	0
	(d) Loans to staff	100
	(e) Other secured loans and advances considered good [except at **(vi)** below]	100
	(f) Bills purchased/discounted	100
	(g) Others (to be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture and fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100
(vi)	Domestic sovereign	
	(a) Fund based claims on the Central Government	0
	(b) Direct loan/credit/overdraft exposure and investment in State Government securities	0
	(c) Central Government guaranteed claims	0
	(d) State Government guaranteed claims, which have not remained in default/which are in default for a period not more than 90 days	20
	(e) State Government guaranteed claims which have remained In default for more than 90 days.	100

Notes:

1. Netting should be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.
2. Assets which have been deducted from owned fund to arrive at net owned fund should have a weightage of ‘zero’.
3. While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, cash margin/caution money/security deposits (against which right to setoff is available) held as collateral against the advances out of the total outstanding exposure of the borrower should be netted off.
4. Norms for investment in securities pertaining to infrastructure facility: (a) Risk weight for investment in AAA rated securitised paper should attract risk weight of 50 per cent subject to the fulfilment

of the following conditions: (i) infrastructure facility generates income/cash flows, which ensures servicing/repayment of the securitised paper, (ii) the rating is current and valid, that is, is not more than one month old, and the rating rationale is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale form part of the offer document, (iii) In the case of secondary market acquisition, the 'AAA' rating of the issue is in force and confirmed from the monthly bulletin published by the respective rating agency, (iv) The securitised paper is a performing asset.

II. Off-balance Sheet Items *(1) General* The applicable NBFC should calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. It should be calculated by means of a two-step process: **(i)** the notional amount of the transaction should be converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and **(ii)** the resulting credit equivalent amount should be multiplied by the risk weight applicable, for example, zero per cent for exposure to Central/State Governments, 20 per cent for exposure to banks and 100 per cent for others.

(2) Non-market-related Off- balance Sheet Items The credit equivalent amount in relation to a non-market related off-balance sheet item should be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF) as detailed below.

Sr. No.	*Instruments*	*Cash conversion factor*
(i)	Financial and other guarantees	100
(ii)	Shares/debentures/underwriting obligations	50
(iii)	Partly-paid shares/debentures	100
(iv)	Bills discounted/rediscounted	100
(v)	Lease contracts entered into but yet to be executed	100
(vi)	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the applicable NBFC	100
(vii)	Forward asset purchases, forward deposits and partly paid share and securities, which represent commitments with certain draw down	100
(viii)	Lending of NBFC securities or posting of securities as collateral, including instances where these arise out of repo style transactions	100
(ix)	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of:	
	up to one year	20
	over one year	50
(x)	Similar commitments that are unconditionally cancellable at any time without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness	0
(xi)	Take-out finance in the books of taking-over institution:	

	(i) Unconditional take-out	100
	(ii) Conditional take-out	50
(xii)	Commitment to provide liquidity facility for securitisation of standard asset transactions	100
(xiii)	Second loss credit enhancement for securitisation of standard transactions provided by third party	100
(xiv)	Other contingent liabilities (to be specified)	50

Note:

1. Cash margins/deposits should be deducted before applying the conversion factor.
2. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of on-balance sheet credit exposure.
   For example: A term loan of ₹700 crore is sanctioned for a large project which can be drawdown in stages over 3-year period. The terms of sanction allow drawdown in three stages: ₹150 crore in Stage I, ₹200 crore in Stage II and ₹350 crore in Stage III, where the borrower needs the applicable NBFC's explicit approval for drawdown under Stages II and III after completion of certain formalities. If the borrower has drawn already ₹50 crore under Stage I, the undrawn portion would be computed with reference to Stage I alone, that is, it will be ₹100 crore. If Stage I is scheduled to be completed within one year, the CCF will be 20 per cent and if it is more than one year then the applicable CCF will be 50 per cent.

(3) Market Related Off-Balance Sheet Items The applicable NBFCs should take into account all market related off-balance sheet items (OTC derivatives and securities financing transactions such as repo/ reverse repo/ CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures. The credit risk on market related off-balance sheet items is the cost to an applicable NBFC of replacing the cash flow specified by the contract in the event of counterparty default. This should depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument. The market related off-balance sheet items would include: **(a)** interest rate contracts including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures; **(b)** foreign exchange contracts, including contracts involving gold, includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options; **(c)** credit default swaps; and **(d)** any other market related contracts specifically allowed by the RBI which give rise to credit risk. Exemption from capital requirements is permitted for - **(a)** foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and **(b)** instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments. The exposures to central counter parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. collateralised borrowing and lending obligations: CBLOs, Repos) outstanding against them should be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. A CCF of 100 per cent should be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure should be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight should

be 20 per cent and for other CCPs, risk weight should be 50 per cent. The total credit exposure to a counterparty in respect of derivative transactions shall be calculated according to the current exposure method as explained below.

(4) Current Exposure Method The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of **(i)** Current credit exposure and **(ii)** potential future credit exposure of the contract. **Current credit exposure** is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The current exposure method requires periodical calculation of the current credit exposure by marking these contracts to market. **Potential future** credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit Conversion Factors for interest rate related, exchange rate related and gold related derivatives

	Credit Conversion Factors (%)	
	Interest Rate Contracts	*Exchange Rate Contracts and Gold*
1 year or less	0.50	2
Over 1 year to 5 years	1.00	10
Over 5 years	3.00	15

(a) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

(b) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity should be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1 per cent.

(c) No potential future credit exposure should be calculated for single currency floating / floating interest rate swaps. The credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

(d) Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the lending rate of the applicable NBFC would have an effective notional amount of USD 2 million.

(5) Credit Conversion Factors for Credit Default Swaps (CDS): The applicable NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds should

be held in current category or permanent category. The capital charge for these exposures shall be as under:

(i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection should be permitted to be recognised to a maximum of 80 per cent of the exposure hedged. Therefore, the applicable NBFC should continue to maintain capital charge for the corporate bond to the extent of 20 per cent of the applicable capital charge. This can be achieved by taking the exposure value at 20 per cent of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition, the bought CDS position should attract a capital charge for counterparty risk which should be calculated by applying a credit conversion factor of 100 per cent and a risk weight as applicable to the protection seller, that is, 20 per cent for banks and 100 per cent for others.

(ii) For corporate bonds held in permanent category and hedged by CDS where there is no -mismatch between the CDS and the hedged bond. The applicable NBFCs can recognise full credit protection for the underlying asset and no capital should be required to be maintained thereon. The exposure should stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller, that, 20 per cent for banks and 100 per cent for others.

Prudential Regulations The prudential regulations relate to income recognition, income from investments, accounting standards, accounting of investments, policy on demand call loans, asset classification and provisioning requirements.

Income Recognition The income recognition should be based on recognised accounting principles. Income including interest/discount/hire-charges/lease rentals or any other charges on non-performing assets (**NPA)** should be recognised only when it is actually realised. Any income recognised before the asset became non-performing (NPA) and remaining unrealised should be reversed.

Income From Investments Income from dividend on shares of corporate bodies and units of mutual funds should be taken into account on cash basis. However, the income from dividend on shares should be taken into account on accrual basis when it has been declared by the corporate body in its annual general meeting and the applicable NBFCs right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds should be taken into account on accrual basis if the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears. Income on securities of corporate bodies/public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government, should be taken into account on accrual basis.

Accounting Standards The Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (**ICAI**) should be followed insofar as they are not inconsistent with any of RBI directions.

Accounting of Investments The Board of Directors of every applicable NBFC should frame investment policy for the company and implement the same. The criteria to classify the investments into **current** and **long term** investments should be spelt out in the investment policy. **Current**

investments means an investment which is by its nature readily realisable and is intended to be held for not more than one year. Investments other than current are **long-term investments**. Investments in securities should be classified into current and long term, at the time of making each investment. Inter-class transfer, should not be on ad-hoc basis. It should be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board. The investments should be transferred scrip-wise, from current to long term or *vice-versa*, at the lower of the book value or market value. The depreciation in each scrip should be fully provided for and appreciation ignored. The depreciation in one scrip should not be set-off against appreciation in another scrip even in respect of the scrips of the same category.

Quoted current investments should, for the purposes of valuation, be grouped into the following categories: **(a)** equity shares, **(b)** preference shares, **(c)** debentures and bonds, **(d)** Government securities including treasury bills, **(e)** units of mutual fund, and **(f)** others. They should be valued at the lower of the cost or market value. The investments in each category should be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost, the net depreciation should be provided for/charged to the profit and loss account. If the aggregate market value exceeds the aggregate cost, the net appreciation should be ignored. Depreciation in one category of investments should not be set-off against appreciation in another category.

Unquoted equity shares in the nature of current investments should be valued at cost or breakup value, whichever is lower. However, applicable NBFCs should substitute fair value for the breakup value of the shares, if considered necessary. **Break-up value** means the equity capital and reserves less intangible assets and revaluation reserves divided by the number of equity shares. **Fair value** means the mean of the earning value and break-up value. **Earning value** means the value of an equity share computed by taking the average of profits after tax less the preference dividend and adjustment for extraordinary/non-recurring items for the immediately preceding 3 years and further divided by the number of equity shares and capitalised at the following rates: in case of **(i)** predominantly manufacturing company, 8 per cent, **(ii)** predominantly trading company, 10 per cent and **(iii)** any other company including NBFC, 12 per cent. In case of a loss making company, the earning value will be zero. Where the balance sheet of the investee company is not available for two years, such shares should be valued at one Rupee only. **Unquoted preference** shares in the nature of current investments should be valued at cost or face value, whichever is lower. Investments in unquoted Government securities/guaranteed bonds should be valued at carrying cost. **Unquoted investments** in the units of mutual funds in the nature of current investments should be valued at the net asset value declared by the mutual fund in respect of each particular scheme. **Commercial papers** should be valued at carrying cost. A **long-term investment** should be valued in accordance with the accounting standard issued by ICAI.

***Note*:** Unquoted debentures should be treated as term loans or other type of credit facilities depending upon their tenure for the purpose of income recognition and asset classification.

Need for Policy on Demand/Call Loans The Board of Directors of every applicable NBFC granting/intending to grant demand/call loans should frame a policy for the company stipulating, *inter alia*, the following **(i)** A cut-off date within which the repayment of demand/call loan should be demanded/called up; **(ii)** The sanctioning authority should record specific reasons in writing, at the time of sanctioning demand or call loan, if the cut-off date for demanding/calling-up is stipulated beyond a period of one year from the date of sanction; **(iii)** The rate of interest payable should be at monthly/quarterly rests; **(iv)** The sanctioning authority should record specific reasons in, if no interest is stipulated or a moratorium is granted for any period; **(v)** A cut-off date, for review of performance of the loan, not exceeding 6 months commencing from the date of sanction; **(vi)** The demand/call loans should not be renewed unless the periodical review has shown satisfactory compliance with the terms of sanction.

Asset Classification The following asset classification norms would apply to every applicable NBFC (**except NBFC-MFIs**). Every NBFC should, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire-purchase assets, loans and advances and any other forms of credit into the following classes: **(i)** Standard assets; **(ii)** Sub-standard assets; **(iii)** Doubtful assets; and **(iv)** Loss assets. The assets should not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation. **Standard asset** means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem or carry more than normal risk attached to the business. **Sub-standard asset** means: an asset **(a)** which has been classified as NPA upto 12 months; **(b)** where the terms of the agreement regarding interest and / or principal have been renegotiated/rescheduled/restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms. **Doubtful asset** means: **(a)** a term loan/lease asset, a hire-purchase asset/any other asset, which remains a sub-standard asset beyond 12 months. **Loss assets** mean: an asset which **(a)** has been identified as loss asset by the NBFCs its internal/external auditor/RBI during inspection, to the extent it is not written-off; and **(b)** is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

> **Standard asset**
> means the asset in respect of which, no default in repayment of principal or payment of interest is perceived.

> **Sub-standard asset**
> means: an asset (a) which has been classified as NPA upto 12 months.

> **Doubtful asset**
> remains a sub-standard asset beyond 12 months.

> **Loss assets**
> mean an asset which has been identified as loss to the extent not written-off.

Non-performing asset means: **(a)** an asset in respect of which interest has remained overdue for of 3 months, **(b)** a term loan inclusive of unpaid interest, when the instalment/interest amount is overdue for of 3 months, **(c)** a demand or call loan which interest remained overdue for 3 months, **(d)** a bill which remains overdue for of 3 months, **(e)** other current assets, that is, the interest in respect of a debt/income on receivables in the nature of short term loans/advances, which facility remained overdue for 3 months, **(f)** any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue of 3 months, **(g)** the lease rental and hire-purchase instalment, which has been overdue for of 12 months, **(h)** loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes NPA. In the case of lease and hire-purchase transactions, an applicable NBFC should classify each account on the basis of its record of recovery.

> **NPA**
> mean (i) an asset/loan/bill/ other current assets in respect of which principal/interest is overdue for 3 months and (ii) lease rental/hire-purchase instalment is over due for 12 months.

Provisioning Requirements The following provisioning requirements apply to every applicable NBFC (except **NBFC-MFIs**). Every applicable NBFC should, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard/doubtful/loss assets. The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted should be as below: **(i) Loss Assets**: the entire asset written-off. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for; **(ii) Doubtful Assets (a)** 100 per cent provision to the extent to which the advance is not covered by the realisable value of the security to which the applicable NBFC has a valid recourse should be made. The realisable value is to be estimated on a realistic basis; **(b)** In addition to **(a)** above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20 to 50 per cent of the secured portion (i.e. estimated realisable value of the outstanding) should be made on the following basis:

Period for which the asset has been considered as doubtful	*Provision (%)*
Up to 1 year	20
1 – 3 years	30
More than 3 years	50

(iii) Sub-standard assets: A general provision of 10 per cent of total outstanding.

The provisioning requirements in respect of hire purchase and leased assets should be as follows: The total dues (overdue and future instalments taken together) as reduced by **(a)** the finance charges not credited to the profit and loss account and carried forward as unmatured finance charge; and **(b)** the depreciated value of the underlying asset. The depreciated value of the asset should be notionally computed as the original cost of the asset to be reduced by 20 per cent per annum depreciation on a straight line method and in the case of second hand asset, the original cost would be the actual cost incurred for acquisition. The additional provision for overdue hire-charges/lease rentals (per cent of net book value) should be made.

(a) Upto 12 months	Nil
(b) 12 – 24 months	10
(c) 24 – 36 months	40
(d) 36 – 48 months	70
(e) More than 48 months	100

On expiry of 12 months after the due date of the last instalment of hire-purchase/leased asset, the entire net book value should be fully provided for. **Net book value** means **(i)** the aggregate of overdue and future instalments receivable less unmatured finance charge and the provisions for NPAs and **(ii)** the aggregate of capital portion of overdue lease rentals accounted as receivables and depreciated book value of the lease assets as adjusted by the balance of lease adjustment account in case of hire-purchase and leased assets respectively.

Standard Asset Provisioning Every applicable NBFC should make provisions for standard assets at 0.40 per cent of the outstanding, which would not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shown separately as **Contingent Provisions against Standard Assets** in the balance sheet.

Multiple NBFCs Applicable NBFCs that are part of a corporate group/are floated by a common set of promoters should not be viewed on a standalone basis. The total assets of the NBFCs in a group including deposit-taking NBFCs should be aggregated to determine if the consolidation falls within the asset sizes of the two categories, that is, those with asset size of below ₹500 crore and those with asset size of ₹500 crore and above. The regulations applicable to the two categories should be applicable to each of the non-deposit taking NBFCs within the group. The statutory auditors should certify the asset size of all the NBFCs in the group. However, NBFC-D, within the group should be governed under the RBI NBFCs Acceptance of Public Deposits Directions 2016 and prudential norms and other directions applicable to deposit-taking NBFCs.

Disclosure in the Balance Sheet Every applicable NBFC should separately disclose in its balance sheet the provisions without netting them from the income or against the value of assets. They should be distinctly indicated under separate heads of account, namely, **(i)** provisions for bad and doubtful debts; and **(ii)** provisions for depreciation in investments. They should not be appropriated from the general provisions and loss reserves held. They should be debited to the profit and loss account. The excess of provisions held under the heads general provisions and loss reserves should be written back without making adjustment against them. In addition, every applicable NBFC should disclose the following particulars in its balance sheet: **(i)** capital to risk assets ratio (CRAR); **(ii)** direct/indirect exposure to real estate sector and **(iii)** maturity pattern of assets and liabilities.

Accounting Year Every applicable NBFC should prepare its balance sheet and profit and loss account as on March 31 every year. Whenever it intends to extend the date of its balance sheet, it should take prior approval of the RBI before approaching the ROCs. Even in cases where the RBI/ROCs grant extension of time, it should furnish to the RBI a proforma balance sheet (unaudited) and the statutory returns as on March 31 of the year. It should finalise its balance sheet within 3 months from the date to which it pertains.

Schedule to the Balance Sheet Every applicable NBFC should append to its balance sheet prescribed under the Companies Act, the particulars in the specified schedule.

Transactions in Government Securities Every applicable NBFC should undertake transactions in Government securities through its CSGL account/its demat account. It should not undertake any transaction in government security in physical form through any broker.

Loans Against NBFCs Own Shares Prohibited No applicable NBFC should lend against its own shares.

Loans Against Security of Shares Applicable NBFC lending against the collateral of listed shares should, maintain a loan to value (LTV) ratio of 50 per cent for loans granted against the collateral of shares. The LTV ratio of 50 per cent should be maintained at all times. Any shortfall in the maintenance of the LTV occurring on account of movement in the share prices should be made good within 7 working days. In case where lending is done for investment in capital markets, accept only Group 1 securities as collateral for loans of value more than ₹5 lakh, subject to review by the RBI.

Concentration of Credit/Investment for Applicable NBFC (except NBFC-MFIs with asset size of ₹500 crore and above) No applicable NBFC should, **(i)** lend to **(a)** any single borrower/any single group of borrowers exceeding 15/25 per cent of its owned fund respectively, **(ii)** invest in **(a)** the shares of another company/single group of companies exceeding 15/25 per cent of its owned fund respectively; **(iii)** lend and invest (loans/investments taken together) exceeding 25 per cent to a single party and 40 per cent of its owned fund to a single group of parties. However, the ceiling on the investment in shares of another company would not be applicable to an applicable NBFC in respect of investment in the equity capital of an insurance company up to the extent specifically permitted by the RBI. The concentration of credit/investment norms may be exceeded by 5 per cent for any single party and by 10 per cent for a single group of parties, if the additional exposure is on account of infrastructure loan and/ or investment. However, these restrictions would not apply to **(a)** investments in shares of subsidiaries/companies in the same group, to the extent they have been reduced from owned funds for the calculation of NOF, and **(b)** the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with subsidiaries and companies in the same group to the extent they have been reduced from owned funds for the calculation of NOF. The infrastructure finance companies may, however, exceed the concentration of credit norms **(a)** in lending to any single borrower, by 10 per cent and any single group of borrowers, by 15 per cent of its owned fund; **(b)** in lending to and investing in, (loans/investments taken together) a single party, by 5 per cent and a single group of parties, by 10 per cent of its owned fund.

The concentration of credit/ investment norms would not apply to any applicable NBFC not accessing public funds in India, either directly or indirectly and not issuing guarantees. Every applicable NBFC (other than NBFC-D) should formulate a policy in respect of exposures to a single party/group of parties. An applicable NBFC which is held by an NOFHC should not **(i)** have any exposure (credit and investments including investments in the equity/debt capital instruments) to the promoters/promoter group entities or individuals associated with the promoter group or the NOFHC, **(ii)** make investment in the equity/ debt capital instruments in any of the financial entities under the NOFHC and **(iii)** invest in equity instruments of other NOFHCs.

***Notes*:**

1. For determining the limits, off-balance sheet exposures should be converted into credit risk by applying the conversion factors as explained earlier.
2. The investments in debentures for should be treated as credit and not investment.
3. These ceilings should be applicable to the credit/investment by an applicable NBFC to companies/firms in its own group as well as to the borrowers/ investee company's group.
4. **(a)** In case of factoring on **with-recourse** basis, the exposure should be reckoned on the assignor. **(b)** In case of factoring on **without-recourse** basis, the exposure should be reckoned on the debtor, irrespective of credit risk cover / protection provided, except in cases of international factoring where the entire credit risk has been assumed by the import factor.

Information With Respect to Change of Address, Directors, Auditors, etc. to be Submitted Every applicable NBFC should communicate to the RBI within one month from the occurrence of any change in: **(i)** the complete postal address, telephone number(s) and fax number(s) of the registered/ corporate office; **(ii)** the names and residential addresses of the directors of the company; **(iii)** the names and the official designations of its principal officers; **(iv)** the names and office address of the auditors of the company; and **(v)** the specimen signatures of the officers authorised to sign on behalf of the company.

Norms for Restructuring of Advances Norms for restructuring of advances by applicable NBFCs should be on the lines of the norms specified by the RBI for banks. **These are available in Khan, M Y, Indian Financial System, MHE (India) 2017, Chapter 11**.

Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries Norms for flexible structuring of long term project loans to infrastructure and core industries by applicable NBFCs should be on the lines of the norms specified by the RBI for banks.

Loans Against Security of Single Product–Gold Jewellery All applicable NBFCs should **(i)** maintain a loan-to-value (LTV) ratio not exceeding 75 per cent for loans granted against the collateral of gold jewellery. The value of gold jewellery should be the intrinsic value of the gold content and no other cost elements should be added. The intrinsic value of the gold jewellery should be arrived at (as **detailed below**); **(ii)** disclose in their balance sheet the percentage of such loans to their total assets. They should not grant any advance against bullion/primary gold and gold coins. They should also not grant any advance for purchase of gold in any form including primary gold, gold bullion, gold jewellery, gold coins, units of exchange traded funds (ETF) and units of gold mutual fund.

Verification of the Ownership of Gold Where the gold jewellery pledged by a borrower at any one time or cumulatively on loan outstanding is more than 20 grams, the NBFCs should keep a record of the verification of its ownership. The ownership verification need not necessarily be through original receipts for the jewellery pledged but a suitable document should be prepared to explain how the ownership has been determined, particularly in each and every case where the gold jewellery pledged by a borrower at any one time or cumulatively on loan outstanding is more than 20 grams.

Standardisation of Value of Gold Accepted as Collateral in Arriving at LTV Ratio The gold jewellery accepted as collateral by the NBFC should be valued as follows. It should be valued by taking into account the preceding 30 days' average of the closing price of 22 carat gold as per the rate quoted by the Bombay Bullion Association Ltd. (BBA) or the historical spot gold price data publicly disseminated by a commodity exchange regulated by the Forward Markets Commission. If the purity of the gold is less than 22 carats, the NBFC should translate the collateral into 22 carat and state the exact grams of the collateral. In other words, jewellery of lower purity of gold should be valued proportionately. While accepting gold as collateral, it should give a certificate to the borrower on their letterhead, of having assayed the gold and state the purity (in terms of carats) and the weight of the gold pledged. They may have suitable caveats to protect themselves against disputes during redemption, but the certified purity should be applied both for determining the maximum permissible loan and the reserve price for auction.

Auction The auction should be conducted in the same town or taluka in which the branch that has extended the loan is located. While auctioning the gold, the NBFC should declare a reserve price for the pledged ornaments which should not be less than 85 per cent of the previous 30-day average closing price of 22 carat gold as declared by the Bombay Bullion Association Ltd. (BBA) or the historical spot gold price data publicly disseminated by a commodity exchange regulated by the Forward Markets Commission and value of the jewellery of lower purity in terms of carats should be proportionately reduced. It would be mandatory on its part to provide full details of the value fetched in the auction and the outstanding dues adjusted and any amount over and above the loan outstanding should be payable to the borrower. They should also disclose in their annual reports the details of the auctions conducted during the financial year including the number of loan accounts, outstanding amounts, value fetched and whether any of its sister concerns participated in the auction.

Safety and Security Measures to be Followed by NBFCs Lending Against Collateral of Gold Jewellery The NBFCs, which are in the business of lending against collateral of gold jewellery, should ensure that necessary infrastructure and facilities are put in place, including safe deposit vault and appropriate security measures for operating the vault, in each of its branches to safeguard the gold jewellery accepted as collateral and to ensure convenience of borrowers. No new branch(es) should be opened without suitable arrangements for security and for storage of gold jewellery, including safe deposit vault.

Fair Practices Code for Applicable NBFCs The applicable NBFCs having customer interface should adopt the following guidelines in respect of processing of applications, loan appraisals and terms/conditions, disbursement of loans, general responsibility of Board of Directors, grievances redressal officer, language and mode communication, regulation of excessive interest, complaint about excessive interest, repossession of vehicles financed and lending against jewellery.

Applications for Loans and Their Processing All communications to the borrower should be in the vernacular language or a language as understood by him. The loan application forms should include necessary information which affects his interest, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by him. It should indicate the documents required to be submitted with the application form. The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

Loan Appraisal and Terms/Conditions The applicable NBFCs should convey in writing to the borrower in the vernacular language as understood by him by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application and keep their acceptance of these terms and conditions by the borrower on its record. As complaints received against NBFCs generally pertain to charging of high interest/penal interest, they should mention the penal interest charged for late repayment **in bold** in the loan agreement.

Borrowers may not fully be aware of the terms and conditions of the loans including rate of interest at the time of sanction of loans, either because the NBFC does not provide details of the same or the borrower has no time to look into detailed agreement. Not furnishing a copy of the loan agreement or enclosures quoted in the loan agreement is an unfair practice and this could lead to disputes between the NBFC and the borrower with regard to the terms and conditions. The applicable NBFCs should furnish a copy of the loan agreement as understood by the borrower along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans.

Disbursement of Loans Including Changes in Terms and Conditions The applicable NBFCs should give notice to the borrower in the vernacular language or a language as understood by him of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges and so on. They should also ensure that changes in interest rates and charges are effected only prospectively. A suitable condition in this regard must be incorporated in the loan agreement.

Any decision to recall/accelerate payment or performance under the agreement should be in consonance with the loan agreement. The applicable NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim they may have against borrower. If such right of set- off is to be exercised, the borrower should be given notice about the same with full particulars about the remaining claims and the conditions under which they are entitled to retain the securities till the relevant claim is settled/paid.

General The applicable NBFCs should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement (unless information, not earlier disclosed by the borrower, has been noticed). In case of receipt of request from the borrower for transfer of borrowal account, the consent or otherwise, that is, objection of the applicable NBFC, should be conveyed within 21 days from the date of receipt of request. Such transfer should be as per transparent contractual terms in consonance with law. In the matter of recovery of loans, an applicable NBFC should not resort to undue harassment, namely, persistently bothering the borrowers at odd hours, use muscle power for recovery of loans and so on. As complaints from customers also include rude behavior from the staff of the companies, they should ensure that the staff are adequately trained to deal with the customers in an appropriate manner. As a measure of customer protection and also in order to bring in uniformity with regard to prepayment of various loans by borrowers of banks and NBFCs, they should not charge foreclosure charges/pre-payment penalties on all floating rate term loans sanctioned to individual borrowers.

Responsibility of Board of Directors The Board of Directors of applicable NBFCs should also lay down the appropriate grievance redressal mechanism within the organisations to ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. They should also provide for periodical review of the compliance of the **Fair Practices Code** and the functioning of the grievances redressal mechanism at various levels of management. A consolidated report of such reviews should be submitted to the Board at regular intervals prescribed by it.

Grievance Redressal Officer At the operational level, all applicable NBFCs should display the following information prominently, for the benefit of their customers, at their branches/places where business is transacted. The name and contact details (telephone/mobile nos. as also *email* address) of the grievance redressal officer who can be approached by the public for resolution of complaints against the company. If the complaint / dispute is not redressed within one month, the customer may appeal to the RBI (with complete contact details).

Language and Mode of Communicating Fair Practice Code The fair practices code (preferably in the vernacular language or a language as understood by the borrower) based on the directions outlined above be put in place by all applicable NBFCs having **customer interface** (i.e. interaction between NBFC and its customers while carrying on it business) with the approval of their Boards. The applicable NBFCs will have the freedom of drafting the fair practices code, enhancing the scope of the directions but in no way sacrificing the spirit underlying the above directions. The same should be put up on their *web-site*, for the information of various stakeholders.

Regulation of Excessive Interest Charged by Applicable NBFC The Board of each applicable NBFC should adopt an interest rate model taking into account relevant factors such as cost of funds, margin and risk premium and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers should be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter. They should also be made available on the *web-site* of the companies or published in the relevant newspapers. The information should be updated whenever there is a change in the rates of interest. The rate of interest must be annualised rate so that the borrower is aware of the exact rates that would be charged to the account.

Complaints About Excessive Interest Charged by Applicable NBFCs Though interest rates are not regulated by the RBI, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. The Board of Directors of applicable NBFCs, therefore, should lay out appropriate internal principles and procedures in determining interest rates and processing and other charges. In this regard, the directions in the fair practices code about transparency in respect of terms and conditions of the loans are to be kept in view.

Repossession of Vehicles Financed The applicable NBFCs must have a built-in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable. To ensure transparency, the terms and conditions of the contract/loan agreement should also contain provisions regarding: **(i)** notice period before taking possession, **(ii)** circumstances under which the notice period can be waived, **(iii)** the procedure for taking possession of the security, **(iv)** a provision regarding final chance to be given to the borrower for repayment of loan before the sale/auction of the property, **(v)** the procedure for giving repossession to the borrower, and **(vi)** the procedure for sale/auction of the property. A copy of these terms and conditions must be made available to the borrower. The applicable NBFCs should invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction/disbursement of loans, which forms a key component of such contracts/loan agreements.

Lending Against Collateral of Gold Jewellery While lending to individuals against gold jewellery, applicable NBFCs should adopt the following in addition to the general directions as above.

- They should put in place Board-approved policy for lending against gold that should, *inter alia*, cover the following: **(a)** adequate steps to ensure that the KYC guidelines stipulated by the RBI are complied with and to ensure that adequate due diligence is carried out on the customer before extending any loan, **(b)** proper assaying procedure for the jewellery received, **(c)** internal systems to satisfy ownership of the gold jewellery, **(d)** adequate systems for storing the jewellery in safe custody, reviewing the systems on an on-going basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to. Normally, such loans should not be extended by branches that do not have appropriate facility for storage of the jewellery, **(e)** the jewellery accepted as collateral should be appropriately insured, **(f)** transparent auction procedure in case of non-repayment with adequate prior notice to the borrower.

There should be no conflict of interest and the auction process must ensure that there is arm's length relationship in all transactions during the auction including with group companies and related entities, **(g)** the auction should be announced to the public by issue of advertisements in at least two newspapers, one in vernacular and another in national daily, **(h)** as a policy, the NBFCs themselves should not participate in the auctions held, **(i)** gold pledged should be auctioned only through auctioneers approved by the Board of Directors, **(j)** the policy should also cover systems and procedures to be put in place for dealing with fraud including separation of duties of mobilisation, execution and approval.

- The loan agreement should also disclose details regarding auction procedure.
- **Other instructions (a)** The NBFCs must insist on a copy of the PAN Card of the borrower for all transaction above ₹5 lakhs. High value loans of ₹1 lakh and above must only be disbursed by cheque. Documentation across all branches must be standardised. The NBFCs should not issue misleading advertisements like claiming the availability of loans in a matter of 2-3 minutes.

Specific Directions Applicable to NBFC-Factor The main elements of the specific directions applicable to NBFC-Factor are: registration, net owned funds, principal business, conduct of business, asset classification, risk management, and import-export factoring. **These are discussed in Chapter 4**.

Specific Directions Applicable to Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFC) The IDF should be set up as a trust/as a company. A trust-based IDF should normally be a mutual fund (MF) while a company-based IDF should normally be a NBFC. The IDF-NBFC should raise resources through issue of either rupee or dollar denominated bonds of minimum 5-year maturity. With a view to facilitate better asset liability management (ALM), IDF-NBFCs can raise funds through shorter tenor bonds and commercial papers (CPs) from the domestic market to the extent of upto 10 per cent of their total outstanding borrowings. The IDF-MF would be regulated by the SEBI while IDF-NBFC would be regulated by the RBI. The specific directions applicable to IDF-NBC relate to eligibility parameters, investments in IDFs, credit rating, capital adequacy, investment by IDF-NBFC and credit concentration.

Eligibility Parameters All NBFCs would be eligible to sponsor IDFs as mutual funds with prior approval of the RBI subject to the specified conditions, in addition to those prescribed by SEBI. The NBFC should have a minimum NOF of ₹300 crore and CRAR of 15 per cent. Its net NPAs should be less than 3 per cent of net advances. It should have been in existence for at least 5 years. It should be earning profits for the last 3 years and its performance should be satisfactory. The CRAR of the NBFC post-investment in the IDF-MF should not be less than the regulatory minimum prescribed for it. The NBFC should continue to maintain the required level of NOF after accounting for investment in the proposed IDF-MF. There should be no supervisory concerns with respect to the NBFC.

Only NBFC-IFCs can sponsor IDF-NBFC with the prior approval of the RBI subject to the specified conditions. The sponsor IFCs should be allowed to contribute a maximum of 49 per cent to the equity of the IDF-NBFCs with a minimum equity holding of 30 per cent of the equity of IDF-NBFCs. Post-investment in the IDF-NBFC, the sponsor NBFC-IFC must maintain minimum CRAR and NOF prescribed for the IFCs. There are no supervisory concerns with respect to the IFC.

The IDF-NBFCs should enter into tripartite agreements to which, the concessionaire, the project authority and IDF-NBFC should be parties. It binds all the parties to the terms and conditions of the other agreements referred to therein also and which collectively provide, *inter alia*, for the following: **(i)** takeover a portion of the debt of the concessionaire availed from senior lenders, **(ii)** a default by the concessionaire should trigger the process for termination of the agreement between project authority and concessionaire, **(iii)** the project authority should redeem the bonds issued by the concessionaire which have been purchased by IDF-NBFC, from out of the termination payment as per the tripartite agreement and other agreements referred to therein (compulsory buyout), **(iv)** the fee payable by IDF-NBFC to the project authority as mutually agreed upon between the two. The NBFC and IFCs that fulfill the above eligibility criteria should approach the RBI, for sponsoring IDFs as MFs and NBFCs. **Concessionaire** means a party which has entered into agreement called concession agreement with a project authority for developing infrastructure. **Project authority** means a authority constituted by a statute for infrastructure development in the country.

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Investment by NBFCs and IFCs in IDFs The exposure of sponsor NBFCs/IFCs and non-sponsor NBFCs / IFCs to the equity and debt of the IDFs should be governed by **the credit concentration norms discussed earlier in this Section**. As regards foreign exchange-related aspects of the functioning of IDF-NBFCs, the guidelines issued by RBI should be adhered to.

Credit Rating The IDF-NBFC should have a minimum credit rating grade of '**A**' or equivalent issued by accredited rating agencies.

Capital Adequacy They should have at the minimum CRAR of 15 per cent and Tier-II capital should not exceed Tier-I.

Investment by IDF-NBFCs They can invest in post-COD infrastructure projects which have completed at least one year of satisfactory commercial operation that are: **(i)** PPP projects and are a party to a tripartite agreement with the concessionaire and the project authority for ensuring a compulsory buyout with termination payment, **(ii)** non-PPP projects and PPP projects without a project authority, in sectors where there is no project authority.

Credit Concentration Norms In addition to the provisions **discussed earlier in this Section**, the following credit concentration norms would be applicable to IDF-NBFCs:

- For PPP and post-COD infrastructure projects which have completed at least one year of satisfactory commercial operation and the IDF-NBFC is a party to a tripartite agreement with the concessionaire and the project authority for ensuring a compulsory buyout with termination payment, the following additional exposures should be applicable: **(a)** the maximum exposure on individual projects should be at 50 per cent of its total capital funds [Tier-I plus Tier-II],**(b)** an additional exposure up to 10 per cent can be taken at the discretion of the Board of the IDF-NBFC, **(c)** the RBI may, upon receipt of an application from an IDF-NBFC and on being satisfied that the financial position of the IDF-NBFC is satisfactory, permit additional exposure up to 15 per cent (over 60 per cent) subject to such conditions as it may deem fit to impose regarding additional prudential safeguards.

- The exposure in respect of other assets should be governed by the directions as applicable to infrastructure finance companies **discussed earlier in this Section.**

Specific Directions Applicable to Non-Banking Finance Company – Micro Finance Institutions (NBFC-MFIs) The main elements of these directions are: entry point norm, prudential norms, pricing of credit, transparency in interest rates, multiple lending, over-borrowing and ghost-borrowers, compliance with conditionalities, channelising agents for schemes and so on.

Entry Point Norms All new companies desiring registration as NBFC-MFI would need a minimum NOF of ₹5 crore and should comply, from the beginning, with all other criteria applicable to the NBFC-MFIs.

Prudential Norms relates to capital adequacy, asset classification ad provisioning norms.

Capital Adequacy The NBFC-MFIs should maintain a minimum capital adequacy ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets. The total of Tier-II capital at any point of time should not exceed 100 per cent of Tier-I capital. The risk weights for on-balance sheet assets and the credit conversion factor for off-balance sheet items will be as applicable to systematic important non-deposit/deposit accepting NBFCs (**discussed in the preceding Section**).

***Notes*:**

1. For loans guaranteed by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH), NBFC-MFIs should assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion should attract a risk-weighted a detailed **in the earlier Section**.
2. For calculation of CRAR, the provisioning made towards loan portfolio in the Andhra Pradesh (AP) should be notionally reckoned as part of NoF to the extent of 20 per cent. Capital adequacy on non-AP portfolio and the notional AP portfolio (outstanding as on the balance sheet date less the provision on this portfolio not notionally added back) should be maintained at 15 per cent of the risk weighted assets.

Asset Classification Norms Standard asset means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business. Non-performing asset means an asset for which, interest/principal payment has remained overdue for 90 days or more.

Provisioning Norms For NPAs meeting **qualifying assets** criteria, provisioning norms for the Andhra Pradesh (AP) portfolio would be applicable as discussed earlier. The provisioning norms for the non-AP portfolio should be the aggregate loan provision maintained by NBFC-MFIs should not be less than the higher of 1 per cent of the outstanding loan portfolio or 50 per cent of the aggregate loan instalments which are overdue for more than 90 days and less than 180 days and 100 per cent of the aggregate loan instalments which are overdue for 180 days or more. If the advance covered by the CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per **provisioning norms as mentioned earlier**. All other provisions mentioned in the **preceding Section** would be applicable to the NBFC-MFIs. An NBFC which does not qualify as an NBFC-MFI would not extend loans to micro-finance sector in aggregate exceeding 10 per cent of its total assets.

Pricing of Credit Margin cap, cap on the difference between the amount charged to the borrower and the cost of funds to the NBFC-MFI, should not exceed 10 per cent for large MFIs (loans portfolios exceeding ₹100 crore) and 12 per cent for the others. The interest charged by an NBFC-MFI should be the lower of the cost of funds plus margin as indicated above and the average base rate of the 5 largest commercial banks by assets multiplied by 2.75. The NBFC-MFIs should ensure that the average interest rate on loans sanctioned during a quarter does not exceed the average borrowing cost during the preceding quarter plus the margin, within the prescribed cap. The maximum variance permitted for individual loans between the minimum and maximum interest rate cannot exceed 4 per cent. The average interest paid on borrowings and charged by the MFI are to be calculated on average monthly balances of outstanding borrowings and loan portfolio respectively. The figures should be certified annually by the statutory auditors and also disclosed in the balance sheet. Processing charges should not be more than 1 per cent of gross loan amount. They need not be included in the margin cap or the interest cap. The NBFC-MFIs should recover only the actual cost of insurance for group, or livestock, life, health for borrower and spouse. The administrative charges should be recovered as per the IRDA guidelines.

Transparency in Interest Rates There should be only three components in the pricing of the loan, namely, the interest charge, the processing charge and the insurance premium (which includes the administrative charges). There should be no penalty on delayed payment. The NBFC-MFIs should not collect any security deposit/ margin from the borrower. There should be a standard form of loan agreement. Every NBFC-MFI should provide to the borrower a loan card reflecting **(a)** the effective rate of interest charged; **(b)** all other terms and conditions attached to the loan; **(c)** information which adequately identifies the borrower; **(d)** acknowledgements by the NBFC-MFI of all repayments including instalments received and the final discharge; **(e)** all entries in the loan card should be in the vernacular language. The effective rate of interest charged by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

Multiple-lending, Over-borrowing and Ghost-borrowers The NBFC-MFIs can lend to individual borrowers who are not member of joint liability group (JLG)/self help group (SHG) or to borrowers that are members of JLG/SHG. A borrower cannot be a member of more than one SHG/JLG. Not more than 2 NBFC-MFIs should lend to the same borrower. There must be a minimum period of moratorium between the grant of the loan and the due date of the repayment of the first instalment. It should not 5 be less than the frequency of repayment, for example, in the case of weekly repayment, the moratorium should not be less than one week. Recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.

Ensuring Compliance with Conditionalities Every NBFC-MFI has to be a member of all credit information companies (CICs) (**discussed in detail in a subsequent Section)** provide timely and accurate data to them and use the data available with them to ensure compliance with the conditions regarding membership of SHG/ JLG, level of indebtedness and sources of borrowing. While the quality and coverage of data with CICs will take some time to become robust, the NBFC-MFIs may rely on self-certification from the borrowers and their own local enquiries on these aspects as well as the annual household income.

Channelising Agents for Schemes Operated by Central/State Government Agencies The NBFC-MFIs acting as channelising agents for schemes operated by central/state government agencies should abide by the following guidelines: **(a)** loans disbursed/managed by NBFC-MFIs should be considered as a separate business segment. These loans should not be included either in the numerator (qualifying assets) or the denominator (total assets) for the purpose of determining compliance with the minimum qualifying assets criteria; **(b)** consequent to above, the interest charged on such loans should be excluded for determining the variance between the maximum and minimum interest rate; and **(c)** the cost of such funds should not be reckoned for arriving at average cost of funds as well as interest rates charged to borrowers.

The NBFC-MFIs may act as channelising agents for distribution of loans under special schemes of central/state government agencies subject to following conditions: **(a)** accounts and records for loans as well as funds received/ receivable from concerned agencies should be maintained in their books distinct from other assets and liabilities, and depicted in the financials/ final accounts/balance sheet with requisite details and disclosures as a separate segment; **(b)** such loans should be subject to applicable asset classification, income recognition and provisioning norms as well as other prudential norms as applicable to NBFC-MFIs except in cases where it does not bear any credit risk; **(c)** they should be reported to the CICs to prevent multiple borrowings and present complete picture of indebtedness of a borrower.

Others All NBFC-MFIs should refer to directions issued to banks by the Financial Inclusion and Development Department (FIDD) on bank loans to Micro Finance Institutions (MFIs) – Priority Sector status with regard to guidelines on priority sector. They should approach their Board of Directors for fixing internal exposure limits to avoid any undesirable concentration in specific geographical locations. They should become member of at least one self-regulatory organisation (SRO) recognised by the RBI and also comply with the code of conduct prescribed by the SRO. Further, the SRO should adhere to a set of specified functions and responsibilities. The same may be modified by the RBI from time to time to improve the efficiency of the sector. The responsibility for compliance to all regulations prescribed for NBFC- MFIs lies primarily with themselves. The industry associations/SROs should also play a key role in ensuring compliance with the regulatory framework. In addition, banks lending to them should also ensure that systems, practices and lending policies in them are aligned to the regulatory framework.

Fair Practices Code (FPC) for NBFC-MFIs In addition to the general principles on **FPC discussed earlier**, NBFC-MFIs should adopt the following specific fair practices:

General The FPC in vernacular language should be displayed by an NBFC-MFI in its office and branch premises. A statement should be made in vernacular language and displayed by them in their premises and in loan cards articulating their commitment to transparency and fair lending practices. The field staff should be trained to make necessary enquiries with regard to existing debt of the borrowers. Training offered to the borrowers should be free of cost. The field staff should be trained to offer such training and also make the borrowers fully aware of the procedure and systems related to loan/other products. The effective rate of interest charged and the grievance redress system set up by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it (in vernacular language) and on its *website*. A declaration that it will be accountable for preventing inappropriate staff behaviour and timely grievance redressal, should be made in the loan agreement and also in the FPC displayed in its office/branch premises. The KYC Directions of the RBI should be complied with. Due diligence should be carried out to ensure the repayment capacity of the borrowers. All sanctions and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function. Adequate steps should be taken to ensure that the procedure for application of loan is not cumbersome and loan disbursements are done as per the pre-determined time structure.

Disclosures in Loan Agreement/Loan Card All NBFC-MFIs should have a Board-approved, standard form of loan agreement preferably be in vernacular language, disclosing the following: **(i)** all the terms and conditions of the loan, **(ii)** the pricing of the loan involves only three components, namely, interest charge, processing charge and insurance premium including the administrative charges, **(iii)** there will be no penalty on delayed payment, **(iv)** no security deposit/margin is being collected from the borrower, **(v)** the borrower cannot be a member of more than one SHG/JLG, **(vi)** the moratorium period between the grant of the loan and the due date of the repayment of the first installment, **(vii)** an assurance that the privacy of borrower data would be respected.

The loan card should reflect the following details: **(i)** the effective rate of interest charged, **(ii)** all other terms and conditions attached to the loan, **(iii)** information which adequately identifies the borrower and acknowledgements by the NBFC-MFI of all repayments including installments received and the final discharge, **(iv)** it should prominently mention the grievance redress system and the name and contact number of the nodal officer, **(v)** non-credit products issued should be with full consent of the borrowers and fee structure communicated in the loan card itself, **(vi)** all entries in the loan card should be in the vernacular language.

Non-coercive Methods of Recovery The recovery should normally be made only at a central designated place. The field staff should be allowed to make recovery at the place of residence/work of the borrower only if he fails to appear at central designated place on two or more successive occasions. The NBFC-MFIs should ensure that a Board-approved policy is in place with regard to code of conduct by field staff and systems for their recruitment, training and supervision. The code should lay down minimum qualifications necessary for the field staff and necessary training tools identified for them to deal with the customers. The training to the field staff should include programmes to inculcate appropriate behaviour towards borrowers without adopting any abusive or coercive debt collection/recovery practices. The compensation methods for them should have more emphasis on areas of service and borrower satisfaction than merely the number of loans mobilised and the rate of recovery. Penalties may also be imposed in cases of non-compliance by the field staff with the code of conduct. Generally, only employees and not out-sourced recovery agents should be used for recovery in sensitive areas.

Customer Protection Initiatives The NBFC-MFIs should ensure that greater resources are devoted to professional inputs in the formation of SHG/JLG and appropriate training and skill development activities for capacity building and empowerment after formation of the groups. They should be prudent and responsible in their lending activity besides educating their borrowers on the dangers of wasteful conspicuous consumption.

Governance Issues

The governance issues pertaining to **(i)** acquisition/transfer of control and **(ii)** corporate governance are discussed below.

Acquisition/Transfer of Control of Applicable NBFCs An applicable NBFC would require prior written permission of the RBI for the following: **(a)** its takeover/acquisition of control of which may or may not result in change of management; **(b)** change in its shareholding including progressive increases over time, which would result in acquisition/transfer of shareholding of 26 per cent or more of its paid-up equity capital. However, prior approval would not be required in case of any shareholding going beyond 26 per cent due to buyback of shares/reduction in capital where it has approval of a competent court. This should be reported to the RBI within one month from its occurrence; **(c)** change in its management which results in change in more than 30 per cent of the directors, excluding independent directors. No prior approval would be required in case of directors who get re-elected on retirement by rotation.

Application for Prior Approval The applicable NBFCs should submit an application, in the company letter head, for obtaining prior approval of the RBI, along with the following documents: **(a)** the specified information about the proposed directors/shareholders, **(b)** sources of funds of the proposed shareholders acquiring its shares, **(c)** declaration by the proposed directors/shareholders that they are not associated with any **(i)** unincorporated body that is accepting deposits, **(ii)** company the application for CoR of which has been rejected by the RBI; **(d)** declaration by the proposed directors/shareholders that there is no criminal case, including for offence under the Negotiable Instruments Act, against them; and **(e)** bankers' report on the proposed directors/shareholders.

Requirement of Prior Public Notice About Change in Control/Management A public notice of at least 30 days should be given before effecting the sale/transfer of the ownership by sale of shares, or transfer of control, with or without sale of shares. The public notice be given by the applicable NBFC and also by the other party or jointly by the parties concerned, after obtaining the prior permission of the RBI. It should indicate the intention to sell or transfer ownership/control, the particulars of transferee and the reasons for such sale/transfer of ownership/control. It should be published in at least one leading national and in one leading local (covering the place of registered office) vernacular newspaper.

Corporate Governance The main elements of the corporate governance are: **(i)** constitution of the committees of the Board of Directors, **(ii)** fit and proper person criteria, **(iii)** disclosure and transparency and **(iv)** rotation of partners of the auditors/audit firm and **(v)** framing of internal guidelines.

Constitution of Committees of the Board of Directors: Audit Committee All applicable NBFCs should constitute an audit committee, consisting of atleast three members of its Board of Directors. It must ensure that an information system audit of the internal systems and processes is conducted at least once in two years to assess operational risks faced by them.

Nomination Committee They should form a nomination committee to ensure **fit and proper** status of the proposed/ existing directors.

Risk Management Committee To manage the integrated risk, they should form a risk management committee, besides the asset liability management committee.

Fit and Proper Criteria All applicable NBFCs should **(i)** ensure that a policy is put in place with the approval of its Board of Directors for ascertaining the fit and proper criteria of the directors at the time of appointment, and on a continuing basis on the lines of the RBI guidelines, **(ii)** obtain a declaration and undertaking from the directors giving additional information on the lines of the prescribed format, **(iii)** obtain a deed of covenant signed by the directors, in the prescribed format, **(iv)** furnish to the RBI a quarterly statement on change of directors, and a certificate from the managing director that fit and proper criteria in selection of the directors has been followed within 15 days of the close of the respective quarter. The statement submitted by applicable NBFC for the quarter ending March 31, should be certified by the auditors. The RBI, if it deems fit and in public interest, reserves the right to examine the fit and proper criteria of directors of any NBFC irrespective of the asset size of the NBFC.

Disclosure and Transparency All applicable NBFCs should put up to the Board of Directors, at regular intervals, as may be prescribed by the Board in this regard, the following: **(i)** the progress made in putting in place a progressive risk management system and risk management policy and strategy followed; **(ii)** conformity with corporate governance standards, namely, in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, and so on.

- They should also disclose the following in their annual financial statements: **(i)** registration/licence/authorisation, obtained from other financial sector regulators; **(ii)** ratings assigned by credit rating agencies and migration of ratings during the year; **(iii)** penalties levied by any regulator; **(iv)** information namely, area, country of operation and joint venture partners with regard to joint ventures and overseas subsidiaries and **(v)** asset-liability profile, extent of financing of parent company products, NPAs and movement of NPAs, details of all off-balance sheet exposures, structured products issued by them as also securitisation/assignment transactions and other specified disclosures.

Rotation of Partners of the Statutory Auditors Audit Firm The NBFCs should rotate the partner(s) of the chartered accountant firm conducting their audit so that the same partner would not conduct its audit continuously for more than three years. However, he would be eligible for conducting the audit of after an interval of three years. It should incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

Framing of Internal Guidelines All applicable NBFCs should frame their internal guidelines on corporate governance with the approval of the Board of Directors, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it should be published on the company's *web-site* for the information of various stakeholders.

RBI NBFC NON-SYSTEMICALLY IMPORTANT NON-DEPOSIT-TAKING (NBFC-ND) COMPANIES DIRECTIONS, 2016

The RBI **(i)** in public interest, **(ii)** and to regulate the financial system to the advantage of the country **(iii)** and to prevent the affair of any NBFC-ND from being conducted in any manner detrimental/prejudicial to their interest, has been issuing directions in exercise of its powers under the RBI Act and the Factoring Regulation Act. These were comprehensively revised in 2016.

The provisions of these directions are applicable to:

(a) NBFCs not accepting/holding public deposits which are not systemically important, that is, having minimum total asset of ₹500 crore;

(b) NBFC-Factor registered with the RBI under the Factoring Regulation Act (**discussed in Chapter 4)** having an asset size below ₹500 crore. Its financial assets in the factoring business constitutes at least 50 per cent of its total assets and its income from factoring business is not less than 50 per cent of it total gross income;

(c) NBFC-Micro-Finance Institution (NBFC-MFI) registered under the RBI Act, having an asset size below ₹500 crore. It is a non-deposit taking NBFC, having a minimum net owned fund of ₹5 crore and not less than 85 per cent of its net assets are in the nature of qualifying assets (**discussed in detail in the earlier Section dealing with NBFC-ND-SI and NBFC-D**);

(d) NBFC Infrastructure Finance Company (NBFC-IFC) registered with the RBI having an asset size below ₹500 crore. A minimum of 75 per cent of its total assets should be deployed in infrastructure loans (**discussed in earlier Section dealing with NBFC-ND-SI**), having a minimum net owned funds of ₹300 crore/credit rating **A** or equivalent grade and CRAR of 15 per cent with a minimum Tier-I capital of 10 per cent. However, the provisions of the directions relating to **(i)** prudential regulations and **(ii)** fair practices code are not applicable to the NBFCs who have not accessed public funds and do not have any **customer interface** (i.e. interaction between the NBFC and its customers while carrying on its business). **Public funds** means funds received directly/indirectly through public/inter-corporate deposits, bank finance and all funds received from outside sources such as commercial papers/debentures but excludes funds raised by issue of compulsorily convertible instruments into equity within 5 years from the date of issue. Similarly, the provisions relating to fair practices code are not applicable to NBFCs accessing public funds but having no customer interface. Finally, NBFCs having customer interface but not accessing public funds are exempt from the applicability of the provisions relating to the prudential regulations;

> **Customer interface** is interaction between the NBFC and its customers while carrying on its business.

> **Public funds** means funds received directly/indirectly through public/inter-corporate deposits, bank finance and all funds received from outside sources such as commercial papers/debentures.

(e) **Infrastructure Debt Fund-NBFC (IDF-NBFC)** which means a non-deposit taking NBFC that has a minimum NoF of ₹300 crore which invests only in public-private partnership (PPP) and post-commencement operation date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a **tripartite agreement** (i.e., between concessionaire, project authority and IDF-NBFC) is excluded from the application of these directions.

These directions are substantially on the same pattern as is applicable to the NBFC-ND-SI and NBFC-D (discussed in the preceding Section). However, they certain some additional features and some features applicable to the former are not applicable to the NBFC-ND.

Additional Features

The new/additional features of the prudential norms applicable to the NBFC-ND are listed below:

Leverage Ratio The maximum leverage ratio (total outside liabilities divided by owned funds) of an applicable NBFC (except NBFC-MFIs NBFC-IFCs) should be 7 at any point of time. The NBFCs primarily engaged in landing against gold jewellery accounting for at least 50 per cent of their financial assets should maintain a minimum Tier-I capital of 12 per cent.

Concentration of Credit/Investment An applicable NBFC held by an **NOFHC** (non-operative financial holding company) should not **(i)** have any exposure (credit/investments including investments in equity/debt capital instruments) to the promoters/promoter group entities/individuals associated with the promoter group/NOFHC **(ii)** invest in the equity/debt instruments in any financial entity under the NOFHCs and **(iii)** invest in equity instruments of the NOFHCs. As already mentioned, NOFHC means a non-deposit-taking NBFC which holds the shares of a bank/all other financial services companies in its group to the extent permissible under the applicable regulatory prescriptions of the RBI/other financial regulators.

Specific Directions Applicable to NBFC-Factor The exposure norms relating to asset classification should be reckoned in case of factoring on **(a)** with recourse basis on the assigner, **(b)** without recourse on the debtor irrespective of the credit risk cover/protection except in cases of international factoring where the entire credit risk has been assumed by the import factor.

Feature Excluded/Not Applicable

The features/elements of the prudential norms relating to the NBFC-SI-ND and which are inapplicable/excluded to/from the NBFC-D relate to **(i)** Infrastructure Debt Fund-NBFCs (IDF-NBFCs), **(ii)** prudential regulations and **(iii)** fair practices code. These are not applicable to the NBFCs who have not accessed public funds and do not have any customer interface. The provisions pertaining to fair practice code are inapplicable to the NBFCs accessing public funds but having no customer interface. The NBFCs having customer interface but not accessing public funds are exempt from the prudential regulations.

NBFCS AUDITORS REPORT (RBI) DIRECTIONS, 2016

In exercise of the powers conferred by Subsection (1A) of Section 45MA of the amended RBI Act, the RBI has given directions to statutory auditors of NBFCs with effect from January 31, 1998. They are applicable to all auditors of NBFCs, as defined in Section 45I(f) of RBI Act. The main contents/requirements of the 2016 directions are briefly discussed in this Section.

Additional Report to the Board of Directors

In addition to the report under Section 143 of the Companies Act 2013 on the accounts of the NBFC for every financial year, the auditors should also make a separate report to its Board of Directors on the matters specified below.

In Case of all NBFCs The auditors have to report whether the NBFC:

- Is engaged in the business of a NBFI in terms of the specified principal business criteria (financial assets/income pattern) and has obtained a certificate of registration (CoR) from the RBI;
- Is entitled to hold the CoR in terms of its financial asset/income pattern;
- Is meeting the required net owned fund requirement. Every NBFC should submit a certificate from its statutory auditor that it is engaged in the business of NBFI requiring it to hold a CoR and is eligible to hold it within one month from the date of finalisation of the balance sheet and in any case before December, 30 of that year.

In Case of NBFCs Accepting/Holding Public Deposits The auditors should include a statement on the following additional matters, whether:

- The public deposits accepted by the NBFC together with other borrowings, namely, **(i)** issue of unsecured non-convertible debentures/bonds to the public, **(ii)** from its shareholders, in case of a public limited company, and **(iii)** any other deposits not excluded from the definition of public deposits in the NBFCs Acceptance of Public Deposits (RBI) Directions 2016 are within the limits admissible under these directions and any excess deposits are regularised in the prescribed manner;

- The NBFC is accepting public deposits without the stipulated minimum investment grade rating. The credit rating for each of the fixed deposit schemes that has been assigned by the rating agency in respect of the above NBFCs **(i)** is in force and **(ii)** the aggregate amount of deposits outstanding at any point during the year exceeds the limit specified by the rating agency;
- The NBFC has violated any stipulated restrictions on acceptance of public deposits;
- The NBFC has defaulted in paying to its depositors the due interest/principal;
- The NBFC has complied with the prescribed prudential norms on income recognition, accounting standards, asset classification, provisioning and concentration of credit/investments;
- The NBFC has complied with the liquid asset requirement prescribed by the RBI and the details of the designated bank in which the approved securities are held is communicated to the RBI;
- It has furnished to the RBI, within the stipulated period, the **(i)** return on deposits, and **(ii)** quarterly return on prudential norms; and
- It has complied with the requirements relating to the opening of new branches/offices to collect deposits or closure of existing branches/offices or appointment of agent(s).

In Case of NBFCs Not Accepting Public Deposits The auditor should include a statement on the following additional matters whether:

- The Board of Directors has passed a resolution for non-acceptance of public deposits;
- The NBFC has accepted any public deposit;
- It has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning;
- In respect of a systematically important non-deposit taking NBFC **(i)** the capital adequacy ratio as disclosed in the return submitted to the RBI has been correctly arrived at and it is in compliance with the minimum CRAR prescribed by the RBI, **(ii)** it has furnished to the RBI annual statement of capital funds, risk assets/exposures and risk asset ratio within the stipulated period;
- It has been correctly classified as NBFC – MFI in terms of the RBI directions.

In case of a NBFI not required to hold a CoR subject to certain conditions, the auditor should include a statement on the following additional matter, namely, where the NBFI has obtained a specific advice from the RBI that it is not required to hold a CoR, whether it is complying with the conditions stipulated as advised by the RBI.

Unfavourable/Qualified Statements

In case the statements in the auditors report relating to the above matters are unfavourable/qualified, the reasons for the same should also be stated. If the auditor is unable to express any opinion on any of the above items/statements, such fact together with reason(s) should also be included in the auditor's report to the RBI.

Obligations of the Auditors to Submit Exception Report to the RBI

If the statement regarding any of the above items is unfavourable/qualified or in the opinion of the auditor, the NBFC has bot complied with the provisions of **(i)** Chapter III-B of the RBI Act, **(ii)** NBFC Acceptance of Public Deposits Directions 2016, **(iii)** NBFC Prudential Norms Directions 2016, it would be his obligation to make a report containing the details of such unfavourable/qualified statement and/or about the non-compliance to the RBI. The duty of the auditor would be to report only the contraventions of the RBI Act/Directions/Guidelines/Instructions but the report should not contain any statement with respect to compliance of any of those provisions.

ASSET-LIABILITY MANAGEMENT (ALM) SYSTEM

In the normal course, NBFCs are exposed to credit and market risks in view of the asset-liability transformation. With liberalisation in Indian financial markets, over the last few years and growing integration of domestic markets with external markets and the entry of MNCs for meeting the credit needs of not only the corporates but also the retail segments, the risks associated with NBFC operations have become complex and large, requiring strategic management. NBFCs are now operating in a fairly deregulated environment and are required to determine interest rates on deposits on their own; subject to the ceiling of maximum rate of interest on deposits, they can offer deposits prescribed by the RBI; they can also offer advances on a dynamic basis. The interest rates on investments of NBFCs in Government and other securities are also now market related. Intense competition for business involving both assets and liabilities has brought pressure on the management of NBFCs to maintain a good balance among spreads, profitability and long-term viability. Imprudent liquidity management can put NBFCs' earnings and reputation at great risk. These pressures call for structured and comprehensive measures and not just ad hoc action. The managements of NBFCs have to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. NBFCs are exposed to several major risks in the course of their business: credit risk, interest rate risk, equity/commodity price risk, liquidity risk and operational risk. It is, therefore, important that NBFCs introduce effective risk management systems that address the issues relating to interest rate and liquidity risks.

> **ALM framework** provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks.

NBFCs need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rates and equity and commodity price risks of major operators in the financial system, which needs to be closely integrated with the NBCFs' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic order to manage risks.

The RBI guidelines relate to interest rate and liquidity risks management systems in NBFCs, which form part of the Asset-Liability Management (ALM) function. **The initial focus of the ALM function would be to enforce the risk management discipline, that is, managing businesses after assessing the risks involved. The objective of good risk management systems should be that these systems will evolve into a strategic tool for NBFC management.**

The ALM process rests on three pillars:

- ALM Information Systems
  - Management information systems
  - Information availability, accuracy, adequacy and expediency
- ALM Organisation
  - Structure and responsibilities
  - Level of top management involvement
- ALM Process
  - Risk parameters
  - Risk identification
  - Risk measurement
  - Risk management
  - Risk policies and tolerance levels.

ALM Information System

ALM has to be supported by a management philosophy that clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with the necessary information system as back up. Thus, information is the key to the ALM process. It is, however, recognised that varied business profiles of NBCFs in the public and private sectors do not make the adoption of a uniform ALM System for all NBFCs feasible. There are various methods prevalent worldwide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement methods. However, though the central element for the entire ALM exercise is the availability of adequate and accurate information with expedience; and the systems existing some of the major NBFCs do not generate information in the manner required for ALM. Collecting accurate data in a timely manner would be the biggest challenge before the NBFCs, particularly those lacking full scale computerisation. However, the introduction of a base information system for risk measurement and monitoring has to be addressed urgently.

NBFCs have heterogeneous organisational structures, capital base, asset sizes, management profile, business activities and geographical spread. Some of them have a large number of branches and agents/brokers, whereas some have unitary offices. Considering the large network of branches and the lack of (an adequate) support system to collect information required for the ALM, which analyses information on the basis of residual maturity and repricing pattern of liabilities and assets, it would take time for NBFCs, in the present state, to get the requisite information. With respect to investment portfolio and funds management, in view of the centralised nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time as the NBFC management gain experience of conducting business within an ALM framework. The spread of computerisation will also help NBFCs in accessing data.

ALM Organisation

(a) Successful implement of the risk management process would require strong commitment on the part of the senior management in the NBFCs to integrate basic operations and strategic decision making with risk management. The Board of Directors of NBFCs should have overall responsibility for management of risks and should decide its risk management policy and set limits for liquidity, interest rate and equity/price risks.

(b) The Asset-Liability Committee (ALCO) consisting of the NBFC's senior management, including the Chief Executive Officer (CEO), should be responsible for ensuring adherence to the limits set by the Board of Directors as well as for deciding the business strategy of the NBFC (on the assets and liabilities sides) in line with the NBFC's budget and decided risk management objectives.

(c) The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to NBFC's internal limits.

The ALCO is a decision making unit responsible for balance sheet planning from the risk-return perspective, including the strategic management of interest rate and liquidity risks. Each NBFC should decide on the role of its ALCO, its responsibility as also the decisions to be taken by it. The business and risk management strategy of the NBFC should ensure that the NBFC operates within the limits/parameters set by its Board of Directors. The business issues that an ALCO would consider, inter-alia, should include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for similar services/ products and so on. In addition to monitoring the risk levels of the NBFC, the ALCO should review the results of, and progress in, implementation of the decisions made in the previous meetings. The ALCO should also articulate the current interest rate view of the NBFC and base its decisions for future business strategy on this view. With respect to the funding policy, for instance, its responsibility would be to decide on the source and mix of liabilities or sale of assets. Towards this end, it should develop a view regarding the future direction of interest rate movements and decide on funding mixes between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, and so on. Individual NBFCs should decide the frequency of holding their ALCO meetings.

Composition of ALCO The size (number of members) of ALCO would depend on the size of each institution, business mix and organisational complexity. To ensure commitment of the Top Management and timely response to market dynamics, the CEO/CMD/President/Director should head the Committee. The Chiefs of Investment, Credit, Resources Management/ Planning, Funds Management/Treasury, International Business and Economic Research can be members of the Committee. In addition, the Head of the Technology Division should also be an invitee for building up of MIS and related computerisation. Large NBFCs may even have sub-committees and support groups.

Committee of Directors The Management Committee or any other specific committee constituted by the Board of Directors should oversee the implementation of the system and review its functioning periodically.

ALM Process

The scope of the ALM function can be described as follows: **(1)** Liquidity risk management, **(2)** Management of market risks, **(3)** Funding and capital planning, **(4)** Profit planning and growth projection and **(5)** Forecasting and analysing 'What if scenario' and preparation of contingency plans. The guidelines, however, mainly address liquidity and interest rate risks.

Liquidity Risk Management Measuring and managing liquidity needs are vital for the effective operation of NBFCs. By ensuring an NBFC's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. The NBFC management should measure not only the liquidity positions of the NBFC on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid, like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. The Maturity Profile given in ***Appendix 1-A on the website*** could be used for measuring the future cash flows of NBFCs in different time-buckets. The time-buckets, may be distributed as under:

(i) 1 day to 30/31 days (one month)
(ii) Over one month and up to 2 months
(iii) Over two months and up to 3 months
(iv) Over 3 months and up to 6 months
(v) Over 6 months and up to 1 year
(vi) Over 1 year and up to 3 years
(vii) Over 3 years and up to 5 years
(viii) Over 5 years

NBFCs holding public deposits are required to invest up to a prescribed percentage (15 per cent as on date) of their public deposits in approved securities, in terms of the liquid asset requirement of Section 45-IB of the RBI Act, 1934. Residuary Non-Banking Companies (RNBCs) are required to invest up to 80 per cent of their deposits in the manner prescribed in the RBI Directions issued under the Act, as detailed in an earlier section. There is no such requirement for NBFCs that are not holding public deposits. Thus, various NBFCs, including RNBCs, would be holding, in their investment portfolio, securities that could be broadly classifiable as 'mandatory securities' (under obligation of law) and 'non-mandatory' securities. In case of NBFCs not holding public deposits, all the investment securities and in case of NBFCs holding public deposits, the surplus securities (held over and above the requirement) would fall in the category of 'non-mandatory securities'. NBFCs holding public deposits may place mandatory securities in any time-bucket suitable to them. The listed non-mandatory securities may be placed in any of the "1 day to 30/31 days (one month)", "over one month and upto 2 months" and "over two months and upto 3 months" buckets, depending upon the defeasance period proposed by NBFCs. Unlisted non-mandatory securities (e.g., equity shares, securities without a fixed term of maturity and so on) may be placed in the "over 5 years" buckets, whereas unlisted non-mandatory securities having a fixed term of maturity may be placed in the relevant time bucket, as per residual maturity. The mandatory securities and listed securities may be marked to market for the purpose of the ALM system. Unlisted securities may be valued as per RBI's Prudential Norms Directions.

Alternatively, NBFCs may also follow the concept of the trading book, which is as follows:

(i) The composition and volume are clearly defined;
(ii) Maximum maturity/duration of the portfolio is restricted;
(iii) The holding period not to exceed 90 days;
(iv) Cut-loss limit prescribed;
(v) Defeasance periods (product-wise), that is, time taken to liquidate the position on the basis of liquidity in the secondary market, are prescribed.

NBFCs that maintain such 'trading books' and comply with the above standards may show the trading securities under "1 day to 30/31 days (one month)", "over one month and upto 2 months" and "over two months and upto 3 months" buckets on the basis of the defeasance periods. The Board of Directors/ALCO of the NBFCs should approve the volume, composition, holding/defeasance period, cut-loss, and so on of the 'trading book'. The remaining investments, should also be classified as short-term and long-term investments, as required under RBI's Prudential Norms.

The policy note recorded by NBFCs on the treatment of the investment portfolio, for the purpose of ALM, and approved by their Board of Directors/ALCO should be forwarded to the Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located.

With in each time-bucket, there could be mismatches depending on cash inflows and outflows. While mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches, that is, 1–30/31 days. NBFCs, however, should monitor their cumulative mismatches (running total) across all time-buckets by establishing internal prudential limits with the approval of the Board of Directors/Management Committee. The mismatches (negative gap) during 1–30/31 days in normal course may not exceed 15 per cent of the cash outflows in this time-bucket.

The Statement of Structural Liquidity may be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability is cash outflow while a maturing asset is a cash inflow. While determining the likely cash inflows/outflows, NBFCs should make a number of assumptions according to their asset-liability profiles. While determining the tolerance levels, NBFCs may take into account all relevant factors based on their asset-liability base, nature of business, future strategy and so on. The tolerance levels should be determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

In order to enable NBFCs to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, NBFCs should estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

Currency Risk Floating exchange rate arrangement has brought in its wake pronounced volatility, adding a new dimension to the risk profile of NBFC balance sheets having foreign assets and liabilities. The increased capital flows across free economies, following deregulation, have contributed to an increase in the volume of transactions. Large cross border flows together with volatility has rendered NBFCs' balance sheets vulnerable to exchange rate movements.

Interest Rate Risk (IRR) The operational flexibility given to NBFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the interest rate risk—defined as the risk where changes in market interest rates might adversely affect an NBFC's financial condition.

The changes in interest rates affect NBFCs in a larger way. The immediate impact of changes in interest rates is on NBFC's earnings (ie, reported profits), by changing its net interest income (NII). A long-term impact of changing interest rates is on NBFCs' market value of equity (MVE) or net worth, as the economic value of NBFC's assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspectives is known as the 'earnings perspective' and 'economic value perspective', respectively. The risk from the earnings perspective can be measured as changes in the net interest income (NII) or net interest margin (NIM). There are many analytical techniques for measurement and management of interest rate risk. To begin with, the traditional Gap analysis is considered as a suitable method to measure the interest rate risk. It is the intention of the RBI to move over to modern techniques of interest rate risk measurement like Duration Gap Analysis, Simulation and Value at Risk (VaR) over a period of time, during which NBFCs would acquire sufficient expertise and sophistication in acquiring and handling MIS.

The Gap or mismatch risk can be measured by calculating Gaps over different time intervals, as on a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets (including off-balance sheet position). An asset or liability is normally classified as rate sensitive if:

(i) Within the time interval under consideration, there is a cash flow;
(ii) The interest rate resets/reprices contractually during the interval;
(iii) Dependent on the RBI changes in interest rates/bank rate;
(iv) It is contractually pre-payable or withdrawn before the stated maturities.

The Gap Report should be generated by grouping rate sensitive liabilities, assets and off-balance sheet positions into time-buckets according to residual maturity or next pricing period, whichever is earlier. The difficult task in Gap analysis is determining the sensitivity rate. All investments, advances, deposits, borrowings, purchased funds and so on that mature/reprice within a specified timeframe are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if the NBFC expects to receive it within the time horizon. This includes final principal payment and interim instalments and certain assets and liabilities, to receive/pay rates that vary from a reference rate. These assets and liabilities are repriced at pre-determined intervals and are rate sensitive at the time of repricing. While the interest rates on term deposits are fixed during their currency, the trenches of advances portfolio is basically flowering. The interest rates on advances received could be repriced on any number of occasions, corresponding to the changes in PLR (prime lending rate).

Gaps may be identified in the following time-buckets:

(i) 1–30/31 days (one month)
(ii) Over one month to 2 months
(iii) Over two months to 3 months
(iv) Over 3 months to 6 months
(v) Over 6 months to 1 year
(vi) Over 1 year to 3 years
(vii) Over 3 years to 5 years
(viii) Over 5 years
(ix) Non-sensitive

The various items of rate sensitive assets and liabilities and off-balance sheet items may be classified as explained in **Appendix 1-B on the website. The website address is http://www.mhhe.com/khanfs9e.**

The Gap is the difference between the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative Gap indicates that it has more RSLs than RSAs. The Gap reports indicate whether the institution is in a position to benefit from rising interest rates by having a positive Gap (RSA > RSL) or whether it is in a position to benefit from declining interests rates by a negative Gap (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Each NBFC should set prudential limits on individual Gaps with the approval of the Board of Directors/Management Committee. The prudential limits should have a relationship with the total assets, earnings assets or equity. The NBFCs may work out earnings at risk (EaR) or a net interest margin (NIM), based on their views on interest rate movements, and fix a prudent level with the approval of the Board of Directors/Management Committee. For working out EaR or NIM, any of the current models may be used.

The RBI intends to introduce capital adequacy for market risks in due course.

General

The classification of various components of assets and liabilities into different time-buckets for preparation of Gap reports (Liquidity and Interest Rate Sensitivity), as indicated in **Appendix 1-A and Appendix 1-B on the website**, is the benchmark NBFCs that are better equipped to reasonably estimate the behavioural pattern of various components of assets and liabilities, on the basis of past data/empirical studies, could classify them in the appropriate time buckets, subject to approval from the ALCO/Board of Directors. A copy of the note approved by the ALCO/Board of Directors may be sent to the Regional Office of the Department of Non-banking Supervision of the RBI under whose jurisdiction the registered office of the company is located. These notes may contain 'what if scenario' analysis under various assumed conditions and the contingency plans to face various adverse developments.

The present framework does not capture the impact of premature closures of deposits and prepayment of loans and advances on the liquidity and interest rate risk profile of NBFCs. The magnitude of premature withdrawal of deposits at times of volatility in market interest rates is quite substantial. NBFCs should, therefore, evolve a suitable mechanism, supported by empirical studies and behavioural analysis, to estimate the future behaviour of assets, liabilities and off-balance sheet items to changes in market variables and estimate the probabilities of the options.

A scientifically evolved internal transfer pricing model of assigning values on the basis of current market rates to funds provided and funds used is an important component for effective implementation of the ALM System. The transfer price mechanism can enhance the management of margin, that is, lending or credit spread, the funding or liability spread and mismatch spread. It also helps centralising interest rate risk at one place, which facilitates effective control and management of interest rate risk. A well defined transfer pricing system also provides a rational framework for pricing of assets and liabilities. The asset liability management practices of a NBFC is illustrated with reference to an actual case in **Appendices 1-C to 1-E on the website. The website address is http://www.mhhe.com/khanfs9e.**

CREDIT INFORMATION COMPANIES (ACT) 2005

To facilitate the efficient distribution of credit and to provide for regulation of credit information companies (CICs), the CICs (Regulation) Act was enacted in 2005. **Credit information** means any information relating to **(a)** the amounts and nature of loans or advances, amounts outstanding under credit cards and other credit facilities granted/to be granted to a borrower by a credit institution (CI); **(b)** nature of security taken/proposed to be taken by a CI from any borrower for credit facilities granted/to be granted; **(c)** guarantee furnished/ any other non-fund based facility granted/to be granted by a CI to any of its borrowers; **(d)** the creditworthiness of a borrower of a CI; and **(e)** any other matter which the RBI may consider necessary and specify for inclusion in the credit information to be collected and maintained by the CICs. A **credit institution** includes **(1)** banks, **(2)** NBFCs, **(3)** PFIs, **(4)** SFCs, **(5)** HFCs, **(6)** companies in the credit card business/dealing with the distribution of credit in any other manner and **(7)** any other institution specified by the RBI from time to time. **Borrower** means a person who has been granted a loan/any other credit facility by a CI, including a client. A **Client** includes **(1)** a guarantor/a person who proposes to give guarantee/security for a borrower of a CI and **(2)** a person who **(a)** has obtained/seeks to obtain financial assistance from a CI by way of loans, advances, hire-purchase, leasing facility, letter of credit, guarantee, venture capital assistance, credit cards, or in any other form/manner; **(b)** has raised/seeks to raise money by issue of securities under the provisions of SCRA/CPs/depository receipt/any other instrument; and **(c)** whose financial standing has been assessed/proposed to be assessed by a CI/other person/institution directed by the RBI. The main elements of the operation of CICs are their: Registration, Management, Auditors, Functions, Information Privacy, Offences and Penalties and Miscellaneous.

> **Credit information** means information relating to **(a)** the amounts and nature of credit facilities **(b)** nature of security **(c)** guarantee/any other non-fund based facility and **(d)** the creditworthiness of a borrower.

Registration of CICs

To commence (new) and to carry on business (existing), a CIC should obtain a certificate of registration from the RBI. While considering an application, the RBI would satisfy itself by an inspection of the records/books or otherwise that the application fulfils the following conditions: **(a)** it has the minimum capital structure (namely, authorised capital of ₹30 crore, which may be increased upto ₹50 crore by the RBI; issued capital of at least ₹20 crore, which may be increased upto the minimum authorised capital of and paid-up capital, not less than 75 per cent of the issued capital; **(b)** the general character of management would not be prejudicial to the interest of the specified users (i.e. etc. any CI/CIC including such other person/institution specified by the RBI), clients, borrowers or any other CIS; and **(c)** any other condition the fulfilment of which would be necessary to ensure that the commencement/carrying on of business of the CIC would not be detrimental/prejudicial to public interest, banking policy, credit system, specified users, clients, borrowers, other CICs or others who would provide credit information to CICs. On being satisfied about these conditions, the RBI would grant registration subject to conditions it may consider fit. It can cancel the registration of an CIC if it **(i)** ceases to carry on its business, **(ii)** fails to comply with any condition subject to which registration was granted, **(iii)** fails to fulfil any condition such as requirement of minimum capital, general character of management and so on and or **(iv)** fails to comply with any provision of any law for the time being in force or any RBI directions to submit, or offer for inspection, its books of accounts and other relevant documents, demanded by the officers, persons, or agency responsible for conducting investigation into its affairs under directions from Government.

Management of CICs

Subject to the superintendence, control and direction of the Board of Directors, the Chairperson/ Managing Director would be entrusted with the management of the whole of its affairs. At least 50 per cent directors should have special knowledge in, or practical experience of, matters relating to public administration, law, banking, finance, accountancy, management and information technology. The Board should act on business principles, with due regard to the interests of its specified users, CIs and the clients/borrowers of the CIs. The specified users mean any CI/ CIC, including any other person/institution specified by the RBI regulations for obtaining credit information from a CIC. In public interest/in the interest of banking policy or credit system the for preventing the affairs of a CIC being managed in a manner detrimental to the interest of the banking policy, CIs, borrowers or clients or for securing its proper management, the RBI can supersede the Board for upto 12 months and appoint an Administrator who would be duly bound to follow RBI directions. He would exercise all the powers, functions and duties of the Board.

Power to Determine Policy and Give Directions If necessary or expedient in public interest/or in the interest of specified users, CICs, CIs, clients or borrowers, the RBI has the power to determine policy in relation to the functioning of the CICs, CIs, specified users generally or in particular, and all concerned parties would be bound to follow it. Similarly, the RBI may issue directions in public interest or in the interest of Cis, specified users, banking policy, or to prevent the affairs of a CIC being conducted in a manner detrimental/prejudicial to the interests of specified users, Cis, borrowers or clients and to secure the proper management of CICs.

The RBI may, in public interest/in the interest of a CIC, **(i)** require the CIC to consider in a meeting of its Board, any matter relating to/arising out of its affairs; **(ii)** depute its officers to watch the proceedings of the meeting, who should be heard and submit a report to it; **(iii)** appoint its officers to observe and report on the manner in which the affairs of the CIC are conducted; and **(iv)** require the CIC to make necessary changes in its management. It may also direct a CIC to furnish within the specified time, statements/information relating to its business/ affairs considered necessary/expedient for the purpose.

Inspection The RBI on its own or on direction from the Government, may carry out by its officers/through other person, or agency, an inspection of a CIC, CI or a specified user and their books of accounts. Every director/other officer/employee would be duty bound to produce all specified books, accounts and other documents in his custody and to furnish any statement/ information relating to them. A director/other officer/employee may be examined on oath in relation to their business. The expenses of or incidental to the inspection would be borne by the CIC/CI/specified user.

Auditors

An auditor would be duty bound to inquire if the CIC has furnished to the RBI, the required statements/information/particulars relating to its business and, if not satisfied, make a report to the RBI. In public interest/in the interest of the CIC or its members/credit system or the CI or its borrower or clients, the RBI may order a special audit by the company auditor or any other auditor, of the accounts of the CIC in relation to any transaction(s)for specified period(s). The auditor should submit a report to the RBI. The remuneration of the auditors and the expenses of audit would be borne by the concerned CIC.

Functions

A CIC may engage in the following forms of business:

- To collect, process and collate information on trade, credit and financial standing of borrowers of the CI which is a member of the CIC;
- To provide credit information/credit scoring to its specified users as well as any other CIC or to any other CIC, being its members. Credit scoring means a system which enables a CI to assess the creditworthiness and capacity of a borrower to repay his loans/advances and discharge his other obligations in respect of credit policy availed/to be availed by him;
- To undertake research projects;
- To undertake any other form of business specified by the RBI as lawful for a CIC to engage in.

A CIC may **(a)** register CIs/other CICs as members, **(b)** charge a reasonable amount of fee, within the ceiling specified by the RBI, for furnishing credit information to a specified user and **(c)** generally do all other acts/perform other functions as are necessary to facilitate a proper conduct of its affairs/business/functions.

Membership Every CI should become a member of at least one CIC. A CIC has the option to become a member of another CIC. Every specified user would be entitled to obtain credit information for its use from the CIC of which he is a member.

Collection/Furnishing of Credit Information A CIC/an authorised person may require its members (i.e., CICs/CIs) to furnish, in the RBI specified form, necessary information within the specified time. The CIC would provide for a specified purpose, the credit information received, to its specified users, on a written request from him as per the specified RBI directions. Any credit information received by the CIC/specified user should not be disclosed to any person other than the specified user/any other person, for purpose other than as permitted or required by any other law for the time being in force.

Information Privacy Principles

The prescribed steps (including security safeguards) should be taken by all CICs/CIs/ specified uses who are in possession/control of credit information to ensure that the data maintained by them is accurate, complete, duly protected against loss or unauthorised access or use or unauthorised disclosure. They should follow the following privacy principles in relation to the collection, processing, collating, recording, preservation, secrecy, sharing and usage of credit information:

- The principle which may be **(i)** followed by every CI for collection of information from borrowers and clients/CIC, for collection of credit information from member CIs or CICs, for processing, recording and protecting the data relating to credit information furnished by, or obtained from, member CIs or CIC and sharing them with specified users, **(ii)** adopted by every specified user for processing, recording, preserving and protecting data and **(iii)** adopted by every CIC for allowing access to records containing credit information of borrowers/clients and alteration of such records in case of need;

- The purpose for which the credit information may be used and the restrictions on such use and disclosures;
- The extent of obligations to check the accuracy before furnishing credit information to CICs/CIs/specified users;
- Preservation of credit information maintained by every CIC/CI/specified user, including the period, manner of deletion of such information and maintenance of records;
- Networking of CICs/CIs/specified users through electronic mode; and
- Any other principles/procedures specified by the RBI.

Any person who applies for grant/sanction of a credit facility from any CI should request and be furnished on the payment of specified charges, a copy of the credit information obtained from the CIC. On request from a borrower/client, the CIC/CI/ specified user would update the credit information in its possession/control by making appropriate correction(s)/addition/deletion/otherwise, within 30 days from the date of request.

No person would have unauthorised access to credit information in the possession/control of a CI/CIC/specified users. Unauthorised access would be punishable with a fine of upto ₹1 lakh for each offence, with a further fine of upto ₹10,000 for every day the default continues and the unauthorised information cannot be taken into account for any purpose.

Offences and Penalties

Penalties for offences are specified below:

- For a wilful false statement in any material particular/wilful omission of a material statement: Imprisonment upto 1 year, together with the fine.
- Breach of any privacy principle by a CIC/CI/Specified user: Fine upto ₹1 crore.
- Wilful provision by CIC/CI/specified user false information in any material particular/wilful omission to make a material statement: Fine upto ₹1 crore.
- Contravention of the provisions of the CICs Act/rules/orders or obstruction of the lawful exercise of any power under the CICs Act/rules/orders/directions: Fine upto ₹1 lakh, with a further fine upto ₹5,000 for each day of contravention/default.
- Every person who was incharge of/responsible to the CIC/CI/specified user for the conduct of business of a company (i.e., body corporate, including a firm/other association of individuals), would be deemed guilty of the contravention/default and punished unless he proves that it was committed without his knowledge or that he exercised all due diligence to prevent the contravention/default. The chairperson/MD/director (i.e., partner in relation to a firm)/manager/secretary/other officers of the CIC/CI would also be liable for punishment if proved that the contravention/default was committed with their consent/connivance or is attributable to any gross negligence on their part. The term 'company' means any body corporate, including a firm/other association of individuals.

Penalty by RBI The RBI can impose penalty as specified below:

- For unauthorised access to credit information: Upto ₹1 lakh.
- For breach of the privacy principle/wilful provision or omission of material particulars: Upto ₹1 crore.

- Contravention of the provisions of the CICs Act/rules/orders/directions: Upto ₹1 lakh, with ₹5,000 each day, after the first day, of the contravention/default.

Miscellaneous

The miscellaneous provisions of the CICs Act are summarised below:

- The RBI would specify the fee leviable for providing information to the specified users and for admission as member of a CIC.
- A chairperson/director/member/auditor/adviser, officer/other employee/agent of a CIC/specified user can disclose any information to any person only if required by a court/tribunal/authority.
- Every CIC should observe the **customary practices/usages** and not divulge any information relating to, or to the affairs of, its members/specified users. A declaration of fidelity and secrecy in the prescribed form should be made before entering upon his duties, by the chairperson/director/member/auditor/adviser/officer/other employee of a CIC. Included in 'practices/usages customary' are such practices and usages which are generally followed by the CICs or may develop in due course in relation to their functions in pursuance of the provisions of the CICs Act/rules/regulations/directions.
- The Government, in consultation with the RBI, can make rules to carry out the provisions of the CICs Act, in particular to provide for the following matters: **(i)** the authority/tribunal to hear appeal against an order of the RBI rejecting/cancelling registration of a CIC; **(ii)** the steps to be taken by every CIC/CI/specified users for ensuring accuracy, completeness and protection of data from any loss/unauthorised access/use/disclosure; **(iii)** the form in which a declaration of secrecy/fidelity would be made; and **(iv)** any other matter.
- The RBI can make regulations consistent with the provisions of the CICs Act/rules, to carry out the provisions of the CICs Act, in particular to provide for the following: **(i)** the persons/institutions to be specified as specified users, **(ii)** the form and the manner of filling of application for registration; **(iii)** any other form of business in which a CIC may engage; **(iv)** the form and notice for the collection and furnishing of information and the procedure and purpose for which credit information may be prescribed; **(v)** the principles/procedures relating to credit information to be specified under privacy principles; **(vi)** the amount to be paid for obtaining a copy of credit information and **(vii)** the maximum charges for providing information to the specified users and for admission of CIs/CICs as members of a CIC.

RBI CORE INVESTMENT COMPANIES DIRECTIONS, 2016

A **core investment company** (CIC) means a non-banking financial company carrying on the business of acquisition of shares and securities satisfying the following conditions as on the date of the last audited balance sheet: **(i)** it holds at least 90 per cent of its **net assets** (total assets excluding cash and bank balances, investments in money market instruments/mutual funds, advance payment of taxes and deferred tax payment) in the form of investment in equity/preference shares, bonds, debentures, debt/loans in group compa-

> **CIC**
> means a non-banking financial company carrying on the business of acquisition of shares and securities.

nies; **(ii)** its investments in the equity shares (including compulsorily convertible instruments within 10 years from the date of issue) in group companies constitute not less than 60 per cent of its net assets; **(iii)** it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; **(iv)** it does not carry on any other financial activity except **(a)** investment in **(i)** bank deposits, **(ii)** money market instruments, including money market mutual funds and liquid mutual funds, **(iii)** government securities, and **(iv)** bonds or debentures issued by group companies, **(b)** granting of loans to group companies and **(c)** issuing guarantees on behalf of group companies.

The provisions of Section 45-I-A of the RBI Act would not apply to a systematically important core investment company (**CIC-ND-SI**) defined as a core company having minimum total assets of ₹100 crore either individually or in aggregate along with other group **CICs** which raise/hold public deposits. The provisions of Section 45I-A(1) **(b)** would also not apply if it meets the stipulated capital requirements and leverage ratios.

The main elements of these directions **(i)** registration, **(ii)** prudential issues, **(iii)** governance issues and **(iv)** overseas investments are discussed in this Section.

Registration

Every CIC-ND-SI should apply to the RBI for grant of certificate of registration (CoR) within three months from the date of becoming a CIC-ND-SI. Every CIC exempted from registration requirement should pass a Board resolution that it will not, in the future, access public funds. However, CICs may be required to issue guarantees or take on other contingent liabilities on behalf of their group entities. Before doing so, they must ensure that they can meet the obligations, as and when they arise. In particular, CICs which are exempt from registration requirement must be in a position to do so without recourse to public funds in the event the liability devolves, else they should approach the RBI for registration before accessing public funds. If unregistered CICs with asset size above ₹100 crore access public funds without obtaining a CoR, they would be seen as violating the RBI directions.

Prudential Issues

Included in prudential issues are: **(i)** capital requirements and leverage ratio and **(ii)** prudential regulations.

Capital Requirements The **adjusted net worth** (i.e. the aggregate of owned funds **plus (i)** 50 per cent of the unrealised appreciation in terms of excess of market value over book value in the book value of quoted investments, **(ii)** any increase in the equity share capital **minus (a)** the amount of diminution in the total value of quoted investments in terms of excess of book value over market value and **(b)** any reduction in the equity share capital) of a CIC-ND-SI should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year. The risk weighted assets and credit conversion factors are the same as applicable to NBFC-SI-ND/NBFC-D discussed in Section 2.

Leverage Ratio The outside liabilities of a CIC-ND-SI should never exceed 2.5 times its adjusted net worth as on the date of the last audited balance sheet as at the end of the financial year.

Prudential Regulations

The prudential regulations applicable to the CIC-ND-SI are the same as applicable to the NBFC-ND-SI/NBFC-D. These are detailed in Section 2 of this Chapter.

Governance Issues

Included in governance issues are **(i)** acquisition/transfer of control of systematically important CICs, **(ii)** application for prior approval, **(iii)** prior public notice about charge in management control.

Acquisition/Transfer of Control of Systematically Important CICs A systematically important CIC would require prior written permission of the RBI for any **(a)** takeover/acquisition of its control, which may or may not result in change of management; **(b)** change in the shareholding of CIC, including progressive increases over time, which results in the acquisition/transfer of its shareholding of 26 per cent or more of the paid-up equity capital. However, prior approval would not be required in case of any shareholding going beyond 26 per cent due to buyback of shares/reduction in capital where it has approval of a competent Court. It should be reported to the RBI within one month from its occurrence; **(c)** any change in the management of the CIC which results in change in more than 30 per cent of the directors, excluding independent directors. However, prior approval would not be required in case of directors who get reelected on retirement by rotation. In any case, the CICs should continue to inform the RBI regarding any change in their directors/management within one month from the occurrence of any change.

Application for Prior Approval The CICs should submit an application, in the company letter head, for obtaining prior approval of the RBI, along with the following: **(a)** specified information about the proposed directors/shareholders, **(b)** sources of funds of the proposed shareholders acquiring the shares in the CIC, **(c)** declaration by the proposed directors/shareholders that **(1)** they are not associated with any **(i)** unincorporated body that is accepting deposits, **(ii)** CoR of which has been rejected by the RBI, **(2)** there is no criminal case, including for offence under the Negotiable Instruments Act, against them and **(d)** Bankers' report on the proposed directors/shareholders.

Requirement of Prior Public Notice About Change in Control/Management A public notice of at least 30 days should be given before effecting the sale of, or transfer of the ownership by sale of shares, or transfer of control, with or without sale of shares by the CIC and also by the other party or jointly by the parties concerned, after obtaining the RBI's prior permission. The public notice should indicate the intention to sell/transfer ownership/control, the particulars of transferee and the reasons for the sale or transfer of ownership/control. It should be published in at least one leading national and in one leading local (covering the place of registered office) vernacular newspaper.

Overseas Investment

These directions are in addition to those prescribed by Foreign Exchange Department of the RBI for overseas investment. The main elements of the directions, namely, **(i)** investment in financial sector overseas, **(ii)** investment in non-financial sector, **(iii)** eligibility criteria, **(iv)** general/specific conditions are discussed below.

Investment in Financial Sector Overseas All CICs investing in joint venture/subsidiary/representative offices overseas in the financial sector would require the RBI's prior approval. They should hold a CoR from the RBI and should comply with all the regulations applicable to CIC-ND-SI.

Investment in Non-Financial Sector A CIC-ND-SI does not need RBI's prior approval for overseas investment in non-financial sector. However, it should report within 30 days of such investment in the stipulated format and at the prescribed periodicity.

Eligibility Criteria The adjusted net worth (ANW) of the CIC should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year. The CIC should continue to meet the requirement of minimum ANW, post overseas investment. The level of NPAs of the CIC should not be more than 1 per cent of the net advances as on the date of the last audited balance sheet. It should generally be earning profit continuously for the last three years and its performance should be satisfactory during the period of its existence.

General Conditions Direct investment in activities prohibited under FEMA would not be permitted. The total overseas investment should not exceed 400 per cent of the owned funds of the CIC. The total overseas investment in financial sector should not exceed 200 per cent of its owned funds. Investment in financial sector should be only in regulated entities abroad. The entities set-up/acquired abroad would be treated as wholly owned subsidiaries (WOS)/joint ventures (JVs) abroad.

The overseas investments by a CIC in financial /non-financial sector should be restricted to its financial commitment. However, with regard to issuing guarantees/letter of comfort in this regard, the following should be noted. The CIC can issue guarantees/letter of comfort to the overseas subsidiary engaged in non-financial activity. It must ensure that investments made overseas would not result in creation of complex structures. In case the structure overseas requires a non-operating holding company, there should not be more than two tiers in the structure. The CICs having more than one non-operating holding company in existence should report the same to the RBI for a review. They should comply with the regulations issued under FEMA from time to time. An annual certificate from statutory auditors should be submitted by the CIC to the RBI, certifying that it has fully complied with all the conditions stipulated under these guidelines for overseas investment. The certificate as on end-March every year should be submitted by April 30 each year. If any serious adverse features come to the notice of the RBI, the permission granted would be withdrawn. All approvals for investment abroad would be subject to this condition.

Specific Conditions ***Opening of Branches*** As CICs are non-operating entities, they would not, in the normal course, be allowed to open branches overseas.

Opening of WOS/JV Abroad by CICs In the case of opening of a WOS/JV abroad by a CIC, all the conditions as stipulated above would be applicable. The NoC to be issued by the RBI is independent of the overseas regulators' approval process. The following additional conditions would apply to all CICs: The WOS/JV should not be **(a)** a **shell company**, that is, a company that is incorporated, but has no significant assets or operations. However, companies undertaking activities such as financial consultancy and advisory services would not be considered as shell companies; **(b)** used as a vehicle for raising resources for creating assets in India for the Indian operations. In order to ensure compliance of these provisions, the parent CIC should obtain periodical/audit reports at least quarterly about the business undertaken by the WOS/JV abroad and make them available to the inspecting officials of the RBI. If the WOS/JV has not undertaken any activity or such reports are not forthcoming, the approvals given for its setting-up the WOS/JV abroad would be reviewed. It should make disclosure in its balance sheet the amount of liability of the parent entity towards it and also whether it is limited to equity/loan or if guarantees are given, the nature of such guarantees and the amount involved. All the operations of the WOS/JV abroad would be subject to regulatory prescriptions of the host country.

Opening of Representative Offices Abroad The CICs would need prior approval from the RBI for opening representative offices abroad for liaison work, undertaking market study and research but not for undertaking any activity which involves outlay of funds. They should also comply with the regulations in this regard stipulated by a regulator in the host country. As it is not envisaged that such offices would be carrying on any activity other than liaison work, no line of credit should be extended. The parent CICs should obtain periodical reports about the business undertaken by the representative offices abroad. If the representative offices have not undertaken any activity or such reports are not forthcoming, the RBI may advise the CIC to wind up the establishment.

RECAPITULATION

- The system/scheme of regulation of the working and operations of the NBFCs comprises: **(i)** RBI Act (Chapter III-B) **(ii)** RBI Directions, **(iii)** ALM Framework, **(iv)** Guidelines for Fair Practices Code and **(v)** Credit Informations Companies Act.
- The RBI regulates and supervises the NBFCs under Chapter III-B of the RBI Act. The regulatory and supervisory objective is to **(a)** ensure the healthy growth of the NBFCs, **(b)** ensure that they function as part of the financial system within the policy framework in such a manner that their existence and functioning do not lead to any systematic aberration and **(c)** ensure that the quality of surveillance and supervision is sustained by keeping pace with the developments that take place in this sector of the financial system. An NBFC is a company engaged in the business of loans and advances, acquisition of shares/bonds/debentures/securities issued by the Government or local authority or other similar marketable securities, leasing, hire-purchase, insurance business, venture capital, merchant banking, broking and housing finance.
- It is mandatory that every NBFC should be registered with the RBI to commence/carry on any business. It should have a minimum net owned fund of ₹25 lakh. The NBFCs registered with the RBI are **(i)** equipment leasing, **(ii)** hire-purchase, **(iii)** loan and **(iv)** investment companies. The other types of NBFCs are regulated by other regulators. They could be further classified into those accepting deposits and those not accepting deposits. The registered NBFCs are required to invest in unencumbered approved securities worth at least 5 per cent of their outstanding deposits. Every NBFC must create a reserve fund by transferring at least 20 per cent of its net profits before declaring any dividend. The RBI can regulate/prohibit solicitation of deposits from public. It can give directions to NBFCs relating to (a) prudential norms for income recognition, accounting standards, provisioning on capital adequacy and (b) deployment of funds. It can also issue directions for providing information relating to deposits/for conduct of business. For contraventions/defaults by an NBFC, the RBI can impose penalty. It can also cancel the registration of an NBFC.

- The RBI has issued five directions to the NBFCs: **(1)** Acceptance of Public Deposits Directions, **(2)** Prudential Norms Directions for NBFCs-D and NBFCs-ND-SI, **(3)** NBFC-ND directions, **(4)** Auditors Reports Directions, and **(5)** Core Investment Companies Directions.
- As per the public deposits directions, there is a ceiling on the acceptance of public deposits. An NBFC maintaining the required net owned funds (NOF) and capital adequacy ratio (CRAR) and complying with the prudential norms, can accept public deposits as follows: Equipment leasing (EL)/hire-purchase companies (HP) maintaining CRAR of 15 per cent without credit rating—the lower of 1.5 times of NOF or ₹10 crore; EL/HP with 12 per cent CRAR and minimum investment grade rating—4 times of NOF; and loan companies/investment companies with 12 per cent CRAR and minimum investment grade rating—1.5 times of NOF. The NBFCs can accept/renew deposits for 12-60 months. They cannot offer interest higher than the ceiling rate prescribed by RBI which may be paid/compounded at rests not shorter than monthly rests. Deposits may be accepted by NBFCs in joint names. Premature withdrawal of deposits within 3 months from the date of acceptance is not permitted. The NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors. They can open branch(es)/appoint agents to collect deposits. They should furnish deposit receipts containing details to the depositors and maintain register(s) of deposits. The unencumbered approved securities required to be maintained by an NBFC should be kept with a bank/depository and cannot be withdrawn/encashed except for payment of deposits.
- The provisions of NBFC-ND-SI/NBFC-D Directions apply to the following: **(i)** (**NBFC-ND-SI**), **(ii)** (**NBFC-D**), **(iii) NBFC-factor**, **(iv)** (**IDF-NBFC**), **(v)** (**NBFC-MFIs**) and **(vi)** (**NBFC-IFC**) having an asset size of ₹500 crore and above. There are specific directions applicable to the specific categories of NBFCs registered as NBFC-Factors, IDF-NBFCs and NBFC-MFIs.
- The main elements of the NBFC-ND-ST/NBFC-D directions are: **(i)** prudential issues and **(ii)** governance issues.
- The prudential issues pertain to **(i)** capital requirements, **(ii)** prudential regulations, **(iii)** fair practices, **(iv)** specific directions applicable to NBFC-Factor, IDF-NBFC and NBFC-MFIs.
- Every applicable NBFC should maintain a minimum capital ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items.
- The prudential regulations relate to income recognition, income from investments, accounting standards, accounting of investments, policy on demand call loans, asset classification and provisioning requirements.
- The applicable NBFCs having customer interface should adopt the specified guidelines pertaining to fair practices code in terms of processing of applications, loan appraisals and terms/conditions, disbursement of loans, general responsibility of Board of Directors, grievances redressal officer, language and mode communication, regulation of excessive interest, complaint about excessive interest, repossession of vehicles financed and lending against jewellery.
- The main elements of the specific directions applicable to NBFC-Factor are: registration, net owned funds, principal business, conduct of business, asset classification, risk management, and import-export factoring.
- The specific directions applicable to IDF-NBC relate to eligibility parameters, investments in IDFs, credit rating, capital adequacy, investment by IDF-NBFC and credit concentration.
- The main elements of the NBFC-MFIs directions are: entry point norm, prudential norms, pricing of credit, transparency in interest rates, multiple lending, over-borrowing and ghost-borrowers, compliance with conditionalities, channelising agents for schemes and so on.

- The governance issues pertain to **(i)** acquisition/transfer of control and **(ii)** corporate governance.
- The main elements of the corporate governance are: **(i)** constitution of the committees of the Board of Directors, **(ii)** fit and proper person criteria, **(iii)** disclosure and transparency and **(iv)** rotation of partners of the auditors/audit firm and **(v)** framing of internal guidelines.
- The provisions of NBFC-ND directions are applicable to **(a)** NBFCs not accepting/holding public deposits which are not systemically important, that is, having minimum total asset of Rs500 crore, **(b)** NBFC-Factor registered with the RBI under the Factoring Regulation Act **(c)** NBFC-Micro-Finance Institution (NBFC-MFI), **(d)** NBFC Infrastructure Finance Company (NBFC-IFC), **(e)** Infrastructure Debt Fund-NBFC (IDF-NBFC). These directions are substantially on the same pattern as is applicable to the NBFC-ND-SI and NBFC-D. However, there are some additional features and some features applicable to the former are not applicable to the NBFC-ND.
- The new/additional features of the prudential norms applicable to the NBFC-ND are: **(1)** Leverage Ratio, **(2)** Concentration of Credit/Investment, **(3)** Specific Directions Applicable to NBFC-Factor The exposure norms relating to asset classification should be reckoned in case of factoring on **(a)** with recourse basis on the assigner, **(b)** without recourse on the debtor irrespective of the credit risk cover/protection except in cases of international factoring where the entire credit risk has been assumed by the import factor.
- The features/elements of the prudential norms relating to the NBFC-SI-ND and which are inapplicable/excluded to/from the NBFC-D relate to **(i)** Infrastructure Debt Fund-NBFCs (IDF-NBFCs), **(ii)** prudential regulations and **(iii)** fair practices code. These are not applicable to the NBFCs who have not accessed public funds and do not have any customer interface. The provisions pertaining to fair practice code are inapplicable to the NBFCs accessing public funds but having no customer interface. The NBFCs having customer interface but not accessing public funds are exempt from the prudential regulations.
- The main elements of the core investment companies directions are: **(i)** registration, **(ii)** prudential issues, **(iii)** governance issues and **(iv)** overseas investments.
- Included in prudential issues are: **(i)** capital requirements and leverage ratio and **(ii)** prudential regulations. The **adjusted net worth** of a CIC-ND-SI should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year.
- The outside liabilities of a CIC-ND-SI should never exceed 2.5 times its adjusted net worth as on the date of the last audited balance sheet as at the end of the financial year.
- The prudential regulations applicable to the CIC-ND-SI are the same as applicable to the NBFC-ND-SI/NBFC-D.
- The main elements of the governance issues are: **(i)** transfer of control, **(ii)** prior approval and **(iii)** change in management and control.
- The main elements of the overseas investment directions are **(i)** investment in financial sector overseas, **(ii)** investment in non-financial sector, **(iii)** eligibility criteria, **(iv)** general/specific conditions.
- In addition to the normal auditors report under the Companies Act, the auditors of the NBFCs should also make a separate report on their financial statements to the shareholders containing statements on matters of supervisory concern to the RBI in respect of all NBFCs/NBFCs accepting deposits/NBFCs not accepting deposits. In case of an unfavourable, qualified report relating to the above matters, the reasons for the same should also be stated. The auditors should also submit a report to the RBI in case of unfavourable/qualified report.

- The main elements of the regulatory framework for core investment companies are their registration, capital requirements, leverage ratio, submission of annual statutory auditors certificate, and overseas investments directions.

  Every systematically important core investment company (CIC-ND-SI) should be registered with the RBI. A CIC-ND-SI means a core investment company, having total assets of at least ₹100 crore and holding public funds in the form of deposits/CPs/bank finance excluding compulsorily convertible instruments within 10 years from the date of issue. A core investment company (CIC) means a NBFC carrying on the business of acquisition of shares/securities where at least **(i)** 90 per cent net assets are in the form of shares/debentures/debt/loan to group companies, **(ii)** 60 per cent net assets are in equity shares including compulsorily convertible instruments in group companies and **(iii)** which trades in its investment only through block sale for dilution/disinvestment/carries on only the business of investment in deposits, money market instruments, units of mutual funds, Government securities, bonds, debentures of and grant of loan/guarantee to, on behalf of, group companies. Group companies refer to an arrangement involving entities related to each other through any of the following relationships: subsidiary—parent; joint venture; associate; promoter-promotee; common brand name; and at least 20 per cent investment in equity.

  The adjusted net worth (ANW) of CIC-ND-SI should be at least 30 per cent of its aggregate risk weighted assets on balance sheet items and risk adjusted value of off-balance sheet items. The ANW means total owned funds **plus** 50 per cent of the unrealised appreciation in the book value of quoted investments and increase in share capital **minus** the diminution in the book value of quoted investments and reduction in share capital.

  Their outside liabilities should never exceed 2.5 times their ANW.

  An annual compliance certificate from the auditors should be submitted to the RBI within one month of the finalisation of the balance sheet.
- The RBI guidelines relating to ALM focus on interest rate and liquidity risk management systems in banks, which form a part of the ALM function. The main elements of the ALM system are: ALM information system, ALM organisation and ALM process.
- The ALM system should be built up on a sound methodology, with the necessary information system as a back up. Information is key to the ALM process. A uniform system is not feasible for all banks. The ALM system analyses information on the basis of residual maturity and behavioural pattern. Banks should initially follow the ABC approach, that is, analyse the behaviour of the asset and liability products in the sample branches that account for significant business and make rational assumptions about the behaviour of the assets and liabilities in other branches. The data and assumptions can be refined over time in the light of experience of conducting business within the ALM framework. The spread of computerisation would facilitate accessing of data.
- The Board of Directors should have the overall responsibility for the management of risk and of deciding the risk management policy of the bank, besides setting limits for liquidity, interest rate, forex and equity price risk. The ALCO should ensure adherence to the limits set by the Board and decide the business strategy of the bank on the assets and liability side, in line with the budget and risk management objectives. A sub-committee of the Board should oversee the implementation of the system and review its functioning periodically.
- The ALM process mainly addresses liquidity and interest rate risks.
- NBFCs management should not only measure the liquidity position of NBFCs on an ongoing basis, but also examine how liquidity requirements are likely to evolve under different assumptions. Liquidity should be tracked through maturity/cashflow estimates. The use of

the maturity ladder and calculation of cumulative surplus/deficit of funds at selected maturity dates may be used to measure/manage the net funding requirements. The maturity profile of the various heads of accounts should be used for measuring the future cashflows in different time brackets: 1-14 days; 15-28 days; 29 days upto 3 months; 3-6 months; 6 months – 1 year; 1 – 3 years; 3 – 5 years; and over 5 years. Within each time bracket, there could be mismatches between cash-inflows and outflows. The main focus should be on short-term mismatches, namely, 1-14 days and 15-28 days. The mismatches (negative gap) in the normal course should not exceed 20 per cent of the cashoutflows in each time bracket.

- A statement of structural liquidity may be prepared by placing all cash inflows (i.e., maturing assets) and cash outflows (i.e., maturing liabilities) in the maturity ladder, according to the timing of the cashflows. While determining the tolerance level in mismatches, NBFCs should take into account all the relevant factors, based on their asset liability base, nature of business, future strategy and so on and further refined with experience gained in liquidity management. To monitor their short-term liquidity on a dynamic basis, over a time horizon spanning from 1–90 days, NBFCs may estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.
- Interest rate risk has two dimensions. The immediate effect of a change in the interest rate is on its net interest income (NII) or net interest margin (NIM). The long-term impact is on the market value of equity (MVE)/networth.
- Initially, NBFCs should use the traditional gap analysis to measure the interest rate risk and move over to modern techniques of interest risk measurement, such as duration gap analysis, simulation and VaR overtime, when they acquire sufficient expertise and sophistication in acquiring and handling MIS.
- Gap analysis measures mismatches between rate sensitive liabilities and assets. Such assets and liabilities should be grouped into time brackets according to the residual maturity or next repricing period, whichever is earlier. The gaps may be classified into the following time-brackets: 1–28 days; 29 days to 3 months; 3–6 months; 6 months – 1 year; 1–3 years; 3–5 years; over 5 years; and non-sensitive.
- The gap is the difference between rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) for each time bracket. RSAs > RSLs = positive gap; RSAs < RSLs = negative gap. The gap report indicates whether the bank can benefit from rising interest rates (positive gap) or from a declining interest rate (negative gap).
- To facilitate the efficient distribution of credit and to provide for regulation of CICs, the CICs Act was enacted in 2005. Credit information includes **(1)** nature of loans, advances, amount under credit cards, other credit facilities; **(2)** nature of security; **(3)** guarantee/non-fund based facility; **(4)** credit worthiness of a borrower and so on. Credit institutions include banks, NBFCs, PFIs, SFCs, HFCs, companies in credit card business and so on. The main elements of the framework of regulation of CICs are: registration, management, auditors, functions, information privacy principles, and offences/penalties.
- To commence/carry on its business, a CIC requires registration with the RBI, for which it has to satisfy conditions like minimum capital, general character of its management and any other condition to ensure that it would not be detrimental/prejudicial to public interest/banking policy/credit system/specified users/borrowers/clients and so on. While granting registration, RBI may impose conditions it may consider fit. It can cancel the registration of a CIC on failure **(1)** to comply with the conditions of registration, **(2)** to fulfil conditions relating to capital, general character of its management and so on, **(3)** to comply with provisions of any law/RBI directions and so on.

- The superintendence, control and direction of the CIC would be vested in its Board of Directors, who should act on business principles. At least 50 per cent directors should have special knowledge in public administration, law, banking, finance, accounting, management and IT. The RBI can supersede the Board for upto 12 months. It has also the powers to determine the policy and to issue directions and conduct inspection of a CIC.
- The auditors of the CIC are duty bound to inquire if it has complied with RBI's requirements of submission of statements/information/particulars of its business and report to the RBI if not satisfied. The RBI may order a special audit of the accounts of the CIC.
- The functions of a CIC are: **(i)** to collect, process and collate information on trade, credit and financial standing of borrowers, **(ii)** to provide credit information/credit scoring to specified users/CICs, **(iii)** to undertake research projects and **(iv)** to undertake any other form of business specified by the RBI. A CIC may register CIs/CICs as members and charge a fee for furnishing credit information to specified users.
- All CICs/CIs/specified users in possession/control of credit information should ensure that the data maintained by them is accurate and complete, duly protected against loss and unauthorised access/use/disclosure. They should follow the following privacy principles in relation to collection, processing, collating, recording, preservation, secrecy, sharing and usage of credit information: **(i)** principles followed/adopted; **(ii)** purpose, **(iii)** extent of obligation, **(iv)** preservation, **(v)** networking and **(vi)** any other.
- Penalties for offences relate to **(a)** a wilful false statement in any material particular/omission of a material statement, **(b)** breach of any privacy principle, **(c)** wilful provision/omission of false information in any material particular/to make a material statement, and **(d)** contravention of any legal provision. The RBI can impose penalty **(a)** for unauthorised access, **(b)** for a breach of the privacy principle/wilful provision or omission of material particulars and **(c)** for a contravention of the provisions of the CICs Act/rules/orders/directions.
- The CICs desirous of making overseas investment in the **financial sector** (i.e. a sector regulated by a financial sector regulator) should hold a certificate of registration (CoR) from the RBI and comply with all the regulations applicable to registered CICs. A registered CIC need not obtain prior approval from the RBI, for overseas investment in non-financial sector. The eligibility criteria for investments abroad and other conditions prescribed for CICs are discussed below.
- The adjusted net worth (ANW) of the CIC should not be less than 30 per cent of its aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet item. The level of net non-performance assets of the CIC should not be more than 1 per cent of its net advances. The CIC should generally be earning profit continuously for the last three years and its performance should be satisfactory during the period of its existence.
- Direct investment in activities prohibited under the FEMA is not permitted. The total overseas investment should not exceed 400 per cent of the owned funds of the CIC. The total overseas investment in financial sector should not exceed 200 per cent of its owned funds. The investment in financial sector should be only in regulated entities abroad. Entities set up/acquired abroad should be treated as wholly owned subsidiaries (WOS)/joint ventures (JV) abroad. Overseas investments by a CIC in financial/non-financial sector would be restricted to its **financial commitment** (i.e. the amount of direct investment by way of contribution to equity and loan and 50 per cent of the amount of guarantees issued by an Indian party to or on behalf of its overseas JV/WOS).
- As non-operating entities, the CICs will not, in the normal course, be allowed to open branches overseas. In the case of opening of a WOS/JV abroad, all the conditions as stipulated above

would be applicable. The WOS/JV being established abroad should not be a **shell company**, that is, **a company that is incorporated, but has no significance assets or operations**. They should not be used as a vehicle for raising resources for creating assets in India for the Indian operations.

- The CICs will need prior approval from the RBI for opening representative offices abroad for the purpose of liaison work, undertaking market study and research but not for undertaking any activity which involves outlay of funds.

REVIEW QUESTIONS

1.1 What are the regulatory and supervisory objectives of the RBI in relation to the NBFCs? Discuss the main elements of the RBI framework of NBFC regulation.

1.2 Briefly discuss the main features of the RBI directions relating to acceptance of deposits by NBFCs.

1.3 Outline the major elements of the RBI prudential norms and directions for NBFCs-D and NBFCs-ND-SI.

1.4 Write notes on:
- NPAs
- Doubtful assets
- Provisioning
- Capital adequacy requirement

1.5 Explain briefly the major thrust of the RBIs auditors report direction for NBFCs.

1.6 Discuss the main features of the RBI NBFC-MFIs directions.

1.7 Outline the features of the framework of regulation of the credit information companies in India.

1.8 Examine briefly the main elements of the regulatory framework for core investment companies.

1.9 Discuss the main features of the RBI IDF-NBFC directions.

PART 2

ASSET/FUND-BASED FINANCIAL SERVICES

The financial services fall into two broad categories, namely, **(1)** asset/fund-based and **(2)** fee-based/advisory. Part Two of the book is devoted to a comprehensive discussion of the fund-based financial services in the country.

Chapter 2 examines the conceptual, regulatory framework and taxation of leasing companies. It also examines the accounting of leasing transactions in the books of the lessee and the lessor and the framework of lease evaluation.

Chapters 3–9 of this Part cover other types of fund-based financial services. The focus is on the nature and type of service, the analytical/regulatory/evaluation framework rather than on quantitative growth and procedural aspects. Chapter 3 examines hire-purchase as an alternative to leasing as a source for equipment financing. It also outlines the analytical framework relating to consumer credit. Another emerging fund-based financial service in the country is factoring and forfaiting. The conceptual/analytical framework underlying factoring and the nature of such services in the country is presented in Chapter 4. Housing finance represents a notable institutional development in the financial services sector in India. The regulatory framework/players/schemes and the emergence of mortgage-based securitisation are examined in detail in Chapter 5. With the opening of the insurance sector since 2000 and the dismantling of the public sector monopoly, insurance services are poised for a great leap forward. The emerging framework is analysed in Chapter 6. Similarly, in the context of the globalisation of the Indian economy, venture capital financing is assuming a centre stage in the financial services sector as a follow-up to the recommendations of the Chandrasekharan Committee Report, 1999. The policy framework and the profile of the venture capital financing in India are covered in Chapter 7. Finally, Chapters 8 and 9 are devoted to a comprehensive account of banking services and products and mutual funds products/services respectively.

CHAPTER 2

Lease Financing

Learning Objectives

- Discuss the two main elements of the theoretical framework of leasing - concept and classification, and its significance and limitations.
- Understand the basic types of leases - finance and operating, sale and lease back, and direct, single lease and leveraged lease, and domestic and international lease.
- Explain the basic features of Indian *Contract Act* as the legislative framework for lease transactions.
- Describe the lease documentation procedure and contents of the lease agreement.
- Explain and illustrate the IAS-17 framework of the accounting treatment for finance lease by (i) lessees and (ii) lessors.
- Outline the accounting treatment of operating lease transactions in the books of the lessees and the lessors.
- Understand the main elements of AS-19: Leases issued by the Institute of Chartered Accountants of India.
- Discuss the special considerations which have a bearing on the income tax aspects of leasing.
- Explain the sales tax implications for leasing transactions.
- Explain and illustrate financial evaluation of finance lease from the lessee's perspective—in terms of net present value of leasing/net advantage of leasing.
- Explain and illustrate lease evaluation from the lessor's viewpoint.
- Discuss other aspects of financial evaluation of lease transactions—break-even lease rentals, negotiation for lease rentals, structuring of lease rentals and profile of lease rentals.

INTRODUCTION

The purpose of this chapter is three-fold: to (a) explain the theoretical and regulatory framework of lease financing; (b) explain and illustrate the accounting treatment of lease transactions prescribed by the IAS-17 and ICAI AS-19: Leases respectively; and (c) discuss the analytical framework/techniques to evaluate the financial terms of the leasing proposal. Sections 1-3 of the chapter respectively cover them. The main points are summarised in the last section.

THEORETICAL AND REGULATORY FRAMEWORK OF LEASING

The purpose of this section is to explain the theoretical and regulatory framework of leasing. The main elements of the theoretical framework, namely, concept and classification of leasing and its significance and limitation are discussed here.

There is no exclusive law/legislation/act/regulation/direction to govern equipment lease financing. The relevant provisions of a number of allied legislations constitute the legislative framework of lease transactions. The lease agreements provide for a number of obligations on the part of the lessee which do not form part of his implied obligations under the legislative framework. The legislative framework and the lease agreements provide the regulatory framework of lease financing in India.

Without going into the intricacies of the legal issues, the Section provides a basic understanding of the framework regulating lease transactions. The laws/acts/regulations which constitute the legislative framework are the *Contract Act*, the *Vehicles Act*, the *Stamp Act*, and the RBI NBFCs Directions under the *RBI Act*. The framework of regulation contained in these is outlined in this Section. The lease documentation procedure and contents of lease agreement are also briefly discussed. **The main elements of the theoretical and regulatory framework of leasing are portrayed in Exhibit 2.1. Appendix 2-A (*on the website*) contains glossary of terms relating to leasing and hire-purchase. The website address is http://www.mhhe.com/khanfs9e.**

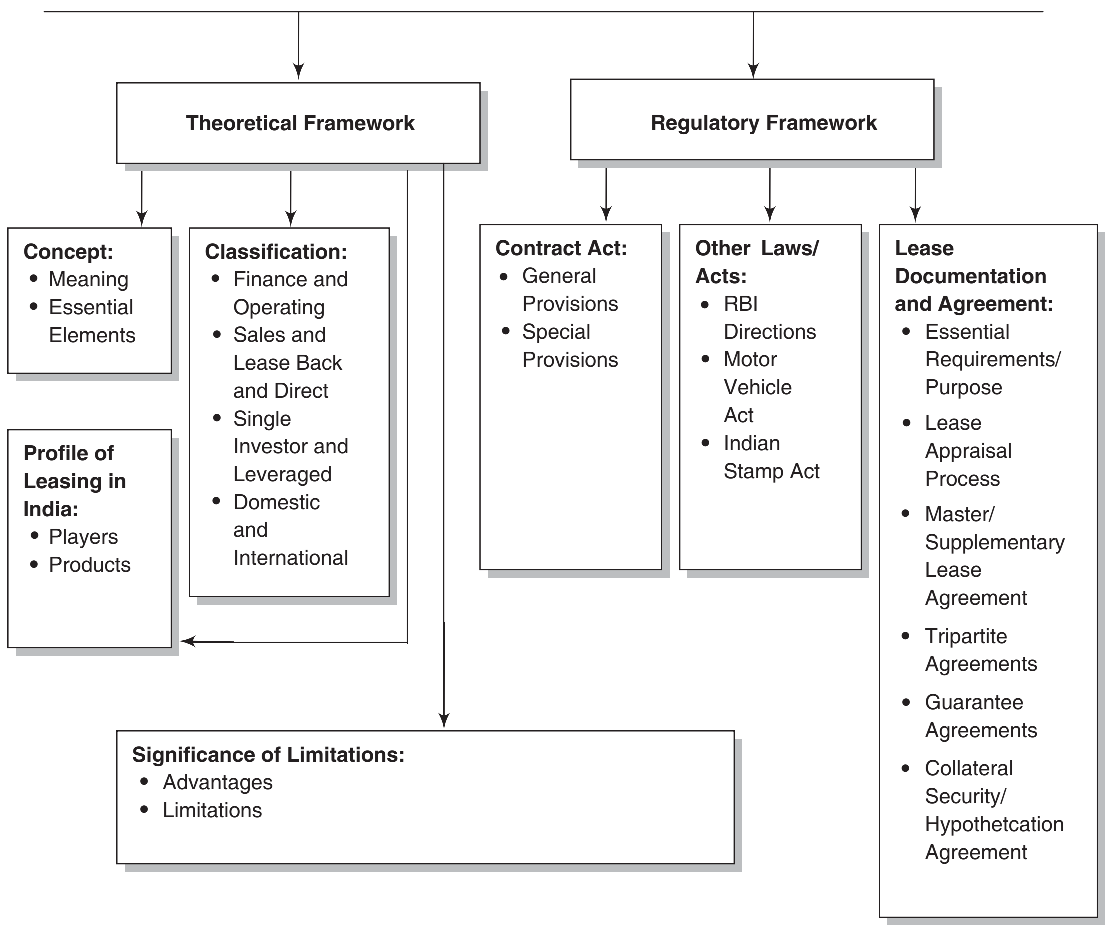
Concept and Classification

Concept Included in conceptual aspect of leasing are its meaning and essential elements.

Meaning Conceptually, a lease may be defined as a contractual arrangement/transaction in which a party owning an asset/equipment (lessor) provides the asset for use to another/transfer the right to use the equipment to the user (lessee) over a certain/for an agreed period of time for consideration in form of/in return for periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset/equipment reverts back to the lessor unless there is a provision for the renewal of the contract. **Leasing** essentially involves the **divorce of ownership from the economic use of an asset/equipment**. It is a device of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (financier) from a manufacturer/vendor selected by the lessee. The **lessee** has possession and use of the asset on payment of the specified

Leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a series of contractual periodic tax-deductible payments (lease rentals).

Exhibit 2.1 Conceptual/Theoretical and Regulatory Framework of Leasing



rentals over a predetermined period of time. Lease financing is, thus, a device of financing/ money lending. The position of a lessee is akin to that of a person who owns the same asset with borrowed money. The real function of a lessor is not renting of asset but lending of funds/ finance/credit, and lease financing is, in effect, a contract of lending money. The **lessor** (financier) is the nominal owner of the asset as the possession and economic use of the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor does not take recourse to the equipment as long as the rentals are regularly paid to him.

Lessor
is the owner of the asset that is being leased.

Essential elements The essential elements of leasing are the following:

Parties to the Contract There are essentially two parties to a contract of lease financing, namely, the owner and the user, called the **lessor** and the **lessee** respectively. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial institutions. Sometimes there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous. Besides, there may be a lease-broker who acts as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and even some private merchant bankers are acting as lease-brokers. They charge certain percentage of fees for their services, ranging between 0.5 to 1 per cent. Besides, a lease contract may involve a **lease financier**, who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

> **Lessee** is the receiver of the services of the asset under a lease contract.

Asset The asset, property or equipment to be leased is the subject-matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft, and so on. The asset must, however, be of the lessee's choice suitable for his business needs.

Ownership Separated from User The essence of a lease financing contract is that during the lease-tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

Term of Lease The **term of lease** is the period for which the agreement of lease remains in operation. Every lease should have a definite period otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e. financial lease) or a period shorter than the useful life of the asset (i.e. operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further specific period.

> **Lease term** is the period for which the lease agreement remains in operation.

Lease Rentals The consideration which the lessee pays to the lessor for the lease transaction is the **lease rental**. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the interest on the investment, repairs and so forth–borne by the lessor, and servicing charges over the lease period.

> **Lease rental** is the consideration which the lessee pays to the lessor for the lease transaction.

Modes of Terminating Lease The lease is terminated at the end of the lease period and various courses are possible, namely,

(a) The lease is renewed on a perpetual basis or for a definite period, or
(b) The asset reverts to the lessor, or
(c) The asset reverts to the lessor and the lessor sells it to a third party, or
(d) The lessor sells the asset to the lessee.

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

Classification An equipment lease transaction can differ on the basis of **(i)** the extent to which the risks and rewards of ownership are transferred, **(ii)** number of parties to the transactions, **(iii)** domiciles of the equipment manufacturer, the lessor and the lessee and so on. **Risk** with reference to leasing refers to the possibility of loss arising on account of under-utilisation or technological obsolescence of the equipment while **reward** means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realisation of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types: **(a)** Finance lease and Operating lease, **(b)** Sales and lease back and Direct lease, **(c)** Single investor lease and Leveraged lease and **(d)** Domestic lease and International lease.

> **Risk**
> is the possibility of loss arising on account of under-utilisation or technological obsolescence of the equipment.

Finance Lease and Operating Lease *Finance Lease* According to the **International Accounting Standards (IAS-17)**, in a **finance** lease the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancellable lease period, sufficient in total to amortise the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason that such leases are also called as '**full payout leases**' as they enable a lessor to recover his investment in the lease and derive a profit. Types of assets included, under such lease, are ships, aircrafts, railway wagons, lands, buildings, heavy machinery, diesel generating sets and so on.

> **Finance lease**
> is for terms that approach the economic life of the asset; the total payments over the term of the lease are greater than the lessor's initial cost of the leased asset.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when:

(i) The ownership of the equipment is transferred to the lessee by the end of the lease term; or

(ii) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and at the inception of the lease it is reasonably certain that the option will be exercised; or

(iii) The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of its **(i) physical life** in terms of the period for which it can perform its function, **(ii) technological life** in the sense of the period in which it does not become obsolete and **(iii) product market life** defined as the period during which its product enjoys satisfactory market. The criterion/cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease; or

(iv) The present value of the minimum lease payment is greater than, or substantially equal to, the fair market value of the asset at the inception of the lease (cost of equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed by using a discount rate equal to the rate implicit in the lease in the case by the lessor and the incremental borrowing rate by the lessee.

According to the **Accounting Standard (AS)-19: Leases** issued by the Institute of Chartered Accountants of India (ICAI) in January, 2001, the classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. **Risks** include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. **Rewards** may be represented by the expectations of profitable operation over the economic life of the asset and of gain from appreciation in value of realisation of residual value.

A lease is classified as a **finance lease** if it transfers substantially all the risk and rewards incidental to ownership. Title may or may not eventually be transferred. A lease is classified as an **operating lease** if it does not transfer substantially all the risks and rewards incidental to ownership.

Since the transaction between a lessor and lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

- **(a)** The lease transfers ownership of the asset to the lessee by the end of the lease term;
- **(b)** The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- **(c)** The lease term is for the major part of the economic life of the asset even if its title is not transferred;
- **(d)** At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- **(e)** The leased asset is of a specialised natures such that only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- **(a)** If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- **(b)** Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- **(c)** The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria outlined above had a changed terms been in effect at the inception of the lease, the revised agreement is considered

as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.
A finance lease is structured to include the following features:

(i) The lessee (the intending buyer) selects the equipment according to his requirements, from its manufacturer or distributor,
(ii) The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment and so on,
(iii) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight- forward leasing) or from the lessee after the equipment is delivered (under sale and lease back),
(iv) The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment,
(v) A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date, However, this practice is rarely found in India,
(vi) The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancellable period called the **primary lease period** during which the lessor seeks to recover his investment alongwith some profit. During this period, cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the **secondary lease period**, during which the rentals are substantially low,
(vii) The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease,
(viii) As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance of the equipment rest with the lessee.

Operating Lease According to the IAS-17, an **operating lease** is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortised during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease is also called '**service lease**'. The lease rentals in an operating lease include a cost for the 'services' provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, some other equipments, telephones, and so on.

> **Operating lease**
> is for a term shorter than the economic life of the asset; generally the payment over the term of the lease is less than the lessor's initial cost of the leased asset.

A operating lease is structured with the following features:

(i) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancellable by either party during the lease period;

(ii) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortise the cost of the assets;

(iii) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time;

(iv) Operating leases normally include maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support staff, fuel, and so on.

Examples of operating leases are:

(a) Providing mobile cranes with operators,

(b) Chartering of aircrafts and ships, including the provision of crew, fuel and support services,

(c) Hiring of computers with operators,

(d) Hiring a taxi for a particular travel, which includes service of driver, provision for maintenance, fuel, immediate repairs, and so on.

Sale and Lease Back and Direct Lease *Sale and Lease Back* In a way, it is an indirect form of leasing. The owner of an equipment/asset sells it to a leasing company (lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits vaults by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank sub-leases the lockers to its customers. The **lease back** arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease.

Direct Lease In direct lease, the lessee, and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.

Bipartite Lease There are two parties in the lease transaction, namely, **(i)** equipment supplier-cum-lessor and **(ii)** lessee. Such a type of lease is typically structured as an operating lease with in-built facilities, like upgradation of the equipment (**Upgrade lease**), addition to the original equipment configuration and so on. The lessor maintains the asset and, if necessary, replace it with a similar equipment in working conditions (**Swap lease**).

Tripartite Lease Such type of lease involves three different parties in the lease agreement: equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the **sales-aid lease** under which the equipment supplier arranges for lease finance in various forms by:

- Providing reference about the customer to the leasing company;
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company;
- Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of the lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

Single Investor Lease and Leveraged Lease *Single Investor Lease* There are only two parties to the lease transaction: the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, that is, in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

Leveraged Lease There are three parties to the transaction: **(i)** lessor (equity investor), **(ii)** lender and **(iii)** lessee. In such type of lease, the leasing company (equity investor) buys the asset through substantial borrowing with full recourse to the lessee and without any recourse to it. The lender (**loan participant**) obtains an assignment of the lease and the rentals to be paid by the lessee and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt-service component of the rental to the loan participant and the balance to the lessor.

> **Leveraged lease** is a lease under which the lessor acts as an equity participant supplying a fraction if the total cost of the asset while the lender supplies the major part (balance).

Illustration 2.1

Assume the Hypothetical Leasing Ltd (HLL) has structured a leveraged lease with an investment cost of ₹50 crore. The investment is to be financed by equity from it and loan from the Hypothetical Bank Ltd (HBL) in the ratio of 1:5. The interest on loan may be assumed to be 20 per cent per annum to be repaid in five equated annual instalments. If the required rate of return (gross yield) of the HLL is 24 per cent, calculate **(i)** the equated annual instalment and **(ii)** the annual lease rental.

Solution

(i) Equated Annual Instalment to HBL:

$$= \frac{\text{Loan amount}}{\text{PVIFA [at 20 per cent after 5 year (20, 5)]}}$$

$$= \frac{₹40 \text{ crore } (0.8 \times ₹50 \text{ crore})}{2.991} = ₹13.4 \text{ crore}$$

(ii) Annual Lease Rental (X):

Annual cash flow to HLL = (X – ₹13.4 crore)

Given the required rate of return of HLL of 24 per cent, (X – ₹13.4 crore) × PVIFA (24, 5) = ₹10 crore (equity) or 2.745 X – ₹36.783 crore (i.e. 2.745 × ₹13.4 crore) = ₹10 crore

Or 2.745 X = ₹46.783 crore

X = ₹17.04 crore

In terms of the standard quote, the lease rental works out to be ₹340/₹1,000 per annum (₹17.04 crore × $\frac{₹1{,}000}{₹\text{ crore}}$).

Like other lease transactions, leverage lease entitles the lessor to claim tax shields on deprecation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (profit after tax divided by networth) is, therefore, high.

From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircraft, ships and so on.

Domestic lease is a transaction if all parties to the agreement are domiciled in the same country.

Domestic Lease and International Lease *Domestic Lease* A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

International Lease If the parties to the lease transaction are domiciled in different countries, it is known as international lease. This type of lease is further sub-classified into **(1)** import lease and **(2)** cross-border lease.

International lease is a lease transaction if all parties to the agreement are domiciled in different countries.

Import Lease In an import lease, the lessor and the lessee are domiciled in the same country but the equipment supplier is located in a different country. The lessor imports the asset and leases it to the lessee.

Cross-border lease is a lease when the lessor and the lessee are domiciled in different countries.

Cross-Border Lease When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease. The domicile of the supplier is immaterial. Operationally, the domestic and international leases are differentiated on the basis of risk. The latter type of lease transaction is affected by two additional risk factors, that is, **country risk** and **currency risk**. The country risk arises from the need to structure the lease transaction in the light of an understanding of the political and economic climate and a knowledge of the tax and regulatory environment governing them in the foreign countries concerned. As the payment to the supplier and the lease rentals are denominated in different currencies, any variation in the exchange rate will involve currency risk.

Profile/Structure of Leasing in India ***Major Players*** They can be categorised into six groups:

Independent Leasing Companies A major part of their income is derived from leasing. Some of them have financial/technical collaboration with overseas partners. They offer their services through direct advertisement, personal contacts, lease brokers including foreign banks and merchant banks.

Other Finance Companies A large number of other finance and investment companies also carry on leasing business because of tax advantage. Leasing is not their regular business and they normally opt for lease finance of 100 per cent depreciation items once in a while so as to defer taxes.

Manufacturer-Lessors A number of manufacturing companies have either set up independent leasing outfits or through separate divisions carry on leasing business to promote the sale of their own products.

Financial Institutions The development finance institutions, both All-India and state level, provide leasing facility.

In-house Lessors Some big business houses have formed captive leasing companies for providing lease finance to group companies.

Commercial Banks With effect from 1994-95, banks have been permitted to directly carry on leasing and hire-purchase business.

Product Profile The salient features of the lease structures in India are as detailed below:

(i) By and large, the structured lease fall in the category of **finance lease**. Operating lease is not very popular primarily because of the virtual non-existence of resale market for most of the used equipments. Such type of leasing ideally suits the requirements of firms (lessees) in sun-rise industries characterised by a high degree of technological risk as the business and technological risk associated with the equipment is borne by the lessor.

(ii) The lease agreements do not provide for transfer of ownership to the lessee as such transactions are classified as hire-purchase from the tax angle.

(iii) The lease rentals are structured so as to recover the entire investment cost during the primary period. They are quite nominal during the secondary period. The lease rates are determined by a number of factors including the relevant tax, depreciation, and so on.

(iv) The lease rentals are payable generally in equated/level monthly instalments at the beginning of every month. A number of rental structures are used, related to the lessees requirements and projected cash flow pattern.

(v) Sale and lease back type of transactions are rare. Most of the agreements are **direct lease**.

(vi) By and large equipment leases are for capital investment not exceeding ₹100 lakh as most lessees view leasing as a kind of **standby** finance for meeting unplanned capital expenditure or for acquiring non-productive assets such as air conditions and other office equipment which are not eligible for assistance by financial institutions.

(vii) Equipment leasing covers a wide range of equipments from industrial plant and machinery of computers, other office equipments to vehicles. But project leasing for infrastructure and so on is done on a very limited scale exclusively by ILFS. Similarly, cross-border lease transactions are not popular.

Significance/Advantages and Limitations

The advantages and limitations of leasing are summarised below.

Advantages of Leasing ***To the Lessee*** Lease financing has following advantages to the lessee:

Financing of Capital Goods Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipments, and so on, upto 100 per cent, without requiring any immediate down payment. Thus, the lessee is able to commence his business virtually without making any initial investment (of course, he may have to invest the minimal sum of working capital needs).

Additional Source of Finance Leasing facilitates the acquisition of equipment, plant and machinery, without the necessary capital outlay, and, thus, has a competitive advantage of mobilising the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

Less Costly Leasing, as a method of financing, is less costly than other alternatives available.

Ownership Preserved Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long-term finance, for example, equity or debentures, normally dilute the ownership of the promoters.

Avoids Conditionalities Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionalities, such as, representations on the Board, conversion of debt into equity, payment of dividend, and so on, which usually accompany institutional finance and term loans from banks.

Flexibility in Structuring of Rentals The lease rentals can be structured to accommodate the cash flow position of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor-made that the lessee is able to pay the rentals from the funds generated from operations. The lease period is also chosen so as to suit the lessee's capacity to pay rentals and considering the operating life-span of the asset. Some of the ways to structure lease rentals is illustrated in Illustration 2.2.

Illustration 2.2

The following data relate to the Hypothetical Leasing Ltd:

(1) Investment outlay/cost, ₹100 lakh
(2) Pre-tax required rate of return, 20 per cent per annum
(3) Primary lease period, 5 years
(4) Residual value (after primary period), Nil
(5) Assumptions regarding alternative rental structures:
- **(A)** Equated/Level,
- **(B)** Stepped (15 per cent increase per annum),
- **(C)** Ballooned (annual rental of ₹10 lakh for years, 1-4),
- **(D)** Deferred (deferment period of 2 years)

Solution

The annual lease rentals under the above four alternatives are computed below:

(A) Equated Annual Lease Rental, (Y):

$$Y = Y \times \text{PVIFA [at 20 per cent for 5 years (20,5)]} = ₹100 \text{ lakh}$$

$$= \frac{₹\ 1{,}000 \text{ lakh}}{2.991} = ₹33.43 \text{ lakh}$$

(B) Stepped Lease Rental (assuming 15 per cent increase annually):

$$Y = Y \times \text{PVIF } (20,1) + (1.15)Y \times \text{PVIF } (20,2) + (1.15)^2\ Y \times \text{PVIF } (20,3) + (1.5)^3 Y \times \text{PVIF } (20,4) + (1.5)^4 Y \times \text{PVIF } (20,5) = ₹100 \text{ lakh}$$

$$= 0.833Y + 0.798Y(0.694 \times 1.15Y) + 0.764Y(0.579 \times 1.32Y) + 0.733Y(0.482 \times 1.52Y) + 0.703\ Y(0.402 \times 1.75\ Y)$$

$$= 3.833\ Y = ₹100 \text{ lakh}$$

Y = ₹26.10 lakh, where Y denotes the annual rental in year 1.

The lease rentals in different years over the lease term will be: Year 2, ₹30.02 lakh; Year 3, ₹34.52 lakh; Year 4, ₹39.70 lakh; and Year 5, ₹45.65 lakh.

(C) Ballooned Lease Rental (₹10 lakh for years 1–4):

$$Y = [10 \times \text{PVIFA } (20,4) + Y \times \text{PVIF } (20,5) = ₹100 \text{ lakh}$$

$0.402\ Y = ₹100 \text{ lakh} - ₹25.9 \text{ lakh}$

or $Y = (₹74.10 \text{ lakh} \times 0.402) = ₹184.33$ lakh, where Y denotes the ballooned payment in year 5.

(D) Deferred Lease Rental (deferment of 2 years):

Denoting Y as the equated annual rental to be charged between years 3-5,

$$Y = Y \times \text{PVIF }(20,3) + Y \times \text{PVIF }(20,4) + Y \times \text{PVIF }(20,5) = ₹100 \text{ lakh}$$

$$1.463\ Y = ₹100 \text{ lakh}$$

$$Y = ₹68.35 \text{ lakh}$$

This flexibility is not available in the debt-servicing pattern of a conventional loan, institutional borrowings for instance. Such loans have to be typically repaid over a specified number of instalments resulting in heavy debt servicing burden in the earlier years of a project, whereas the project may actually generate substantial cash flows in later years.

Simplicity A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation, causing procedural delays.

Tax Benefits By suitable structuring of lease rentals, a lot of tax advantage can be derived. If the lessee is in a tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortised more rapidly than in a case where the asset is owned by the lessee, since deprecation is allowable at the prescribed rates. If the lessor is in tax paying position, the rentals may be lowered to pass on a part of the tax benefit to the lessee. Thus, the rentals can be adjusted suitably for postponement of taxes.

Obsolescence Risk is Averted In a lease arrangement, the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with latest technology.

To the Lessor A lessor has the following advantages:

Full Security The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset if the lessee defaults. As against it, realising an asset secured against a loan is more difficult and cumbersome.

Tax Benefit The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor is in high tax bracket, he can lease out assets with high depreciation rates and, thus, reduce his tax liability substantially. Besides, the rentals can be suitably structured, to pass on some tax benefit to the assessee.

High Profitability The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowings. Also the rate of return is more than in case of lending finance directly.

Trading on Equity Lessors usually carry out their operations with greater financial leverage. That is, they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the ultimate return on equity is very high.

High Growth Potential The leasing industry has a high growth potential. Lease financing enables the lessees to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital. Leasing, thus, maintains the economic growth even during recessionary period.

Limitations of Leasing Lease financing suffers from certain limitations too:

Restrictions on Use of Equipment A lease arrangement may impose certain restrictions on use of the equipment, or require compulsory insurance, and so on. Besides, the lessee is not fee to make additions or alterations to the leased asset to suit his requirement.

Limitations of Financial Lease A financial lease may entail a higher payout obligations, if the equipment is found not useful and the lessee opts for premature termination of the lease agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

Loss of Residual Value The lessee never becomes the owner of the leased asset Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessee or caused by inflation or otherwise, such as appreciation in value of leasehold land.

Consequences of Default If the lessee defaults is complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

Understatement of Lessee's Asset Since the leased assets do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross underestimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way of footnote to the balance sheet.

Double Sales-tax With the amendment of sale-tax law of various States, a lease financing transaction may be charged to sales-tax twice–once when the lessor purchases the equipment and again when it is leaded to the lessee.

Contract Act

The law of contract applies to all types of contracts including leasing and hire-purchase. In addition, there are certain provisions of law of contract which are specifically applicable to leasing transactions. The main features of the special provisions of the law of contracts are very briefly outlined here.

General Provisions The general provisions of Contract Act are summarised in Appendix 2-A on the website. The website address is **http://www.mhe.com/khanfs9e**.

Special Provisions The provisions of the law of contract relating to bailment are specifically applicable to leasing contracts/transactions. In fact, leasing agreement is primarily a bailment agreement. The main features of the contract law pertaining to bailment are outlined below:

Leasing as a Bailment Agreement Leasing is essentially a bailment agreement as the main elements of the two types of transactions are similar. They are:

(i) There are two parties to a bailment agreement, that is, bailor who delivers the goods and bailee to whom the goods are delivered for use. The lessor and the lessee in a lease transaction are in the position of bailor and bailee respectively.

(ii) There is delivery of possession/transfer of goods from the bailor (lessor) to the bailee (lessee). The ownership of the goods continues with the bailor (lessor). The transfer of goods may be either actual or constructive.

(iii) The goods in bailment should be transferred for a specific purpose under a contract. The purpose in lease agreement is to allow the lessee (bailee) by the lessor (bailor) to make economic use of the asset/goods during the lease term.

(iv) When the purpose is accomplished, the goods are to be returned to the bailor or disposed off according to his directions. The assets in a leasing transaction are returned back to the lessor (bailor) on the accomplishment of the purpose or on expiry of the lease term.

Liabilities of Lessee (Bailee) The liabilities of a lessee under a contract of lease are similar to that of a bailee. These are:

Reasonable Care A lessee is required to take reasonable care of the goods leased to him, in the same manner as a man of ordinary prudence would do to protect his own goods. If the lessee fails to take reasonable care, he is liable for loss of, or damage to, the goods caused by his own, or his employee's/agent's negligence.

However, unless there is an agreement to the contrary, the lessee is not responsible for the loss of, or damage to, the goods, if he has taken reasonable care to protect the goods, for instance, where the goods are damaged by flood or burnt by riotous mob. It is generally, therefore, that lease agreements specifically make lessee liable for all damages irrespective of lessee's negligence.

Not to Make Unauthorised Use The lessee must not use the goods for a purpose different from that stipulated in the lease agreement or do any unauthorised act in relation to the goods. If the lessee does anything which is not permissible under the lease agreement, the agreement is immediately terminated and the lessor may recover the possession of the goods.

To Return the Goods The lessee is under an obligation to return the goods, as soon as the time for which they were leased has expired, or the purpose for which they were leased has been accomplished. Besides, the lessee is bound to return the goods to the lessor in the following cases:

(a) When the lessee has exercised his right to terminate the agreement;

(b) hen the lessee himself has terminated agreement; and

(c) When some event occurs which under the terms of the lease agreement causes an automatic termination of the lease agreement.

The lessee can avoid his liability to return the goods, if the goods were lost/destroyed for none of his fault. Where, however, the goods are lost after the date stipulated for the return of the goods, the lessee cannot avoid his liability.

If the lessee fails to return the goods, the lessor may sue him for damages, or may bring an action for sale proceeds of the goods when wrongfully disposed off by the hirer.

Not to Set up an Adverse Title The lessee must protect the lessor's title by informing him, as soon as practicable, of any adverse claim on the goods leased.

To Pay the Lease Rental The lessee is under an obligation to pay the lease rentals at the times and in the manner laid down in the lease agreement.

To Insure and Repair the Goods A lease agreement may also require a lessee to get the goods insured and/or repaired as and when necessary. But if the agreement does not provide so, the lessee is under no express/implied obligation to do the same.

Liabilities of Lessor (Bailor) The obligations of a lessor are:

Delivery of Goods The lessor is required to ensure the delivery of goods to the lessee and to supply him the necessary documents to enable him to use the goods lawfully. If the goods are not delivered, the lease does not commence.

Peaceful Possession In a lease agreement, the lessee is allowed only the possession of the goods to make economic use of the goods. Thus, the lessor must ensure that the lessee enjoys quiet possession of the goods during the currency of the agreement.

Fitness of Goods The lessor must ensure that the asset leased is in a reasonably fit condition for the purpose for which the lessee is to use it. This applies where the lessee has made known his particular purpose to the lessor and he relies upon lessor's skill and judgement. However, in a typical equipment lease arrangement, the lessor is only a financial intermediary whose role is limited to purchasing the equipment from the supplier and delivering it to the lessee. The equipment supplier is identified by the lessee and the equipment specification and the terms and conditions relating to its performance are negotiated by the lessor. Therefore, the implied obligation of the lessor (bailor) to ensure that the equipment (s) leased is fit for the purpose for which the lessee (bailee) is to use it is expressly negatived in a lease agreement.

To Disclose All Defects The lessor must disclose, to the lessee, the faults or defects in the goods leased of which the lessor has knowledge and which might interfere with their use or expose the lessee to extra-ordinary risks. If he fails to do so and the lessee suffers any loss due to such non-disclosure, the lessor must compensate the lessee. The lessor must remove the defects as reasonable examination would have disclosed. However, he is not liable for latent defects in goods, whether discoverable or not.

Remedies for Breach The remedies available to the lessor (bailor) and the lessee (bailee) against breach of obligations by the other, are discussed below.

Remedies to the Lessor **Forfeiture** The lessor has a right to forfeit the rentals paid by the lessee upto the date of termination, irrespective of the fact that the amount exceeds the amount of benefit received by the lessee upto that date. The lessee may however, seek a relief in equity.

As regards an initial deposit, its forfeiture depends on the purpose of deposit. If the deposit is a security for the asset and the lessee has caused some loss to the asset, it can be forfeited. If the deposit is a security for rent, and the lessee fails to pay rent, it can again be forfeited.

Damages Where the asset has been converted by the lessee, in case of a lease for a fixed term, the lessor may claim damages for conversion. The measure of damages is the value of goods expected to be at the end of the lease period.

Where the lease is for a fixed term and the lessor terminates the agreement for lessee's breach before the expiry of lease period, the lessor can recover the arrears of rent alongwith damages for any specific breach, for example, interest for non-payment of rentals.

Repossession Upon breach of any obligation by the lessee giving the lessor the right to repudiate the contract, the lessor may serve a notice upon the lessee for termination of the agreement and asking for repossession of the goods. For repossession of the asset, the lessor may use such physical force as may be reasonably necessary. For this purpose, the lessor or his agent may have to enter the lessee's premises. It is, thus, desirable that a right to enter the lessee's premises should be provided in the lease agreement.

Remedies to the Lessee Where the contract is repudiated for lessor's breach of any obligation, the lessee may claim damages for loss resulting from termination. The measure of damages is the increased lease rentals (if any) the lessee has to pay on lease of other asset, plus the damages for depriving him from the use of the leased asset from the date of termination of the date of expiry of lease term.

Insurance of Leased Asset and Claims

Necessity It is a general practice to get the leased asset insured. Generally, it is the lessee's responsibility. If the lessor obtains the insurance, he either claims reimbursement of the same from the lessee or adjusts the rentals suitably.

Apart from being a commercial necessity, insurance of motor vehicles is legally necessary under Section 146 of the *Motor Vehicles Act, 1988*.

Risks Insured Insurance on leased assets is normally obtained to cover **(i)** risk of loss/damage by fire, riot, strike, burglary, act of God, faulty handling, electric failure and so on; **(ii)** risk to life or limb of the operator/third parties.

Insurable Interest The insurable interest in the leased asset vests both with the lessor and the lessee and, thus, any of them can obtain insurance. The lessee may obtain insurance cover against his own liability (that is, the amount he is required to pay to the lessor), or for the full value of the goods.

Claims Where the lessee has obtained insurance for full value of the goods, he can claim the full value from the insurer, irrespective of whether the lessee has suffered any loss or not.

Where the insurance has been obtained on behalf of the lessor, he can claim the value of interest insured direct from the insurer. Where the goods have been insured in the name of the lessor only, then only he can claim.

Treatment of Claim Proceeds Where the asset is fully destroyed, the lessor takes the insurance proceeds towards his receivables and the agreement comes to an end. The deficit (or surplus) is to be computed by working out the present value of rentals outstanding but payable in future. The discounting rate and the method of calculation of present value must, therefore, be specified in the agreement.

Where the asset is partially damaged, the insurance proceeds should not normally be applied for repair of the asset. Alternatively, the lessor should adjust be proceeds towards the amount financed and recompute the rentals on the balance amount then outstanding. The proceeds should in no case be adjusted towards the rental obligations of the lessee.

Sub-Lease of Leased Asset *Right to Sub-lease* As stated earlier, the lessee must not do any act which is not consistent with the terms of the lease agreement. Lease agreements generally expressly exclude the right to sub-lease the leased asset. Thus, the lessee must not sub-lease the asset unless the agreement expressly provides or the right to sub-lease can be inferred from the circumstances. For example, in a lease of earth-moving equipment, the lessee has the right to sub-lease by implication. Where the right to sub-lease is within the apparent authority of the lessee, the sub-lease is valid and the sub-lessee is entitled to retain possession of the asset, even if the act of sub-lease amounts to breach of the main lease agreement.

Effect of Sub-lease The effect of a valid sub-lease is that the sub-lease becomes a lease of the original lessor as well. The sub-lessee and the original lessor have the same rights and obligations against each other as between any lessee and lessor.

Effect of Termination of Main Lease A right to sub-lease is restricted to the operation of the main lease agreement. Thus, termination of the main agreement automatically terminates the sub-lease. This may create some unwarranted complications for the sub-lessee, particularly, where the sub-lease is for a fixed term. Such a situation may be avoided by executing a tripartite agreement between the lessor, the lessee and the sub-lessee.

RBI NBFCs Directions

With a view to coordinate, regulate and control the functioning of all non-banking financial companies, the RBI issues directions from time to time under the *RBI Act.* **A detailed account of these as applicable now is available in Chapter 1 of the book.** They apply to leasing and hire-purchase (asset finance) companies as well.

Other Acts/Laws

The other acts/laws applicable to the NBFCs are Motor Vehicles Act and Stamp Act.

Motor Vehicles Act The lessor is regarded as a **dealer** and although the legal ownership vests in the lessor, the lessee is regarded as the owner for purposes of registration of the vehicle under the Act and so on. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is treated as a financier.

Indian Stamp Act The Act requires payment of stamp duty on all instruments/documents creating a right/liability in monetary terms. The contracts for equipment leasing are subject to stamp duty which varies from state to state.

Lease Documentation and Agreement

Lease transactions involve a number of formalities and various documents. The lease agreements have to be properly documented to formalise the deal between the parties concerned and to bind them. The important aspects of lease documentation and agreement are briefly discussed in this Section.

Purposes and Essential Requirements The documentation of lease agreements is significant as it provides proof of indebtedness; evidences availability and enforceability of security; brings to sharp focus the terms and conditions agreed between the borrower and the lender; and enables the leasing company to take appropriate legal action in case of default.

The essential requirements of documentation of lease agreements are that the person(s) executing the document should have the legal capacity to do; the documents should be in the prescribed format; should be properly stamped, witnessed; and the duly executed and stamped documents should be registered, where necessary, with appropriate authorities.

Lease Approval Process Having carried out the appraisal of the lease proposal and having negotiated funding programme with the lessee, the leasing company proceeds to complete the other formalities. The decision of approval of the leasing facility is conveyed to the lessee through a letter of offer, which is in the nature of commitment spelling out the main terms of the lease facility. The lease offer is normally kept open for a specified period of time.

The lessee is asked to sign, date and return a copy of the offer letter within the stipulated time and also to pass a resolution at a Board meeting accepting the offer and approving the financial arrangements. Board resolution is not a legal requirement, but commercial prudence necessitates it.

A leasing transaction requires a numbers of commercial documents such as purchase order, invoice, bill of sale from the supplier or manufacturer, delivery note, insurance policies, consent and wavier of any interest, import license, copy of shops and establishments registration certificate or sales tax registration certificate, memorandum and articles of association, copies of Board resolutions, copies of audited balance sheet and profit and loss account for the last three years, provisional results for the first six months or the current year, if available, latest income-tax return and assessment order (or salary certificate), wealth-tax return/assessment order, a letter of delegation of powers by the Board of directors (or director) authorised to sign the agreement on behalf of the company and so on. All these documents should be obtained by the lessor from the lessee. These documents are called "attendant" lease documents as they help in taking a decision on a leasing proposal.

The equipment/asset leased out should be properly insured irrespective of the fact who pays the premium. The insurance policies should be in the name of the lessor account lessee. All insurance policies should be in the custody of the lessor. The insurance policies should be renewed well before the expiry date.

Master Lease and Supplemental Lease Agreements The lease agreement specifies the legal rights and obligations of the lessor and lessee. Usually a **master lease agreement** is signed which stipulates all the conditions that govern the lease. This sets out the qualitative terms in the main part of the document while the equipment details, credit limits, rental profile and other details are provided in the attached schedules.

> **Master lease agreement** stipulates/specifies the legal right and obligations of the lessor and the lessee.

Additional lease facilities, as and when finalised, are documented under supplemental lease agreements, with reference to the covenants of the master lease agreement, incorporating the details of the specific leased equipment, at the time of the lease of the respective equipment. This document of the specific lease is the real lease agreement.

To simplify the process of executing and integrating the specific lease arrangement, the master lease agreement provides that:

(i) The lease of equipment is governed by the provisions of the master lease agreement;

(ii) The details of the leased equipment (including the equipment description, supplier's name, acquisition cost for lease, cost of the equipment, the total rental payable, the commencement date for rental payments, fixed period of the lease) would be communicated by the lessor to the lessee; and

(iii) The lessee consents and confirms that the details to be provided by the lessor would be final and binding on the lessee.

The simplified method of documentation also significantly reduces the administrative overheads of the legal departments of leasing companies.

Clauses in Lease Agreement There is no standardised lease agreement. The contents differ from case to case. A typical lease agreement has the following clauses:

Nature of the Lease This clause specifies whether the lease is an operating lease, a financial lease or a leveraged lease. It also specifies that the lessor agrees to lease the equipment to the lessee and the lessee agrees to take on lease from the lessor subject to terms of the lease agreement, the leased equipment.

Description The clause specifies the detailed description of equipment, its actual condition, size, components, estimated useful life, and so on.

Delivery and Re-delivery The clause specifies when and how the equipment would be delivered to the lessee and re-delivered to the lessor or expiry of the lease contract.

Period This clause specifies that the lessee has to take the equipment for his use on lease on the terms specified in the schedule to the agreement. It also includes an option clause to the lessee to renew the lease of the equipment. The renewal period is referred to as secondary lease period.

Lease Rentals This clause specifies the procedure for paying lease rentals by the lessee to the lessor at the rates specified in the schedule to the agreement. It also includes the mobilisation advance required and any guarantees which may be applicable. Apart from this, the clause has to explicitly state that the lessee would pay on demand a late payment charge, a percentage per month of each instalment of lease rent.

Use This clause enjoins upon the lessee the responsibility for proper and lawful usage.

Title Identification and ownership of equipment.

Repairs and Maintenance This clause specifies the responsibility for repairs and maintenance, insurance, and so on.

Alteration It specifies that no alteration to the leased equipment may be made without the written consent of the lessor.

Peaceful Possession This clause guarantees to the lessee peaceful possession of the leased equipment clear of any charges, liens or any other encumbrances.

Charges This clause specifies clearly which party to the agreement would bear the delivery, re-delivery, customs, transport income tax, sales tax and clearance charges.

Indemnity Clause Indemnifies the lessor from any consequential losses arising on account of non-performance of the leased equipment.

Inspection It gives the lessor or his representative a right to enter the lessee's premises for the purpose of confirming the existence, condition and proper maintenance of the equipment.

Prohibition of Sub-leasing This clause prohibits the lessee from the sub-leasing or selling the equipment to third parties.

Events of Default and Remedies This clause specifies the consequences of defaults by the lessee and recourse available to the lessor. This clause may also specify other remedies, if any.

Applicable Law This clause specifies the country whose laws would prevail in case of a dispute. It may also provide for arbitration.

Tripartite Lease Agreement A tripartite lease involves three parties, namely, the manufacturer, the lessor (financier) and the lessee. A common agreement may be made between the parties, specifying their respective obligations and so on.

Guarantee Agreement In addition to the master lease agreement, sometimes the sanction terms include the creation of additional security such as personal/corporate/bank guarantee. In a guarantee, the guarantor guarantees the obligations of the lessee in the event of default by the lessee, in which event the guarantor assumes responsibility as a principal debtor.

While obtaining a guarantee, the lessor must ensure that the guarantor is a man of resources and in case the guarantor is company, the guarantee must be supported by a Board resolution of that company. The guarantor may sometimes be required to furnish proof of his income and proof of his address. The guarantee agreement should be written on a stamp paper of appropriate value.

Promissory Note As a matter of abundant precaution, the lessee is also required to execute an unconditional promissory note in favour of the lessor or his order, for the full amount of lease rentals payable under the agreement. The promissory note is counter guaranteed by the guarantor. Where the lease term extends beyond three years, a fresh promissory note should be obtained within the limitation period of three years.

Receipt of Goods The equipment is delivered by the lessor or the manufacturer/supplier in a tripartite lease, to the lessee. The lessee, thus, executes a receipt for the goods.

Power of Attorney The lessee executes an irrevocable power of attorney constituting the lessor to be the lawful attorney for and on behalf of the lessee to do certain acts, such as, to take delivery, to transfer, sell or dispose of the equipment, to engage broker for effecting such sale and to receive any consideration.

Collateral Security/Hypothecation Agreement Sometimes the lessor may require the lessee to provide a collateral security by way of pledge or hypothecation of other assets. A collateral is normally required when the financial position of the lessee is considered to be weak and the risk associated with the leased asset is high. A collateral security may be obtained in the form of a promissory note signed by the lessee in favour of the lessor.

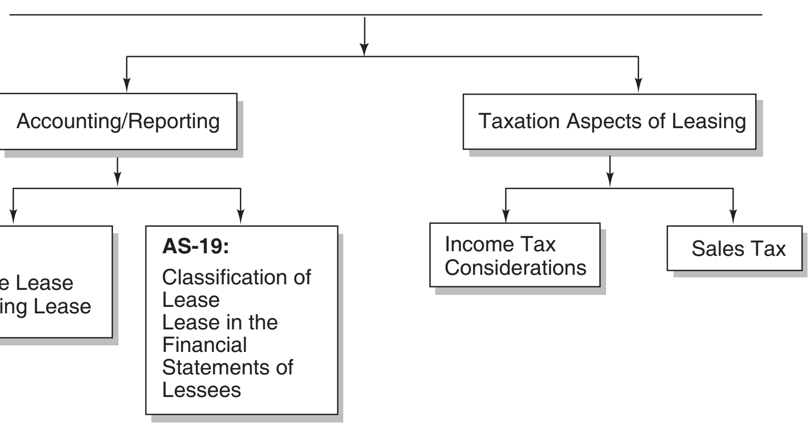
A deed of hypothecation must be executed on a stamp paper of appropriate value. A hypothecation, if made by a company, must be registered under Section 125 of the *Companies Act* by filing a notice of charge. The lessor may also accept pledge of the shares or insurance policies of the promoters of the business enterprise. No pledge deed is necessary for creating the pledge. The shares and so on should be deposited with the lessor by the promoters of the lessee's business along with a letter of confirmation signed by the person who has pledged the shares with the leasing company.

ACCOUNTING/REPORTING FRAMEWORK AND TAXATION OF LEASING

An appropriate method of accounting is necessary for income recognition for the lessor and asset disclosure for the lessee. The concern for a proper method of accounting for lease transaction is based on two considerations. In the first place, there is likely to be a distortion in the profit and loss account if lease rental is recognised as per the lease agreement. Secondly, distortions are also likely to occur if the assets taken on lease are not disclosed in the lessees' balance sheet.

Recognising the need for special accounting for lease financing, the International Accounting Standard Committee issued Accounting Standard (IAS-17: Accounting for Leases) in 1982. The Accounting Standards Board of the ICAI issued Accounting Standard (AS) 19: Leases in January 2001. This Section seeks to explain and illustrate the accounting treatments of lease transactions, prescribed by IAS-17 and the ICAI AS 19: Leases. It also discusses the tax implications of leasing. **The accounting/reporting framework and taxation of leasing is portrayed in Exhibit 2.2.**

Exhibit 2.2 Accounting/Reporting Framework of Leasing



IAS-17 Framework

The main features of the accounting treatment for leases by **(a)** lessees and **(b)** lessors as recommended by the IAS-17 are summarised/illustrated below.

Accounting for Leases by a Lessee Accounting for finance and operating leases by a lessee and disclosures in their financial statements are discussed below.

Finance Lease A finance lease should be reflected in the balance sheet of a lessee by recording an asset and a liability at amounts equal at the inception of the lease to the fair value of the leased asset net of grants and tax credits receivable by the lessor; if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the discount factor is the interest implicit in the lease, if this is practicable to determine, otherwise the lessee's incremental borrowing rate should be used.

The rentals should be appropriated between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to the periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. Some form of approximation may be used if necessary.

A finance lease gives rise to a depreciation charge for the asset as well as a finance charge for each accounting period. The depreciation policy for leased assets should be consistent with that for depreciable assets which are owned and the depreciation charge should be calculated on the basis set out in the '**IAS-4: Depreciation Accounting**'.

Operating Lease The charge to income under an operating lease should be the rental expenses for the accounting period, recognised on a systematic basis that is representative of the time pattern of the user's benefit.

Disclosures in Financial Statements of Lessees Disclosure should be made of the amount of the assets that are subject to finance lease at each balance sheet date. Liabilities related to these leased assets should be shown separately from other liabilities, differentiating between the current and the long-term portions.

Commitment for minimum lease payments under finance lease/non-cancellable operating leases with a term of more than one year should be disclosed in summary form giving the amounts and periods in which the payment would become due.

Disclosure should be made of significant financing restrictions, renewal/repurchase options, contingent rentals and other contingencies arising from leases.

Accounting for Leases by Lessors Accounting for finance, sale and leaseback transactions and operating leases by lessors and disclosure in their financial statements are discussed below.

Finance Leases An asset held under a finance lease should be recorded in the balance sheet not as property, plant and equipment but as a receivable, at an amount equal to the net investment in the lease.

Subject to the consideration of prudence, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either the lessor's net investment outstanding or the net cash investment outstanding in respect of finance lease. The method used should be applied consistently to leases of a similar financial character.

Manufacturer or dealer-lessors should include selling profit or loss in income in accordance with the policy normally followed by enterprise for outright sales.

Assets held for operating leases should be recorded as property, plant and equipment in the balance sheet of the lessor.

Rental income should be recognised on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earning process contained in the lease.

The depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets and the depreciation charge should be calculated on the basis set out in **IAS-4: Depreciation Accounting**.

Sale and Leaseback Transactions If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be immediately recognised in income in the financial statements of a seller-lessee. If such an excess is recognised, it should be deferred and amortised over the lease term.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future rentals at below market price, it should be deferred and amortised in proportion to the rental payment over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Operating Lease If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Disclosures in the Financial Statements of Lessors Disclosure should be made at each balance sheet date of the gross investment in leases reported as finance leases, and the related unearned finance income and unguaranteed residual values of the leased assets.

Disclosure should be made of basis used for allocating income so as to produce a constant periodic rate of return, indicating whether the return relates to the net investment outstanding or the net cash investment outstanding in the lease. If more than one basis is used, the basis should be disclosed.

When a significant part of the lessor's business comprises operating leases, the lessor should disclose the amount of the asset by each major class of asset together with related accumulated depreciation at each balance sheet date.

The accounting treatment for finance lease as recommended by the IAS-17 is illustrated below.

Illustration 2.3 (Finance Lease: In the Books of the Lessee)
Assume the Hypothetical Manufacturers Ltd (HML) has entered into a lease agreement for an equipment costing ₹750 lakh. The lease is non-cancellable for a period of five years. The annual lease rentals payable in arrears amount to ₹300/₹1,000. The economic life of the equipment is expected to be eight years. The HML uses written down value method and 30 per cent rate to depreciate the equipment. The incremental borrowing rate is 16 per cent and the HML is in tax bracket of marginal rate of 35 per cent.
From the foregoing information

(A) Determine the capitalised value of the equipment and pass the relevant journal entries for capitalisation,
(B) Prepare a schedule showing the allocation of unexpired finance charge,
(C) Prepare all relevant ledger accounts for the first three years of the lease. Also, show how the ledger balances will be reflected in the financial statements,
(D) If incremental borrowing rate is 14 per cent, compute the capitalised value of the equipment and prepare the schedule showing the allocation of the unexpired finance charge

assuming (1) effective rate of interest method/actuarial method, (2) sum-of-years' digits method and (3) straight line method.

Solution

(A) Capitalised Value of the Equipment and Journal Entries

(₹ *lakh*)

Fair market value of the equipment			(a)	750.00
Present value of the minimum lease payment (750 × 0.30) × PVIFA (16,5)			(b)	736.70
Capitalised value [as (b) < (a)]				736.70
Journal entry for capitalisation:				
Lease equipment A/c	Dr	736.70		
To Lease payable A/c				736.70

(B) Allocation of Unexpired Finance Charge [Actuarial/Effective Rate of Interest Method*]

(₹ *lakh*)

Year	*Outstanding lease liability*	*Rate of interest (percent)*	*Interest charge*	*Lease payment [(₹300 ÷ ₹1,000) × ₹750 lakh]*	*Principal*
	(A)	*(B)*	*(C) [(A) × (B)]*	*(D)*	*(E) [(D) – (C)]*
1	736.7	0.16	117.9	225	107.1
2	629.6	0.16	100.7	225	124.3
3	505.3	0.16	80.8	225	144.2
4	361.1	0.16	57.8	225	167.2
5	193.9	0.16	31.0	225	194.0

****Note:*** According to the IAS-17, the unexpired finance charge must be allocated to each accounting period according to the actuarial/effective rate of interest method. According to this method of allocation, the unexpired finance charge must be allocated to each accounting period so as to produce a constant periodic rate of interest on the balance of the liability during each accounting period.

Unexpired finance charge = (₹750 × 0.30 × 5) – ₹736.70 = ₹388.3 lakh

(C) Ledger Accounts

Leased Equipment A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Lease Payable A/c	736.70	1	By Balance c/d	736.70
2	To Balance b/d	736.70	2	By Balance c/d	736.70
3	To Balance b/d	736.70	3	By Balance c/d	736.70

Accumulated Depreciation A/c@

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Balance c/d	221.0	1	By Depreciation A/c	221.0
2	To Balance c/d	375.7	2	By Balance b/d	221.0
				By Depreciation A/c	154.47
		375.7			375.7
3	To Balance b/d	484.0	3	By Balance b/d	357.7
				By Depreciation a/c	108.3
		484.0			484.0

@ Working note 1 for depreciation schedule.

Depreciation A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Accumulated depreciation A/c	221.0	1	By Profit and loss A/c	221.0
2	To Accumulated depreciation A/c	154.7	2	By Profit and loss A/c	154.7
3	To Accumulated depreciation A/c	108.3	3	By Profit and loss A/c	108.3

Lease Rental A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Bank A/c	225.0	1	By Lease payable A/c	107.1
				By Finance charges A/c	117.9
		225.0			225.0
2	To Bank A/c	225.0	1	By Lease payable A/c	124.3
				By Finance charges A/c	100.7
		225.0			225.0
3	To Bank A/c	225.0	1	By Lease payable A/c	144.2
				By Finance charges A/c	80.8
		225.0			225.0

Finance Charges A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Lease rental A/c	117.9	1	By Profit & Loss A/c	117.9
2	To Lease rental A/c	100.7	2	By Profit & Loss A/c	100.7
3	To Lease rental A/c	80.7	3	By Profit & Loss A/c	80.8

Lease Payable A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Lease rental A/c	107.1	1	By Leased equipment A/c	730.7
	To Balance b/d	629.6			
		736.7			
2	To Lease rental A/c	124.7	2	By Balance c/d	629.6
	To Balance c/d	505.3			
		629.6			
3	To Lease rental A/c	144.2	3	By Balance c/d	505.3
	To Balance c/d	361.1			
		505.3			

Disclosure in the Financial Statements

Year 1:

Profit and Loss A/c

	Amount (₹ lakh)
To Finance charges	117.9
To Depreciation	221.0

Balance Sheet

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
Secured loans		*Fixed assets*	
Lease payable	505.3	Leased equipment: Gross block	736.7
Current liabilities			
Lease payable	124.3	*Less:* Accumulated depreciation	221.0
		Net block	515.7

Notes to Accounts: The commitments for minimum lease payments under the finance lease are as follows:

Year	*Lease payment (₹ lakh)*
2	225
3	225
4	225
5	225

Year 2:

Profit and Loss A/c

	Amount (₹ lakh)
To Finance charges	100.7
To Depreciation	154.7

Balance Sheet

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
Secured loans		*Fixed assets*	
Lease payable	361.1	Leased equipment: Gross block	736.7
Current liabilities		*Less:* Accumulated depreciation	375.7
Lease payable	144.2	Net block	361.0

Notes to Accounts: The commitments for minimum lease payments under the finance lease are as follows:

Year	*Lease payment (₹ lakh)*
3	225
4	225
5	225

Year 3:

Profit and Loss A/c

	Amount (₹ lakh)
To Finance charges	80.8
To Depreciation	108.3

Balance Sheet

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
Secured loans		*Fixed assets*	
Lease payable	193.9	*Leased equipment:* Gross block	736.7
Current liabilities			
Lease payable	167.2	*Less:* Accumulated depreciation	484.0
		Net block	252.7

Notes to Accounts: The commitments for minimum lease payments under the finance lease are as follows:

Year	*Lease payment (₹ lakh)*
4	225
5	225

It may be noted that the depreciation charge and finance charge for each accounting period do not add up to the leased rentals payable for that period. Therefore, the values of the leased assets and the corresponding liability are unlikely to equal after the inception of the lease.

(D) Computation of Capitalised Value

(1) The minimum lease payment (MLP) **(c)** = (₹750 × 0.30) × PIFA (14,5)

= ₹225 × 3.433 = ₹772.4 lakh

Capitalised value [as **(a)** i.e. fair market value of the asset of ₹750 lakh is less than **(c)** i.e. MLP]

= ₹750 lakh

or PVIFA (r, 5) = 3.333

r = 15.24 per cent

Allocation of Unexpired Finance Charge: Actuarial Method

(₹ lakh)

Year	*Outstanding lease liability*	*Rate of interest (percent)*	*Interest charge*	*Lease payment*	*Principal*
1	750.0	0.1524	114.3	225	110.7
2	639.3	0.1524	97.4	225	127.6
3	511.7	0.1524	78.0	225	147.0
4	364.7	0.1524	55.6	225	169.4
5	195.3	0.1524	29.7	225	195.3

Allocation of Unexpired Finance Charge: Sum of – Years' – Digits Method

(₹ lakh)

Year	*Total finance charge to be allocated*	*Weightage*	*Allocated charge*
1	383.3	5/15	129.4
2	383.3	4/15	103.5
3	383.3	3/15	77.7
4	383.3	2/15	51.8
5	383.3	1/15	25.9

Note: The denomination 15 is the sum of (1 + 2 + 3 + 4 + 5).

Allocation of Unexpired Finance Charge: Straight Line Method

Year	*Allocated charge (₹ lakh)*
1	77.7
2	77.7
3	77.7
4	77.7
5	77.7

According to IAS-17, the finance charge should be allocated according to the actual/effective rate of interest method. However, for simplified computations, some form of approximation is also allowed. The sum of digits method provides such an approximation.

Working Notes

1. Depreciation Schedule (@ 30% on WDV basis)

Year	*Depreciation charge*	*Amount (₹ lakh)*
1	736.7×0.30	221.0
2	$736.7 \times (1.0.3) \times 0.3$	154.7
3	$736.7 \times (1.0.3)^2 \times 0.3$	108.3
4	$736.7 \times (1.0.3)^3 \times 0.3$	75.8
5	$736.7 \times (1.0.3)^4 \times 0.3$	51.3

2. As per the requirements of IAS-17, the portion of the lease payable which falls due for payment in the next accounting period has been classified as a current liability at the end of each accounting period.

Illustration 2.4 *[Finance Lease: In the Books of the (Third Party) Lessor]*

For the foregoing facts relating to the Hypothetical Manufacturers Ltd (HML), assume that the lease under consideration is structured by the Hypothetical Leasing Ltd (HLL). The direct cost of setting up the lease transaction is estimated to be ₹7.50 lakh. The unguaranteed residual value of the asset at the end of five years is expected to be ₹37.5 lakh.

You are required to:

(A) Prepare a schedule showing the allocation of the respective unearned finance income;

(B) Show ledger accounts for the first three years of lease. Also prepare the financial statements for the respective periods.

Solution

1. Allocation of Unearned Finance Income: Actuarial Method

(₹ lakh)

Year	*Outstanding lease liability*	*Rate of interest (percent)*	*Interest charge*	*Lease payment*	*Principal*
	(1)	(2)	(3) [(1) × (2)]	(4)	(5) [(4) – (3)]
1	750.0	0.1612	120.9	225.0	104.1
2	645.9	0.1612	104.1	225.0	120.9
3	525.0	0.1612	84.6	225.0	140.4
4	384.6	0.1612	62.0	225.0	163.0
5	221.6	0.1612	35.7	225.0	221.6

Working Notes

1. Interest rate, r, implicit in the lease transaction = (₹750 × 0.30 × 12) × PVIFA (r, 5) + [32.5 × PVIF (r, 5)] = ₹750 = 16-17%, by interpretation = 16.12 per cent
2. Unearned finance income = ₹[(750 × 0.30 × 5) + 32.5 – 750] lakh = ₹407.5 lakh

2. Ledger Accounts

Gross Investment in Lease A/c

Year		Amount (₹ lakh)	Year		Amount (₹ lakh)
1	To Inventory A/c	750.0	1	By Bank A/c	225.0
	To Unearned finance income A/c	407.5		By Balance	932.5
		1,157.5			1,157.5
2	To Balance b/d	932.5	2	By Bank A/c	225.0
				By Balance c/d	707.5
		932.5			932.5
3	To Balance b/d	707.5	3	By Bank A/c	225.0
				By Balance c/d	482.5
		707.5			707.5

Unearned Finance Income A/c

Year		Amount (₹ lakh)	Year		Amount (₹ lakh)
1	To Finance income A/c	120.9	1	By Gross investment in lease A/c	407.5
	To Balance c/d	286.6			
		407.5			407.5
2	To Finance income A/c	104.1	2	By Balance b/d	286.6
	To Balance c/d	182.5			
		286.6			286.6
3	To Finance income A/c	84.6	3	By Balance b/d	182.5
	To Balance c/d	97.9			
		182.5			182.5

Finance Income A/c

Year		Amount (₹ lakh)	Year		Amount (₹ lakh)
1	To Profit and loss A/c	120.9	1	By Unearned finance income A/c	120.9
2	To Profit and loss A/c	104.1	2	By Unearned finance income A/c	104.1
3	To Profit and loss A/c	84.6	3	By Unearned finance income A/c	84.6

Initial Direct Cost A/c

Year		Amount (₹ lakh)	Year		Amount (₹ lakh)
1	To Bank A/c	7.5	1	By Profit and loss A/c	7.5

3. Disclosure in the Financial Statements

Year 1:

Dr. Profit and Loss A/c Cr.

	Amount (₹ lakh)		*Amount (₹ lakh)*
To Initial direct costs	7.5	By Finance income	120.9

Balance Sheet

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
		Current assets: Net investment in lease (1,157.5 – 407.5 – 104.1)	645.9

Year 2:

Profit and Loss A/c

	Amount (₹ lakh)
By Finance income	104.1

Balance Sheet

Liabilities	*Assets*	*Amount (₹ lakh)*
	Current assets: Net investment in lease (645.9 – 120.9)	525.0

Year 3:

Profit and Loss A/c

	Amount (₹ lakh)
By Finance income	84.6

Balance Sheet

Liabilities	*Assets*	*Amount (₹ lakh)*
	Current assets: Net investment in lease (525.0 – 140.4)	384.6

Note: The recognition of finance income here is based on the **net investment in lease**, that is, the gross investment in lease less the unearned finance income.

In some special types of leasing, for example, leveraged lease, where the lessor finances the cost of acquisition through a mix of own funds and non-recourse long-term debt, the basis for recognising finance income is the **net cash investment in lease**, that is, net investment in lease less the non-recourse debt. Since the patterns of income recognition based on the **net investment** and the **net cash investment** are likely to differ significantly, according to **IAS-17** the chosen basis must be applied consistently to leases of the same financial nature.

Finance Lease: In the Books of the Manufacture/Dealer-Lessor According to the IAS-17, finance lease gives rise to two types of income to a manufacture/dealer-lessor, namely, the profit/loss resulting from an outright sale of a similar equipment at the normal selling price and the finance income inherent in the transaction. The sales revenue associated with the transaction should be accounted for as per the following procedure:

(i) Determination of the present value of the minimum lease rentals/payments plus the unguaranteed residual value at the commercial rate of interest;
(ii) Estimation of the fair market value of the leased equipment;
(iii) The sale revenue should be taken to be equal to the lower of the two values determined in **(i)** and **(ii)** above.

Illustration 2.5 *(Finance Lease in the Books of Manufacturer/Dealer-Lessor)*
Assume that the Hypothetical Manufacturers Ltd (HML) is a dealer-lessor in industrial machinery. It sells its products on the basis of a 5-year non-cancellable lease. The cash price of the machinery is 36 lakh inclusive of a 25 per cent margin on cost. The lease rate is ₹240/₹1,000. The rentals are payable annually in advance. The unguaranteed residual value of the machinery at the end of the lease period is estimated to be ₹1.80 lakh. The market rate of interest may be assumed to be 15 per cent per annum.
You are required to:

(i) Determine the sale revenue to be recognised under the finance lease proposal,
(ii) Show the allocation of the finance income,
(iii) Show the necessary ledger accounts for the first year of the lease as also the financial statements at the end of the first year.

Solution

(a) Determination of Sales Revenue
(i) Annual lease rental = ₹36 lakh × 0.24 × 12 = ₹10.38 lakh
Present value of advance annual lease rent plus the unguaranteed estimated residual value = [₹10.38 lakh × PVIFA (15, 5)] + [₹1.80 lakh × PVIF (15, 4)] = ₹40.92 lakh
(ii) Fair market value = ₹36 lakh
Since **(ii)** < **(i)**, the recorded sales revenue = ₹36 lakh

(b) **Allocation of Unearned Finance Income: Actuarial Method**

(₹ lakh)

Year	*Outstanding investment at the beginning*	*Rate of interest*	*Interest content*	*Capital content*	*Lease receipts*
1	36.00	0.2392	8.58	4.26	12.84
2	32.34	0.2392	7.56	5.28	12.84
3	26.46	0.2392	6.30	6.54	12.84
4	19.92	0.2392	6.54	6.30	12.84
5	11.82	0.2392	2.82	11.82	14.64

Working Notes

The rate of interest implicit in the proposal,

$$r = [10.38 \times \text{PVIFA}(r, 5)] + [1.80 \times \text{PVIF}(r, 5)] = 36$$

Or $[10.38 \times (1 + r) \times \text{PVIFA}(r, 5)] + [1.80 \times \text{PVIF}(r, 5)] = 36 = 2.392\%$ (by trial and error and interpolation).

Unearned finance income = [(₹10.38 lakh × 5) + ₹1.80 lakh] – ₹36 lakh = ₹17.70 lakh

Annual lease rental (in arrear) = (₹10.38 lakh × 1.2392) = ₹12.84 lakh

Since the lease rentals are received annually in advance, the annual lease rentals must be adjusted for an interest rebate of ₹2.46 lakhs (= 12.84 – 10.83). The allocation of the unearned finance income after effecting this adjustment is shown in Table 2.1.

Table 2.1 Allocation of Unearned Finance Income

(₹ lakh)

Year	*Outstanding investment at the beginning*	*Interest content*	*Capital content*	*Lease related receipts*
1	36.00	6.12	4.26	10.38
2	32.34	5.10	5.28	10.38
3	26.46	3.84	6.54	10.28
4	19.92	2.28	8.10	10.38
5	11.82	0.36	11.62	11.98

(c) Ledger Accounts

Cost of Goods Sold A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Inventory A/c (36 × 0.80)	28.80	1	By Profit and loss A/c	28.80

Finance Income A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
1	To Profit and loss A/c	6.12	1	By Unearned finance income A/c	6.12

Disclosure in the Financial Statements:

Profit & Loss A/c

Year		*Amount (₹ lakh)*	*Year*		*Amount (₹ lakh)*
	To Cost of goods sold	28.80		By Sales income	36.00
				By Finance income	6.12

Balance Sheet

Liabilities	*Assets*	*Amount (₹ lakh)*
	Current assets:	32.34
	Net investment in lease (36 – 4.26)	

Accounting and Reporting for Operating Lease As the risks and rewards incidental to ownership of the asset remain with the lessor, the accounting for such transactions is simple and uncomplicated.

In the Books of the Lessee The lease rentals must be allocated to each accounting period in a manner that reflects the time pattern of the benefit to the user (lessee). The implication from the reporting viewpoint is that any excess of lease rentals paid over the accrued amount should be treated as pre-paid lease rental and **vice versa**. Thus, the lease rentals are to be treated as a charge to the profit and loss account.

In the Books of the Lessor The leased asset should be treated as depreciable asset and the lease rentals as income. For a manufacturer/dealer-lessor, there is no realised selling profit as the lease is not sale. The rental income exclusive of receipts for services, e.g., insurance and maintenance must be accounted for on a straight line basis over the lease term unless some other more systematic basis better reflects the pattern of earnings associated with the lease. The costs inclusive of depreciation incurred must be charged to income. Depreciation on leased must be consistent with the depreciation policy of the lessor for similar assets. Finally, initial direct costs can be written off in the period of incurrence or alternatively as deferred revenue expenditure written off over the lease term proportionate to the rental income recognised.

The mechanics of reporting is illustrated below.

Illustration 2.6 *(Operating Lease)*

The Hypothetical Manufacturers Ltd (HML) acquires a machine on a 3-year operating lease from the Hypothetical Leasing Ltd (HLL). The following details are available:

(₹ lakh)

Cost of equipment		48.000
Assumed rental charges: Year	1	14.688
	2	14.112
	3	13.536

The lease rentals are to be paid in arrear. The HML depreciates plant and machinery on straight line basis @ 10 per cent per annum. Show the recording of the transactions in the books of HML (lessee).

Solution

Computation of Rentals: Straight Line Basis *(₹ lakh)*

Year		*1*	*2*	*3*
(A)	Rental paid	14.688	14.112	13.536
(B)	Rental prepaid during the previous year	—	0.576	0.576
(C)	Rental expense for the year	14.112	14.112	14.112
(D)	Rental prepaid for the year (A + B + C)	0.576	0.576	Nil

Record in Financial Statements

Year 1:

Income Statement *(₹ lakh)*

Rental expenses	14.112

Balance Sheet *(₹ lakh)*

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
		Current assets:	
		Prepaid lease rental	0.576

Year 2:

Income Statement *(₹ lakh)*

Rental expenses	14.112

Balance Sheet *(₹ lakh)*

Liabilities	*Amount (₹ lakh)*	*Assets*	*Amount (₹ lakh)*
		Current assets:	
		Prepaid rental	0.576

Balance Sheet *(₹ lakh)*

Liabilities	*Amount (₹ lakh)*	*Assets*		*Amount (₹ lakh)*
Current liabilities:		*Fixed assets*		
Rental received in advance	0.576	*Assets on Lease:*		
		Gross block	48.00	
		Less: Accumulated depreciation	9.60	38.40

Year 3:

Income Statement *(₹ lakh)*

Depreciation on	4.80	Rental income	14.112

Balance Sheet *(₹ lakh)*

Liabilities	*Amount (₹ lakh)*	*Assets*		*Amount (₹ lakh)*
		Fixed assets		
		Assets on Lease:		
		Gross block	48.00	
		Less: Accumulated Depreciation	14.40	33.60

AS-19: Leases

This Section discusses the main features of the AS-19: Leases issued by the ICAI. The standard portion applicable to material items are set in bold type. The context of the background material has been set in normal type.

Objective The objective of this statement is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Scope This statement should be applied in accounting for all leases other than:

- **(a)** Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights;
- **(b)** Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- **(c)** Lease agreements to use lands.

It applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, it does not apply to agreements that are contracts of service that do not transfer the right to use assets from one contracting party to the other.

Definitions The following terms are used in this statement with the meanings specified:

Lease A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance Lease A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

Operating Lease An operating lease is a lease other than a finance lease.

Non-cancellable Lease A non-cancellable lease is a lease that is cancellable only **(a)** upon the occurrence of some remote contingency; or **(a)** with the permission of the lessor; or **(c)** if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or **(d)** upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Inception of Lease The inception of the leas is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

Lease Term The lease term is the non-cancellable period for which the lessee has agreed to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum Lease Payments They are the payments over the leased term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- **(a)** In the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or
- **(b)** In the case of the lessor, any residual value guaranteed to the lessor **(i)** by or on behalf of the lessee; or **(ii)** by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date of option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair Value It is the amount for which an asset should be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Economic Life It is either:

(a) The period over which an asset is expected to be economically usable by one or more users; or
(b) The number of production or similar units expected to be obtained from the asset by one or more users.

Useful Life Useful life of a leased asset is either:

(a) The period over which the leased asset is expected to be used by the lessee; or
(b) The number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual Value Residual value of a leased asset is the estimated fair value of the asset at the end of the least term.

Guaranteed Residual Value It is:

(a) In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
(b) In the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed Residual Value of a Lease Asset It is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross Investment in the Lease It is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned Finance Income It is the difference between:

(a) The gross investment in the lease;
(b) The present value of **(i)** the minimum lease payments under a finance lease from the standpoint of the lessor; and **(ii)** any unguaranteed residual value accruing to the lessor at the interest rate implicit in the lease.

Net Investment in the Lease Is the gross investment in the lease less unearned finance income.

Implicit Interest The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of **(a)** the minimum lease payments under a finance lease from the standpoint of the lessor; and **(b)** any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Incremental Borrowing Rate The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent Rent It is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire-purchase agreements. Hire-purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

Classification of Leases The classification of leases adopted in this statement is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. **Risks** include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. **Rewards** may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the different circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally led to a lease being classified as a finance lease are:

- **(a)** The lease transfers ownership of the asset to the lessee by the end of the lease term;
- **(b)** The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- **(c)** The lease term is for the major part of the economic life of the asset even if title is not transferred;
- **(d)** At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- **(e)** The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
(b) Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
(c) The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria outlined above had changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Leases in the Financial Statements of Lessees ***Finance Leases*** At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the stand point of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the stand point of the lease. In calculating the present value of the minimum lease payments, the discount factor is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example: **(a)** An enterprise (the lessee) acquires machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery, that is, 3 years. The fair value of the machinery on January 1, 20X0 is ₹2,35,500. The lease agreement requires the lessee to pay an amount of ₹1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of ₹17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only ₹3,500 on December 31, 20X2.

The interest rate implicit in the lease is approximately 16 per cent. This is calculated using the following formula:

$$\text{Fair value} = \frac{\text{ALR}}{(1+r)^1} + \frac{\text{ALR}}{(1+r)^2} + \ldots + \frac{\text{ALR}}{(1+r)^n} + \frac{\text{RV}}{(1+r)^n}$$

Where, ALR is annual lease rental,
RV is residual value (both guaranteed and unguaranteed),
n = the lease term,
r = interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is ₹2,35,500.

The lessee would record the machinery as an asset at ₹2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of ₹17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of ₹5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at approximately 16 per cent. The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be ₹2,27,805. As this amount is lower than the fair value of the leased asset (₹2,35,500), the lessee would recognise the asset and the liability arising from the lease at ₹2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be compound using the lessee's incremental borrowing rate.

Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lease may acquire no legal title to the leased asset, in the case of finance lease the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is, therefore, appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented in the balance sheet as a current liability or a long-term liability as the case may be.

Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example: In the above **(a)** illustration, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows:

Year		*Finance charge*	*Payment*	*Reduction in outstanding liability*	*Outstanding liability*
1	(January 1)	₹2,35,500			
	(December 31)	₹37,680	₹1,00,000	₹62,320	1,73,180
2	(December 31)	27,709	1,00,000	72,291	1,00,889
3	(December 31)	16,142	1,00,000	83,858	17,031*

*The difference between this figure and guaranteed residual value (₹17,000) is due to approximation in computing the interest rate implicit in the lease.

In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is a reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the assets; otherwise, the asset is depreciated over the lease term or its useful life, whichever is shorter.

The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets, that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

The lessee should, in addition to the requirements of AS-10: Accounting for Fixed Assets, AS-6: Depreciation Accounting, and the governing statute, make the following disclosures for finance lease:

(a) Assets acquired under finance lease as segregated from the assets owned;

(b) For each class of assets, the net carrying amount at the balance sheet date;

(c) A reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods: **(i)** not later than one year; **(ii)** later than one year and not later than five years; **(iii)** later than five years;

(d) Contingent rents recognised as income in the statement of profit and loss for the period;

(e) The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and

(f) A general description of the lessee' significant leasing arrangements including, but not limited to, the following: **(i)** the basis on which contingent rent payments are determined; **(ii)** the existence and terms of renewal or purchase options and escalation clauses; and **(iii)** restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Operating Leases Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is representative of the time pattern of the user's benefit.

For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

The lessee should make the following disclosures for operating leases:

(a) The total future minimum lease payments under non-cancellable operating leases for each of the following periods; **(i)** not later than one year; **(ii)** later than one year and not later than five years; **(iii)** later than five years;

(b) The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

(c) Lease payments recognised in statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) Sub-lease payments received (or receivable) recognised in statement of profit and loss for the period;

(e) A general description of the lessee's significant leasing arrangements including, but not limited to, the following: **(i)** the basis on which contingent rent payments are determined; **(ii)** the existence and terms of renewal or purchase options and escalation clauses; and **(iii)** restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Leases in the Financial Statements of Lessors *Finance Lease* **The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.**

Under a finance lease, substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, that is, net investment in the lease and finance income to reimburse and reward the lessor for its investment and services.

The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, reduced from both the principal and the unearned finance income.

Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance lease, these initial direct costs are incurred to produce finance income and are either recognised immediately in statement of profit and loss or allocated against the finance income over the lease term.

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, selling profit should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Manufacturer or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) The profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling price, reflecting any applicable volume or trade discounts; and

(b) The finance income over the lease term.

The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is lower than the fair value, the amount recorded as sale revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased item less the present value of the unguaranteed residual value. The difference between the sale revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

The lessor should make the following disclosures for finance leases:

(a) A reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods: **(i)** not later than one year; **(ii)** later than one year and not later than five years; **(iii)** later than five years;

(b) Unearned finance income;

(c) The unguaranteed residual values accruing to the benefit of the lessor;

(d) The accumulated provision for uncollectible minimum lease payments receivable;

(e) Contingent rents recognised in the statement of profit and loss;

(f) A general description of the significant leasing arrangements of the lessor; and

(g) Accounting policy adopted in respect of initial direct costs.

As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

Operating Leases **The lessor should present an asset given on operating lease in its balance sheet under fixed assets.**

Lease income from operating leases should be recognised in statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

Costs, including depreciation, incurred in earning the income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS-6: Depreciation Accounting.

To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets that set out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

The lessor should, in addition to the requirements of AS-6: Depreciation Accounting and AS-10: Accounting for Fixed Assets, and the governing statute, make the following disclosures for operating leases:

- **(a)** For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and **(i)** the depreciation recognised in the statement of profit and loss for the period; **(ii)** impairment losses recognised in the statement of profit and loss for the period; **(iii)** impairment losses reversed in the statement of profit and loss for the period;
- **(b)** The future minimum lease payments under non-cancellable operating leases in the aggregate and for each of other following periods; **(i)** not later than one year; **(ii)** later than one year and not later than five years; **(iii)** later than five years;
- **(c)** Total contingent rents recognised as income in the statement of profit and loss for the period;
- **(d)** A general description of the lessor's significant leasing arrangements; and
- **(e)** Accounting policy adopted in respect of initial direct costs.

Sale and Lease Back Transactions A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately. The application of the accounting standard is illustrated in Appendix 3-A on the website. The address is http://www.mhhe.com/khanfs9e.

For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of **Accounting Standard (AS)-5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.**

Tax Aspects of Leasing

The tax aspects of leasing pertain to both income-tax and sales tax. This Section focuses on only those considerations which have a bearing on lease transactions.

Income Tax Considerations Leasing, as a finance device, has tax implications for, and offers tax benefits both to, the lessor and the lessee. In fact, a significant variable in the choice of leasing is the scope for tax avoidance, reduction/deferment of tax liability and sharing tax savings in the event of heavy tax incidence. In a way, leasing provides a convenient technique for transferring the benefits of tax incentives from the purchaser-owner (lessor) to the user (lessee) of the asset/equipment.

For Lessor The main attraction of leasing device to the lessor is the deduction of depreciation from his taxable income. The relevant provisions applicable to the computation of the lessor's income, the tax rates and so on are summarised as follows.

Taxability of Lease Rentals The computation of taxable income of an assessee under the provisions of the *Income-tax Act, 1961* involves computation under various heads of income which are aggregated and then reduced by certain deductions. Different sets of provisions govern the computation of taxable income under each head. The provisions apply to leasing companies also as there are no provisions specific to leasing business.

Where leasing constitutes the business/main activity of the assessee (lessor/leasing company), income from lease rentals (operations) is taxable under the head **Profits and Gains of Business and Profession**. In other cases, the income from lease is taxed as **Income from Other Sources**.

Deductability of Expenses While computing the income of lessor from leasing, certain expenses are allowed as a deduction to determine the taxable income. These include, *inter-alia*:

- Depreciation,
- Rent, rates, taxes, repairs and insurance of the leased asset where such expenditure is borne by the lessor,
- Amortisation of certain preliminary expenses, such as expenditure for preparation of project report, feasibility report, market survey and so on, legal charges for drafting/printing of memorandum of association and articles of association, registration expenses, public issue expenses other than on debentures and loans, subject to a maximum of 2.5 per cent of the cost of the project/capital employed, allowable in 10 equal instalments,
- Interest on borrowed capital,
- Bad debts
- All expenses incurred in furtherance of trade/business,
- Entertainment expenses subject to prescribed limits,
- Travel expenses as per approved norms.

Amongst the allowable deductions, depreciation and interest are the most important expenses for the lessor in the computation of his taxable income. In other words, depreciation claim by the lessor involves tax shield on the leased asset. The salient features of the provision relating to depreciation are summarised below.

Depreciation provisions are prescribed by the *Companies Act* for accounting purpose and by the *Income Tax Act* for taxation purposes. The purpose of the provisions of depreciation contained in the Companies Act is the computation of managerial remuneration, dividend payment and disclosure in financial statements. Since leasing companies in India are regulated by the Companies Act, they should provide depreciation in the books of accounts in accordance with Section XIV of the Act which prescribes the rate of depreciation for various types of depreciable assets on written down value (WDV) basis as well as straight line basis. It also permits companies to charge depreciation on any other basis provided it has the effect of writing-off 95 per cent of the original cost of the asset on the expiry of the specified period and approved by the Government. In actual practice, however, leasing companies (lessors) follow the provisions of the *Income Tax Act* with the basic objective of tax-deductability and as incentive to investment in specified assets leased out for leasing business.

The provisions of *Income Tax Act* relating to depreciation are contained in Section 32. The section envisages three important conditions for allowing depreciation, namely, **(i)** the asset is owned by the assessee, **(ii)** the asset is used by the assessee for the purpose of business and **(iii)** the asset is in the form of buildings, furniture, machinery and plant including ships, vehicles, books, scientific apparatus and surgical equipments and so on. The Section does not explicitly provide for claims of depreciation allowance on leased assets by a lessor. The lessor in an equipment lease is the legal owner of the leased asset. It is also legally accepted through rulings by courts and appellate tribunals that the **leased assets are deemed to be used in the lessor's business of leasing assets**. Therefore, the lessor is eligible to claim depreciation tax shields. However, other than tax shield on depreciation, the lessor is not eligible for any other investment-related tax shield. Further, in sale and lease back transactions where the asset is transferred at a value higher than the book value with a view to minimise tax liability, the lessor cannot claim depreciation on the enhanced value. In a syndicated arrangement, leasing companies jointly own the leased asset. As their ownership in the equipment purchased and leased jointly is fractional, they are not entitled to depreciation allowance in respect of such asset in proportion to their share in joint ownership (cost). The option to the leasing companies who jointly own leased assets is to form an association of persons for the purpose of income tax assessment which is eligible to claim depreciation shield as a separate entity of persons.

Secondly, the amount of annual depreciation on an asset is determined by **(a)** the actual cost of the asset and **(b)** its classification in the relevant block of assets. The actual cost means the cost of acquisition of the asset and the expenses incidental thereto which are necessary to put the asset in usable state, for example, freight and carriage inwards, installation charges and expenses incurred to facilitate the use of the asset like expenses on the training of the operators or on essential construction work.

Depreciation is charged with a view to simplify the computation not on an individual asset but on a block of assets defined as **a group of assets falling within a class of assets, being building machinery, plant or furniture in respect of which the same rate of depreciation is prescribed**. Thus, assets which fall within the same class of assets and in respect of which the same percentage/rate of depreciation has been prescribed irrespective of their nature form one block of assets. For example, all assets under the category of plant and machinery which qualify for depreciation at 25 per cent will form one block and depreciation is computed with reference to the actual cost of the block. Similarly, assets depreciable at 40 per cent will constitute another block; third block consists of assets depreciable at 50 per cent and the fourth block comprises assets subject to 100 per cent write-off. Other classes of assets are like-wise grouped into different blocks to determine the applicable depreciation allowance.

Thirdly, depreciation is computed at the block-wise rates on the basis of written down value (WDV) method only. Presently, the block-wise rates for plant and machinery are at 25 per cent, 40 per cent and 100 per cent. The depreciation allowance on office buildings and furniture and fittings is 10 per cent. Where the actual cost of plant and machinery does not exceed ₹5,000, the entire cost is allowed to be written-off in the first year of its use. If an asset acquired during a year has been used for a period of less than 180 days during the year, depreciation on such assets is allowed only at 50 per cent of the computed depreciation according to the relevant rate.

Fourthly, apart from the simplification of the computation of the amount of depreciation, a significant implication of the categorising assets into blocks is that if an asset falling in a block is sold out, there is no capital gain or terminal depreciation or balancing charge. The sale proceeds of the asset are reduced from the WDV of the block. Capital gain/loss can arise in these situations:

(i) When the sale proceeds exceed the WDV of the whole block;
(ii) When the entire block is sold out;
(iii) In case of 100 per cent depreciable assets

The terminal loss is not allowed in the relevant assessment year but is spread over a number of years to be allowed by way of depreciation.

Finally, in case of insufficiency/absence of profit, unabsorbed depreciation can be set-off against income under any head against business income as in the case of unabsorbed loss. It can be carried forward to the next year without time limit. However, it cannot be assigned/transferred/claimed by the transfer of business.

The mechanics of computation of depreciation is illustrated below.

Illustration 2.7

Assume the following facts relating to the Hypothetical Leasing Ltd (HLL):

Block of assets	*Depreciation rate (percentage)*	*WDV as on 1.4.20X0 (₹ lakh)*	*Additions during 20X0–X1 (₹ lakh)*
A	25	500	250
B	40	300	150

Assets sold during 20X0–X1 amounted to ₹35 lakh (Block A) and ₹50 lakh (Block B). It is expected that fresh investments in assets during 20X1–X2 will be: Block A (₹160 lakh) and Block B (₹80 lakh). It is also projected by the HLL that dis-investment proceeds from the assets will amount to ₹45 lakh in case of Block A and ₹25 lakh in case of Block B. Assume that about 50 per cent of additional investment during 20X1–X2 will be made before September 20X1.

Compute the relevant depreciation charge for 20X0–X1 and the projected depreciation charge for 20X1–X2.

Solution

The relevant depreciation charge for 20X0–X1 and the projected depreciation charge for 20X1–X2 is calculated in Tables 2.2 and 2.3 respectively.

Table 2.2 Computation of Depreciation Charge During 20X0–X1 *(₹ lakh)*

		Blocks	
		A	*B*
1.	WDV as on 1.4.20X0	500	300
2.	*Add:* Cost of assets acquired during 20X0–X1	250	150
		750	450
3.	*Less:* Sales during 20X0–X1	35	50
4.	WDV (for depreciation)	715	400
5.	Depreciation allowances	179	160
6.	WDV as on 1.4.20X1	536	240

Table 2.3 Projected Depreciation Charge During 20X1–X2 *(₹ lakh)*

		Blocks	
		A	*B*
1.	WDV as on 1.4.20X1	536	240
2.	Add: Cost of assets acquired during 20X1 – X2 (1 + 2)	160	80
		696	320
3.	Less: Expected proceeds of sales during 20X1 – X2	45	25
4.	WDV (for depreciation)	651	295
5.	Depreciation allowances@	153	110
6.	WDV as on 1.4. 20X2	498	185

@	Normal depreciation allowance	163	118
	Less: Depreciation allowance inadmissible in respect of assets acquired after 30.9.20X0	10	8
		(80 × 0.25.05)	(40 × 0.4 × 0.5)
		153	110

Note: If the entire block of assets is sold during a year for an amount exceeding (1 + 2), the difference represents short-term capital gains subject to tax. Where the sale proceeds are lower than (1 + 2), the difference is short-term capital loss and the HLL is entitled to tax shield.

For Lessee The income tax considerations for the lessees are: **(i)** allowability of lessee rentals, **(ii)** deduction of incidental expenses and **(iii)** tax planning.

Allowability of Lease Rentals Lease rentals are allowed by the Income Tax Act as a normal business expenditure of the lessee for assessment purposes provided the expense is not **(i)** of capital nature, **(ii)** a personal expense and it relates wholly and exclusively to business purposes of the assessee (lessee).

Deductability of Incidental Expenses The lessee is normally required to bear expenses associated with the leased asset such as repairs and maintenance, insurance, finance charge and so on. These incidental expenses to the lease are allowed as a deduction by the Income Tax Act from taxable income of the lessee. If the lessee is required to bear some expenses on the installation of the equipment, such expenses can also be claimed as a revenue expense in the year of incurrence but cannot be capitalised as the ownership of the asset is not vested in the lessee (assessee).

Tax Planning Leasing enables tax planning both for the lessor and the lessee and save taxes. The deductibility of depreciation in the computation of the taxable income of a lessor is the main device of saving taxes. The leasing transaction offers scope for the lessee for tax planning through primarily allowing deduction of lease rentals. There are basically two ways in which lessees can use leasing as a tax planning instrument: **(1)** flexible structuring of lease rentals, **(2)** transfer of unabsorbed capital allowance to the lessor.

Flexible Restructuring of Lease Rentals The lessee can reduce his current or future tax liability by a flexible structuring of lease rentals. Theoretically, a lessor can structure a lease package in which a substantial part of the lease rentals (say, as high as 99 per cent) is payable in the first year and a very small fraction during the remaining lease term. It is also hypothetically possible to structure a **back-ended rental stream** (lower rentals in earlier years and higher in later years) depending on the lessees' cash flows, though, of course, purely tax-driven structure of lease rentals may not always be allowed by the income tax authorities.

Illustration 2.8

Assume for the Hindustan Manufacturers Ltd (HML) a capital investment proposal of ₹1,000 lakh during 20X0–X1. The investment outlay can be financed by either 20 per cent debt, repayable in five equal annual instalments or leasing, the annual lease rentals per ₹1,000 being ₹500 (Year 1), ₹400 (Year 2) and ₹200 (Years 3-5). The depreciation rate relevant for the block is 25 per cent while the assumed marginal tax rate for the HML is 35 per cent. If the HML wishes to minimise/reduce its tax liability during 20X0–X1 and 20X1–X2, which alternative method of financing (borrowing or leasing) of investment should it select?

Solution

The decision analysis is presented in Table 2.4.

Table 2.4 Decision Analysis: Debt Vs Lease Financing (₹ *lakh*)

Tax deductible expenses	*20X0–X1*		*20X1–X2*	
	Debt financing	*Lease financing*	*Debt financing*	*Leasing financing*
1. Interest on debt	200	—	160	—
2. Depreciation	250	—	150	—
3. Total (1 + 2)	450	—	310	—
4. Tax shield [(3) X 0.35)]	157.5	—	108.5	—
5. Lease rentals	—	500	—	400
6. Tax shield	—	175	—	140

Due to tax shield differential, the HML should select the lease financing alternative.

Working Notes

1. Debt Repayment Schedule (₹ *lakh*)

	20X0–X1	*20X1–X2*
Loans outstanding (beginning)	1,000	800
Interest (0.20)	200	160
Loan instalment	200	200
Loan outstanding (end)	800	600

2. Depreciation Schedule

WDV (opening)	1,000	600
Depreciation	250	150
WDV (closing)	750	450

3. Lease Rentals

$0.50 \times 1{,}000$	500	—
$0.40 \times 1{,}000$	400	400

Transfer of Investment-related Unabsorbed Tax Shield The second form of tax planning by a lessee is by way of transfer of investment-related unabsorbed tax shield to the lessor who can absorb it. This type of transfer is, in fact, one of the significant tax-based advantages of leasing. In a case where a firm (lessee) enjoys 100 per cent deduction of income for tax purpose, for example, income from exports, the tax shield on fresh capital investment by such a firm would not have any impact on its cash flows (it cannot absorb tax shields). If the tax shields can be transferred to a lessor who is prepared to pass on a part of these to the lessee in the form of lower lease rentals, the operating cash flows can be increased.

Illustration 2.9

Assume the Hypothetical Textiles Ltd (HTL), a 100 per cent export-oriented firm, is considering a capital investment of ₹400 lakh to modernise its plant. An option available to HTL is to lease the required equipment from the Hypothetical Leasing Ltd (HTL) structured as a 6-year non-cancellable finance lease with equated annual rental. Assuming further, no salvage value and 20 per cent marginal cost of capital of HTL, what is the maximum lease rental it will be willing to pay to HTL?

Solution

If the HTL had been a tax-paying firm, its effective investment cost would be ₹400 lakh (investment outlay) less the present value (PV) of tax advantage/shield on depreciation. The firm would not be agreeable to a lease rental stream whose PV exceeds ₹400 lakh. In other words, the maximum equated annual lease rental, L, is given by the equation:

$$L \times \text{PVIFA}\,(20{,}5) = ₹400 \text{ lakh}$$

or

$$2.991\,L = ₹400 \text{ lakh}$$

$$L = ₹133.8 \text{ lakh}$$

The interpretation is that if the equated annual lease rental is less than ₹133.8 lakh, it will be worthwhile for the HTL to lease the equipment, otherwise not.

Implications The income-tax provisions applicable to leasing transactions have important implications for financial analysis for both the lessors and the lessees. First, the lessee is entitled to tax shield on lease rentals as a business expenditure. But he is not eligible for tax shield associated with depreciation. The implication for financial analysis is that the tax shield on lease rentals represent a cash inflow and that on depreciation as cash outflow (cash inflow foregone) in determining the lease-related cash flows of the lessee. Second, for the lessor, the implication is exactly reverse: the tax shield on depreciation constitutes a cash inflow and the tax liability on lease rentals a cash outflow. Finally, both for the lessor and the lessor, the net salvage value of an equipment is treated as a post-tax cash flow. This is so because capital gains on the sale of individual assets of a block are normally not taxed; similarly, estimated salvage value is not adjusted for tax shield on capital loss.

Sales Tax Aspects The legislative framework governing levy of sales tax consists of the *Central Sales Tax Act, 1957* (CST) enacted by the Government of India and *Sales Tax Acts* (STAs) of the various states. The CST deals with the levy and collection of sales tax on the inter-state sale of goods only. The tax on sale of goods within a state (intra-state sale) is governed by the provisions of the respective STAs. A lease normally has three important elements from the viewpoint of sales tax.

(i) The purchase of an asset by a lessor for the purpose of leasing to a lessee;
(ii) The **transfer of the right to use an asset** to a lessee for a specified period of time, including its renewal, for cash, deferred payment or other valuable considerations; and
(iii) The sale of the asset at the expiry of the lease.

In other words, as per the present framework, a lease transaction attracts sales-tax at three stages: **(1)** purchase of equipment by a lessor, **(2)** transfer of the right to a lessee to use the equipment for a lease rental and **(3)** sale of asset by the lessor at the end of the lease period. We focus here on the sales tax implications of lease transactions at the three stages and their implications for financial analysis.

Purchase of Equipment When purchase of an equipment by a lessor involves inter-state sale, the transaction attracts the provisions of the CST according to which the normal rate of sales tax (10 per cent) or the appropriate rate applicable to intra-state purchase/sale of goods in the respective state, whichever is higher, is imposed. According to a recent Supreme Court ruling, the place of signing the lease agreement would decide the taxing jurisdiction of the lease and not in the State where the goods are put to use. The equipment supplier to a lessor is not entitled to the concessional rate of sales tax. Thus, the cost of equipment to the lessor includes the central sales tax at the normal rate (10 per cent). The intra-state purchase of equipment attracts sales tax stipulated in the appropriate STA.

Lease Rentals Before 1982, there was no sales tax on lease rentals. The incidence of sales tax on them was introduced by the *Constitution (Forty-Sixth Amendment) Act, 1982* which enlarged the concept of **tax on the sale and purchase of goods** to enable the state Governments to levy tax on transaction which did not fell in the category of conventional sale/purchase covered by the CST and STAs. Accordingly, tax on **transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration** was included in the tax on purchase/sale of goods. Thus, leasing was brought within the scope of sale tax. Lease rentals now attract sales tax under the STAs in all the states, except Maharashtra which has enacted a separate legislation (Maharashtra Sales Tax on the *Transfer of Right to Use Any Goods for Any Purpose Act, 1985*, popularly known as Maharashtra Lease Act) to tax lease rentals. A detailed discussion of the CST and the STAs is beyond the scope of this book. The salient features of the sales tax on lease rentals, in general, are:

(i) Sales tax is payable on the annual taxable turnover (aggregate lease rentals) of the lessor. The rates of tax vary between a minimum and maximum; they also vary from state to state;

(ii) In addition, in several states, surcharge, additional surcharge, additional sales tax on turnover exceeding a specified limit/turnover tax are also levied on the lease rentals;

(iii) Lessor with an annual taxable turnover beyond specified limits must seek registration as "**dealer**" under the local sale-tax law. Since one of the requirements of registration is to have a place of business in the state in which registration is sought, leasing companies may have to obtain multiple registrations; and

(iv) The taxable event (point of transfer of equipment) in a lease transaction is the exercise/ enjoyment of the right to use goods. In other words, only after acquiring possessions of the goods/assets leased out, the lessee becomes legally entitled to possess and use the goods. Sales tax on lease is, therefore, related to the actual use of the asset.

Sale of Asset Second sale exemptions available for the normal second sale transaction within the state are usually not available for lease transactions. For example, a leasing company buys an equipment from a supplier and leases it to a lessee, both within the same state. The transaction between the leasing company and the equipment supplier is called the **first sale**; it will attract local sales tax. The transaction between the lessor and the lessee being a **deemed sale** is called **second sale**. Normally, second sale of some specified goods is exempted from (second) levy of sales tax. But this exemption is usually not available in lease transactions. In other words, equipment lease transactions suffer a multiple-point levy irrespective of the goods covered by the transaction.

Implications The incidence of sales tax has implications for financial analysis of lessee in terms of **(1)** the lease-related cash flow stream and (2) the lease rentals to the extent the impact of the tax is borne by the lessee although the tax is levied on the lessor.

Illustration 2.10

The Hindustan Manufacturers Ltd (HML) has under consideration the purchase of an equipment from the Delhi-based Hypothetical Suppliers Ltd (HSL) at a cost of ₹150 lakh subject to 4 per cent sales tax. As an alternative, the equipment can be leased from the Avon Leasing Ltd (ALL) on the basis of a 5-year quote of ₹26.75 per thousand per month (ptpm) payable at the end of every month. The ALL is required to pay a 4 per cent sales tax on the quoted lease rental. Show the payable lease rental.

Solution

Payable Lease Rental

(₹ lakh)

1.	Cost of equipment to HML	= ₹150 × 1.04	₹156
2.	Cost of equipment to ALL	= ₹150 × 1.10	165
3.	Lease rentals paid by HML	= ₹165 × 0.02675 (monthly)	4.41

The interpretation is that against the saving of initial cash outflow of ₹156 lakh, the HML would have to pay higher lease rental on enhanced investment cost to the extent of the 10 per cent sales tax incidence borne by the ALL - the lessor. Therefore, the present value of the lease rental (cash outflow) paid by the HML will be higher than the saving of the initial cost of the equipment.

Given 4 per cent sales tax on lease rentals, the monthly lease rental payable by the lessee = ₹4.41 lakh × 1.04 = ₹4.59 lakh. The effect of state sale tax on lease rentals is to increase the monthly lease rental payable by the lessee and, by implication, reduce the financial attractiveness of leasing.

FINANCIAL EVALUATION OF LEASING

The process of financial appraisal in a lease transaction generally involves three steps: **(i)** appraisal of the client in terms of financial strength and credit worthiness; **(ii)** evaluation of the security/collateral security offered and **(iii)** financial evaluation of the proposal. The most critical part of a leasing transaction is the financial evaluation of the proposal both to the lessor and lessee. The present chapter discusses the analytical framework/technique to evaluate the financial terms of a leasing proposal. The objective of the evaluation is to identify the cheaper source of finance to a lessee and better investment alternative to the lessor. The evaluation framework from the viewpoint of the lessees and the lessors are accordingly discussed in this Section.

Lessee's Perspective

Finance lease effectively transfers the risks and rewards associated with the ownership of an equipment from the lessor to the lessee. A lease can be evaluated either as an investment decision or as a financing alternative. Given that an investment decision has already been made, a firm (lessee) has to evaluate whether it will purchase the asset/equipment or acquire it on lease basis. Since lease rental payments are similar to payments of interest on debt, leasing in essence is an alternative to borrowing. The lease evaluation from the lessee's point of view, thus, essentially involves a choice between debt financing *versus* lease financing. It is in this context that an evaluation of lease financing from the view point of lessee is presented in this Section. The **decision-criterion** used is the Net Present Value of Leasing [NPV(L)]/Net Advantage of Leasing (NAL). The discount rate used is the marginal cost of capital for all cashflows other than lease payments and the tax cost of debt for lease payments. The value of the interest tax shield is included as a foregone cash flow in the computation of NPV(L)/NAL.

> **Net preset value of leasing [NPV(L)]/Net advantage of leasing (NAL)**
> is the decision criteria in lease evaluation.

NPV(L)/NAL = Investment cost

Less: **Present value of lease payment (discounted by K_d),**

Plus: **Present value of tax shield on lease payment (discounted by K_c)**

Less: **Management fee**

Plus: **Present value of tax shield on management fee (discounted by K_c)**

Minus: **Present value of depreciation shield (discounted by K_c)**

Minus: **Present value of interest shield (discounted by K_c)**

Minus: **Present value of residual/salvage value (discounted by K_c)**

where **K_c = Post-tax marginal cost of capital**

K_d = Pre-tax cost of long-term debt

If the NAL/NPV(L) is positive, the leasing alternative should be used, otherwise the borrowing alternative would be preferable.

An alternative approach is to compare the leasing and buying/borrowing alternative. Given the fact that investment decision has already been taken, the lessee is to evaluate whether it should purchase an equipment through borrowing or acquire it on lease basis. Why borrowings only? Since lease rentals are similar to the payment of interest on debt, leasing, in essence, is an alternative to borrowing. The lease, as a source of finance, should be logically compared exclusively with debt as an alternative source of finance to purchase the required equipment/plant. The lessee, obviously, would opt for the cheaper source of finance. For the purpose of financial evaluation, the two methods in vogue are: **(1)** Present-value method and **(2)** Internal-rate of return method.

Present-Value Method The present value method involves a comparison of present value (PV) of cash outflows after taxes (COAT) under both the alternatives. An alternative with the lower PV would be a preferred choice. The steps involved are summarised below.

(1) Determine the cash outflows after taxes for each year under the lease alternative. This is arrived at multiplying the lease rental payment (L) by (1 – tax rate, t).

(2) Determine the cash outflows after taxes for each year under the buy/borrow alternative. The COAT is equal to the loan instalment (Gross cash outflows, GCO) less **(i)** tax advantage on interest (I) component of loan instalment ($I \times t$) and **(ii)** tax shield due to depreciation allowance (D) $\times$ t).

(3) Compare the PV of the cash outflows associated with leasing (Step 1) and buy/borrow alternative (Step 2) by employing after-tax cost of debt (k_d) as the discount rate. The focus of analysis, essentially, is to compare the two sources of finance, namely, leasing and debt. Therefore, the relevant required values are after-tax cost of (i) leasing and debt.

(4) Select the alternative with the lower PV of cash outflow after taxes.

(5) Decision criterion is:

- **(a) In favour of buy/borrow alternative if** PV of COAT under lease alternative > PV of COAT under buy/borrow alternative.
- **(b) In favour of lease alternative in case** PV of COAT under lease alternative < PV of COAT under buy/borrow alternative.

Note: (A) In step 2, cash inflows in the terminal year are expected from two more sources: **(i)** Salvage value and **(ii)** Tax shield on short-term capital loss (as machine, more often than not, is sold at a price lower than its book value). In rare cases, when the sale yields profits, the tax due on short-term capital gains should be subtracted from the salvage value.

(B) Normally, taxes and maintenance expenses are borne by the lessee. Since such costs are common costs under both options, they might be ignored. However, if they are to be incurred by the lessor, after tax maintenance costs are incremental costs under buy/borrow alternative and should be taken into account.

Internal Rate Return (IRR) Under the IRR method/alternative, the after-tax cost of leasing is determined and is compared with the after-tax cost of debt. The alternative with the lower cost is selected. Both methods provide identical answers. The virtue of IRR method is that it is devoid of the problem of choosing an appropriate discount rate. The steps required to compute IRR (representing after tax cost of leasing) is summarised below.

(1) Capital cost of plant and machinery is saved due to lease option. The cost saved is equal to the present value of cash outflows after taxes (for the lease period) associated with lease alternative (determined as per Step 2). The rate which makes the two sides equal is the IRR.

(2) Cash outflows after taxes (COAT) under the lease alternative are equal to the lease payments (L) minus the tax advantage on the excess amount of lease payments over depreciation allowed on plant and machinery. Symbolically, it is [L – t (L – D)]. These net cash outflows are to be determined for each year.

(3) In the terminal year, the salvage value (SV) as well as the tax advantage on short-term capital loss (TASTCL) are to be reckoned as opportunity costs of using the lease alternative. The sum of the two would constitute the cash outflows in terminal (nth) year.

(4) Symbolically, the IRR representing the cost of leasing would be:

$$\text{Cost of plant and machinery} = \sum_{t=1}^{n} \frac{\text{COAT(net)}_t}{(1+k_1)^t} + \frac{\text{SV}_n + \text{TASTCL}_n}{(1+k_1)^n}$$

(5) Decision criterion: If the after-tax cost of leasing (k_1) < the after-tax cost of debt (k_d), choose the leasing alternative and vice versa.

The mechanics of computation of (i) PV/IRR associated with the leasing and the borrowing alternatives and (ii) the NAL/NPV(L) is illustrated below.

Illustration 2.11

XYZ Ltd is in the business of manufacturing steel utensils. The firm is planning to diversify and add a new product line. The firm either can buy the required machinery or get it on lease.

The machine can be purchased for ₹15,00,000. It is expected to have a useful life of 5 years with salvage value of ₹1,00,000 after the expiry of 5 years. The purchase can be financed by 20 per cent loan repayable in 5 equal annual instalments (inclusive of interest) becoming due at the end of each year. Alternatively, the machine can be taken on year-end lease rentals of ₹4,50,000 for 5 years. Advise the company, which option it should choose. For your exercise, you may assume the following:

(i) The machine will constitute a separate block for depreciation purposes. The company follows written down value method of depreciation, the rate of depreciation being 25 per cent.

(ii) Tax rate is 35 per cent and cost of capital is 18 per cent.

(iii) Lease rents are to be paid at the end of the year.

(iv) Maintenance expenses estimated at ₹30,000 per year are to be borne by the lessee.

Solution

(A) Present Value Approach

PV of Cash Outflows Under Leasing Alternative

Year-end	*Lease rent after taxes [R (1 – t)] [₹4,50,000 (1 – 0.35)]*	*PVIFA at 13% [20%(1 – 0.35)]*	*Total PV*
1-5	₹2,92,500	3.517	₹10,28,723

PV of Cash Outflows Under Buying Alternative

Year -end	Loan instalment	Tax advantage on Interest (I × 0.35)	Tax advantage on Depreciation (D × 0.35)	Net cash outflows (col. 2 – col. 3 + col. 4)	PVIF at 13%	Total PV
1	2	3	4	5	6	7
1	₹5,01,505	₹1,05,000	₹1,31,250	₹2,65,255	0.885	₹2,34,751
2	5,01,505	90,895	98,437	3,12,173	0.783	2,44,431
3	5,01,505	73,968	73,828	3,53,709	0.693	2,45,120
4	5,01,505	53,656	55,371	3,92,478	0.613	2,40,589
5	5,01,505	29,114	41,528	4,30,863	0.543	2,33,959
						11,98,850
Less: PV of salvage value (₹1,00,000 × 0.543)						54,300
Less: PV of tax savings on short-term capital loss: (₹3,55,958 – ₹1,00,00) × 0.35 = (₹89,585 × 0.543)					48,645	
NPV of cash outflows						10,95,905

*Equivalent annual loan instalment = ₹15,00,000/2.991 (PVIFA for 5 years at 20% i.e. 20,5) = ₹5,01,505.

Recommendation: The company is advised to go for leasing as the PV of cash outflows under leasing option is lower than under buy/borrowing alternative.

Working Notes

Schedule of Debt Payment

Year-end	Loan instalment	Loan at the beginning of the year	Payments: Interest (col. 3 × 0.20)	Payments: Principal repayment (col. 2 – col. 4)	Loan outstanding at the end of the year (col. 3 – col. 5)
1	2	3	4	5	6
1	₹5,01,505	₹15,00,000	₹3,00,000	₹2,01,505	₹12,98,495
2	5,01,505	12,98,495	2,59,699	2,41,806	10,56,689
3	5,01,505	10,56,689	2,11,338	2,90,167	7,66,522
4	5,01,505	7,66,522	1,53,304	3,48,201	4,18,321
5	5,01,505	4,18,321	83,184*	4,18,321	—

*Difference between loan instalment and loan outstanding.

Schedule of Depreciation

Year	Depreciation		Balance at the end of the year
1	₹15,00,000 × 0.25 =	₹ 3,75,000	₹11,25,000
2	11,25,000 × 0.25 =	2,81,250	8,43,750
3	8,43,750 × 0.25 =	2,10,937	6,32,813
4	6,32,813 × 0.25 =	1,58,203	4,74,610
5	4,74,610 × 0.25 =	1,18,652	3,55,958

(B) IRR Approach

Determination of After-tax Cost of Lease Financing (IRR Approach)

Year-end	*Cost of machine*	*Lease payments (L)*	*Depreciation of machine (D)*	*Incremental tax shield on leasing [0.35 × (L – D)]*	*Net cash outflows under leasing [(3) – (5)]*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
0	₹15,00,000	—	—	—	₹15,00,000
1		₹4,50,000	₹3,00,000	₹52,500	(3,97,500)
2		4,50,000	2,40,000	73,500	(3,76,500)
3		4,50,000	1,92,000	90,300	(3,59,700)
4		4,50,000	1,53,600	1,03,740	(3,46,260)
5		4,50,000	1,22,880	1,14,492	(3,35,508)
5* Salvage value					(1,00,000)*
5* Tax savings on short-term capital loss					(1,37,032)/**

*Machine has been sold after the expiry of five years (that is, at the beginning of year 6). The PV of salvage value and tax savings can be computed with reference to year-end 5.
**Salvage value of machine foregone and short-term capital loss constitute the opportunity cost of lease financing and, therefore, cash outflows of lease financing.

Determination of IRR

Year	*Net cash outflows under leasing*	*PV factor at 10%*	*PV factor at 11%*	*Total PV at 10%*	*Total PV at 11%*
1	₹3,97,500	0.909	0.901	₹3,61,375	₹3,58,148
2	3,76,500	0.826	0.812	3,10,989	3,05,718
3	3,59,700	0.751	0.731	2,70,135	262,941
4	3,46,260	0.683	0.659	2,36,496	2,28,185
5	5,72,540@	0.621	0.593	3,55,547	3,39,516
				15,34,542	14,94,508

@[₹3,35,508 + ₹1,00,000 salvage value + ₹1,37,032, tax advantage on short-term capital loss]
IRR1 = 11% – (₹5,492/₹40.034 = 0.14) = 10.86 per cent

Recommendation: The company is advised to go for leasing to take advantage of its lower cost relative to the cost of debt.

Illustration 2.12 *(Annual Lease Rentals)*
The following details relate to an investment proposal of the Hypothetical Industries Ltd (HIL):

— Investment outlay, ₹180 lakh
— Useful life, 4 years
— Net salvage value after 3 years, ₹18 lakh
— Annual tax relevant rate of depreciation, 40 per cent

The HIL has two alternatives to choose from to finance the investment:

Alternative I : Borrow and buy the equipment. The cost of capital of the HIL, 0.12; marginal rate of tax, 0.35; cost of debt, 0.17 per annum.

Alternative II : Lease the equipment from the Hypothetical Leasing Ltd on a 3-year full-payout basis @ ₹444/₹1,000 payable annually in arrear. The lease can be renewed for a further period of 3 years at a rental of ₹18/₹1,000 payable annually in arrear.

Which alternative should the HIL choose? Why?

Solution

Decision Analysis (₹ *lakh*)

1.	Investment outlay	₹180.00
2.	*Less:* Present value of lease rentals (working note 1)	176.61
3.	*Plus:* Present value of tax shield on lease rentals (2)	67.19
4.	*Less:* Present value of tax shield on depreciation (3)	41.01
5.	*Less:* Present value of interest shield on displaced debt (4)	18.29
6.	*Less:* Present value of net salvage value (5)	12.81
	NAL/NPV(L)	(1.53)

Since the NAL is negative, the lease is not economically viable. The HIL should opt for the alternative to borrow and buy.

Working Notes

1. Present value of lease rentals:

$$= ₹(180 \text{ lakh} \times 0.444) \times \text{PVIFA } (17,3)$$
$$= ₹79.92 \text{ lakh} \times 2.210 = ₹176.61 \text{ lakh}$$

2. Present value of tax shield on lease rentals:

$$= ₹(180 \text{ lakh} \times 0.444 \times 0.35) \times \text{PVIFA } (12,3)$$
$$= ₹27.972 \text{ lakh} \times 2.402 = ₹67.19 \text{ lakh}$$

3. Present value of tax shield on depreciation:

$$= [72 \times \text{PVIF } (12,1) + 43.2 \times \text{PVIF } (12,2) + 25.92 \times \text{PVIF } (12,3)] \times 0.35$$
$$= [72 \times 0.893) + (43.2 \times 0.797) + (25.92 \times 0.712)] \times 0.35 = ₹41.01 \text{ lakh}$$

4. Present value of interest tax shield on displaced debt:

$$= [30.03 \times \text{PVIF } (12,1) + 21.54 \times \text{PVIF } (12,2) + 11.61 \times \text{PVIF } (12,3)] \times 0.35$$
$$= [(30.03 \times 0.893) + (21.54 \times 0.797) + (11.61 \times 0.712)] \times 0.35$$
$$= ₹18.29 \text{ lakh}$$

(Displaced) Debt (Present Value of Lease Rentals) Amortisation Schedule (₹ *lakh*)

Year	*Loan outstanding at the beginning**	*Interest content (at 17%)*	*Capital content*	*Instalment amount (176.61 ÷ 2.210)*
1	176.61	30.03	49.89	79.92
2	126.72	21.54	58.38	79.92
3	68.34	11.61	68.34	79.92

*Equal to the present value of lease rentals.

5. Present value of net salvage value: $= 18 \times \text{PVIF } (12,3) = 18 \times 0.712 = ₹12.81$ lakh

Illustration 2.13 *(Monthly Lease Rentals)*
For **Illustration 2.12**, assume the lease rental of ₹35/₹1,000 payable monthly in advance. Compute the NAL/NPV(L). Should the HIL opt for the lease financing?

Solution

Decision Analysis *(₹ lakh)*

1.	Investment outlay	₹180.00
2.	*Less:* Present value of lease rentals (working note 1)	182.10
3.	*Plus:* Present value of tax shield on lease rentals (2)	63.56
4.	*Less:* Present value of tax shield on depreciation (3)	41.01
5.	*Less:* Present value of interest shield on displaced debt (4)	19.69
6.	*Less:* Present value of net salvage value (5)	12.81
	NAL	(12.05)

As the NAL is negative, the lease is not financially advantageous and the HIL should not opt for it.

Working Notes

1. Present value of lease rentals:
$$= ₹(180 \times 0.035 \times 12) \times \text{PVIFAm } (17,3)$$
$$= 75.6 \times i/d(12) \times \text{PVIFA } (i, 3)$$
where $i = 0.17 = 75.6 \times 1.09 \text{ (Table A-3)} \times 2.210 \text{ (Table A-2)}$
$$= ₹182.10 \text{ lakh}$$
2. Present value of tax shield on lease payments:
$$= [(180 \times 0.035 \times 12) \times \text{PVIFA } (12,3) \times 0.35]$$
$$= 75.6 \times 2.402 \times 0.35 = ₹63.56 \text{ lakh}$$
3. Present value of tax shield on depreciation: No change from the annual lease payment (₹41.01 lakh)
4. Present value of interest tax shield on displaced debt:
$$= [(30.96 \times 0.893) + (23.27 \times 0.787) + (14.47 \times 0.712) \times 0.35$$
$$= ₹19.69 \text{ lakh}$$

Debt Amortisation Schedule

(₹ lakh)

Year	*Loan outstanding at the beginning*[@]	*Interest content (0.17)*	*Capital content*	*Instalment amount [182.10 ÷ 2.409 (1.09 × 2.210)]*
1	182.10	30.96	44.64	75.60
2	137.46	23.27	52.33	75.60
3	85.13	14.47	70.66	75.60

[@]Equal to the present value of lease rentals.

5. Present value of net salvage: No change from annual payment basis (₹12.81 lakh)

It can be seen that in case of monthly lease payment, the component of the lease-related cash flow streams that will change are: (1) Lease rentals, (2) Tax shield on lease rentals, and (3) Interest tax shield on displaced debt.

Break-Even Lease Rental The break-even lease rental (BELR) is the rental at which the lessee is indifferent between lease financing and borrowing and buying. Alternatively, BELR has NAL as zero. It reflects the maximum level of rental which the lessee would be willing to pay. If the BELR exceeds the actual lease rental, the lease proposal would be accepted, otherwise rejected. The computation of the BELR is shown in Illustration 2.4.

Illustration 2.14

For the HIL in **Illustration 2.12**, assume monthly lease payments in advance. Compute the break-even monthly lease rental. Can the HIL accept a lease quote of ₹35/₹1,000 per month payable in advance?

Solution

The monthly break-even lease rental (BL) can be obtained when NAL = zero. Thus,
$180 - (12\ B_L \times 3.27 \times 2.210) + (12\ B_L \times 0.35 \times 2.402) - 58.59 - [(11.49 \times 0.893) + (7.35 \times 0.797) \times (2.43 \times 0.712)] \times 0.35\ Bl - 12.81 = 0$

$$B_L = ₹2.78 \text{ lakh}$$

Monthly lease rental payable by HIL = ₹180 lakh × 0.035 = ₹6.30 lakh

Since the B_L is less than the actual rental to be paid, the lease proposal cannot be accepted.

Working Note

Required Amortisation Schedule

(₹ lakh)

Year	*Amount outstanding at the beginning*	*Capital content*	*Interest content*	*Instalment*
1	86.73 B_L	24.51 B_L	11.49 B_L	12 B_L
2	62.22 B_L	28.65 B_L	7.35 B_L	12 B_L
3	33.57 B_L	33.57 B_L	2.43 B_L	12 B_L

Lessor's Viewpoint

The lease evaluation from the point of view of the lessor aims at ascertaining whether to accept a lease proposal or to choose from alternative proposals. As in the case of the evaluation by a lessee, the appraisal method used is the discounted cash flow technique based on the lessor's cash flows. The lease-related cash flow from his angle consist of **(a)** outflows in terms of the initial investment/acquisition cost of the asset at the inception of the lease; income-tax on lease payments, sales-tax on lease transaction, if any; lease administration expenses such as rental collection charges, expenses on suits for recovery and other direct cost and so on, **(b)** inflows such as lease rentals, management fee, tax shield on depreciation, residual value and security deposit, if any and so on. This Section illustrates lease evaluation from the point of view of a lessor and includes aspects such as break-even rental for the lessor, negotiation and fixation of lease rentals.

Illustration 2.15

For Illustration 2.11, assume further that: **(i)** the lessor's weighted average cost of capital is 14 per cent. Is it financially profitable for leasing company to lease out the machine?

Solution

Determination of NPV of Cash Inflows

	Years				
	1	*2*	*3*	*4*	*5*
Lease rent	₹4,50,000	₹4,50,000	₹4,50,000	₹4,50,000	₹4,50,000
Less: Depreciation	3,75,000	2,81,250	2,10,937	1,58,203	1,18,652
Earnings before taxes	75,000	1,68,750	2,93,063	2,91,797	3,31,348
Less: Taxes (0.35)	26,250	59,062	83,672	1,02,129	1,15,972
Earnings after taxes	48,750	1,09,688	1,55,391	1,89,668	2,15,376
Cash inflows after	4,23,750	3,90,938	3,66,328	3,47,871	3,34,028
taxes × PV factor at (0.14)	0.877	0.769	0.675	0.592	0.519
Total PV	3,71,629	3,00,631	2,47,271	2,05,940	1,73,361
Total PV (operations) [1-5]					12,98,832
Add: PV of salvage value of machine (1,00,000 × 0.519)					51,900
Add: PV of tax savings on short-term capital loss (₹89,585 × 0.519)					46,495
Gross PV					13,97,227
Less: Cost of machine					15,00,000
NPV					(1,02,773)

It is not financially profitable to let out machine on lease by the leasing company, as NPV is negative.

Break-Even Lease Rental From the viewpoint of a lessor, the break-even lease rental represents the minimum (floor) lease rental which he can accept. The NAL/NPV(L) at this level of rental is zero. The discount rate to compute the NAL is the marginal over-all cost of funds to the lessor. The application of the NAL approach to compute the break-even lease rental to a lessor is illustrated below.

Illustration 2.16

For facts contained in Illustration 2.15 **(a)** determine the minimum lease rentals at which the lessor would break-even. Also, prepare verification table. Determine the lease rentals if the lessor wants to earn NPV of ₹1 lakh.

Solution

(a) Break-even Lease Rental

Cost of machine	₹15,00,000
Less: PV of salvage value to be received at the end of 5 years (₹1,00,000 × 0.519)	51,900
Less: PV of tax savings on short-term capital loss at the end of the 5th year (₹89,585 × 0.519)	46,495
Less: PV of tax shield on depreciation: (₹3,75,000 × 0.35 × 0.877) + (₹2,81,250 × 0.35 × 0.769) + (₹2,10,937 × 0.35 × 0.675) + (₹1,58,203 × 0.35 × 0.592)+ (₹1,18,562 × 0.35 × 0.519)	2,94,955
Required total PV of after-tax lease rent	11,06,650
Divided by PVIFA for 5 years at 0.14 (14, 5)	÷ 3.433
After-tax lease rentals	3,22,357
Break-even/lease rentals [₹3,22,352/(1 – 0.35)]	4,95,933

Verification Table

	Years				
	1	2	3	4	5
Lease rent	₹4,95,933	₹4,95,933	₹4,95,933	₹4,95,933	₹4,95,933
Less: Depreciation	3,75,000	2,81,250	2,10,937	1,58,203	1,18,652
Earnings before taxes	1,20,933	2,14,683	2,84,996	3,37,730	3,77,281
Less: Taxes (0.35)	42,327	75,139	99,749	1,18,206	1,32,049
Earnings after taxes	78,606	1,39,544	1,85,247	2,19,524	2,45,232
CFAT (EAT + Depreciation)	4,53,606	4,20,794	3,96,184	3,77,727	3,63,884
XPV factor at (0.14)	0.877	0.769	0.675	0.592	0.519
Total PV	3,97,812	3,23,591	2,67,424	2,23,614	1,88,856
PV of Lease rent (1-5)					14,01,297
Add: PV of salvage value					51,900
Add: PV of tax savings on short-term capital loss					46,495
Total PV					15,00,000

(b) Lease-Rentals to be Charged to Earn NPV of ₹1,00,000

Required total PV of after-tax lease rentals (₹11,06,650 for break-even + ₹1,00,000)		₹12,06,650
Divided by PVIFA for 5 years at 0.14 (14, 5)		÷ 3.433
After-tax lease rentals		3,51,486
Lease rentals to be charged [₹3,51,486/(1 – 0.35)]	5,40,740	

Illustration 2.17

The under-mentioned facts relate to a lease proposal before the Hypothetical Leasing Ltd. (HLL):

The initial cost of equipment to be leased out is ₹300 lakh, on which 10 per cent central sales tax would be levied. At the end of the lease term after 5 years, the salvage value is estimated to be ₹33 lakh. The other costs associated with the lease proposal payable in advance (front-ended) are initial direct cost, ₹3 lakh and management fee, ₹5 lakh. The marginal cost of funds to the HLL is 14 per cent while the marginal rate of tax is 35 per cent.

What is the break-even rental for HLL if the tax relevant rate of depreciation is 25 per cent?

Solution

Computation of Break-even Rental (L)

		Amount (₹ lakh)
1.	Equipment cost (including CST)	330.000
2.	Present value of lease rentals (working note 1)	3.433 L
3.	Present value of tax on lease rentals (2)	1.202 L
4.	Present value of tax shield on depreciation (3)	64.900
5.	Present value of initial direct costs	3.000
6.	Present value of management fee	5.000
7.	Present value of tax shield on initial direct cost (4)	0.920
8.	Present value of tax on management fee (5)	1.530
9.	Present value of salvage value (6)	17.100

The break-even rental (L) can be derived from the equation:

3.433 L – 1.202 L + ₹64.90 lakh – ₹3 lakh + ₹5 lakh + ₹0.92 lakh – ₹1.53 lakh + ₹17.10 lakh – ₹330 lakh = 0

L = ₹123.30 lakh

Working Notes

1. Present value of lease rentals:

   = L [PVIFA (14,5)] = 3.433 L
2. Present value of tax on lease rental:

   = 0.35 × L × PVIFA (14,5) = 1.202 L
3. Present value of tax shield on depreciation:

   = [₹82.50 lakh × PVIF (14,1) + ₹61.90 lakh × PVIF (14,2) + ₹46.40 lakh × PVIF (14,3) + ₹34.80 lakh × PVIF (14,4) + ₹26.1 lakh × PVIF (14,5)] × 0.35 = [(₹82.50 × 0.877) + (₹61.90 × 0.769) + (₹46.40 × 0.675) + (₹34.80 × 0.592) + (₹26.1 × 0.519)] × 0.35 = ₹64.90 lakh
4. Present value of tax shield on initial direct costs:
   = ₹3 lakh × 0.35 × PVIF (14,1) = ₹0.92 lakh
5. Present value of tax shield on management fee:
   = 0.35 × ₹5 lakh × PVIF (14,1) = ₹1.53 lakh
6. Present value of salvage value:
   = ₹33 lakh × PVIF (14,5) = ₹17.10 lakh

Illustration 2.18

The Hypothetical Leasing Ltd (HLL) has under consideration a lease proposal. Its post-tax cost of funds is 14 per cent and it has to pay central sales tax (CST) @ 10 per cent of the basic price of the capital equipment on inter-state purchases. The marginal tax rate of the HLL is 35 per cent. The details of the proposed lease are given below:

- Primary lease period, 3 years
- Tax relevant depreciation, 40 per cent on written down basis (with other assets in the block)
- Residual value, 8 per cent of the original cost.
  - **(a)** If the monthly lease rentals are collected in advance, what is the minimum lease rental the HLL should charge for per ₹1,000 for the lease?
  - **(b)** What is the minimum monthly lease rental for a lease proposal costing ₹660 lakh (including CST at 10 per cent)?

Solution

(a) Minimum Monthly Rental Per ₹1,000

1.	Investment cost	₹1,000.00
2.	Present value of lease rentals (working note 1)	29.93 L
3.	Present value of tax shield on rentals (2)	9.75 L
4.	Present value of tax shield on depreciation (3)	24.48
5.	Present value of residual value (4)	54.00

The break-even level of rental (L) can be derived from the equation (NAL = 0)

= – ₹1,000 + 29.93L – 9.75L + ₹24.48 + ₹54 = 0

L = ₹35.90, that is, ₹35.90/₹1,000/month

(b) Minimum monthly lease rental for the proposal costing ₹660 lakh = ₹660 lakh × 0.03590 = ₹23.69 lakh

Working Notes

1. Present value of lease rentals:

   = 12 L × PVIFAm (14,3) = 12 L × 2.322 × 1.0743 = 29.93 L

2. Present value of tax shield on lease rentals:

   = 12L × PVIFA (14,3) × 0.35 = 12 L × 2.322 × 0.35

   = 9.75L

3. Present value of tax shield on depreciation:

   = [₹400 × PVIF (14,1) + ₹240 × PVIF (14,2) + ₹144 × PVIF (14,3) × 0.35

   = (₹400 × 0.877) + (₹240 × 0.769) + (₹144 × 0.675) = ₹24.48

4. Present value of residual value:

   = ₹1,000 (0.08) × PVIF (14,3) = ₹54

Negotiation of Lease Rentals The break-even rentals of the lessor and the lessee represent the range of acceptable level of rentals. The break-even lease rental of the lessor sets the lower limit, while the break-even rental of the lessee sets the upper limit of the range. The actual rental has to be negotiated within the range. A rental within the range implies a positive NAL/NPV(L) both for the lessor and the lessee. In a way, the difference between the break-even lease rental for the lessor and the lessee (i.e., the spread) represents the bargaining area for the negotiation of the actual lease rental for a lease proposal.

Illustration 2.19

Consider the following facts:

(A) About the lessee (Hypothetical Industries Ltd):

- Tax relevant of depreciation, 40 per cent
- Useful life of an asset, 5 years
- Estimated salvage value, Nil
- Marginal cost of debt, 17 per cent (pre-tax)
- Marginal cost of capital, 14 per cent
- Marginal tax rate, 35 per cent.

(B) About the Hypothetical Leasing Ltd (lessor):

- Minimum lease rental, ₹25/₹1,000/month, (i.e., ₹25 ptpm), payable in advance
- Required minimum post-tax return on lease portfolio, 13 per cent.

  (a) What is the break-even rental per ₹1,000 for (1) the lessee and (2) the lessor?

  (b) What is the (1) minimum lease rental of the lessee and (2) the maximum lease rental of the lessor on an investment cost of ₹210 lakh? The equipment can be assumed to be imported without any sales tax implication.

  (c) Assuming the equipment is indigenously available, the CST on inter-state sale is 4 per cent for the lessee and 10 per cent for the lessor on the basic price. Compute the monthly break-even lease rental for the lessee and the lessor.

Solution

(a) (1) Break-Even Lease Rental for the Lessee

1.	Investment cost	₹1,000.00
2.	Present value of lease rentals (note 1)	41.84 L
3.	Present value of tax shield on lease rental (2)	14.42 L
4.	Present value of tax shield foregone on depreciation (3)	248.64
5.	Present value of the interest tax shield on displaced debt (4)	4.75 L

The break-even rental is given by the equation: ₹1,000 – 41.84 L + 14.42 L – ₹248.64 – 4.75 L = 0

L = ₹23.36,

where L represents rental per thousand per month (ptpm).

Working Notes

1. Present value of lease rentals:

   = 12L × PVIFAm (17,5) = 12L × 1.09 × 3.199 = 41.84L

2. Present value of tax shield on lease rentals:

   = 12L × PVIFA (14,5) × 0.35 = 14.42L

3. Present value of tax shield foregone on depreciation:

   = [₹400 × PFIV (14,1) + ₹240 × PVIF (14,2) + ₹144 × PVIF (14,3) + ₹86 × PVIF (14,4) + ₹52 × PVIF (14,5)] × 0.35 = ₹248.64

4. Present value of interest tax shield on displaced debt:

   = [6.03 L × PVIF (14,1) + 5.02 L × PVIF (14,2) + 3.83 L × PVIF (14,3) + 2.44 L PVIF (14,4) + 0.84 L × PVIF (14,5)] × 0.35 = 4.75 L

(Displaced) Debt Repayment Schedule

Year	*Amount outstanding at the beginning*	*Capital content*	*Interest content*	*Instalment*
1	41.84 L	5.97 L	6.03 L	12 L
2	35.87 L	6.98 L	5.02 L	12 L
3	28.89 L	8.17 L	3.83 L	12 L
4	20.72 L	9.56 L	2.44 L	12 L
5	11.16 L	11.16 L	0.84 L	12 L

(a) (2) Break-even Lease Rental for the Lessor

1.	Initial investment	₹1,000.00
2.	Present value of lease receipts (working note 1)	45.12 L
3.	Present value of tax liability on lease receipts (2)	14.772 L
4.	Present value of depreciation tax shields (3)	252.933

The break-even rental for the lessor can be obtained from the equation:

45.12 L – ₹1,000 – 14.772L + ₹252.933 = 0

= 35.366L – ₹747.067 = 0

L = ₹24.62 (ptpm)

Working Notes

1. Present value of lease receipts:

$= 12\text{ L} \times \text{PVIFAm}(13,5) = 12\text{ L} \times 1.069 \times 3.517 = 45.12\text{ L}$

2. Present value of the tax liability on lease receipts:

$= [(12\text{ L} \times 0.35) \times \text{PVIFA}(13,5)] = 14.772\text{ L}$

3. Present value of depreciation tax shields:

$= [₹400 \times \text{PVIF}(13,1) + ₹240 \times \text{PVIF}(13,2) + ₹144 \times \text{PVIF}(13,3) + ₹86 \times \text{PVIF}(13,4) + ₹52 \times \text{PVIF}(13,5)] \times 0.35 = [(₹400 \times 0.0885) + (₹240 \times 0.783) + (₹144 \times 0.693) + (₹86 \times 0.613) + (₹52 \times 0.543)] \times 0.35 = ₹252.933$

(a) (1) Minimum Lease Rental of the Lessor = ₹210 lakh × ₹24.62 ptpm = ₹5.17 lakh

(b) (2) Maximum Lease Rental of the Lessee = ₹210 lakh × ₹23.36 ptpm = ₹4.91 lakh

Thus, the break-even rental required by the lessor (₹5.17 lakh) is more than the maximum rental (₹4.91 lakh) the lessee is willing to pay. There is a positive difference/spread and there is scope for negotiating the lease rental (bargaining area).

(c) (1) Monthly Break-even Lease Rental for the Lessee: = ₹218.4 lakh (₹210 lakh + 4% sales tax) × ₹0.02336 = ₹5.10 lakh

(2) Monthly Break-even Rental for the Lessor: = ₹221 lakh (₹210 lakh + 0.10 sales tax) × ₹0.02462 = ₹5.44 lakh.

The spread is positive and there is room for negotiation of a lease package financially attractive to the lessor and the lessee.

Structuring of Lease Rentals The lease rentals are structured to suit the lessors and the lessees. From the lessee's angle, the structure of the lease rental should synchronise with his operational cash flow pattern. The dimensions of the synchornisation between the lease rental and the pattern of cash flows of the lessee are periodicity of rentals, lease rentals in advance/arrear, profile of rentals and so on. The lease rentals should ensure a given/expected return to the lessor. The structuring of an appropriate lease rental, both for pre-tax as well as post-tax rates of return is illustrated below.

Illustration 2.20

The pre-tax cost of capital of the Hypothetical Leasing Ltd (HLL) is 20 per cent. Its expected pre-tax return on investment is 23 per cent. Assuming a non-cancellable lease period of five years, determine the lease rental per ₹1,000 so as to give to the HLL its expected return.

Solution

While computing the pre-tax return, the lease may be viewed as a loan bearing interest equal to the expected rate of return by the lessor payable in equal instalments corresponding to the lease period. Or, it may be visualised as a series of future cash inflows such that discounted by the expected rate of return, their present value equals the investment in the lease transactions.

Computation of Lease Rental

Year	Lease rental	Present value (PV) factor (0.23)	Present value (PV) of rental [(2) × (3)]
(1)	(2)	(3)	(4)
1	L	0.813	0.813 L
2	L	0.661	0.661 L
3	L	0.537	0.537 L
4	L	0.429	0.427 L
5	L	0.355	0.355 L
Total			2.803 L

Thus, L 2.803 = ₹1,000

L = ₹356.7

The pre-tax return of 0.23 for HLL has two components: (1) pre-tax cost of capital, 0.20 (₹681.3) and a net profit of 0.03 (₹102.2) as depicted in Table 2.6.

Table 2.6 Cost of Capital and Profit Components of Lease Rentals

Year	Lease rental	Investment in lease	Cost of capital [0.20 ×(3)]	Net profit [0.03 × (3)]	Gross expected return (0.23) [(4) + (5)]	Principal recovery [(2) – (6)]	Balance [(3) – (7)]
1	2	3	4	5	6	7	8
1	₹356.7	₹1,000.0	₹200.0	₹30.0	₹230.0	₹126.7	₹873.3
2	356.7	873.3	174.7	26.2	209.9	155.8	717.5
3	356.7	717.5	143.5	4.5	165.0	191.7	525.8
4	356.7	525.8	105.1	15.8	120.9	235.8	290.0
5	356.7	290.0	58.0	8.7	66.7	290.0	—
Total	1,783.5		681.3	102.2	783.5	1,000.0	

Illustration 2.21 *(Quarterly Rental)*

For the facts relating to the HLL, in **Illustration 2.20,** compute the quarterly rental to earn a pre-tax return of 23 per cent.

Solution

The required rental (L) can be derived from the equation:

4L × PVIFAm (23,5) = ₹1,000 = 4L × 2.803 × 1.1206 = ₹1,000

L = ₹79.62 (₹1,000/12.56)

Illustration 2.22 *(Rental Paid in Advance)*

For the facts in **Illustration 2.20** assume the rental is paid in advance, that is, at the beginning of each year and compute the annual lease rental.

Solution

The required rental (L) can be obtained by the equation:

L × PVIFA (23,4) + PVIF (23,0) = ₹1,000

= 3.448 L = ₹1,000

L = ₹290

Profile of Lease Rentals The lease rentals may be quoted in several forms, e.g., (1) level or constant each period (2) stepped where the lease rental increases at a fixed percentage over the earlier period, (3) deferred, where the rental is deferred for certain periods to accommodate gestation period, (4) ballooned under which major part of the rentals is collected in a lumpsum at the end of the primary period, (5) bell-shaped where the rental is gradually stepped up, rises to its peak in the middle of the lease period and then gradually stepped down and (6) zig-zag where the rental is stepped up in one period and then stepped down in the succeeding period and so on.

Illustration 2.23 *(Stepped Rentals)*
The pre-tax expected rate of return for the Hypothetical Leasing Ltd (HLL) is 24 per cent for a five-year non-cancellable lease. The annual lease rental would be stepped at 10 per cent over the period. Compute the lease rental per ₹1,000.

Solution

Computation of Stepped Rentals

Year	*Lease rental*	*PVIF (0.24)*	*(PV) of rental [(2) × (3)]*
(1)	*(2)*	*(3)*	*(4)*
1	L (1.00)	0.806	0.806 L
2	L (1.10)	0.650	0.715 L
3	L $(1.10)^2$	0.524	0.635 L
4	L $(1.10)^3$	0.423	0.564 L
5	L $(1.10)^4$	0.341	0.499 L
Total			3.217 L

3.217 L = ₹1,000
L = ₹310.8

Schedule of lease rental:

Year	1	₹310.8
	2	341.9
	3	376.1
	4	413.4
	5	454.8

Illustration 2.24 *(Deferred Rentals)*
Assume for the HLL in **Illustration 2.23** that the lease rentals are deferred for the first two years. Compute the lease rentals per ₹1,000.

Solution

The rentals for the first two years is zero. For years 3-5, the present value of lease rentals = 1.2886L = ₹1,000. Therefore, L = ₹776.1.

Illustration 2.25 *(Bell-Shaped Rentals)*
For the facts in **Illustration 2.23**, the lease rentals will be stepped up by 25 per cent and then by 40 per cent and subsequently stepped down in the reverse order in the fourth and the fifth years. Compute the lease rentals per ₹1,000.

Solution

Computation of Lease Rental (Bell Shaped)

Year	*Lease rental*	*PV factor (0.24)*	*(PV) of lease rental*
(1)	*(2)*	*(3)*	*(4)*
1	L	0.806	0.806 L
2	L (1.25)	0.650	0.813 L
3	L (1.40)	0.524	0.734 L
4	L (1.25)	0.423	0.529 L
5	L (1.40)	0.341	0.477 L
Total			3.358L = ₹1,000

L = ₹310.2 (₹1,000/3.358)

Schedule of lease rental:

Year 1	₹297.8
2	372.2
3	416.9
4	372.2
5	416.9

Illustration 2.26 *(Lease Rentals at Post-tax Rate)*

The following facts relate to a lease proposal:

Lease period, 5 years

Depreciation, 0.40

Tax, 0.50

Pre-tax expected rate of return, 0.30

Compute the post-tax lease rentals payable in arrears per ₹1,000.

Solution

Computation of Post-tax Lease Rentals

Year	*Investment (WDV)*	*Depreciation (0.40)*	*Tax savings on depreciation*	*Lease rental*	*PV factor (0.15)*	*PV of tax savings*	*PV of lease rental*
0	₹1,000	—	—	—	—	—	—
1	1,000	₹400	₹200	L	0.870	₹173.9	₹0.870 L
2	600	240	120	L	0.756	90.7	0.756 L
3	360	144	72	L	0.658	47.4	0.658 L
4	216	86	43	L	0.572	24.7	0.572 L
5	130	52	26	L	0.497	12.9	0.497 L
Total						349.6	3.253 L

3.253 L = ₹1,000 – ₹349.6

L = ₹194

RECAPITULATION

- Conceptually, a lease is a contractual arrangement/transaction in which the owner of an asset/equipment (lessor) provides the asset for use to another/transfers the right to use the asset to the user (lessee) for an agreed period of time in return for periodic payment (rental). At the end of the lease period the asset reverts back to the owner. Leasing essentially involves the divorce of ownership from the economic use of an equipment/asset.
- Leasing can be classified into four categories: **(i)** Finance and operating lease, **(ii)** Direct lease and sale and lease back lease, **(iii)** Single investor and leveraged lease and **(iv)** Domestic lease and international lease which can be further sub-classified as cross-border and import lease. Of these, the classification of lease into finance and operating is of fundamental importance. The distinction between the two types of leases is based on the extent to which the risks and rewards of ownership are transferred from the lessor to the lessee. Risk means the possibility of loss arising out of under-utilisation or technological obsolescence of the leased asset, while reward refers to the incremental net cash flows generated by the usage of the equipment over its economic life and the realisation of the anticipated residual value on the expiry of the economic life. If a lease transfers a substantial part of the risks and rewards, it is called finance lease; otherwise it is operating lease. The cut-off criterion in India is that if the lease term exceeds 75 per cent of the useful life of the asset or if the present value of the minimum lease rentals exceeds 90 per cent of the fair market value of the equipment at the inception of the lease, the lease is classified as finance lease.
- The major players in leasing in India are independent leasing companies, other finance and investment companies, manufacturer-lessors, development finance institutions, in-house lessors and banks.
- As far as the product profile of leasing in India is concerned, by and large leases, are of finance type and operating leases are not very popular. The lease rentals are payable generally in equated monthly instalments at the beginning of every month. The rental structures are related to the requirements of the lessee and projected cash flow pattern. They are structured so as to recover the entire investment during the primary period. Further, most of the transactions are direct lease; sale and lease back type are rare. Equipment leasing covers a wide range of assets and equipment but project leasing and cross-border leasing are not popular.
- The significance of lease financing is based on several advantages both to the lessors and the lessees such as flexibility, user-orientation, tax-based benefits, convenience, expeditious disbursements of funds, hundred per cent financing and better utilisation of own funds and so on. However, the advantages of off-balance sheet financing in the sense that it does not affect the debt capacity of the firm is not real.
- There is no law/legislation/act/direction which exclusively applies to equipment leasing. Such transactions are governed by the relevant provisions of number of acts/laws/directions and so on. Some of these are quite intricate involving fine points of law.
- Since the features of an equipment lease transaction closely resemble the features of bailment, the provision of *Contract Act* in general and those relating to contracts of bailment in particular apply to equipment lease transactions. The implied obligations of the bailor (lessor) and bailee (lessee) are defined by this enactment. However, one implied obligation of lessor, namely, fitness of the bailed goods is inapplicable. As in a typical equipment lease transaction, the lessor plays the role of a financier, the implied obligation of the lessor (bailor) relating to fitness of the goods/assets is expressly negatived by the lease agreement.

- Some provisions of Motor Vehicle Act and Stamp Act also apply to equipment leasing.
- With a view to coordinate, regulate and control the functioning of all the NBFCs, RBI has issued directions under the RBI Act. These also apply to leasing companies.
- The lease documentation process is fairly simple. It starts with the submission of a proposal by the lessee. On approval, the lessor issues a letter of offer detailing the terms and conditions of the lease. The letter of offer is accepted by the lessee by passing a Board resolution. This is followed by the lessor and lessee entering into a formal lease agreement.
- The lease agreements provide for a number of obligations on the part of the lessee which do not form part of his implied obligations under the Contract Act. While the exact contents of the lease contract differ from case to case, a typical lease contract provides for nature of lease, description of the equipment, delivery and re-delivery, period, lease rentals, repairs and maintenance, alteration, peaceful possession, charges, indemnity clause, inspection, prohibition of sub-leasing, defaults and remedies and so on.
- An appropriate method of accounting is necessary for income recognition for the lessor and asset disclosure for the lease. Recognising the need for a proper accounting system for lease transactions, IAS-17 was issued in 1982. The ICAI issued a guidance note in 1988 which favoured the adoption of IAS-17 in the long run but recommended for the interim period a set of accounting guidelines in the context of the state of leasing industry in India and the income-tax framework. However, due to court intervention its recommendatory character was kept in abeyance. After judicial pronouncement, the ICAI Revised Guidances Notes was issued in September 1995. The Reserve Bank of India constituted a study group on the guidance note and on its recommendations made it compulsory on the leasing companies. The ICAI issued the AS-19: Lease based on IAS-17 in January 2001.
- According to the IAS-17, in case of operating lease, the lease has to allocate the aggregate lease rental over the lease term on straight line basis or any other systematic basis which better reflects the pattern of the timing of the benefit of the use of the equipment to the lessee (user). Finance lease should be shown in the balance sheet of lessee as an asset to properly account for the economic resources and as a liability to reflect the level of its obligations. It stipulates that
  - The asset and liability should be recorded at the inception of the lease at an amount equal to the fair market value of the asset or the present value of the minimum lease payment whichever is lower;
  - The lease rentals should be apportioned into interest and capital components using the effective rate of interest/actuarial method or any other acceptable approximation (e.g., sum of the year's digits);
  - The interest/finance charge should be expensed;
  - The leased asset should be depreciated in line with the depreciation policy of the firm in respect of owned asset. It must be fully depreciated over the lease term or the useful life whichever is shorter.
- As regards the lessor, the IAS-17 guidelines require that a finance lease should be recorded as a receivable in his books equal to the net investment in lease; that is, gross investment in lease minus unearned finance income. The unexpired finance income should be allocated according to effective rate of interest method to the relevant accounting period.
- According to AS-19, the lessee should recognise the finance lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset or the present value of the minimum lease payments using the interest implicit in the lease/incremental borrowing rate of the lessee as the discount factor. The lease payments should be apportioned between finance charge and the reduction in the outstanding liability. The finance charge should be

allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The depreciation policy for a leased asset should be consistent with that for owned assets. The asset should be fully depreciated over the lease term or its useful life whichever is shorter.

- As regards operating leases, lease payments should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term or another systematic basis to represent the time pattern of the users' benefit.
- The lessor should recognise assets given under a finance lease in its balance sheet as receivables at an amount equal to the net investment in the lease. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease. The manufacturer-dealer lessor should recognise the transaction of sale and selling profit/loss in accordance with policy followed for outright sales. Initial direct costs should be recognised as a expense at the inception of the lease.
- The assets given on operating lease by a lessor should be shown under fixed assets. Lease income should be recognised on straight line basis or other systematic basis representing the time pattern in which the benefit derived is diminished.
- The depreciation of leased assets should be on a basis consistent with the normal depreciation policy for similar assets.
- If a sale and lease back transaction results in a finance lease, any excess/deficiency of sale proceeds over the carrying amount should not be immediately recognised as income/loss by a seller-lessee but deferred/amortised over the lease term. If it results in an operating lease established at a fair value, any profit/loss should be recognised immediately. If the sale price is below fair value, profit/loss should be recognised immediately. However, if the loss is compensated by future lease payments at below market price, it should be deferred/amortised in proportion to the lease payments over the period the asset is expected to be used. The excess of sale price over fair value should be amortised. If the fair value at the time of a sale and lease back transaction is less than the carrying amount of the asset, a loss equal to the difference should be recognised immediately.
- The tax aspects of leasing pertain to both income tax and sales tax.
- Leasing, as a finance device, has income tax implications for, and offers tax benefits both to, the lessor and the lessee. The main attraction of leasing device to the lessor is the deduction from his taxable income. The lease rental income of the lessor is included under the head Profits and Gains of Business and Profession for the purpose of assessing the income-tax liability. While computing the income from leasing, deprecation on the leased asset is allowed as a deduction to determine the taxable income. Depreciation claim by the lessor, thus, involves tax shield on the leased asset. The deductability of depreciation on leased assets is not explicitly provided by the Income Tax Act but is deduced from rulings by courts and appellate tribunals which accept that the leased assets are deemed to be used in the lessor's business of leasing of assets. However, other than the shield on depreciation, the lessor is not eligible for any other investment-related tax-shield.
- The income tax considerations for the lessees are claims for lease rentals and the operating costs of the leased assets being treated as deductible expenses from taxable income. The lease rentals and the incidental expenses such as repairs and maintenance, insurance and finance charge are treated as normal business expenditure.
- Leasing can be used as a tax planning device by **(1)** exploiting the flexibility in structuring lease rentals, or (2) transferring the investment-related tax shield from a firm which has low capacity to absorb such tax shields to a lessor who can absorb them. Through such transfer of unabsorbed capital allowance to the lessor, the firm transferring the tax shields can benefit through a reduction in the lease rentals.

- A lease transaction attracts sales tax at three stages: **(1)** purchase of equipment by the lessor, **(2)** transfer of the right to a lessee to use the equipment for a lease rental and **(3)** sale of asset by the lessor at the end of the lease period.
- A finance lease can be evaluated either as an investment alternative or as a financing alternative depending upon the information available about the financial desirability of a capital investment. Given the need for investment in a project that an investment decision has already been made, leasing should be evaluated as a financing alternative to borrow and buy. The decision-criterion is the net present value of leasing [NPV(L)] or net advantage of leasing (NAL). The appropriate discount rate is the marginal cost of capital for all cash flows other than lease payments. The lease payments should be discounted using the pre-tax cost of debt. In operational terms NAL/NPV(L):

  = Investment cost

  Minus Present value of lease payments discounted by the pre-tax cost of debt (Kd)

  Plus present value of tax shield on lease payments discounted by the marginal cost of capital (Kc)

  Minus Management fee

  Plus Present value of the tax shield on management fee discounted by Kc

  Minus Present value of tax shield on depreciation discounted by Kc

  Minus Interest tax shield discounted by Kc

  Minus Residual value discounted by Kc
- Alternatively, the **(i)** present values or **(ii)** IRR of cash outflows after tax under the leasing and buying alternative should be used as decision-criterion.
- The break-even lease rental is the rental at which the lessee is indifferent to the choice between the option of leasing and buying and borrowing. At this level the NAL is zero. In a way, it represents the maximum lease rental which the lessee is willing to pay and contributes an important input in the negotiation/determination of the lease rental.
- From the point of view of the lessor, the break-even lease rental is the minimum which he can accept in lieu of leasing the equipment. At this level of rental, the NAL/NPV(L) to the lessor is zero. The lease-related cash flow stream relevant to the computation of the NAL are initial investment and often direct costs, income tax on lease payments, management fee, lease payments, tax shield on depreciation and residual value. The discount rate used is the marginal cost of funds/capital to the lessor based on the debt-equity base in the target capital structure.
- The lease rental is determined on the basis of a negotiation between the lessor and the lessee. The difference between the break-even lease rentals to the lessee and the lessor represents the spread/range for negotiation of lease rentals. A lease rental within the range ensures a positive NAL/NPV(L) both to the lessor and the lessee. The NAL to a lessor = Present value of lease payment **plus** (1) present value of management fee, (2) present value of depreciation tax shield, (3) present value of net salvage value, (4) present value of tax shield on initial direct costs, **minus**, (1) initial investment, (2) present value of tax on lease payments, (3) present value of tax on management fee, (4) present value of initial direct cost.
- The lease rentals are structured to suit the lessors and the lessees. From the lessee's angle, the structure of the lease rental should synchronise with his operational cashflows pattern. The dimensions of synchronisation between the lease rental and the cashflows pattern are periodicity of rentals, lease rentals in advance/arrear, profile of rentals and so on. The lease rental should ensure a given/expected return to the lessor.

SOLVED PROBLEMS

P.2.1 The Hypothetical Equipments Ltd (HEL) has recently leased assets worth ₹2,500 lakh from the Hypothetical Leasing Ltd (HLL). The following facts are available:

(1) Lease period, 9 years, of which the first 6 years constitute the lease term;

(2) Annual lease rates: First 6 years, ₹360/₹1,000; Next 3 years, ₹15/₹1,000;

(3) Incremental borrowing rates for HEL, 22 per cent.

(a) Assuming 14 years as the average economic life of the equipment, is the lease a finance lease or an operating lease"

(b) Assuming further **(i)** physical life of 14 years, **(ii)** technological life of 9 years and **(iii)** product-market life of 11 years, how will you classify the lease?

Solution

A lease is finance lease if one of the following two conditions is satisfied:

(1) The lease term exceeds 75 per cent of the useful life of the equipment (the minimum of physical useful life, technological life and product market life).

(2) The PV of lease payments exceeds 90 per cent of the fair market value of the equipment (cost of equipment), the discount rate being incremental borrowing rate in the case of lessee and cost of capital in the case of lessor.

(a) **(i)** Term of lease is 9/14 years = 64 per cent.

(ii) Determination of PV of lease payment *(₹ in lakh)*

Year	*Lease payment*	*Discount factor (0.22)*	*Total PV*
1 – 6	900	3.167	₹2,850
7 – 9	37.5	0.62*	23
			2,873

*(0.249 + 0.204 + 0.167)

The lease is finance lease as the PV of lease payment exceeds the cost of asset.

(b) Finance lease as term of lease is 9/9 = 100 per cent.

P.2.2 The following data are furnished by the Hypothetical Leasing Ltd (HLL):

Investment cost	₹500 lakh
Primary lease term	5 years
Estimated residual value after the primary period	Nil
Pre-tax required rate of return	24 per cent

The HLL seeks your help in determining the annual lease rentals under the following rental structures:

(a) Equated, **(b)** Stepped (an annual increase of 15 per cent), (c) Ballooned (annual rental of ₹80 lakh for years 1–4) and (d) Deferred (2 years deferment period).

You are required to compute the relevant annual rentals.

Solution

(a) Equated annual lease rentals, *Y*:

$$Y = \text{Investment cost/PVIFA (24, 5 years)}$$
$$= ₹500 \text{ lakh}/2.745 = ₹182.15 \text{ lakh}$$

(b) Stepped lease rental (assuming annual increase of 15 per cent annually), Y:

$Y \times \text{PVIF}(24, 1) + (1.15)Y \times \text{PVIF}(24, 2) + (1.15)^2 Y \times \text{PVIF}(24, 3) + (1.15)^3 Y \times \text{PVIF}(24, 4) + (1.15)^4 Y \times \text{PVIF}(24, 5) = ₹500$ lakh.

Or $0.806Y + 0.7475Y + 0.693Y + 0.6433Y + 0.5894Y = ₹500$ lakh

Or $3.4792Y = ₹500$ lakh or $Y = ₹500 \text{ lakh}/3.4792 = ₹143.71$ lakh

Lease rentals (year-wise)

(₹ lakh)

Year	*1*	*2*	*3*	*4*	*5*
Lease rent	143.71	165.26	190.05	218.56	251.34

(c) Ballooned lease rental (₹80 lakh for years, 1 – 4)

$$₹80 \text{ lakh} \times \text{PVIFA}(24, 4), + Y \times \text{PVIF}(24, 5) = ₹500 \text{ lakh}$$
$$₹80 \text{ lakh} \times 2.404 + 0.341Y = ₹500 \text{ lakh}$$
$$0.341Y = ₹500 \text{ lakh} - ₹192.32 \text{ lakh}$$
$$= ₹307.68 \text{ lakh}$$

or $$Y = ₹307.68/0.341 = ₹902.29 \text{ lakh}$$
(ballooned payment)

(d) Deferred lease rental (deferment of 2 years)

Denoting *Y* as the equated annual rental to be charged between years 3–5,

$$Y \times \text{PVIF}(24, 3) + Y \times \text{PVIF}(24, 4) + Y \times \text{PVIF}(24,5) = ₹500 \text{ lakh}$$
$$0.524\,Y + 0.423\,Y + 0.341Y = ₹500 \text{ lakh}$$
$$Y = ₹500 \text{ lakh}/1.288 = ₹388.20 \text{ lakh.}$$

P.2.3 ABC Machine Tool Company Ltd is considering the acquisition of a large equipment to set up its factory in a backward region for ₹12,00,000. The equipment is expected to have an economic useful life of 8 years. The equipment can be financed either with an 8-year term loan at 14 per cent interest, repayable in equal instalments of ₹2,58,676 per year, or by an equivalent amount of lease rent per year. In both cases, payments are due at the end of the year. The equipment is subject to the straight line method of depreciation for tax purposes. Assuming no salvage value after the 8-year useful life and 50 per cent tax rate, which of the financing alternatives should it select?

Solution

PV of cash inflows under leasing alternative

Year end	Lease payment after taxes (L) (1 – 0.5)	PV factor at 0.07 (K_d)	Total PV
1–8	₹1,29,338	5.971	₹7,72,277

Determination of interest and principal components of loan instalment

Year-end	Loan instalment	Loan at the beginning of the year	Payments		Principal out-standing at the end of the year (Col 3 – Col 5)
			Interest on loan (Col 3 × 0.14)	Principal re-payment (Col 2 – Col 4)	
1	2	3	4	5	6
1	₹2,58,676	₹12,00,000	₹1,68,000	₹90,676	₹11,09,324
2	2,58,676	11,09,324	1,55,305	1,03,371	10,05,953
3	2,58,676	10,05,953	1,40,833	1,17,843	8,88,110
4	2,58,676	8,88,110	1,24,335	1,34,341	7,53,769
5	2,58,676	7,53,769	1,05,528	1,53,148	6,00,621
6	2,58,676	6,00,621	84,087	1,74,589	4,26,032
7	2,58,676	4,26,032	59,644	1,99,032	2,27,000
8	2,58,676	2,27,000	31,676	2,27,000	—

PV of cash outflows under buying alternative

Year	Loan instalment	Tax advantage on		Net cash outflows [Col 2 – (Col 3 + Col 4)	PV factor at 0.07	Total PV
		Interest (1 × t)]	Depreciation (D × t)			
1	2	3	4	5	6	7
1	₹2,58,676	₹84,000	₹75,000	₹99,676	0.935	₹93,197
2	2,58,676	77,652	75,000	1,06,024	0.873	92,559
3	2,58,676	70,416	75,000	1,13,260	0.816	92,420
4	2,58,676	62,167	75,000	1,21,509	0.763	92,711
5	2,58,676	52,764	75,000	1,30,912	0.713	93,340
6	2,58,676	42,043	75,000	1,41,633	0.666	94,328
7	2,58,676	29,822	75,000	1,53,854	0.623	95,851
8	2,58,676	15,838	75,000	1,67,838	0.582	97,682
						7,52,088

Recommendation: The borrowing (buying) alternative of financing the purchase of the large equipment should be selected.

P.2.4 For **P.2.3** compute the net advantage of leasing (NAL) to the lessee assuming **(i)** The company follows written down value method of depreciation, the deprecation rate being 25 per cent; **(ii)** The corporate tax is 35 per cent; **(iii)** Post-tax marginal cost of capital (Kc) is 12 per cent and **(iv)** The company has several assets in the asset block of 25 per cent.

Solution

Computation of NAL to the lessee

Benefits from lease:	
Cost of the equipment (investment saved)	₹12,00,000
PV of tax shield on lease rentals (working note **2**)	4,49,786
Total	16,49,786
Cost of lease:	
PV of lease rental **(1)**	11,99,998
PV of tax shield foregone on depreciation **(3)**	2,72,333
PV of interest tax shield foregone on debt **(4)**	2,08,381
Total	16,80,712
NAL	(30,926)

Recommendation: The lease is not financially viable.

Working Notes

(1) PV of lease rentals: Lease rentals × PVIFA (14,8) = ₹2,58,676 × 4.639 = ₹11,99,998.

(2) PV of tax shield on lease rentals: Lease rentals × tax rate × PVIFA (12,8) = ₹2,58,676 × 0.35 × 4.968 = ₹4,49,786

(3) PV of tax shield foregone on depreciation

Year	*Interest*	*Tax shield*	*PV factor (at 0.12)*	*Total PV*
1	₹3,00,000	₹1,05,000	0.893	₹93,765
2	2,25,000	78,750	0.797	62,764
3	1,68,750	59,062	0.712	42,052
4	1,26,562	44,297	0.636	28,173
5	94,922	33,223	0.567	18,837
6	71,191	24,917	0.507	12,633
7	53,393	18,688	0.452	8,447
8	40,045	14,016	0.404	5,662
				2,72,333

(4) PV of interest tax shield

Year	*Interest*	*Tax shield*	*PV factor (at 0.12)*	*Total PV*
1	₹1,68,000	₹58,800	0.893	₹52,508
2	1,55,305	54,357	0.797	43,322
3	1,40,833	49,292	0.712	35,096
4	1,24,335	43,517	0.636	27,677
5	1,05,528	36,935	0.567	20,942
6	84,087	29,430	0.507	14,921
7	59,644	20,875	0.452	9,436
8	31,676	11,087	0.404	4,479
				2,08,381

P.2.5 For facts in **P.2.4**, determine the break-even lease rentals (BELR) for the lessee.

Solution

Computation of BELR

Benefits from lease:	
Cost of the equipment	₹12,00,000
PV of tax shield on lease rentals (working note 2)	1.62365
Cost of lease:	
PV of lease rentals (note 1)	4.639L
PV of tax shield foregone on depreciation	2,72,333
PV of interest tax shield foregone on debt	2,08,381

$$\text{BELR (L)} = 4.639L + ₹2{,}72{,}333 + ₹2{,}08{,}381 = 1.62365L + ₹12{,}00{,}000$$

$$4.639L - 1.62365L = ₹12{,}00{,}000 - ₹4{,}80{,}714$$

$$L = ₹7{,}19{,}286/3.01535 = ₹2{,}38{,}541$$

Working Notes

(i) PV of lease rentals: L × PVIFA (14,8) = 4.639 × L = 4.639*L*

(ii) PV of tax shield on lease rentals: L × PVIFA (14,8) × tax rate = 4.639*L* × 0.35 = 1.62365L

P.2.6 Hypothetical Limited is contemplating having an access to a machine for a period of 5 years Discussions with various financial institutions have shown that the company can have the use of machine for the stipulated period through leasing arrangement, or the requisite amount can be borrowed at 14 per cent to buy the machine. The firm is in the 50 per cent tax bracket. In case of leasing, the firm would be required to pay an annual end-of-year rent of ₹1,20,000 for 5 years. All maintenance, insurance and other costs are to be borne by the lessee.

In the case of purchase of the machine (which costs ₹3,43,300), the firm would have a 14 per cent, 5-year loan, to be paid in 5 equal instalments, each instalment becoming due at the end of each year. The machine would be depreciated on a straight line basis for tax purposes, with no salvage value.

Advise the company regarding the option it should go for, assuming lease rentals are paid **(a)** at the end of the year **(b)** in advance.

Solution

(a) PV of cash outflows under leasing alternative (year-end payment of lease rentals)

Year-end	*Lease payment (L) after tax*	*PV factor at after tax cost of debt (0.07)*	*Total PV of lease payment Col (2) × Col (3)*
1	*2*	*3*	*4*
1–5	₹60,000	4.100	₹2,46,000

Determination of the interest and principal components of loan instalment

Year-end	*Loan instalment*	*Loan at the beginning of the year*	*Payments*		*Principal outstanding at the end of the year (Col 3 – Col 5)*
			Interest on loan (Col 3 × 0.14)	*Principal re-payment (Col 2 – Col 4)*	
1	*2*	*3*	*4*	*5*	*6*
1	₹1,00,000*	₹3,43,300	₹48,062	₹51,938	₹2,91,362
2	1,00,000	2,91,362	40,791	59,209	2,32,153
3	1,00,000	2,32,153	32,501	67,499	1,64,654
4	1,00,000	1,64,654	23,052	76,948	87,706
5	1,00,000	87,706	12,294	87,706	—

**Determination of loan instalment:* Amount of loan/PVIFA(14,5) = ₹3,43,300/3.433 = ₹1,00,000.

PV of cash outflows after tax under buying (borrowing) alternative

Year-end	*Loan instalment*	*Tax advantage on interest payment*	*Tax advantage on depreciation*	*Net cash outflows (Col 2 – Col 3 + 4)*	*PV factor at after tax cost of debt (0.07)*	*PV of buying alternative*
1	*2*	*3*	*4*	*5*	*6*	*7*
1	₹1,00,000	₹24,031	₹34,330	₹41,639	0.935	₹38,932
2	1,00,000	20,395	34,330	45,275	0.873	39,525
3	1,00,000	16,250	34,330	49,420	0.816	40,327
4	1,00,000	11,526	34,330	54,144	0.763	41,312
5	1,00,000	6,147	34,330	59,523	0.713	42,440
Total						2,02,536

Recommendation: Since the PV of cash outflows for buying/borrowing (₹2,02,536) is lower than that of leasing (₹2,46,000), the buying alternative is preferred.

(b) PV of cash outflows under leasing alternative, when lease rental is paid in advance

Year-end	*Lease payment*	*Tax shield*	*Cash outflows after taxes*	*PV factor (0.07)*	*Total PV*
1	*2*	*3*	*4*	*5*	*6*
0	₹1,20,000	—	₹1,20,000	1.000	₹1,20,000
1–4	1,20,000	₹60,000	60,000	3.387	2,03,220
5	—	60,000	(60,000)	0.713	(42,780)
					2,80,440

Recommendation: Buying alternative is better.

P.2.7 For the Hypothetical Ltd in **P.2.6**, assume: **(i)** The company follows written down value method of depreciation, the depreciation rate being 25 per cent. There is no other asset in this asset block; **(ii)** The corporate tax rate is 35 per cent; **(iii)** Post-tax marginal cost of capital is 10 per cent; **(iv)** Salvage value, ₹40,000 at the end of 5th year.
Compute the NAL to the lessee if lease rentals are paid **(a)** at the end of the year **(b)** in advance.

Solution

(a) Computation of NAL (lease rentals are paid in arrear, that is, at the year-end)

Benefits from leasing:	
Cost of the machine	₹3,43,300
PV of tax shield on lease rentals (working note 2)	1,59,222
Total	5,02,522
Cost of leasing:	
PV of lease rentals (1)	4,11,960
PV of tax shield foregone on depreciation (3)	67,259
PV of interest tax shield foregone on debt (4)	43,810
PV of salvage proceeds (₹40,0000 × 0.621)	24,840
PV of tax shield on short-term capital loss (5)	24,018
Total	5,71,887
NAL	(69,365)

Recommendation: Leasing is not financially viable.

Working Notes

(1) PV of lease rentals: Lease rentals × PVIFA (14,5) = ₹1,20,000 × 3.433 = ₹4,11,960

(2) PV of tax shield on lease rentals: ₹1,20,000 × 0.35 × 3.791 = ₹1,59,222

(3) PV of shield foregone on depreciation

Year	*Depreciation*	*Tax shield*	*PV factor (at 0.10)*	*Total PV*
1	₹85,825	₹30,039	0.909	₹27,305
2	64,369	22,529	0.826	18,609
3	48,277	16,897	0.751	12,690
4	36,207	12,672	0.683	8,655
				67,259

*No depreciation is to be charged in 5th year as the block of assets ceases to exist.

(4) PV of interest tax shield

Year	*Interest*	*Tax shield*	*PV factor (at 0.12)*	*Total PV*
1	₹48,062	₹16,822	0.909	₹15,291
2	40,791	14,277	0.826	11,793
3	32,501	11,375	0.751	8,543
4	23,052	8,068	0.683	5,511
5	12,294	4,303	0.621	2,672
				43,810

(5) *PV of tax shield on short-term capital loss*: (Cost of machine – Accumulated depreciation – Salvage value) × t = (₹3,43,000 – ₹2,34,678 – ₹40,000) = ₹68,622 × 0.35 = ₹24,018.

(b) Computation of NAL (lease rentals are paid in advance)

Benefits from leasing:	
Cost of the machine	₹3,43,300
PV of tax shield on lease rentals	1,59,222
Total	5,02,522
Cost of leasing:	
PV of lease rentals (1)	4,69,680
PV of tax shield foregone on depreciation	67,259
PV of interest tax shield foregone on debt	43,810
PV of salvage proceeds	24,840
PV of tax shield on short-term capital loss	24,018
Total	6,29,607
NAL	(1,27,085)

Recommendation: Leasing is not financially viable.

Working Notes

(1) PV of lease rentals

Year	*Lease payment*	*PV factor (at 0.14)*	*Total PV*
0	₹1,20,000	1.000	₹1,20,000
1–4	1,20,000	2.914	3,49,680
			4,69,680

P.2.8 For the facts in **P.2.7**, determine the break even lease rental (BELR) for the lessee in both the situations.

Solution

(a) Computation of BELR (lease rentals paid in arrears)

Benefits from leasing:		
Cost of machine	₹3,43,300	
PV of tax shield on lease rentals (2)		1.20155L
Cost of leasing:		
PV of lease rentals (1)		3.433L
PV of tax shield foregone on depreciation	₹67,259	
PV of interest tax shield foregone on debt	43,810	
PV of salvage proceeds	24,840	
PV of tax shield on short-term capital loss	24,018	1,59,927

$$\text{BELR } (L) = ₹3{,}43{,}300 + 1.20155L = 3.433L + ₹1{,}59{,}927$$

$$2.23145L = ₹1{,}83{,}373$$

$$L = ₹82{,}177$$

Working notes

(1) PV of lease rentals: $L \times$ PVIFA (14,5) = $3.433 \times L = 3.433L$

(2) PV of tax shield on lease rentals: $3.433L \times$ tax rate = $3.433L \times 0.35 = 1.20155L$

(b) BELR (lease rents paid in advance)

Benefits from leasing:		
Cost of the machine	₹3,43,300	
PV of tax shield on lease rentals (2)		1.3699L
Cost of leasing		
PV of lease rentals (1)		3.914L
Other costs (already computed)	1,59,927	
BELR(L) = ₹3,43,300 + 1.3699L = 3.914L + ₹1,59,927		
2.5441L = ₹1,83,373		
L = ₹1,83,373/2.5441 = ₹72,078		

Working Notes

(1) PV of lease rentals = 3.914 × L = 3.914L, PVIFA = 2.914 (years, 1–4) + 1 (year 0) = 3.914

(2) PV of tax shield on lease rentals: 3.914L × 0.35 = 1.3699L

P.2.9 HB Finance Ltd is considering entering the computer leasing business. Miniframe computers can be purchased for ₹2,00,000 each and, in turn, be leased out at ₹50,000 per year for 8 years with the initial payment occurring at the end of the first year. You may ignore taxes and depreciation.

(i) Estimate the annual before expense and tax IRR for the company.

(ii) What should be the yearly payment charged by the company in order to earn a 20 per cent annual compound rate of return before expenses and taxes?

(iii) Assume that the firm uses the straight line method of depreciation, there is no salvage value, the annual expenses are ₹20,000, and the tax rate is 35 per cent. Calculate the yearly lease payment in order to enable the firm to earn 20 per cent after tax annual compound rate of return.

(iv) Further, assume that the computer has a resale value of ₹40,000. Determine the revised lease rent to enable the firm to earn 20 per cent.

Solution

(i) Determination of IRR

PB period = Cash outflows (₹2,00,000)/Cash inflows per year (₹50,000) = 4.000

The PV factor closest to 4.000 corresponding to 8 years is 4.078 at 18 per cent. Accordingly,

IRR = 18 per cent.

(ii) Desired lease rent to earn 20 per cent IRR before expenses and taxes

Cash outflows [(₹2,00,000)/PV factor annuity (20,8) 3.837] = ₹52,124

(iii) Desired lease rental to earn 20 per cent IRR after expenses and taxes

$PVfr[(X - E - D)(I - t) + D] = CO$

$PVfr$ = Relevant PV factor in terms of annuity of Re 1 for the life of the project (8 years) at the rate of discount (0.20)

X = Desired lease rent

E = Expenses

D = Depreciation

CO = Cost of the equipment

Substituting the values, we have,

$$3.837\,[(X - ₹20{,}000 - ₹25{,}000) \times (1 - 0.35) + ₹25{,}000] = ₹2{,}00{,}000$$
$$3.837\,[(X - ₹45{,}000) \times 0.65 + ₹25{,}000] = ₹2{,}00{,}000$$
$$3.837\,[0.65X - ₹29{,}250 + ₹25{,}000] = ₹2{,}00{,}000$$
$$2.49405X + ₹16{,}307 = ₹2{,}00{,}000$$
$$X = ₹2{,}16{,}307/2.49405$$
$$= ₹86{,}729$$

Confirmation Table

Lease rent		₹86,729
Less: Expenses	₹20,000	
Depreciation	25,000	45,000
EBT		41,729
Less: Taxes (0.35)		14,605
EAT (Earnings after taxes)		27,124
Add: Depreciation		25,000
CFAT (t = 1 – 8)		52,124
₹2,00,000 ÷ ₹52,124 = 3.837, or 0.20 (20 per cent)		

(iv) Desired lease rent to earn 20 per cent when salvage value is given

$PVfr\,[(X - E - D)(I - t) + D] + (PVfs \times SV) = CO$

$PVfs$ = PV factor of Re 1 in the year of the sale of plant (8 years) at 20 per cent rate of discount

SV = Salvage value

Substituting the values, we have

$$3.837\,[(X - ₹20{,}000 - ₹20{,}000) \times 0.65 + ₹20{,}000] + (₹40{,}000 \times 0.233) = ₹2{,}00{,}000$$
$$3.837\,[(X - ₹40{,}000) \times 0.65 + ₹20{,}000] + 9{,}320 = ₹2{,}00{,}000$$
$$3.837\,[0.65X - ₹26{,}000 + ₹20{,}000] + ₹9{,}320 = ₹2{,}00{,}000$$
$$2.49405X - ₹23{,}022 + ₹9{,}320 = ₹2{,}00{,}000$$
$$X = ₹2{,}13{,}702/2.49405 = ₹85{,}685$$

Confirmation Table

Lease rent		₹85,685
Less: Expenses	₹20,000	
Depreciation	20,000	40,000
EBT		45,685
Less: Taxes		15,990
EAT		29,695
Add: Depreciation		20,000
CFAT		49,695
CO – PV of salvage value/CFAT = ₹2,00,000 – ₹9,320/₹49,695 = 3.837 or 20 per cent.		

P.2.10 The Hypothetical Manufacturers Ltd (HML) has under consideration investment in a project. The cost of the equipment estimated to be ₹900 lakh plus 4 per cent central sales tax (CST). The useful life of the equipment is 5 years, with a salvage value of 40 per cent of the book value after 5 years. The depreciation relevant for tax purposes is 25 per cent. The HML has other assets in this block of 25 per cent. The investment is likely to generate an incremental earnings before depreciation, interest and tax of ₹720 lakh per annum for the first 3 years and ₹480 lakh per annum for the last 2 years.

The HML has two alternatives to choose from to finance the equipment:

Alternative I: Leasing of the equipment from the Hypothetical Leasing Ltd (HLL). The lease rental for a 5-year non-cancellable lease is ₹27 pmpt (per month per thousand) payable in arrears (at the end of the year). The purchase of the equipment by the HLL is subject to a CST of 10 per cent.

Alternative II: Borrow and buy the equipment at 20 per cent per annum. The debt is repayable in 5 equated annual instalment payable at the end of the year. The target debt-equity ratio of the HML is 2:1. Its cost of debt may be assumed to be 20 per cent while the cost of equity is 22 per cent. The marginal tax rate of HML is 35 per cent.

You are required to compute the BELR for the lessee (HML). Should it buy or lease the equipment?

Solution

Computation of BELR (L) for the lessee *(₹lakh)*

Benefits of leasing:	
Investment cost (saved)	936
PV of tax shield on lease rentals (working note 2)	13.75L
Cost of leasing:	
PV of lease rentals (note 1)	39.66L
PV of tax shield foregone on depreciation (3)	177.18
PV of the interest tax shield foregone on debt	6.58L
PV of salvage value (5)	178.21

₹936 lakh + 13.75L = 39.66L + 6.58L + ₹177.18 lakh + 178.12 lakh

Or 32.49L = ₹580.61 lakh or L = ₹580.61/32.49 = ₹17.87 lakh per month

Working notes

(1) PV of lease rentals: = 12L × $i/d^{(12)}$ × PVIFA(20,5) = 12L × 1.015 × 2.991 = 39.66L

(2) PV of tax shield on lease rentals: = $12L \times$ PVIFA (16*,5) $\times$ 0.35 = $13.75L$
*0.16 = (cost of debt, $0.13 \times 2/3$) + (cost of equity, $0.22 \times 1/3$)

(3) PV of tax shield foregone on depreciation *(₹lakh)*

Depreciation	*(Tax shield × PVf)*	*PV of tax shield*
234	(81.90 × 0.862)	70.6
175	(61.25 × 0.743)	45.51
132	(46.20 × 0.641)	29.61
99	(34.65 × 0.552)	19.13
74	(25.90 × 0.476)	12.33
		177.18

(4) PV of interest on tax shield:

(a) Equated annual instalment = Amount borrowed/PVIFA(20,5) = $39.66L/2.991$ = ₹$13.26L$

(b) Debt repayment schedule *(₹lakh)*

Year	*Amount outstanding at the beginning*	*Interest content (at 0.20)*	*Capital content*	*Instalment*
1	39.66*L*	7.93*L*	5.33*L*	13.26*L*
2	34.33*L*	6.87*L*	6.39*L*	13.26*L*
3	27.94*L*	5.59*L*	7.67*L*	13.26*L*
4	20.27*L*	4.05*L*	9.21*L*	13.26*L*
5	11.06*L*	2.20*L*	11.06*L*	13.26*L*

(c) PV of interest tax shield: $[(7.93L \times 0.862) + (6.87L \times 0.743) + (5.59L \times 0.641) + (4.05L \times 0.552) + (2.20L \times 0.476)] \times 0.35 = (6.84L + 5.10L + 3.58L + 2.24L + 1.05L) \times 0.35 = 6.58L$

(5) PV of salvage value: ₹936 lakh $\times$ 0.4 $\times$ 0.476 = ₹178.21 lakh

P.2.11 For the Hypothetical Manufacturers Ltd (HIM) of **P.2.10**, compute the NAL to the lessee. Is the lease economically viable?

Solution

Computation of NAL to the lessee *(₹lakh)*

Benefits of leasing:	
Investment cost (saved)	936
PV of tax shield on lease rentals (2)	367.57
Total	1,303.57
Cost of leasing:	
PV of lease rentals (working note 1)	1,064.93
PV of tax shield foregone on depreciation	177.18
PV of the interest tax shield foregone on debt (3)	176.73
PV of salvage value	178.21
Total	1,597.05
NAL (₹1,303.57 – ₹1,597.05)	(293.48)

Since NAL is negative, the lease is economically not viable.

Working notes

(1) PV of lease rentals: (₹990 lakh × 0.027 × 12 months) × i/d^{12} × PVIFA(20,5)
= ₹320.76 lakh × 1.11 × 2.991 = ₹1,064.93 lakh

(2) PV of tax shield on lease rentals: (₹320.76 lakh × 0.35) × PVIFA(16,5)
= ₹112.27 lakh × 3.274 = ₹367.57 lakh

(3) (a) Debt repayment schedule

Year	*Amount outstanding at the beginning*	*Interest content (at 0.20)*	*Capital content*	*Instalment**
1	1,064.93	212.99	143.05	356.04
2	921.88	184.38	171.66	356.04
3	750.22	150.04	206.00	356.04
4	544.22	108.84	247.20	356.04
5	297.02	59.02	297.02	356.04

*₹1,064.93/2.991 = ₹356.04.

(3) (b) *PV of interest tax shield (₹ lakh)*
[(₹212.99 × 0.862) + (₹184.38 × 0.743) + (₹150.04 × 0.641) + (₹108.84 × 0.552) + (₹59.02 × 0.476)] × 0.35 = (₹183.60 + ₹137 + ₹96.18 + ₹60.08 + ₹28.09) × 0.35 = ₹176.73 lakh.

P.2.12 For the facts in **P.2.10**, assume the lease rental is payable annually in arrear. What is the break even lease rental (BELR) from the point of view of the lessor? Which alternative would you suggest and why? Assume the marginal cost of funds to the HLL is 15 per cent.

Solution

Computation of BELR (L) for the lessor *(₹ lakh)*

Benefits from leasing:	
PV of lease rentals (working note 1)	3.352*L*
PV of tax shield on depreciation (3)	190.56
PV of salvage proceeds (₹990 lakh × 0.4 × 0.476)	188.50
Cost of leasing:	
Cost of equipment (₹900 lakh + 10%)	990
PV of tax payment on lease rentals (2)	1.173*L*

3.352L + 190.56 lakh + ₹188.50 lakh – ₹990 lakh – 1.173L = 0

3.352L – 1.173L = ₹990 lakh – ₹190.56 – ₹188.50

2.179L = ₹610.94 lakh or L

= ₹610.94/2.179

= ₹280.38 lakh

Working Notes

(1) PV of lease rentals: $L \times$ [PVIFA(15,5)] = 3.352L

(2) PV of tax payment on lease: 0.35 $\times$ 3.352L = 1.173L

(3) PV of tax shield on depreciation *(Amount in lakh of rupees)*

Depreciation	*(Tax shield × PVf)*	*PV of tax shield*
247	₹86.45 × 0.870	₹75.21
185	64.75 × 0.756	48.95
139	48.65 × 0.658	32.01
104	36.40 × 0.572	20.82
78	27.30 × 0.497	13.57
		190.56

P.2.13 The Hypothetical Manufacturers Ltd (HML) has taken a plant on lease, valued at ₹20 crore. The lease arrangement is in the form of a leveraged lease. The HLL is the equity participant and the Hypothetical Bank Ltd (HBL) is the loan participant. They fund the investment in the ratio of 2 : 8. The loan from HBL carries a fixed rate of interest of 19 per cent, payable in 6 equated annual instalments. The lease term is 6 years, with lease rental payable annually in arrear.

(a) Compute the equated annual instalment from the point of view of HBL.

(b) If the lease rate is unknown, and HBL's per-tax yield is 25 per cent, what is the minimum lease rate that must be quoted?

Solution

(a) Equated annual instalment to HBL: Loan amount, or ₹20 crore × 8/10 = ₹16 crore/PVIFA(19, 6), or 3.410 = ₹4.792 crore

(b) Annual lease rental (Y): Annual cash flow to HLL = (Y – ₹4.692 crore). Given the required rate of return to HLL of 25 per cent, Y would be, (Y – ₹4.692 crore) × PVIFA (25,6) = ₹4 crore equity or 2.951 (Y – ₹4.692 crore) = ₹4 crore

Y = 17.846 crore/2.951 = ₹6.05 crore.

Mini Case

2.C.1 Leasing Vs. Buying–Borrowing Teddy Bear Ltd is in the business of making toys of different ranges. Presently, Teddy Bear has one manufacturing plant having production capacity of 30,00,000 toys annually. They are sold through registered dealers in India who take delivery of toys directly from the factory situated in NOIDA. Teddy Bear does not incur any transport cost.

The demand for toys has shown tremendous growth in recent years. The Vice President, marketing, Sanjay Khanna, has submitted a proposal to the CEO, Bikrant Kumar Singh, to expand the production capacity of Teddy Bear to 40,00,000 toys. The CEO directs the Vice President, Manufacturing, Virender Kumar Rathi, to put a proposal regarding the availablility of the required equipment for the expansion of the plant. A survey shows that the machinery is available for ₹12.5 crore having a useful life of five years and no salvage value. Assume straight line depreciation for tax purposes. It also shows that there are two alternatives to finance the proposal. The equipment can be bought and financed by borrowing from the Udharwala Financial Services Ltd at 10 per cent interest. The equipment can be alternatively taken on lease form the First Leasing Company of India Ltd at ₹3.5 crore annual lease rental. The First Leasing would bear the associated taxes, insurance and maintenance cost amounting to ₹60,00,000 annually.

Required Bikrant Singh engages you as a financial consultant to advice him on the choice of the funding alternative. Should Teddy Bear buy the equipment through borrowing or acquire it on lease? What advice would you give and why? Assume 30 per cent corporate tax.

Solution

1. Present Value of Cash Outflows Under Leasing Alternative (₹ crore)

Year-end	*Lease rent after taxes [₹3.50 (1 – 0.30)]*	*FVIFA [10% (1 – 0.30)]*	*Total PV*
1 – 5	₹2.45	4.100	₹10.04

2. Present Value of Cash Outflows Under Buying-Borrowing Alternative (₹ crore)

	Year-end tax advantage					
	1	*2*	*3*	*4*	*5*	*Total*
Tax advantage:						
Interest on loan	₹1.25	₹1.04	₹0.82	₹0.57	₹0.30	₹3.98
(Working note 10 Taxes/maintenance cost	0.60	0.60	0.60	0.60	0.60	3.00
Depreciation	2.50	2.50	2.50	2.50	2.50	12.50
(₹12.50 crore + 5 years)						
	4.35	4.14	3.92	3.67	3.40	19.48
(A) Tax advantage (0.30)	1.30	1.24	1.18	1.10	1.02	5.84
(B) Payments:						
(a) Loan payment	3.30	3.30	3.30	3.30	3.30	16.5
(Working note 1)						
(b) Taxes/maintenance costs	0.60	0.60	0.60	0.60	0.60	3.00
	3.90	3.90	3.90	3.90	3.90	19.50
(C) Net cash outflows (B-A)	2.60	2.66	2.72	2.80	2.88	13.66
(D) PVIF (0.07)	0.935	0.873	0.816	0.763	0.713	
(E) Total present value	2.43	2.31	2.22	2.14	2.05	11.15

Advice: As the present value of cash flow under the buying-borrowing alternative is higher, lease financing is a better alternative

Working Notes

1. Loan repayment schedule (₹ crore)

Year	*Total@*	*Interest*	*Principal*
1	3.30	1.25	2.05
2	3.30	1.04	2.26
3	3.30	0.82	2.48
4	3.30	0.57	2.73
5	3.30	0.30	3.00

Comprehensive Case is available in the website. The website address is **http://www.mhhe.com/khanfs9e.**

REVIEW QUESTIONS

2.1 Define lease. What are its essential elements?

2.2 **(a)** What is finance lease? Discuss its main features.
(b) Briefly explain the main features of an operating lease.

2.3 Write notes on:
- Sale and lease back vs Direct lease
- Single investor lease vs Leveraged lease
- Domestic lease vs International lease

2.4 Discuss briefly the significance and limitations of leasing.

2.5 Explain briefly the provisions of the law of contract which are specifically applicable to leasing transactions.

2.6 Give a brief account of the important aspects of **(i)** lease documentation and **(ii)** lease agreement.

2.7 The following data are furnished by the Hypothetical Leasing Ltd (HLL):

Investment cost, ₹500 lakh
Primary lease term, 5 years
Estimated residual value after the primary period, Nil
Pre-tax required rate of return, 12 per cent

The HLL seeks your help in determining the annual lease rentals under the following rental structures:
(a) Equated,
(b) Stepped (an annual increase of 15 per cent),
(c) Ballooned (annual rental of ₹80 lakh for years 1-4) and
(d) Deferred (2 years deferment period).
You are required to compute the relevant annual rentals.

2.8 From the under-mentioned facts relating to the Hypothetical Leasing Ltd, calculate the annual rentals under the following rental structures for the 6-year period:
(a) Equated,
(b) Stepped (annual increase of 12 per cent),
(c) Ballooned (annual rental of ₹15 lakh for year 1-2),
(d) Deferred (deferment period of one year).

Investment cost, ₹96 lakh
Primary lease term, 3 years
Residual value, Nil
Pre-tax required rate of annual return, 12 per cent
Assume that the lease can be renewed for an additional period of 3 years (secondary lease period). The lease rental for the secondary period will be 5 per cent of the rental charged during the primary period.

2.9 The Hypothetical Equipments Ltd (HEL) has recently leased assets worth ₹2,500 lakh from the Hypothetical Leasing Ltd (HLL). The following facts are available:

(1) Lease period, 9 years, of which the first 6 years constitute the lease term;
(2) Annual lease rates: First 6 years, ₹360/₹1,000; Next 3 years, ₹15/₹1,000;
(3) Incremental borrowing rates for HEL, 12 per cent.

(a) Assuming 14 years as the average economic life of the equipment, is the lease finance lease or operating lease? **(b)** Assuming further **(i)** physical life of 14 years, **(ii)** technological life of 9 years and **(iii)** product-market life of 11 years, how will you classify the lease?

2.10 In reviewed question **2.9**, assume the following:

(1) Monthly lease rentals payable in advance: First 6 years, ₹26/₹1,000; Next 3 years, ₹1.50/₹1,000;

(2) Incremental borrowing rate of HEL, 12 per cent compounded monthly.

What will be your answer to reviewed questions 2.3**(a)** and 2.3**(b)**?

2.11 For review question **2.9**, assume **(i)** average economic life of the equipment, 10 years, **(ii)** salvage value, 10 per cent of the original cost, **(iii)** implicit rate of interest in lease, 15 per cent. Is it a finance lease?

2.12 The Hypothetical Manufacturers Ltd (HML) has taken a plant on lease, valued at ₹20 crore. The lease arrangement is in the form of a leveraged lease. The HLL is the equity participant and the Hypothetical Bank Ltd (BHL) is the loan participant. They fund the investment in the ratio of 2:8. The loan from BHL carries a fixed rate of interest of 15 per cent, payable in 6 equated annual instalments. The lease term is 6 years, with lease rental of ₹700/₹1,000 payable annually in arrear.

(a) You are required to compute the cash flow from the point of view of HLL.

(b) If the lease rate is unknown, and HLL's per-tax yield is 15 per cent, what is the minimum lease rate that must be quoted?

2.13 Briefly explain the accounting framework for finance and operating leases by a lessee and their disclosures in financial statements.

2.14 Discuss the accounting treatment for finance and operating leases by a lessor and their disclosures in financial statements.

2.15 Explain the income tax considerations which have a bearing on lease transactions **(a)** for the lessor and **(a)** for the lessee.

2.16 How does leasing enable tax planning both for the lessor and the lessee and save taxes.

2.17 How does sales tax affect a leasing transaction.

2.18 Explain briefly the net present value of leasing [NPV(L)]/net advantage of leasing (NAL) as the decision-criterion for lease evaluation from the lessees' perspective.

2.19 Write brief notes:

- Break-even lease rentals
- Negotiation of lease rentals
- Structuring of lease rentals
- Profile of lease rentals

2.20 The Hypothetical Equipments Ltd (HEL) has recently leased assets worth ₹2,500 lakh from the Hypothetical Leasing Ltd ((HLL). The following facts are available.

1. Lease period, 9 years, of which the first 6 years constitute the lease term;
2. Annual lease rates: First 6 years, ₹360/₹1,000; Next three years, ₹15/₹1,000;
3. Incremental borrowing rates for HEL, 22 per cent.

(a) Assuming 14 years as the average economic life of the equipment, is the lease finance lease or operating lease? **(b)** Assuming further **(i)** physical life of 14 years, **(ii)** technological life 9 years, and **(iii)** product-market life of 11 years, how will you classify the lease?

2.21 Elite Builders has been approached by a foreign embassy to build for it a block of six flats to be used as guest houses. As per the terms of the contract, the foreign embassy would provide Elite Builders the plans and the land costing ₹25 lakhs. Elite Builders would build the flats at their own cost and lease them out to the foreign embassy for 15 years at the end of which the flats will be transferred to the foreign embassy for a nominal value of ₹8 lakh. Elite Builders estimates the cost of construction as follows:

Area per flat, 1,000 sq. feet
Construction cost, ₹400 per sq. feet
Registration and other costs, 2.5 per cent of cost of construction
Elite Builders will also incur ₹4 lakh each in years 14 and 15 towards repairs.

Elite Builders proposes to charge the lease rentals as follows:

Years	*Rentals*
1 - 5	Normal
6 - 10	120 per cent of normal
11 - 15	150 per cent of normal

Elite builders present tax rate averages at 35 per cent which is likely to be the same in future. The full cost of construction and registration will be written off over 15 years at a uniform rate and will be allowed for tax purposes.

You are required to calculate the normal lease rental per annum per flat. For your exercise you may assume: **(a)** Minimum desired return of 10 per cent, **(b)** Rentals and repairs will arise on the last day of the year, and (c) Construction, registration and other costs will be incurred at time = 0.

2.22 Computeronics Ltd sells computer services to its clients. The company has recently completed a feasibility study and decided to acquire an additional computer the details of which are as follows:

1. The purchase price of the computer is ₹2,30,000; maintenance, property taxes and insurance will be ₹20,000 per year. The additional annual expenses to operate the computer are estimated at ₹80,000. If the computer is rented, the annual rent will be ₹85,000, *plus* 5 per cent of annual billings. The rent is due on the last day of each year. Maintenance expenses are to be borne by the lessor.
2. Due to competitive conditions, the company feels it will be necessary to replace the computer at the end of 3 years with a more advanced model. The resale value is estimated at ₹1,10,000.
3. The appropriate income tax rate is 50 per cent, and the straight-line method of depreciation is used.
4. The estimated annual billing for the services of the new computer will be ₹2,20,000 during the first year, and ₹2,60,000 during the subsequent two years.
5. If the computer is purchased, the company will borrow to finance the purchase from a bank with interest at 16 per cent. The interest will be paid regularly, and the principal will be returned in one lumpsum at the end of year 3.

Assuming cost of capital at 12 per cent, you are required to analyse the financial viability of the proposal from the viewpoint of the leasing company as well as the Lessor.

2.23 ABC Ltd produces and sells a wide range of products. The firm is considering adding a new product line. There are two alternative ways to acquire the needed equipment: **(i)** purchase, or **(ii)** lease.

The equipment can be purchased for ₹1,25,000. The equipment has no salvage value at the end of its useful life of 5 years. The firm can borrow to finance its purchase at a concessional rate of interest of 8 per cent. The loan repayment is as follows:

	Year-end payment		
Year	*Interest*	*Principal*	*Total*
1	₹10,000	₹21,307	₹31,307
2	8,295	23,012	31,307
3	6,454	24,853	31,307
4	4,466	26,841	31,307
5	2,320	28,987	31,307

The yearly lease rental would be ₹40,000. The taxes, insurance and maintenance will be paid by the lessor. Engineering and management studies provide the following revenue and cost estimates (excluding lease payments and depreciation) for manufacturing the new product.

	Equipment	
	Leased	*Purchased*
Unit selling price	₹5.0	₹5.0
Unit production costs:		
Materials	1.80	1.80
Conversion costs	1.65	1.65
Total	3.45	3.45
Unit contribution margin	1.55	1.55
Estimated unit volume	× 40,000	× 40,000
Estimated total contribution	62,000	62,000
Other costs:		
Supervision	16,000	16,000
Taxes and insurance	—	3,000
Maintenance	—	3,000
Total	16,000	22,000

The firm uses the straight line method of depreciation. The after tax cost of capital of the firm is 10 per cent.

(a) Should the company lease, or buy the equipment?

(b) Analyse the financial implications of the proposal from the view point of the leasing company, assuming as follows:
- — required rate of return at 14 per cent
- — straight line depreciation
- — tax rate of 50 per cent

(c) Determine the lease rental if the leasing company targets **(i)** to earn ₹25,000 from the project, **(ii)** 16 per cent required IRR.

ANSWERS

2.7 **(a)** ₹182.15 lakh
(b) Year 1,₹143.71 lakh; Year 2, ₹165.26 lakh; Year 3, ₹190.5 lakh; Year 4, ₹218.56 lakh; Year 5, ₹251.34 lakh
(c) ₹902.29 lakh
(d) ₹388.20 lakh

2.8 **(a)** ₹45.75 lakh (primary); ₹2.79 lakh (secondary)
(b) ₹23.92 lakh
(c) ₹103.07 lakh
(d) ₹75.04 lakh

2.9 **(a)** Finance lease (PV of lease payments exceeds the cost of the asset
(b) Finance lease (term is 100 per cent)

2.20 **(a)** Financial lease
(b) Financial lease

2.21 ₹59,097.

2.22 **(a)** Computeronics should buy the computer (PV of cash outflows under leasing alternative is ₹1.25 lakh and under buying alternative is ₹1.17 lakh)
(b) Proposal is financially unsound from the point of leasing company (–NPV of ₹0.11 lakh).

2.23 **(a)** Company should buy the equipment (PV of cash outflows under leasing alternative is ₹89,040 and under buying alternative ₹84,000).
(b) Not commercial profitable from the point of view of leasing company (–NPV of ₹40,000).
(c) **(i)** ₹68,388, **(ii)** ₹57,000

CHAPTER

3

Hire-Purchase Finance and Consumer Credit

LEARNING OBJECTIVES

- Understand the basic characteristics of hire-purchase and distinguish it from instalment purchase and leasing.
- Discuss the main features of a hire-purchase agreement.
- Outline the three aspects of taxation of hire-purchase transactions—income-tax, sales tax and interest tax.
- Explain and illustrate the accounting and reporting practices relating to hire-purchase transactions in the books of the hirer as well as the hire-vendor.
- Discuss and illustrate the framework of financial evaluation of a hire-purchase deal *vis-à-vis* a finance lease.
- Understand the basic features of consumer credit as a financial service.

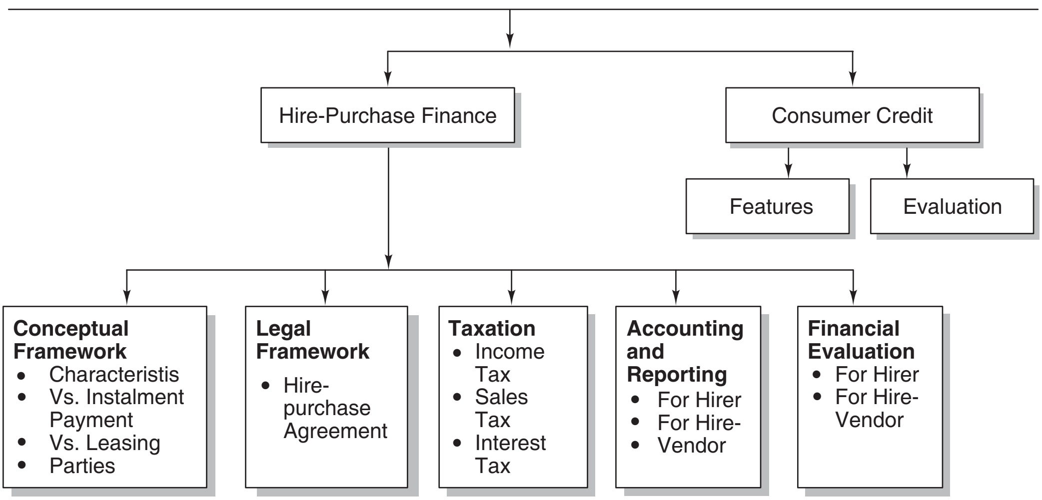
INTRODUCTION

This chapter examines the conceptual, legal, tax, accounting and evaluation framework of hire-purchase finance in India. It also outlines the salient aspects of consumer finance. Historically, hire-purchase finance has been associated with financing of commercial vehicles for road transport operators. It has emerged as a source of equipment financing in recent years as an alternative to lease financing. The consumer credit includes all asset-based financing to individuals to acquire consumer durables. Section 1 of the chapter explains the salient features/basics of hire-purchase transactions. The legal, tax and accounting aspects of such transactions are discussed in Sections 2, 3 and 4 respectively. The evaluation framework of hire-purchase transactions from the viewpoint of the hirer as well as the intermediary (finance company) is explained in Section 5. While Section 6 describes the salient features of consumer finance, the main points are summarised in the last Section. **These are portrayed in Exhibit 3.1.**

CONCEPTUAL FRAMEWORK

This Section covers **(i)** meaning and characteristics of hire-purchase, **(ii)** hire-purchase vs. instalment purchase, **(iii)** hire-purchase vs. leasing and **(iv)** parties to a hire-purchase contract.

Exhibit 3.1 Hire-Purchase Finance and Consumer Credit



Meaning and Characteristics

> **Hire-purchase** is a peculiar kind of transaction in which the goods are let on hire with the option to the hirer to purchase them.

Hire-purchase is a mode of financing the price of the goods to be sold on a future date. In a hire-purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and the hirer is allowed an option to purchase the goods by paying all the installments. A **hire-purchase** agreement is defined as peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations:

(a) Payment to be made in instalments over a specified period;

(b) The possession is delivered to the hirer at the time of entering into the contract;

(c) The property in the goods passes to the hirer on payment of the last instalment;

(d) Each instalment is treated as hire charges so that if default is made in payment of any instalment, the seller becomes entitled to take away the goods; and

(e) The hirer/purchaser is free to return the goods without being required to pay any further instalments falling due after the return.

Thus, a hire-purchase agreement has two aspects, firstly, an aspect of bailment of goods subject to the hire-purchase agreement, and secondly, an element of sale which fructifies when the option to purchase is exercised by the intending purchaser. Though the option to purchase is allowed in the very beginning, it can be exercised only at the end of the agreement. The essence of the agreement is that the property in the goods does not pass at the time of the agreement but remains in the intending seller, and only passes later when the option is exercised by the intending purchaser.

The *modus operandi* of a hire-purchase transaction is structured around the following features:

The finance (hire-purchase) company purchases the equipment from the equipment supplier and lets it on hire to the hirer to use it who is required to make a down payment of, say, 20–25 per cent of the cost and pay balance with interest in Equated Monthly Installments (EMI) in advance or arrears spread over 36–48 months. Alternatively, in place of the margin in the down-payment plan, under a deposit-linked plan, the hirer has to put an equal amount as a fixed deposit with the finance company which provides the entire finance on hire-purchase terms repayable with interest as EMI over 36–48 months. The deposit together with the accumulated interest is returned to the hirer after the payment of the last instalment. ***The interest component of each hire-purchase instalment is computed on the basis of a flat rate of interest and the effective rate of interest is applied to the declining balance of the original loan amount to determine the interest component of each instalment***. For a given flat rate of interest, the equivalent effective rate of interest is higher. **The computation of the effective rate of interest is illustrated in Appendix 3-A at the end of the chapter.** During the hire-period (period of agreement/contract), the hirer can opt for an early repayment and repurchase the asset by paying the remaining installments (not fallen due) **minus** an interest rebate. **The computation of interest rebate is shown in Appendix 3-B at the end of the chapter.** Finally, the hirer has the right to terminate the contract after giving due notice (*call option*).

Hire-Purchase *vs* Instalment Payment

In an **instalment sale**, the contract of sale is entered into, the goods are delivered and the ownership is transferred to the buyer but the price of the goods is paid in specified installments over a definite period. The first distinction between hire-purchase and instalment purchase is based on the **call option** (to purchase the goods at any time during the term of the agreement) and the right of the hirer to terminate the agreement at any time before the payment of the last instalment **(right of termination)** in the former while in the latter the buyer is committed to pay the full price. Secondly, in instalment sale the ownership in the goods passes on to the purchaser simultaneously with the payment of the initial/first instalment, whereas in hire-purchase the ownership is transferred to the hirer only when he exercises the option to purchase/or on payment of the last instalment.

> **Instalment sale** is a contract of sale in which the ownership is transferred to the buyer but the price is paid in specified instalments over a definite period.

Lease Financing *vs* Hire-purchase Financing

These two modes of financing differ in the following respects:

Ownership The lessor (finance company) is the owner and the lessee (user/manufacturer) is entitled to the economic use of the leased asset/equipment only in case of lease financing. The ownership is never transferred to the user (lessee). In contrast, the ownership of the asset passes on to the user (hirer) in case of hire-purchase finance on payment of the last installment; before the payment of the last instalment, the ownership of the asset vests in the finance company/intermediary (seller).

Depreciation The depreciation on the asset is charged in the books of the lessor in case of leasing while the hirer is entitled to the depreciation shield on assets hired by him.

Magnitude Both lease finance and hire-purchase are generally used to acquire capital goods. However, the magnitude of funds involved in the former is very large, for example, for the purchase of aircrafts, ships, machinery, air-conditioning plants and so on. The cost of acquisition in hire-purchase is relatively low, that is, automobiles, office equipments and generators and so on are generally hire-purchased.

Extent Lease financing is invariably 100 per cent financing. It requires no margin money or immediate cash down payment by the lessee. In a hire-purchase transaction typically a margin equal to 20 – 25 per cent of the cost of the equipment is required to be paid by the hirer. Alternatively, the hirer has to invest an equivalent amount on fixed deposits with the finance company which is returned after the payment of the last installment.

Maintenance The cost of maintenance of hired asset is to be borne typically by the hirer himself. In case of finance lease only, the maintenance of the leased assets is the responsibility of the lessee. It is the lessor (seller) who has to bear the maintenance cost in an operating lease.

Tax Benefits The hirer is allowed the depreciation claim and finance charge and the seller may claim any interest on borrowed funds to acquire the asset for tax purposes. In case of leasing, the lessor is allowed to claim depreciation and the lessee is allowed to claim the rentals and maintenance cost against taxable income.

Parties to Hire-purchase Contract

Basically, there are two parties in a hire-purchase contract, namely, the intending seller and the intending purchaser or the hirer. Now a days, however, hire-purchase contracts generally involve three parties, namely, the seller, the financier and the hirer. With the acknowledgment of the finance function as a separate business activity and the substantial growth of finance companies in the recent times, the sale element in a hire-purchase contract has been divorced from the finance element. A dealer now normally arranges a hire-purchase agreement through a finance company with the customer. It is, therefore, a tripartite deal. A tripartite hire-purchaser contract is arranged with following modalities:

1. The dealer contracts a finance company to finance hire-purchase deals submitted by him. For this purpose, they enter into a contract drawing out the terms, warranties that the dealer gives with each transaction, and so on.
2. The customer selects the goods and expresses his desire to acquire them on hire-purchase. The dealer arranges for him the full set of documents to be completed to make a hire-purchase agreement. The documents are generally printed by the finance company.
3. The customer then makes cash down payment on completing the proposal form. The down payment is generally retained by the dealer as a payment on account of the price to be paid to him by the finance company.
4. The dealer then send the documents to the finance company requesting them to purchase the goods and accept the hire-purchase transactions.
5. The finance company, if it decides to accept the transactions, signs the agreement and sends a copy to the hirer along with the instructions as to the payment of the installments. The finance company also notifies the same to the dealer and asks him to deliver the goods, if not already done so.
6. The dealer delivers the goods to the hirer against acknowledgments and the property in the goods passes on to the finance company.
7. The hirer makes payment of the hire installment periodically.
8. On completion of the hire-term, the hirer pays the last instalment and the property in the goods passes to him on issue of a completion certificate by the finance company.

LEGAL FRAMEWORK

There is no exclusive legislation dealing with hire-purchase transactions in India. *The Hire-Purchase Act* was passed in 1972. An Amendment Bill was introduced in 1989 to amend some of the provisions of the *Hire-Purchase Act*. However, the Act has not been enforced so far. The provisions of the Act are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire-purchase transactions. The Act contains provisions for regulating **(1)** the format/contents of the hire-purchase agreement, **(2)** warrants and the conditions underlying the hire-purchase agreement, **(3)** ceiling on hire-purchase charges, **(4)** rights and obligations of the hirer and the owner. A brief account of these is given in the **Appendix 3-C on the Website. The address of the website is http://www.mhhe.com/khanfs9e.**

In the absence of any specific law, the hire-purchase transactions are governed by the provisions of the *Indian Contract Act* and the *Sales of Goods Act*. The hire-purchase transaction/agreement has two aspects: **(1)** an aspect of bailment of goods which is covered by the Contract Act, **(2)** an element of sale when the option to purchase is exercised by the hirer/intending purchaser which is covered by the *Sales of Goods Act*. The provisions of the *Contract Act* in sofaras they relate to hire-purchase transaction have already been discussed in Chapter 2. The stipulation contained in the *Sales of Goods Act* are available in Appendix 3-D on the website. The website address is **http://www.mhhe.com/khanfs9e.** The contents of a hire-purchase agreement are, however, briefly outlined.

Hire-purchase Agreement

A hire-purchase agreement is in many ways similar to a lease agreement, in so far as the terms and conditions are concerned. The important clauses in a hire-purchase agreement are:

Nature of Agreement Stating the nature, term and commencement of the agreement.

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

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

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

Hire-Charges To be paid by the hirer, the time schedule, the rate of interest/penalty for delayed payment/default.

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

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

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

Risk Of loss and damage to be borne by the hirer.

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

Indemnity clause

Stamp Duty

Schedule of equipments forming subject-matter of agreement.

Schedule of hire charges.

The agreement is usually accompanied by a promissory note signed by the hirer for the full amount payable under the agreement including the interest element or finance charge.

TAXATION ASPECTS

The taxation aspects of hire-purchase transactions can be divided into three parts: **(i)** income tax, **(ii)** sales tax and **(iii)** interest tax.

Income Tax

Hire-purchase, as a financing alternative, offers tax benefits both to the hire-vendor, (hire-purchase finance company) and the hire-purchaser (user of the asset).

Assessment of Hire-purchaser (Hirer) According to circular issued by the Central Board of Direct Taxes in 1943 and a number of court rulings, the hirer is entitled to **(a)** the tax shield on depreciation calculated with reference to the cash purchase price and **(b)** the tax shield on the '**consideration for hire**' (total charge for credit). In other words, though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price. Similarly, he can claim deduction on account of 'consideration for hire', that is, finance charge. The finance charge is the difference between the hire-purchase price and the cash price. The amount of finance charge to be deducted each year is to be spread evenly over the term of the agreement. No method is specified for evenly distributing the finance charge. The hirer can choose one of the alternatives, namely, **(1)** level/equal distribution, or **(2)** distribution on the basis of sum-of-years-digits method, or **(3)** rate of return method. If the hire-purchase agreement does not materialise and is terminated by return of the asset to the owner (hire-vendor), no deduction is allowed in respect of finance charge after the date of termination. If the agreement is terminated by outright purchase of the equipment, the deduction similarly ceases from its date of termination. Finally, the consideration is viewed as rental charge rather than interest. Therefore, if the agreement/contract expressly provides for the **option of purchasing the goods at any time** or of returning **the same before the total amount is paid**, no deduction of tax at source is to be made from the consideration of hire paid to the owner.

Assessment of Owner (Hire-Vendor) The consideration for hire/hire charge/income received by the hire-vendor is liable to tax under the head profits and gains of business and profession where hire purchase constitutes the business (mainstream activity) of the assessee, otherwise as income from other sources. The hire income from house property is generally taxed as income from house property. Normal deduction (except depreciation) are allowed while computing the taxable income.

Tax Planning in Hire-purchase The hire-purchase transaction can be used as a tax planning device in two ways:

First, the net income (finance income less interest on borrowings by the hire-vendor) can be inflated at the rear end of the transaction and thereby defer tax liability. This is permissible by distributing the finance charge/income over the period of hire/agreement as the interest on his borrowings which is a major item of expense is larger in the early years and declines as the hire installments are received whereas the finance income remains constant. The hirer can similarly postpone his tax liability by allocating finance charge on the basis of a actuarial/rate of return method which implies a higher deduction in the early years.

Secondly, another possible area of tax planning is to use hire-purchase as a bridge between the lessor and the lessee. In other words, instead of a direct lease an intermediate financier is introduced. Suppose, X wants to lease an asset to Z. Instead of going for a direct lease they adopt a different strategy, wherein Y steps in as a intermediary. Y takes the asset on hire-purchase from X and gives the same asset to Z on lease. There is no prohibition on such arrangement, unless the hire purchase agreement prohibits the sub-lease. Under this strategy Y gets the dual advantage of depreciation and finance charge against his income from lease rentals, thereby postponing his taxes. This strategy can be very useful in case Y is a high tax paying entity. Y in consideration for reduction in his tax liability will pass off some income to X in the form of high hire charges and to Z by way of low lease rentals. Even if the intermediary Y derives no financial gains, substantial tax savings can be reaped by distributing the income and tax benefits.

Sales-Tax Aspects

The salient features of sales tax pertaining to hire-purchase transactions after the Constitution (Forty-sixth Amendment) Act, 1982, are as detailed below:

Hire-purchase as Sale Hire-purchase, though not sale in the true sense, is **demand to be sale**. Such transactions are *per se* liable to sales tax. The sales tax is payable once the goods are delivered by the owner (hire-vendor) to the hirer (hire-purchaser) even if the transaction does not fructify into a sale. There is no provision for the refund of sales tax on the unpaid installment. In other words, full tax is payable irrespective of whether the owner gets the full price of the goods or not.

Delivery *vs* Transfer of Property: ***Taxable Event*** A hire-purchase deal is regarded as a sale immediately the goods are delivered and not on the transfer of the title to the goods. That is, the taxable event is the delivery of the goods and not transfer of the title to the goods. For the purpose of levying sales tax, a sale is deemed to take place only when the hirer exercises the option to purchase.

Taxable Quantum The quantum of sales tax is related to the sales price. It must be determined to be the consideration for the transfer of the goods when the delivery of the goods takes place. The consideration for the sale of the goods is the total amount which is agreed to be paid before the transfer of the goods takes place in a hire purchase contract. In other words, sales tax is levied on the entire amount payable under the agreement by deeming it to be the sale price of the goods instead of reducing the amount by the hire charges assumed to be included and by depreciation in the value of the goods for the period when the goods were on hire.

States Entitled to Impose Tax When a hire-purchase transaction is entered in the state where the goods are lying, the concerned state is entitled to impose sales-tax. In case where the contract of hire-purchase is entered into one state and the goods are in another state, the entitlement to tax vests with the state in which the goods are delivered by the hire-vendor to the hirer even though the goods may be transported/transferred to a different states subsequently.

Sales tax on hire-purchase is not levied if the state in which goods are **delivered** has a single point levy system in respect of such goods and if the owner (finance company) had purchased the goods within the same state. Moreover, sales tax is not levied on hire purchase transactions structured by finance companies if they are not dealers in the type of goods given on hire.

The inter-state hire-purchase deals attract central sales tax (CST). But in actual practice, no hire-purchase transaction is likely to be subject to CST. Under the CST, the taxable event is not delivery but the transfer of goods. In inter-state hire-purchase deals, movement of goods would normally be occasioned at the time of delivery while the property in the goods is transferred when the option to buy is exercised. In other words, inter-state movement of goods is not occasioned when the property in goods is transferred and a hire-purchase deal is concluded. In fact, there is, strictly speaking, no inter-state hire-purchase deal.

Rate of Tax The rates of sales tax on hire-purchase deals vary from state to state. There is, as a matter of fact, no uniformity even regarding the goods to be taxed. If the rates undergo a change during the currency of a hire-purchase agreement, the rate in force on the date of delivery of the goods to the hirer is applicable.

Interest-tax

The hire-purchase finance companies, like other credit/finance companies, have to pay interest-tax under the Interest-Tax Act, 1974. According to this Act, interest tax is payable on the total amount of interest earned less bad debts in the previous year @ 2 per cent. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income under the Income-tax Act.

ACCOUNTING AND REPORTING

Hire-purchase, as a form of financing, differs from lease financing in one basic respect: while in a hire-purchase transaction, the hirer has the option to purchase the asset at the end of the period on payment of the last installment of hire-charge, the lessee does not have the option to acquire the ownership of the leased asset. A hire-purchase transaction has, therefore, some typical features from the point of view of accounting and reporting. First, although the legal title over the equipment remains with the hire-vendor (finance company), all risks and rewards associated with it stand transferred to the hirer (purchaser) at the inception of the transaction. The accounting implication is that the asset should be recorded in the books of the hirer. The hire-vendor should record them **(a)** as hire-asset stock-in trade or as receivables. Secondly, the hirer should be entitled to the depreciation claim. Finally, the hire charges, like the lease rental in a financial lease, have two components: **(i)** interest/finance charge, **(ii)** recovery of principal. But there is no accounting standard/guidelines note for accounting treatment of hire-purchase in India. There is also no specific law/regulation to govern hire-purchase contracts. The issues/aspects which have a bearing on the accounting and reporting of hire-purchase deals are the timings of the capitalisation of the asset **(inception *vs* conclusion of the deal)**, the price, the depreciation charge and the treatment of hire-charges. This Section highlights the prevalent accounting practices relating to hire-purchase transactions in the books of the hirer as well as the hire-vendor.

In the Books of the Hirer

The cash purchase price of the asset is capitalised and the capital content of the hire-purchase installment, that is, the cash purchase price less down payment, if any, is recorded as a liability. The depreciation is based on the cash purchase price of the asset in conformity with the policy regarding similar owned assets. The total charge for credit (unmatured finance charge at the inception of the hire-purchase transaction/deal) is allocated over the hire-period, using one of the several alternative methods, namely, effective rate of interest method, sum-of-the-years-digits method and straightline method. The mechanisms of accounting and reporting is shown in Illustration 3.1.

Illustration 3.1

Under a hire-purchase deal structured by the Hypothetical Finance Ltd (HFL) for the Hypothetical Industries Ltd (HIL), the HFL has offered to finance the purchase of an equipment costing ₹150 lakh. The (flat) rate of interest would be 13 per cent. The amount would have to be repaid in 48 equated monthly installments in advance. The HIL is required to make a cash down payment of 25 per cent. It uses WDV method of depreciation @ 30 per cent on similar assets.

From the foregoing information, you are required to show: **(A)** the allocation of total charge for credit (finance charge), on the basis of **(1)** effective rate of interest (ERI)/annual percentage rate (APR) method, **(ii)** sum-of-year's-digits (SOYD) method and **(iii)** straight line method (SLM) of depreciation; **(B)** how the deal will be recorded in the financial statements (profit and loss account and balance sheet) of the hirer (HIL) in the first two years. You can make, if necessary, your assumptions.

Solution

(A) (i) Allocation of Total Charge for Credit: ERI/APR Method *(₹ lakh)*

Year	*Outstanding amount at the beginning*	*Interest content*	*Capital content/ recovery*	*Annual installment (3.5625 × 12)*
1	112.50	23.54	19.21	42.75
2	93.29	18.52	24.22	42.75
3	69.06	12.20	30.55	42.75
4	38.52	4.22	38.53	42.75

Working Notes

1. Computation of ERI/APR:
Total charge for credit = ₹112.50 [₹150 lakh – down payment (₹37.50 lakh)] × 0.13 × 4 = ₹58.50 lakh
Monthly installment = (₹112.50 lakh + ₹58.50 lakh) ¸ 48 = ₹3.5625 lakh
Annual installment = ₹3.5625 lakh × 12 = ₹42.75 lakh
The ERI per annum, I, is given by equation:

$$3.5625 \times 12 \times \frac{1}{d^{(12)}} \text{ PVIFA}_{12} \text{ (I,4)} = ₹112.50 \text{ lakh}$$

$$\text{or } 3.5625 \times 12 \times \frac{1}{d^{(12)}} \times \text{PVIFA (1,4)} = ₹112.50 \text{ lakh}$$

$$\text{or } \frac{I}{d^{(12)}} \times \text{PVIFA (1,4)} = 2.632$$

By trial and error and interpolation, I = 26.1 per cent

2. Annual installment equivalent to the value of the 12-monthly installment
= where I = 0.261 = 3.5625 × 12 × 1.1363 = ₹48.58 lakh

3. Annual installment and interest netted for interest rebate = ₹[48.58 – (3.5625 × 12) lakh = ₹5.82 lakh

4. Assumption: Salvage value after 4 years, nil.

(A) (ii) Allocation of Total Charge for Credit: SOYD Method (₹ lakh)

Year	*Annual installment (3.5625 × 12)*	*Finance charge*	*Capital recovery*
1	42.75	25.42	17.33
2	42.75	18.21	24.55
3	42.75	11.04	31.71
4	42.75	3.83	38.92

Working Notes

Finance charge (₹ lakh)

$$\text{Year} \quad 1 = \frac{48+47+\ldots+37}{48+47+\ldots+1} \times ₹58.50 \text{ lakh} = ₹25.42 \text{ lakh}$$

$$2 = \frac{36+35+\ldots+25}{48+47+\ldots+1} \times ₹58.50 \text{ lakh} = ₹18.21 \text{ lakh}$$

$$3 = \frac{24+23+\ldots+13}{48+47+\ldots+1} \times ₹58.50 \text{ lakh} = ₹11.04 \text{ lakh}$$

$$4 = \frac{12+11+\ldots+1}{48+47+\ldots+1} \times ₹58.50 \text{ lakh} = ₹3.83 \text{ lakh}$$

(A) (iii) Equated Annual Finance Charge: SLM

₹58.50 lakh ÷ 4 = ₹14.62 lakh

(B) Financial Statements

Income Statement (₹ lakh)

Expenses	Year 1	Year 2
Depreciation (150 × 0.30)	45.00	—
(105 × 0.30)	—	31.50
Finance charge	23.54	18.52

Balance Sheet (₹ lakh)

Liabilities	Amount Year 1	Amount Year 2	Assets	Amount Year 1	Amount Year 2
Secured loans:			Fixed assets:		
Hire-purchase outstanding	69.06	38.51	Equipment on hire purchase:	150.00	150.00
(due after one year)			Gross Block	45.00	76.50
Current liabilities:			*Less:* Accumulated depreciation		
Hire-purchase outstanding	24.22	30.50	Net block	105.00	73.50
(due within one year)					

In the Books of Hire-Vendor (Finance Company)

At the inception of the transactions, the finance company should record the hire-purchase installments receivables as a current asset (i.e. stock on hire) and the (unearned) finance income component of these installments as a current liability under the head Unmatched Finance Charges. At the end of each accounting period, an appropriate part of the unmatured finance income should be recognised as current income for the period. It would be allocated over the relevant accounting periods on the basis of any of the following methods, namely, **(i)** ERI, **(ii)** SOYD and **(iii)** SLM. At the end of each accounting period, the hire-purchase price less the installments received should be shown as a receivable/stock on hire and the finance income component of these installments should be shown as a current liability/unmatched finance charge. The direct costs associated with structuring the transaction/deal should be either expensed immediately or allocated against the finance income over the hire period. The accounting treatment in the books of the finance company is shown in Illustration 3.2.

Illustration 3.2

For the Hypothetical Finance Ltd (HFL) in **Illustration 3.1**, assume that the initial cost of structuring the deal is ₹1.2 lakh. Using the effective rate of interest method for allocating finance income, show how the transaction will appear in the books of the HFL. You can make other assumptions, if necessary.

Solution

Allocation of Unearned Finance Income (ERI: 26.1%) *(₹ lakh)*

Year	*Outstanding amount at the beginning*	*Installment*	*Interest component*	*Capital recovery*
1	112.50	42.75	23.54	19.21
2	93.29	42.75	18.52	24.22
3	69.06	42.75	12.22	30.55
4	38.52	42.75	4.22	38.53

Record in Financial Statements:

Income Statement *(₹ lakh)*

Expenses	*Amount*		*Income*	*Amount*	
	Year 1	*Year 2*		*Year 1*	*Year 2*
Direct costs	1.2	—	Hire finance income	23.54	18.52

Balance Sheet *(₹ lakh)*

Liabilities	*Amount*		*Assets*	*Amount*	
	Year 1	*Year 2*		*Year 1*	*Year 2*
Current liabilities:			Current assets:		
Finance income/charge (unmatured/unearned)	34.95	16.42	Stock on hire (agreement value less amount/installment received)	128.24	85.49

FINANCIAL EVALUATION

The framework of financial evaluation of a hire-purchase deal *vis-a-vis* a finance lease discussed in this Section covers both the hirer's as well the finance company's viewpoint.

From the Point of View of the Hirer (Hire-purchaser)

The tax treatment given to hire-purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire-purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire installment. Thus, hire-purchase and lease financing represent alternatives modes of acquisition of assets. The evaluation of hire-purchase transaction from the hirers' angle, therefore, has to be done in relation to leasing alternative.

Decision-criterion The decision-criterion from the point of view of a hirer is the cost of hire-purchase *vis-a-vis* the cost of leasing. If the cost of hire-purchase is less than the cost of leasing, the hirer (purchaser) should prefer the hire-purchase alternative and *vice versa.*

Cost of Hire-purchase The cost of hire-purchase to the hirer (CHP) consists of the following:

1. Down payment
2. *Plus* Service charges
3. *Plus* Present value of hire purchase payments discounted by cost of debt (K_d)
4. *Minus* Present value of depreciation tax shield discounted by cost of capital (K_c)
5. *Minus* Present value of net salvage value discounted by cost of capital (K_c)

Cost of Leasing The cost of leasing (COL) consists of the following elements:

1. Lease management fee
2. *Plus* Present value of lease payments discounted by K_d
3. *Less* Present value of tax shield on lease payments and lease management fee discounted by K_c
4. *Plus* Present value of interest tax shield on hire purchase discounted by K_c

The computation of the CHP and CL is illustrated in illustration 3.3

Illustration 3.3

The Hypothetical Industries Ltd (HIL) has an investment plan amounting to ₹108 lakh. The tax relevant rate of depreciation of the HIL is 25 per cent, its marginal cost of capital and marginal cost of debt are 16 per cent and 20 per cent respectively and it is in 35 per cent tax bracket.

It is examining financing alternative for its capital expenditure. A proposal from the Hypothetical Finance Ltd (HFL), with the following salient features, is under its active consideration:

Hire Purchase Plan: The (flat) rate of interest charged by the HFL is 16 per cent. The repayment of the amount is to be made in 36 equated monthly installments in advance. The hirer/hire-purchaser is required to make a down payment of 20 per cent.

Leasing Alternative: The lease rentals are payable @ ₹28 ptpm in advance. The primary lease period can be assumed to be 5 years.

Assume that the SOYD method is used to allocate the total charge for credit under the hire-purchase plan. The net salvage value of the equipment after 3 years can be assumed to be ₹33 lakh.

Which alternative–leasing or hire-purchase–should the HIL use? Why?

Solution

The choice will depend on the relative cost of hire-purchase and leasing

Cost of Hire-Purchase (CHP)	*(₹ lakh)*
1. Down payment (working note 1)	₹21.6
2. Present value of monthly hire-purchase installment (working note 2)	99.19
3. Minus: Present value of depreciation tax shield (working note 3)	20.44
4. Minus: Present value of net salvage value	15.70
Total cost of hire-purchase	84.65

Working Notes

1. Down payment = ₹108 lakh × 0.20 = ₹21.6 lakh
2. Monthly hire-purchase installment = [₹86.4 lakh (₹108 lakh less 20 per cent down payment) + (₹86.4 lakh × 0.16 × 3 years)] × 36 = ₹3.552 lakh

Present value of monthly hire-purchase installment

$$= ₹3.552 \text{ lakh} \times 12 \frac{1}{d^{(12)}} \times \text{PVIFA }(20,3) \quad \text{where I} = 0.20$$

= (₹3.553 lakh × 12) × 2.106 × 1.105 = ₹99.19 lakh

3. Present value of depreciation tax shield:

= [₹27 lakh × PVIF (16,1) + ₹20.25 lakh × PVIF × (16,2) + ₹15.19 lakh × PVIF (16,3) + ₹11.39 lakh × PVIF (16,4) + ₹8.54 lakh × PVIF (16,5)] × 0.35

= [(27 × 0.862) + (20.25 × 0.743) + (15.19 × 0.641) + (11.39 × 0.552) + (8.54 × 0.476)] × 0.35

= ₹20.44 lakh

Cost of Leasing (COL) *(₹ lakh)*

1. Present value of lease payments (working note 1)	₹119.93
2. *Minus:* Present value of tax shield on lease payment (2)	41.58
3. *Plus:* Present value of tax shield on charge for credit (3)	11.56
Total cost of leasing	89.91

Working Notes

1. Present value of lease payments:

$$= \left[(₹108 \text{ lakh} \times 0.028 \times 12) \times \frac{1}{d^{(12)}} \times \text{PVIFA }(20,5) \right], \quad \text{where I} = 0.20$$

= ₹108 lakh × 0.028 × 12 × 1.105 × 2.991 = ₹119.93 lakh

2. Present value of tax shield on lease payment = [₹108 lakh × 0.028 × 12 × PVIFA (16,5)] × 35 = (₹36.29 lakh × 3.274) × 0.35 = ₹41.58 lakh

3. Present value of tax shield on charge for credit: Total charge for credit = ₹108 lakh × 0.80 × 0.16 × 3 = ₹41.47 lakh

Allocation of total charge for credit: SOYD method

Year	*SOYD Factor*	*Annual charge (₹ lakh)*
1	$\frac{36+35+\ldots+25}{36+35+\ldots+1} = \frac{366}{666}$	22.79
2	$\frac{24+23+\ldots+1}{36+35+\ldots+1} = \frac{222}{666}$	12.82
3	$\frac{12+11+\ldots+1}{36+35+\ldots+1} = \frac{78}{666}$	4.86

Present value of tax shield = [(₹22.79 × 0.862) + (₹13.82 × 0.743) + (₹4.86 × 0.641)] × 0.35 = ₹11.56 lakh.

Decision: Since the cost of leasing exceeds the cost of hire-purchase, the HIL should acquire the equipment from the HFL under the hire-purchase plan.

From the Viewpoint of Finance Company (Hire-Vendor)

Hire-purchase and leasing represent two alternative investment decisions of a finance company/financial intermediary/hire-vendor. The decision-criterion, therefore, is based on a comparison of the net present values of the two alternatives, namely, hire-purchase and lease financing. The alternative with a higher net present value would be selected and the alternative having a lower net present value would be rejected.

Net Present Value of Hire-purchase Plan [NPV (HPP)] The NPV (HPP) consist of:

1. Present value of hire-purchase installments
2. *Plus:* Documentation and service fee
3. *Plus:* Present value of tax shield on initial direct cost
4. *Minus:* Loan amount
5. *Minus:* Initial cost
6. *Minus:* Present value of interest tax on finance income (interest)
7. *Minus:* Present value of income tax on finance income (interest) meted for interest tax
8. *Minus:* Present value of income tax on documentation and service fee

Net Present Value of Lease Plan [NPV (LP)] The NPV (LP) consists of the following elements:

1. Present value of lease rentals
2. *Add:* Lease management fee
3. *Add:* Present value of tax shield on initial direct costs and depreciation
4. *Add:* Present value of net salvage value
5. *Less:* Initial investment
6. *Less:* Initial direct costs
7. *Less:* Present value of tax liability on lease rentals and lease management fee

The decision-analysis is shown in illustration 3.4.

Illustration 3.4

For the HFL in **illustration 3.3**, assume the following:

- Front-end (advance) cost of structuring the deal, 0.5 (half) per cent of the amount financed
- Marginal cost of debt, 20 per cent
- Marginal cost of equity, 25 per cent
- Target long-term debt-equity ratio, 4:1
- Marginal tax rate, 35 per cent
- Residual value under lease plan, 10 per cent of the investment cost

Required: Which plan — hire-purchase or lease — is financially more attractive to the HFL? Why?

Solution

(A) (i) Net Present Value of Hire-Purchase Plan

(₹ lakh)

1.	Present value of monthly hire-purchase instalment (working note 1)	104.46
2.	*Plus:* present value of tax shield on initial direct costs (working note 2)	0.13
3.	*Less:* amount financed (₹108 lakh – 21.60 lakh, down payment)	86.40
4.	*Less:* initial direct cost (0.5 per cent of 86.4 lakh)	0.43
5.	*Less:* present value of interest tax on hire purchase-related income (working note 3)	0.67
6.	*Less:* present value of income tax on net finance income (working note 4)	11.41
	Total	5.68

Working Notes

Marginal cost of capital [0.80 × 0.20 × 0.65] + [0.20 × 0.25] = (0.104 + 0.05) = 15.4 per cent

1. Monthly hire-purchase installment = [(₹86.4 lakh + (₹86.4 lakh × 0.16 × 3)] × 36 = ₹3.552 lakh

Present value of monthly hire-purchase instalments: = ₹3.552 lakh × $PVIFA_m$ (15.4, 3) = ₹3.552 lakh × 12 × 2.265 × 1.082 = ₹104.46 lakh

2. Present value of tax shield on initial direct costs: Initial direct costs (0.5 per cent of ₹86.4 lakh) = 0.432 lakh

Present value = ₹0.432 lakh × 0.866 × 0.35 = ₹0.13 lakh

3. Present value of interest tax on hire-purchase-related income:

Unexpired finance income (total charge for credit) at inception = ₹86.4 lakh × 0.16 × 3 = ₹41.47 lakh

Allocation of unexpired finance income based on SOYD method

Year	*SOYD Factor*	*Annual charge (₹ lakh)*
1	$\frac{36+35+\ldots+25}{36+35+\ldots+1}=\frac{366}{666}$	22.79
2	$\frac{24+23+\ldots+1}{36+35+\ldots+1}=\frac{222}{666}$	12.82
3	$\frac{12+11+\ldots+1}{36+35+\ldots+1}=\frac{78}{666}$	4.86

Interest tax and income-tax on annual finance income *(₹ lakh)*

Year	*Gross finance income*	*Interest tax (2%)*	*Net finance income*	*Income tax (0.35)*
1	22.79	0.46	22.33	7.82
2	13.82	0.28	13.54	4.74
3	4.86	0.10	4.76	1.67

Present value = (₹0.46 lakh × 0.866) + (₹0.28 lakh × 0.751) + (₹0.10 lakh × 0.648) = ₹0.67 lakh

4. Present value of income tax on net finance income: = (₹7.82 lakh × 0.866) + (₹7.74 lakh × 0.751) + (₹1.67 lakh × 0.648) = ₹11.41 lakh

(A) (ii) Net Present Value of Leasing	*(₹ lakh)*
1. Present value of lease rentals/receipts (working note 1)	130.08
2. *Plus:* Present value of depreciation tax shield (note 2)	20.62
3. *Plus:* Present value of tax shield on initial direct cost (note 3)	0.16
4. *Plus:* Present value of residual value (note 4)	5.21
5. *Less:* Initial investment	108.00
6. *Less:* Initial direct cost	0.54
7. *Less:* Present value of income tax on lease rentals (note 5)	42.09
Total	5.44

Working Notes

1. Present value of lease rentals = ₹108 lakh × 0.028 × 12 × PVIFA (15.4, 5) = ₹108 lakh × 0.028 × 12 × 1.082 × 3.313 = ₹130.08 lakh
2. Present value of depreciation tax shield = [₹27 lakh × PVIF (15.4,1) + ₹20.25 lakh × PVIF (15.4,2) + ₹15.19 lakh × PVIF (15.4,3) + ₹11.34 lakh × PVIF (15.4,4) + ₹8.55 lakh × PVIF (15.4,5)] × 0.35 = [₹27 lakh × 0.866) + (₹20.25 lakh × 0.751) + (₹156.19 lakh × 0.648) + (₹11.34 lakh × 0.562) + (₹8.55 lakh × 0.482)] × 0.35 = ₹20.62 lakh
3. Present value of tax shield on initial direct cost:
   = 0.54 lakh (0.5 per cent of ₹108 lakh) × PVIF (15.4,1) × 0.35 = ₹0.16 lakh
4. Present value of residual value = ₹10.80 lakh (0.10 × ₹108 lakh) × PVIF (15.4,5) = ₹5.21 lakh
5. Present value of income tax on lease rentals = ₹108 lakh × 0.028 × 12 × PVIFA (15.4,5) × 0.35 = (₹36.29 lakh × 3.314) × 0.35 = ₹42.09 lakh

Decision: As the net present value of hire-purchase (₹5.68 lakh) exceeds the net present value of leasing (₹5.44 lakh), the hire-purchase plan is financially more attractive to the HFL.

CONSUMER CREDIT

> **Consumer credit** includes all asset-based financing plans offered to primarily individuals to quire durable consumer goods.

Consumer credit includes all asset-based financing plans offered to primarily individuals to acquire durable consumer goods. Typically, in a consumer credit transaction the individual-consumer-buyer pays a fraction of the cash purchase price at the time of the delivery of the asset and pays the balance with interest over a specified period of time. From a modest beginning in the early eighties, the consumer credit has emerged as an important asset-based financial service in India. The main suppliers of consumer credit are foreign/multi-national banks, commercial banks, and finance companies and cover items such as cars, scooters, VCRs, VCPs, TVs, refrigerators, washing machines, home appliances, personal computers, cooking ranges, food processors, and so on. There is, however, no specific legislation to regulate consumer credit in India. This Section briefly discusses the salient aspects of consumer credit as a financial service.

Salient Features

The salient features of consumer credit are: **(1)** parties to the transaction, **(2)** structure of the transaction, **(3)** mode of payment, **(4)** repayment period and rate of interest, and **(5)** security.

Parties to the Transaction The parties to a consumer credit transaction depend upon the nature of the transaction: In **(i)** A bipartite arrangement, there are two parties, namely, borrower-consumer-customer and dealer-cum-financier; **(ii)** A tripartite arrangement where the parties are dealer, financier and the customer. The dealer in this type of arrangement arranges the credit from the financier.

Structure of the Transaction A consumer credit arrangement can be structured in three ways:

Hire-Purchase The customer has the option to purchase the assets. But he may not exercise the option and return the goods according to the terms of the agreement. Most of the tripartite consumer credit transaction are of this type.

Conditional Sale The ownership is not transferred to the customer until the total purchase price including the credit charge is paid. The customer cannot terminate the agreement before the payment of the full price.

Credit Sale The ownership is transferred to the customer on payment of the first installment. He cannot cancel the agreement.

Mode of Payment From the point of view of payment, the consumer credit arrangements fall into two groups: **(i) down payment schemes** and **(ii) deposit-linked schemes**. The down payment may range between 20-25 per cent of the cost while the deposit may vary between 15-25 per cent of the amount financed at compound rate of interest. Some arrangements also provide zero deposit scheme with higher equated monthly installment (EMI).

Payment Period and Rate of Interest A wide range of options are available. Typically, the repayment period ranges between 12-60 monthly installments. The rate of interest is normally expressed at a flat rate; the effective rate of interest is generally not disclosed. In some schemes, the rate of interest is not disclosed, instead the EMI associated with the different repayment periods is mentioned. Most of the schemes provide for easy repayment. They also provide for either a rebate for prompt payment and charge for delayed payment.

Security is generally in the form of a first charge on the asset. The consumer cannot sell/pledge/hypothecate the asset.

Evaluation

The evaluation of consumer credit can be made with reference to effective rate of interest, rebate for early repayment and effective rate of interest on completed transaction. The mechanism is shown in **illustrations 3.5 to 3.6.**

Illustration 3.5 *(Flat and Effective Rates of Interest)*
The Hypothetical Consumer Finance Ltd (HCFL) has structured a consumer credit deal for ₹4,00,000 on the following basis:

Monthly repayment period	*Equated monthly instalment*
12	₹38,000
24	₹21,400

Required: Compute the flat and effective rates of interest for each alternative/option.

Solution

Flat and Effective Rates of Interest

	Repayment period (months)	
	12	*24*
Total charge for credit	₹56,000	₹56,800
Flat rate of interest (%)	0.14	0.142
Effective rate of interest (%)	0.2585	0.2726

Working Notes

1. Total annual charge for credit = (₹38,000 × 12) – ₹4,00,000 = ₹56,000; = [(₹21,400 × 24) – (₹4,00,000)] × 2 = ₹56,800

2. Flat rate of interest $= \frac{₹56{,}000}{₹4{,}00{,}000} \times 100 = 0.14$; $= \frac{₹56{,}800}{₹4{,}00{,}000} \times 100 = 0.142$

3. Effective rate of interest $= \frac{n}{n+1} \times 2\text{F}$; $= \frac{n}{n+1} \times 2\tilde{\text{F}}$

$= \frac{12}{13} \times 28$ = 25.85 per cent $= \frac{24}{25} \times 28.4$ = 27.26 per cent

Illustration 3.6

The Hypothetical Consumer Finance Ltd (HCFL) has structured the following types of consumer credit schemes to finance some specified assets for ₹30,000:

(A) Zero Deposit Scheme: **(1)** Repayment period, 36 months, **(2)** Equated monthly installment, ₹1,110, **(3)** Bullet installment at the end, ₹2,700.

(B) 25% Deposit Scheme: **(1)** Repayment period, 36 months, **(2)** Equated monthly installment, ₹1,068, **(3)** Accumulated interest on deposit after 36 months, ₹3,833.

(C) Prompt Payment Bonus Scheme: Bonus of ₹10 per ₹1,000 per month on the expiry of the repayment period in respect of both the above schemes — A and B.

The HCFL levies a front-ended (advance) documentation and service fee of ₹600 in both the schemes. The EMI is payable at the end of every month.

Required:

(a) Calculate the effective rate of interest for all the schemes.

(b) Assume an early settlement after 24 months under the second scheme, that is, the 25 per cent deposit scheme. The HCFL would levy a 2 per cent service charge on the principal amount outstanding on the date of settlement. It also gives a prompt payment bonus in respects of installments paid. Further, interest rebate would also be due according to Rule of 78 method. What would be the effective rate of interest on the completed transaction?

Solution

(a) (i) Effective rate of interest implicit in the 25 per cent deposit scheme:

The effective rate of interest, i, is given by the equation:

Loan amount – Present value of installment paid – Service fee + Present value of accumulated value of deposit + Present value of prompt payment bonus = 0

Accumulated value of deposit after 36 months = ₹7,500 (deposit) + ₹3,833 (accumulated interest) = ₹11,333

Or ₹7,500 × PVIF ($i_{,3}$) = ₹11,333

Simplifying the equation, i_1 = 14.75 per cent per annum or 14 per cent per annum compounded quarterly.

(ii) Effective rate of interest on zero deposit scheme with prompt bonus:

$$\text{Prompt payment bonus } = \frac{₹1{,}100}{₹3{,}000} \times 0.10 \times 36 = ₹39.36$$

Effective rate of interest (i_1) is given by the equation:

₹30,000 – ₹600 – (₹1,110 × 12 × PVIFA$_m$ (i_1,3) – ₹2,700 × PVIF (i_1,3) + ₹39.96 × PVIF (i_1,3) = 0

By trial and error and interpolation, i_1 = 27.41 per cent

(iii) Effective rate of interest, i_2, on 25 per cent deposit scheme with prompt payment bonus:

$$\text{Prompt payment bonus } = \frac{₹1{,}0368}{₹3{,}000} \times 0.10 \times 36 = ₹38.45$$

Effective rate of interest (I_2) can be obtained from the equation:

₹22,500 – ₹600 – {₹1,068 × 12 × PVIFA$_m$ (i_2,3) + ₹11,333 × PVIF (i_2,3) + [₹38.45 × PVIF (i_2,3) = 0

By trial and error and interpolation, i_2 = 25.3 per cent

(b) Effective rate of interest (i_3) on the completed transaction:

The i_3 is given by the equation:

₹22,500 – ₹600 – [₹1,068 × 12, PVIFA$_m$ (i_3, 2)] – [₹12,037 × PVIF (i_3,2) + [₹9,876 × PVIF (i_3, 2) = 0

By trial and error and interpolation, i_3 = 24.85 per cent

Thus, the effective rate of interest on the completed transaction is higher than the effective rate of interest implicit in the original transaction.

Working Notes

1. Total charge for credit = (₹1,068 × 12 × 3) – ₹30,000 = ₹8,448.

2. Interest rebate according to rule of 78 method = $\frac{12 \times 13}{36 \times 37} \times ₹8{,}448 = ₹989.4$

3. Capital content of the installment outstanding on payment of the 24th installment: (₹12,816** – ₹989.4) = ₹11,827

   **Total payment liability (₹30,000 + 8,448 = ₹38,498) – Payment made upto 24 months (EMI × 24 = ₹25,632) = ₹12,816

4. Service charge on the amount of principal outstanding = (₹11,827 × 0.02) = ₹236.54

5. Rebate for prompt payment = $\dfrac{₹1{,}068}{₹3{,}000} \times 0.10 \times 24 = ₹25.5$

6. Amount payable on early settlement = (₹12,816 + ₹236.4 – ₹989.4 – ₹25.5) = ₹12,037.5

7. Accumulated value of deposits after 2 years $= ₹7{,}500 \times \left[1 + \dfrac{0.14}{4}\right]^8 = ₹7{,}500 \times (1.035)^8 =$ ₹9,876

RECAPITULATION

- Hire-purchase is a mode of financing the price of goods to be sold on a future date. It is an agreement relating to a transaction in which goods are let on hire, the purchase price is to be paid in installments and the hirer is allowed the option to purchase the goods paying all the installments. Though the option to purchase the goods/assets is allowed in the very beginning, it can be exercised only at the end of the agreement.
- The essence of the agreement is that the property in the goods does not pass at the time of the agreement but remains in the intending seller (hire-vendor) and only passes when the option is exercised by the hirer (intending hire-purchaser). In contrast, in installment sale the ownership in the goods passes on to the purchaser simultaneously with the payment of the initial/first installment. The hire-purchase also differs from the installment sale in terms of the call option and right of termination in the former but not in the latter. Similarly, hire-purchase and leasing as modes of financing are also differentiated in several respects such as ownership of the asset/equipment, its capitalisation, depreciation charge, extent of financing and accounting and reporting.
- Under the down payment plan of hire-purchase, the hirer has to make a down payment of 20-25 per cent of the cost and pay the balance in equated monthly installments (EMIs). As an alternative, under a deposit-linked plan the hirer has to invest a specified amount in the fixed deposit of the finance company which is returned together with interest after the payment of the last EMI by the hirer. The hire-purchase installment has two components: **(i)** interest/finance charge and **(ii)** recovery of principal. The interest component is based on a flat rate of interest while effective rate is applied to the declining balance of the original amount to determine the interest component of each installment. During the hire-period, the hirer can opt for early repayment/purchase of the equipment/asset by paying the remaining installments minus an interest rebate. The hirer has the right to terminate the contract after giving due notice.
- There is no exclusive legislation dealing with hire purchase transactions in India. The *Hire-Purchase Act* was passed in 1972. A bill was introduced in 1989 to amend some of the provisions of the Act. However, the Act has not been enforced so far. In the absence of any specific law, the hire-purchase transactions are governed by the general laws. The hire-purchase transaction has to aspects: **(i)** an aspect of bailment of goods which is covered by the *Indian Contract Act*, **(ii)** an element of sale when the option to purchase is exercised by the hirer which is covered by the *Indian Sales of Goods Act*. The hire-purchase agreements also contain provisions for the regulation of hire-purchase deals.
- There are three aspects of taxation of hire-purchase deals: **(i)** income-tax, **(ii)** sales tax and, **(iii)** interest tax. Though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price. He can also claim deduction on account of consideration for hire, that is, finance charge. The amount of finance charge to be deducted each year is to be spread evenly over the term of the agreement on the basis of a method

chosen from amongst the alternatives: SOYD, ERI, SLM. The consideration is viewed as a rental charge rather than interest and no deduction of tax at source is made. The hire-purchase transaction can be used as a tax planning device in two ways: **(i)** by inflating the net income (finance income – interest on borrowings by the finance company) at the rear-end of the deal and **(ii)** by using hire-purchase as a bridge between the lessor and the lessee, that is, introduction of an intermediate financier instead of a direct lease. Hire-purchase transaction, as deemed sales, are liable to sales tax. However, hire-purchase transaction structured by finance companies (which are not hire-vendors), being essentially a financing arrangement, do not attract sales tax. An interest tax has to be paid on the interest earned less bad debts. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income under the *Income-Tax Act*.

- There was no accounting standard/guidance note for accounting treatment of hire-purchase in India. According to the current reporting practices, in the books of the hirer, the cash purchase price of the equipment is capitalised and an equal amount less down payment, if any, is recorded as a liability. The depreciation is charged on the cash purchase price in conformity with the general depreciation policy for similar assets. The total charge for credit is spread over hire-term according to one of the alternative methods: ERI, SOYD, SLM. As far as the finance company is concerned, the hire installment receivable is shown as a current asset under the head stock on hire and the finance income element of the installment is recorded as a current liability under the head unmatured/unearned finance charge and is spread over the accounting period (hire-term). The direct costs are expensed immediately/amortised over the accounting period. The ICAI has recently issued AS-19: Leasing, 2001. It defines leasing to include hire-purchase for accounting and reporting purposes. These are discussed in an earlier chapter.
- The decision-criterion for evaluation of a hire- purchase deal from the point of view of a hirer is the cost of hire-purchase *vis-a-vis* the cost of leasing. If the discounted cost of hire-purchase is less than the discounted cost of leasing, the hire-purchase alternative should be preferred and *vice versa*. The preference for the alternative implies that the equipment should be acquired under that alternative. The decision-criteria from the viewpoint of the financial intermediary is based on a comparison of the NPVs of the hire-purchase and the leasing alternatives. The finance company would choose the financing plan with higher NPV.
- Consumer credit includes all asset-based financing plans offered to primarily individuals to acquire durable consumer goods. In a typical consumer credit deal, the customer pays a fraction of the cash purchase price on delivery of the goods and the balance is paid together with interest over a specified period of time. The consumer credit plans/schemes can be down payment type or deposit-linked type. Such credit usually carries a flat rate of interest. The loan is secured by a first charge on the concerned equipment.

REVIEW QUESTIONS

3.1 Discuss the main characteristics of hire-purchase. How does it differ from **(a)** installment payment, and **(b)** finance lease.

3.2 Write notes on

- Tax benefits of hire-purchase to the hire-purchase and the hire-vendor.
- Tax planning in hire-purchase

3.3 What are the accounting practices relating to hire-purchaser transactions in the books of the hirer as well as the hire-vendor?

3.4 Briefly explain the evaluation framework of hire-purchase transaction *vis-à-vis* leasing.

3.5 Discuss the main features of consumer credit.

3.6 The Hypothetical Manufacturer Ltd (HML) has under consideration an investment in equipment amounting to ₹144 lakh. It is expected to generate a stream of operating profit (profit before depreciation, lease rental, interest and taxes) detailed below:

Years	1 – 3,	₹33 lakh
	4 – 6,	₹27 lakh
	7 – 8,	₹18 lakh

The experience has been that cost of similar capital equipments escalate annually by 12 per cent and the salvage value after five years is 10 per cent of the original cost. Further, the disposal of used equipments in the secondary markets entails a transaction cost of 15 per cent of the estimated residual value. The following assumptions can be made: **(i)** tax relevant rate of depreciation, 25 per cent, **(ii)** marginal tax rate, 35 per cent, **(iii)** marginal cost of capital and debt 15 per cent and 18 per cent respectively.

The finance manager of the HML is evaluating, *inter alia*, the following two financing alternatives structured by the Hypothetical Finance Ltd (HFL):

Hire-Purchase Plan: Flat rate of interest, 15 per cent; Repayment in 48 EMI in advance; Amount of financing 100 per cent with an initial 4-year deposit equal to 20 per cent of the investment cost, on which quarterly compounded rate of interest, 16 per cent; Rebate for prompt payment, 2 per cent of the loan.

Lease Plan: Period, 8 years, lease rate, ₹28 ptpm during the primary period of 5 years and ₹2 ptpm during the secondary period of 3 years; Payment monthly in advance.

Which plan should be used by the HML? Why? You can make your own assumptions, if necessary.

3.7 For the facts in review question **3.1**, assume the HML opts for the hire-purchase plan. How will the deal be recorded in the books over the hire-period, according to SOYD method of allocating the total charge for credit?

3.8 For the facts a review question **3.1**, if the hire-purchase deal is accepted, show how the transaction will be recorded in the financial statements of the HFL according to SLM for allocating the unearned finance income over the hire period.

3.9 The undermentioned facts relate to a hire-purchase deal structured by the Hypothetical Finance Ltd:

- Hire-term, 3 years.
- Deposit required, 20 per cent of the amount financed. Interest on the security deposit @ 15 per cent compounded quarterly.
- Flat rate of interest, 14 per cent.
- Repayment in equated monthly installment in advance.
- Front-ended documentation fee, 1 per cent of the loan.
- Rebate for prompt payment, 2 per cent of the amount.

  If the rebate for prompt payment is availed of by the hirer, what would be the effective rate of interest?

3.10 The Hypothetical Finance Ltd has structured a hire-purchase deal. The hirer is required to make a down payment of 20 per cent of the investment cost. The hire-term is four years with quarterly payment in advance. The flat rate of interest is 13 per cent. The finance company would charge a front-ended documentation and service fee and allow rebate for prompt payment @ 0.5 per cent and 1 per cent of investment outlay respectively.

Assuming after paying 24th installment, a hirer wishes to exercise the purchase option, what is the interest rebate according to **(i)** actuarial method, **(ii)** rule of 78 method and, **(iii)** SLM?

3.11 From the facts in review question **3.7**, assume a rebate of 1 per cent of the aggregate installment paid till date as rebate for prompt repayment and modified rule of 78 with 3 months time-lag for calculating interest rebate, what is the effective rate of interest per annum implicit in the completed transaction?

Appendix 3-A
Flat Rate vs Effective Rate of Interest/Annual Percentage Rate

The interest component of each hire-purchase installment is calculated on the basis of a flat rate of interest. But the original amount of the loan is repaid over the term of the loan in equated installments. To determine the interest component of each installment of the declining balance of the principal amount over a period of time, the equivalent effective rate of interest (invariably higher than the flat rate) is to be used. Thus, the effective rate of interest (ERI) is an important element of accounting and reporting of a hire-purchase transaction. It is also known as annual percentage rate (APR). The computation of APR depends on whether the hirer has to (a) make a down payment, or (b) invest in fixed deposit of the finance company. The APR also depends on the fact that the equated installments are paid in arrears or advance. The computation of APR/ERI is shown in **illustrations 3.A.1–3.A.2.**

Illustration 3-A.1 *(Cash Down Payment)*

Under a hire-purchase deal structured by the Hypothetical Finance Ltd (HFL) for the Hypothetical Industries Ltd (HIL), the (flat) rate of interest is 15 per cent. The HIL is required to make a cash down payment of 25 per cent and the repayment of the loan is to be made in 36 equated monthly installments. On the assumption of payment of installment in (a) advance (b) arrear, compute the ERI/APR for the plan.

Solution

The ERI/APR can be computed (i) by applying the trial and error approach or (ii) by using the approximation formula.

(A) Approximation Approach/Formula

(a) Computation of APR/ERI (Payment in Arrear)

$$I = \frac{N}{N+1} \times 2F$$

I = APR/ERIs

N = Number of repayments

F = Flat rate of interest per unit time

$$= \frac{36}{37} \times 2 \times 0.15 = 0.292 = 29.2 \text{ per cent}$$

(b) Computation of APR/ERI (Payment in Advance):

$$I = \frac{N}{N-1} \times 2F = \frac{36}{35} \times 2 \times 0.15 = 0.0309 = 30.9 \text{ per cent}$$

(B) Trial and Error Approach (Assumed Amount of ₹1,000)

(a) Computation of APR/ERI (Payment in Arrear):

Amount of loan (0.75 × ₹1,000) = ₹750

Total credit charge = ₹750 × 0.15 × 3 = ₹337.5

Equated monthly installment = [₹1,087.5 (₹750 + ₹337.5)] × 36 = ₹30.21

The value of I (APR) is given by the equation:

(₹30.21 × 12) × PVIFA_m (I, 3) = ₹750

$$= 362.52 \times \frac{1}{I^{(12)}} \times \text{PVIFA}\,(1, 3) = ₹750$$

By trial and error and interpolation,

I = 29.4 per cent

(b) Computation of IPR/ERI (Payment in Advance):

The value of I can be obtained by the equation:

(30.21 × 12) PVIFA_m (I, 3) = ₹750

By trial and error and interpolation

I = 31.2 per cent

Illustration 3-A.2 *(Deposit-Linked Plan)*

Under a purchase deal structured by the Hypothetical Finance Ltd (HFL) for the Hypothetical Industries Ltd (HIL), the HFL offers to provide 100 per cent finance to the HIL at a flat rate of interest of 13 per cent. The HIL has to invest 20 per cent of the investment cost as fixed deposit with the HFL during the hire-purchase period of three years at 15 per cent compounded monthly. The repayment has to be made in 36 monthly installments in arrear. Compute the ERI/APR on an investment cost of ₹1,000.

Solution

APR/ERI (I) = Rate of interest which equates the present value of the cash inflows with the present value of the cash outflows. The elements of the monthly cash flows are: (1) loan amount (2) initial deposit (3) installment amount (4) accumulated value of deposit. The monthly net cash flow = Loan amount less initial deposit less installment amount plus accumulated value of deposit.

Month	*Net monthly cashflow*
0	₹800 [(₹1,000 loan) – (₹200 deposit)] – 38.61 (monthly installment)
1-35	274.18 [(accumulated deposit, ₹312.79 – installment, 38.61)]
36	

$$\text{Monthly instalment} = \frac{\text{Total charge for credit}}{\text{Months}} = ₹38.61$$

Total charge for credit = Loan amount + Interest

= ₹1,000 + [(₹1,000 × 0.13 × 3)] = ₹1,390

$$\text{Accumulated value of deposit} = ₹200 \times \left[1 + \frac{0.15}{36}\right]^{36} = ₹312.79$$

ERI, (I) is given by the equation:

$$₹38.61 \times \text{PVIFA}_m\,(I, 35/12) = ₹800 + ₹274.18 \times \text{PVIF}\,(I, 3)$$

or $$₹463.32 \times \frac{1}{I^{(12)}} \times \text{PVFIA}\,(1, 2.9167) = ₹800 + ₹274.18 \times \mathit{PVIF}\,(I, 3)$$

By trial and error and interpolation, I = 31.39 per cent

APPENDIX 3-B
Interest Rebate

The interest rebate for early repayment of hire-purchase installments to exercise the option to purchase the asset can be computed in either of two ways: (1) on the basis of effective rate of interest method and (2) by Rule/modified rule of 78 method or sum-of-year's-digits method.

Interest Rebate: Effective Rate of Interest (ERI) Method

This is a true and fair method to determine the interest rebate. This is also known as IRR method. According to it, the interest rebate is equal to the total amount of outstanding (but not due) installments less the discounted value of the outstanding installment as on the date of early repayment. The computation is shown in illustration 3.B.1.

Illustration 3-B.1

The Hypothetical Finance Ltd (HFL) has structured a hire- purchase deal for the Hypothetical Industries Ltd (HIL) at a (flat) rate of interest of 13 per cent. The payment would be made in 36 equal monthly installments in arrears. The HIL is required to make a cash down payment of 20 per cent.

Assume that after paying the 24th installment, the HIL wishes to repay the outstanding amount and purchase the equipment. What is the interest rebate per ₹1,000 of investment cost, according to the ERI/IRR method?

Solution

Amount of loan/hire-purchase finance = 0.80 × ₹1,000 = ₹800

Total charge for credit = ₹800 × 0.13 × 3 years = ₹312

$$\text{Monthly Installment} = \frac{(₹800 + ₹312)}{36} = ₹30.89$$

Amount outstanding on the date of repayment = ₹30.89 × 12 = ₹370.68 (X)

Discounted value of the outstanding installments on the date of repayment = ₹30.89 × PVIFA$_m$ (25.38@, 1)

$$= ₹30.89 \times\times 12 \times \times\frac{0.2538}{0.2283} \times \times \text{PVIFA}\ (25.38^{@}, 1)$$

$$= ₹30.89 \times 12 \times \frac{0.2538}{0.2283} \times 0.7976 = ₹328.68\ (Y)$$

$$\text{Interest rebate} = (X) - (Y) = ₹370.68 - ₹328.68 = ₹42$$

Working Notes

$$@\ \text{ERI} = \frac{N}{N+1} \times\ 2F,\ \text{where } N = \text{total number of repayments.}$$

F = flat rate of interest per unit time

$$\text{ERI} = \frac{36}{37} \times 2 \times 0.13 = 0.253 = 25.38 \text{ per cent}$$

Interest Rebate: Rule of 78/Sum-of-Year's-Digits Method

According to this method, the interest rebate (*IR*)

$$= \frac{t\ (t+1)}{n\ (n+1)} \times D$$

where, t = number of level investments (not due) outstanding
n = total number of level installments
D = total charge for credit

Illustration 3-B.2

For the facts in **illustration 3-B.1**, compute the interest rebate (*IR*) according to the rule of 78 method.

Solution

$$\text{IR} = \frac{12 \times 13}{36 \times 37} \times ₹312 = ₹36.54$$

Compared to the ERI method, the IR is lower in case of rule of 78 method. The implication of lower interest rebate is that the effective rate of interest on the completed transaction will be higher than what was implicit in the original transaction. When the interest rebate is calculated according to the ERI method, the implicit rate of interest is the same as the rate of interest implicit in the original transaction. For instance, for the facts in illustration 5-B.1, the effective rate of interest implied by the completed transaction (E_i) according to the ERI method:
= ₹30.89 × 12 × PVIFA$_m$ (E_i,2) + (₹370.67 – ₹42) × PVIF (E_i,1) = ₹800
By trial and error and interpolation, E_i = 25.38 per cent
If the interest rebate is calculated on the basis of rule of 78 method, the E_i = ₹30.89 × 12 × PVIFA$_m$ (E_i, 2) + (₹370.67 – ₹36.5) × PVIF (E_i, 2) = ₹800
By trial and error and interpolation, E_i = 26 per cent that is, marginally higher than what is implicit in the original transaction.

Interest Rebate: Modified Rule 78 Method

According to this method, finance companies allow for a deferment period for the repayment of the outstanding amount. Accordingly

$$\text{IR} = \frac{(T - dp)(t - d + 1)}{n(n+1)} \times \text{D} = 0, \text{ where } dp = \text{deferent period}$$

Illustration 3-B.3

For facts in **illustration 3.B.1**, compute interest rebate (*IR*) assuming that the HFL calculates the rebate on the basis of modified rule of 78 which provides for a deferment period of 3 months. If the borrower wants to repay the outstanding loan after paying the 33rd installment, calculate the amount of interest rebate and the rate of interest on the completed transaction.

Solution

(a) IR = $\dfrac{(12 \times 3) \times (12 \times 3 + 1)}{36 \times 37} \times ₹312 = ₹21.1A$

The implicit rate of interest for the completed transaction would work out to be 27 per cent.
(b) Since the number of remaining unpaid installments is equal to the deferment period, IR would be = 0. The effective rate of interest on the completed transaction (E_i) would be given by the following equation: ₹30.89 × 12 × PVIFA$_m$ (E_i, 2.75) + ₹92.67 × PVIFA (E_i, 2.75) = ₹800.
E_i = 26 per cent

CHAPTER 4

Factoring and Forfaiting

Learning Objectives

- Understand the concept and mechanism of factoring.
- Discuss the functions of a factor and forms of factoring.
- Compare and contrast factoring with forfaiting.
- Explain and illustrate the evaluation framework of factoring.
- Understand the main elements of recently-codified regulatory framework.
- Outline nature of factoring services in India.

INTRODUCTION

Factoring, as a fund-based financial service, provides resources to finance receivables as well as facilitates the collection of receivables. Although such services constitute a critical segment of the financial services scenario in the advanced countries, they appeared on the Indian financial scene only in the early nineties as a result of RBI initiatives. This Chapter discusses the theoretical framework of factoring services and the salient features of such services currently in operation in the country and is divided into three sections. The theoretical/conceptual framework is comprehensively examined in Section 1. The current status of such services in the country is described in the Section 2. The main points are summarised in Section 3. **These are portrayed in Exhibit 4.1.**

Factoring involves the outright sale of receivables at a discount to a factor to obtain funds.

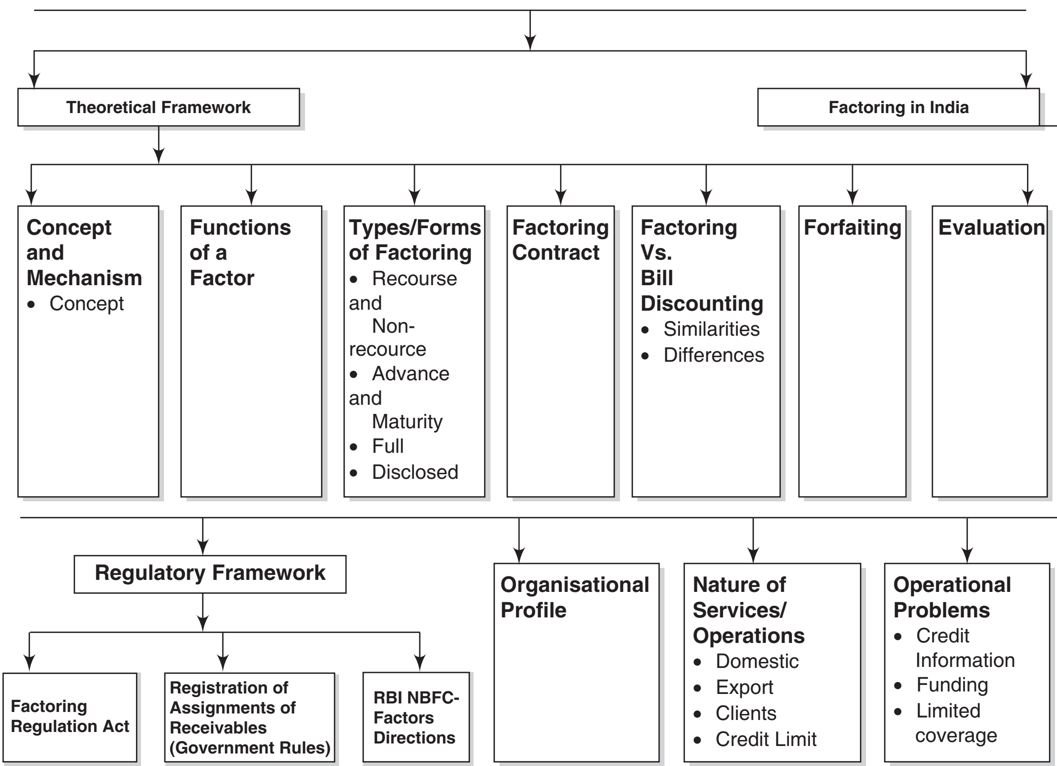
THEORETICAL FRAMEWORK

This section describes the theoretical framework of factoring services with reference to aspects such as its concept and mechanism, types, functions of a factor, legal aspects of factoring, its relationship with bills discounting and forfaiting, its advantages and evaluation and so on.

Concept and Mechanism

Concept In the absence of any uniform codified law, the term "factoring" has been defined in various countries in different ways. Many efforts have been made to arrive at a consensus

Exhibit 4.1 Factoring and Forfaiting



regarding uniform meaning and defining a well laid scope for such a type of service contract. The Study Group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988, recommended, in general terms, the definition of factoring as under: "Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor: **(i)** Finance, **(ii)** Maintenance of accounts, **(iii)** Collection of debts, and **(iv)** Protection against credit risk".

However, the above definition applies only to factoring in relation to supply of goods and services: **(i)** across national boundaries; **(ii)** to trade or professional debtors; **(iii)** when notice of assignment has been given to the debtors. Domestic factoring is not yet a well defined concept and it has been left to the discretion of legal framework as well as trade usage and convention of the individual country.

Nevertheless, following the development of factoring concept in various developed countries of the world, some broad agreement has been arrived at towards defining the term. Factoring can broadly be defined as an agreement in which receivables arising out of sale of goods/services are sold by a firm (client) to the "factor" (a financial intermediary) as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Henceforth, the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s). In a full service factoring (without recourse facility), if any of the debtors fails to pay the dues as a result of his financial inability/insolvency/bankruptcy, the factor has to absorb the losses.

Mechanism Credit sales generate the factoring business in ordinary course of business dealings. Realisation of credit sales is the main function of factoring services. Once sale transaction is completed, the factor steps in to realise the sales. Thus, factor works between the seller and the buyer and sometimes with seller's banks together.

A schematic view of factoring mechanism explaining the interaction between the different parties and flow of information between them is summarised below:

The Buyer

- **(a)** Buyer negotiates terms of purchasing the material with the seller;
- **(b)** Buyer receives delivery of goods with invoice and instructions by the seller to make payment to the factor on due date;
- **(c)** Buyer makes payment to factor in time or gets extension of time or in the case of default is subject to legal process at the hands of factor.

The Seller

- **(a)** Memorandum of understanding (MOU) with the buyer in the form of letter exchanged between them or agreement entered into between them;
- **(b)** Sells goods to the buyer as per MOU;
- **(c)** Delivers copies of invoice, delivery challan, MOU, instructions to make payment to factor given to buyer;
- **(d)** Seller receives 80 per cent or more payment in advance from factor on selling the receivables from the buyer to him;
- **(e)** Seller receives balance payment from factor after deduction of factor's service charges, etc.

The Factor

- **(a)** The factor enters into agreement with seller for rendering factor services to it;
- **(b)** On receipt of copies of sale documents as referred to above makes payment to the seller of the 80 per cent of the price of the debt;
- **(c)** The factor receives payment from the buyer on due dates and remits the money to seller after usual deductions;
- **(d)** The factor also ensures that the following conditions should be met to give full effect to the factoring arrangements:
  - **(i)** The invoice, bills or other documents drawn by the seller should contain a clause that these payments arising out of the transaction as referred to or mentioned in might be factored;
  - **(ii)** The seller should confirm in writing to the factor that all the payments arising out of these bills are free from any encumbrances, charge, lien, pledge, hypothecation or mortgage or right of set-off or counter-claim from another etc.;
  - **(iii)** The seller should execute a deed of assignment in favour of the factor to enable him to recover the payment at the time or after default;
  - **(iv)** The seller should confirm (by a letter of confirmation) that all conditions to sell-buy contract between him and the buyer have been complied with and the transactions complete; and
  - **(v)** The seller should procure a letter of waiver from a bank in favour of factor in case the bank has a charge over the assets sold out to buyer and the sale proceeds are to be deposited in the account of the bank.

Functions of a Factor

Factor
is a financial institution that specialises in purchasing receivables from business firms.

Depending on the type/form of factoring, the main functions of a **factor**, in general terms, can be classified into five categories:

- Maintenance/administration of sales ledger;
- Collection facility/of accounts receivable;
- Financing facility/trade debts;
- Assumption of credit risk/credit control and credit protection; and
- Provision of advisory services.

Administration of Sales Ledger The factor maintains the clients' sales ledgers. On transacting a sales deal, an invoice is sent by the client to the customer and a copy of the same is sent to the factor. The ledger is generally maintained under the open-item method in which each receipt is matched against the specific invoice. The customer's account clearly reflects the various open invoices outstanding on any given date. The factor also gives periodic (fortnightly/weekly depending on the volume of transaction) reports to the client on the current status of his receivables, receipts of payments from the customers and other useful information. In addition, the factor also maintains a customer-wise record of payments spread over a period of time so that any change in the payment pattern can be easily identified.

Provision of Collection Facility The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection and enables him to concentrate on other important functional areas of the business. This also enables the client to reduce the cost of collection by way of savings in manpower, time and efforts. The use of trained manpower with sophisticated infrastructural back-up enables a factor to systematically follow up and make timely demands on the debtors to make payments. Also, the debtors are more responsive to the demands from a factor being a credit institution.

Collection of receivables can be considered as the most important function of a factor. He is generally not required to consult the client with regard to the collection procedure. But he may consult the client if legal action has to be initiated in case of non-payment and so on.

Financing Trade Debts The unique feature of factoring is that a factor purchases the book debts of his client at a price and the debts are assigned in favour of the factor who is usually willing to grant advances to the extent of 80-85 per cent of the assigned debts. The balance 15-20 per cent is retained as a factor reserve. Where the debts are factored with recourse, the finance provided would become refundable by the client in case of non-payment by the buyer. However, where the debts are factored without recourse, the factor's obligation to the seller becomes absolute on the due date of the invoice whether or not the buyer makes the payment.

Credit Control and Credit Protection Assumption of credit risk is one of the important functions of a factor. This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to purchase all trade debts of the customer without recourse. In other words, the factor assumes the risk of default in payment by customers. Arising from this function of the factor, there are two important incidental benefits accruing to the client: first, factoring relieves the client of the collection work; secondly, with access to extensive information available on the financial standing and credit rating of individual customers and their track record of payments, the factor is able to advise the client on the credit worthiness of potential customers leading to better credit control.

Operationally, the line of credit/credit limit up to which the client can sell to the customer depends on his financial position, his past payment record and the value of the goods sold by the client to the customer. One approach followed by the factors is to define the monthly sales turnover for each customer which will be automatically covered by the approved credit limit. If, for instance, the approved limit for a customer is ₹5 lakh and the average collection period is 60 days, sales up to ₹2.5 lakh [(5 × 30)/60] per month will be automatically covered. Alternatively, some factors provide periodic reports to the clients on customer-wise outstanding and ageing schedules to enable the clients to assess the extent of credit utilisation before any major sale is made. The credit-worthiness of customers is assessed by factors on the basis of information from a number of sources such as credit rating reports, if available; bank reports and trade references; analysis of financial statements on the basis of current ratio, quick ratio, net profit margin and return on investment (ROI); prior collection experience; customer visits and so on.

Advisory Services These services are spin-offs of the close relationship between a factor and a client. By virtue of their specialised knowledge and experience in finance and credit dealings and access to extensive credit information, factors can provide a variety of incidental advisory services to their clients such as:

- Customer's perception of the client's products, changes in marketing strategies, emerging trends and so on;
- Audit of the procedures followed for invoicing, delivery and dealing with sales returns;
- Introduction to the credit department of a bank/subsidiaries of banks engaged in leasing, hire-purchase, merchant banking and so on.

Cost of Services The factors provide the various services at a charge. The charge for collection and sales ledger administration is in the form of a **commission** expressed as a per cent of the value of debt purchased. It is collected up-front/in advance. The charge for short-term financing in the form of advance part-payment is in the form of interest charge for the period between the date of advance payment and the date of collection/guaranteed payment date. It is also known as **discount charge**. The computation of these charges is shown in illustration 4.1.

> **Commission** is the charge for collection and sales ledger administration.

> **Discount charge** is the interest charge for short-term financing by the factor between the date of advance payment and the date of guaranteed payment/collection.

Illustration 4.1

The Hypothetical Manufacturers Ltd (HML) enters into a factoring arrangement with the Hypothetical Factors Ltd (HFL). According to the agreement, the HFL would pay in advance 80 per cent of the value of the factored receivables at 25 per cent interest compounded quarterly, the balance retained as factor reserve to disputes and deductions. It also provides for guaranteed payment after three months from the date of purchase of the receivables. The factoring commission would be two per cent of the value of factored receivables. It is stipulated that interest and commission would be collected in advance. Assuming an advance payment of ₹42 lakh, compute:

(A) Advance payable to HML;
(B) Effective cost of funds; and

(C) Effective cost of funds on the assumption that interest is collected in arrear while the commission is collected in advance.

Solution

(A) Advance Funds to HML	(₹ *lakh*)
Value of factored receivables (42 ÷ 0.80)	52.50
Maximum advance (52.50 × 0.80)	42.00
Less: Commission (0.02 × 52.50)	1.05
	40.95
Less: Discount/interest charge (42 × 0.25 × 90/360)	2.62
	38.33

(B) Effective Cost of Funds to HML	(₹ *lakh*)
Discount/interest charge as percentage of funds [(2.62 ÷ 40.95) × 100]	6.40
Effective rate (%) of interest per quarter	6.40
Annualised rate of interest/cost of funds (%) [$(1.0640)^4$ – 1)] × 100	28.16

(C) Effective Cost of Funds to HML	(₹ *lakh*)
Maximum advance	42.00
Less: Commission on advance	0.84
Funds available to HML	41.16
Interest charge in arrear (42 × 0.25 × 90/360)	2.62
Interest charges per quarter as a percentage of funds [(2.62 ÷ 41.16) × 100)]	6.37
Annualised interest cost (%) [$(1.0637)^4$ – 1] × 100	28.02

Types/Forms of Factoring

Depending upon the features built into the factoring arrangement to cater to the varying needs of trade/clients, there can be different types of factoring. The collection of receivables and sales-ledger administration is a common feature of practically all factoring transactions. Additional features are also included in some of these arrangements. The important forms of factoring arrangements are briefly discussed below.

Recourse factoring is the basis on which recievables are sold to the factor with the understanding that all credit risks would be borne by the firm.

Non-recource factoring is the basis on which recievables are sold to a factor with the understanding that all credit risks are on the purchased accounts (factor).

Recourse and Non-recourse Factoring Under a **recourse factoring arrangement**, the factor has recourse to the client (firm) if the debt purchased/receivables factored turns out to be irrecoverable. In other words, the factor does not assume credit risks associated with the receivables. If the customer defaults in payment, the client has to make good the loss incurred by the factor. The factor is entitled to recover from the client the amount paid in advance in case the customer does not pay on maturity. The factor charges the client for maintaining the sales ledger and debt collection services and also for the interest for the period on the amount drawn by the client.

The factor does not have the right of recourse in the case of **non-recourse factoring**. The loss arising out of irrecoverable receivables is borne by him, as a compensation for which he charges a higher commission.

The additional fee charged by him as a premium for risk-bearing is referred to as a **del credere** commission. Additionally, he is actively associated with the process of grant of the credit and the extension of line of credit to the customers of the client.

Advance and Maturity Factoring The factor pays a pre-specified portion, ranging between three-fourths to nine-tenths, of the factored receivables in advance, the balance being paid upon collection/on the guaranteed payment date. A drawing limit, as a pre-payment, is made available by the factor to the client as soon as the factored debts are approved/the invoices are accounted for. The client has to pay interest (discount) on the advance/repayment between the date of such payment and the date of actual collection from the customers/or the guaranteed payment date, determined on the basis of the prevailing short-term rate, the financial standing of the client and the volume of the turnover.

An extension of advance factoring is **Bank Participation Factoring**, under which a bank provides an advance to the client to finance a part, say 50 per cent, of the factor reserve, that is, the factored debt less advance given by the factor. Assuming 75 per cent advance by the factor and 50 per cent advance by the banks (12.5 per cent of the factored receivables), the factor and the bank between them make a pre-payment of 87.5 per cent of the debt and the client's share is only 12.5 per cent of the investment in receivables.

The **maturity factoring** is also known as **Collection Factoring**. Under such arrangements, the factor does not make a pre-payment to the client. The payment is made either on the guaranteed payment date or on the date of collection. The guaranteed payment date is generally fixed taking into account the previous ledger experience of the client and a period for slow collection after the due date of the invoice.

> **Maturity factoring** is an arrangement under which the factor does not make a prepayment to the client.

Full Factoring This is the most comprehensive form of factoring combining the features of almost all the factoring services specially those of non-recourse and advance factoring. It is also known as **Old Line Factoring**. Full factoring provides the entire spectrum of services, namely, collection, credit protection, sales-ledger administration and short-term finance.

Disclosed and Undisclosed Factoring In disclosed factoring, the name of the factor is disclosed in the invoice by the supplier-manufacturer of the goods asking the buyer to make payment to the factor. The supplier may continue to bear the risk of non-payment by the buyer without passing it on to the factor. Generally, the factors assumes the risk under **non-recourse** arrangements. The limit within the factor works as non-recourse is laid down in the agreement beyond which the dealings are done on a recourse basis.

The name of the factor is not disclosed in the invoice in undisclosed factoring although the factor maintains the sales ledger of the supplier-manufacturer. The entire realisation of the business transaction is done in the name of the supplier company but all control remains with the factor. He also provides short-term finance against sales invoices.

Domestic and Export/Cross-Border/International Factoring In the **domestic factoring**, the three parties involved, namely, customer (buyer), client (seller-supplier) and factor (financial intermediary) are domiciled in the same country. The mechanics of such factoring deal is outlined in the preceding discussion relating to different types of factoring. The process of export factoring is almost similar to domestic factoring except in respect of the parties involved. While in domestic factoring three parties are involved, there are usually four parties to a cross-border factoring transaction. They are:

> **Domestic factoring** is the factoring in which the buyer, seller-supplier and factor are domiciled in the same country.

(i) exporter (client), **(ii)** importer (customer), **(iii)** export factor and **(iv)** import factor. Since two factors are involved in the deal, international factoring is also called **Two-Factor System of Factoring.**

The two-factor system results in two separate but inter-linked agreements: **(i)** between the exporter (client) and the export factor and **(ii)** between the export factor and the import factor. Usually, the export and the import factors belong to a formal chain of factors with well-defined rules governing the conduct of business. Otherwise, they evolve an *ad hoc* relationship to conduct specific transactions. The import factor provides a link between export factor and the importer and serves to solve the international barriers like language problem, legal formalities and so on. He also underwrites customer trade credit risk, collects receivables and transfers funds to the export factor in the currency of the invoice. The flow of documents and information between the parties involved in cross-border factoring takes the following shape:

- The exporter informs the export factor about the export of goods to a particular import-client domiciled in a specified country. The goods are sold on open-credit.
- The export factor writes to import factor (domiciled in the country of the importer) enquiring about the credit-worthiness, reputation and so on of the importer.
- On getting satisfactory information from the import factor, the exporter delivers the goods to the importer and the relevant invoices, bills of lading and other supporting documents are delivered to the export factor. The export receivables on a non-recourse basis are factored.
- The export factor farms out the work of credit checking, sales ledgering and collection to the import factor.
- The import factor collects the payment from the importer (customer) and effects payment to the export factor on assignment/maturity/collection as per the terms of assignment in the currency of the invoice.
- Finally, the export factor makes payment to the exporter upon assignment or maturity or collection depending upon the type of factoring arrangement between them.

International factoring provides a non-recourse factoring deal. The clients (exporters) have cent per cent protection against bad debt loss on credit-approved sales. The factors take requisite assistance and avail facilities provided in the exporting country for export promotion. They handle exporter's overseas sales on credit terms. In fact, the factor becomes the sole debtor to the exporter once documentation is complete and goods have been shipped.

Legal Aspects of Factoring: Factoring Contract

There is no codified legal framework/code to regulate factoring services in India. Factoring contract is like any other sale-purchase agreement regulated under the law of contract. The legal relationship between a factor and a client is largely determined by the terms of the factoring contract entered into before the factoring process starts. Some of the contents of a factoring agreement and legal obligations of the parties are listed below:

(i) The client gives an undertaking to sell and the factor agrees to purchase receivables subject to terms and conditions mentioned in the agreement.

(ii) The client warrants that the receivables are valid, enforceable, undisputed and recoverable. He also undertakes to settle disputes, damages and deductions relating to the bills assigned to the factor.

(iii) The client agrees that the bills purchased by the factor on a non-recourse basis (i.e., approved bills) will arise only from transactions specifically approved by the factor or those falling within the credit limits authorised by the factor.

(iv) The client agrees to serve notices of assignments in the prescribed from to all those customers whose receivables have been factored.

(v) The client agrees to provide copies of all invoices, credit notes, etc., relating to the factored accounts, to the factor and the factor in turn would remit the amount received against the factored invoices to the client.

(vi) The factor acquires the power of attorney to assign the debts further and to draw negotiable instruments in respect of such debts.

(vii) The timeframe for the agreement and the mode of termination are specified in the agreement.

(viii) The legal status of a factor is that of an assignee. The customer has the same defence against the factor as he would have against the client.

(ix) The customer whose account has been factored and has been notified of the assignment is under legal obligation to remit the amount directly to the factor failing which he will not be discharged from his obligations to pay the factor even if he pays directly to the client unless the client remits the amount to the factor.

(x) Before factoring a receivable, the factor will require a letter of disclaimer from the bank which has been financing the book debts through bank finance to the effect that from the date of the letter the bank will not create a charge against the receivables, i.e., the bank will not provide post-sales finance as the factor provides the same.

(xi) Priority over other claimants to book debts: It will be extremely important for the factor to make sure that the book debts it handles are free from any encumbrances which would entitle someone else to the money due. The firm will have to guarantee that the book debts are free from any rights of a third party in the factoring agreement.

(xii) Other powers: The factor will sometimes need to act quickly to recover money due on an invoice. A customer with money outstanding to the factor may be in difficulty and any delays in acting could see the money gone forever. The agreement must provide for the factor to act swiftly in his own name, whenever necessary.

(xiii) The factoring agreement will set out in detail how the firm is to be paid.

(xiv) Approved and unapproved debts: The attractions of factoring for many companies is that non-recourse factoring can give a degree of insurance against the customer who does not pay. This will depend on whether the debt is approved or not which is decided before the factoring process starts.

(xv) Where the factor may reclaim money already advanced: Factoring agreements provide for payment by the customer directly to the factor. If any of the customer pay it to the client by mistake, the agreement provides that the firm must hold the money for the factor. If he does not do so, this is effectively a breach of trust and the firm may be held responsible for any losses incurred by the factor.

(xvi) Warrants: Some warrants that will be required are:

- **(a)** The firm should disclose any material facts that it knows might affect the factor's decision to approve a debt.
- **(b)** It will have to warrant that the invoices sent for factoring represent a proper debt for goods supplied.

(xvii) Disputed debts: The factor may require the customer to notify it immediately in case of disputed debts. The firm may be expected to return any advances made to it in respect of the disputed debt.

(xviii) The factor's power to inspect the firm's books and accounts and the period of the factoring arrangement is usually laid down in the agreement.

(xix) The client undertakes:

- **(a)** To have the factor serve as the sole factor (clients occasionally may have more than one factor but that is more exception than the rule);
- **(b)** To provide a satisfactory assignment together with actual invoices and evidence on delivery;
- **(c)** To submit all sales to the factor prior to shipping for credit approval.
- **(d)** To warrant that each customer has received his merchandise and will accept the same without any counter-claim and disputes, if any, will be the responsibility of the client.
- **(e)** To grant the factor the right to hold any balances standing to its credit as security for any debts owed by the client to the factor, no matter how arising.

(xx) The factor on the other hand undertakes:

- **(a)** To purchase bonafide accounts receivable that it has previously approved;
- **(b)** To advance against the purchase price, at its discretion, a percentage thereof and to remit the balance on the monthly average due date of receivables assigned plus 5 to 10 days for collection;
- **(c)** To charge interest on sums advanced at a certain defined interest rate;
- **(d)** To render a statement of account monthly.

A few other points of interest may be noted in the context of the legal implications of factoring:

1. When a customer presents a bill of exchange or hundi along wit his invoice, the factor must first check if there is a genuine underlying trade transaction. This may be verified by checking the invoice and other evidence of delivery.
2. The factor must check with the client's banker to ensure that there is no double financing.
3. Situations may arise where the client receives payments from the customer in his name and the factor may not be aware of this. The factoring agreement should provide for this contingency and further in order to ensure against default the factor should obtain a personal guarantee of the proprietor or the directors of the company.
4. Regarding assignment of book debts of clients, provisions of Section 130 of the Transfer of *Property Act* protect the interests of the factor.

Factoring *vis*-a-*vis* Bills Discounting: A Comparison

Apart from factoring, a source of receivables/working capital financing is bill discounting arrangement offered by banks and finance companies. A detailed account of bills financing in India is given in the chapter 9.

Similarities Factoring is somewhat similar to bills discounting in the sense that both these services provide short-term finance. Again, both discount accounts receivable which the clients would have otherwise received from the buyer at the end of the credit period.

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

- Bill discounting is always with recourse whereas factoring can be either with recourse or without recourse.
- In bill discounting the drawer undertakes the responsibility of collecting the bills and remitting the proceeds to the financing agency, while the factor usually undertakes to collect the bills of the client.

- Bill discounting facility implies only provision of finance but a factor also provides other services like sales ledger maintenance and advisory services.
- Discounted bills may be rediscounted several times before they mature for payment. Debts purchased for factoring cannot be rediscounted, they can only be refinanced.
- Factoring implies the provision of bulk finance against several unpaid trade generated invoices in batches; bill financing is individual-transaction-oriented, that is, each bill is separately assessed and discounted.
- Factoring is an off-balance mode of financing.
- Bill discounting does not involve assignment of debts as is the case with factoring.

Forfaiting

Forfaiting is a form of financing of receivables pertaining to international trade. It denotes the purchase of trade bills/promissory notes by a bank/ financial institution without recourse to the seller. The purchase is in the form of discounting the documents covering the entire risk of non-payment in collection. All risks and collection problems are fully the responsibility of the purchaser (forfaiter) who pays cash to seller after discounting the bills/notes. The salient features of forfaiting, as a form of export-related financing, are summarised below:

> **Forfaiting**
> is a form of financing of receivables in international trade.

(i) In pursuance of a commercial contract between an exporter and importer, the exporter sells and delivers the goods to the importer on a deferred payment basis.

(ii) The importer draws a series of promissory notes in favour of the exporter for payment including interest charge. Alternatively, the exporter draws a series of bill which are accepted by the importer. The bills/notes are sent to the exporter. The promissory notes/bills are guaranteed by a bank which may not necessarily be the importer's bank. The guarantee by the bank is referred to as an **Aval,** defined as an endorsement by a bank guaranteeing payment by the buyer (importer).

(iii) The exporter enters into a forfaiting arrangement with a forfaiter which is usually a reputed bank including exporter's bank. The exporter sells the availed notes/bills to the bank (forfaiter) at a discount without recourse. The agreement provides for the basic terms of the arrangement such as cost of forfaiting, margin to cover risk, commitment charges, days of grace, fee to compensate the forfaiter for loss of interest due to transfer and payment delays, period of forfaiting contract, instalment of repayment, usually bi-annual instalment, rate of interest and so on. The rate of interest/discount charged by the forfaiter depends upon the terms of the note/bill, the currency in which it is determined, the credit rating of the **availing** bank, the country risk of the importer etc.

(iv) Payment to forfaiter to the exporter of the face value of the bill/note less discount.

(v) The forfaiter may hold these notes/bills till maturity for payment by the importer's bank. Alternatively, he can securitise them and sell the short-term paper in the secondary market as high-yielding unsecured paper.

Forfaiting vs Export Factoring Forfaiting is similar to cross-border factoring to the extent both have common features of non-recourse and advance payment. But they differ in several important respects:

(a) A forfaiter, discounts the entire value of the note/bill. The implication is that forfaiting is hundred per cent financing arrangement of receivables finance. But the extent of advance receivables financing with a factoring arrangement is only partial ranging between 75-85 per cent. The balance is retained by the factor as a factor reserve which is paid after maturity.

(b) The **avalling bank** which provides an unconditional and irrevocable guarantee is a critical element in the forfaiting arrangement. The forfaiter's decision to provide financing depends upon the financial standing of the availing bank. On the other hand, in a factoring deal, particularly non-recourse type, the export factor bases his credit decision on the credit standards of the exporter and participates in the credit-extension and credit protection process.

> **Avalling bank** provides an unconditional/irrevocable guarantee in a forfaiting arrangement.

(c) Forfaiting is a pure financing arrangement while factoring also includes ledger-administration, collection and so on.

(d) Factoring is essentially a short-term financing deal. Forfaiting finances notes/bills arising out of deferred credit transaction spread over three to five years.

(e) A factor does not guard against exchange rate fluctuations; a forfaiter charges a premium for such risk.

Advantages and Evaluation

Advantages Factoring, as a financial service, has several positive features from the point of view of the firm (client of the factor). Some of these advantages are briefly discussed on next page.

Impact on the Balance Sheet The impact of factoring on the balance sheet of the client and its implications are illustrated in the Tables 4.1 and 4.2.

Table 4.1 Balance Sheet: Pre-Factoring Scenario *(₹ lakh)*

Current liabilities and net working capital (NWC)			*Current assets*	
Bank borrowings:			Inventory	100
Cash credit against inventory	70		Receivables	80
Cash credit against receivables	40	110	Other current assets	20
Other current liabilities (OCL)		40		
Net working capital (NWC)		50		
Total		200		200

Current ratio = 1.33 : 1

The requirement of NWC is ₹50 lakh (current assets minus current liabilities). As the borrower carries other current liabilities to the extent of ₹40 lakh, he will be eligible for a maximum permissible bank finance (MPBF) of ₹110 lakh. This is bifurcated into cash credit limits of ₹70 lakh against inventory and ₹40 lakh against receivables taking into account the stipulated margins for inventory and receivables and also the proportion of individual levels of inventory of ₹100 lakh and receivables of ₹80 lakh. On the basis of above configuration, the borrower is eligible for working capital limits aggregating ₹110 lakh.

Assume the borrower decides to factor his debts. The factoring transaction is as follows: Receivables aggregating ₹80 lakh are purchased by a factor who makes prepayment of 80 per cent, that is, ₹64 lakh. He retains ₹16 lakh (factor reserve) which will be repaid on payment by the customer. The impact on the balance sheet is shown in Table 4.2.

Table 4.2 Balance Sheet: Post-Factoring Scenario *(₹ lakh)*

Current liabilities and net working capital (NWC)			*Current assets*	
Bank borrowings:			Inventory	100
Cash credit against Inventory	70		Due from factor	16
Cash credit against receivables	-	70	Other current assets	20
Other current liabilities		16		
Net working capital (NWC)		50		
Total		136		136

Current ratio = 1.58 : 1

The impact of factoring on the balance sheet as revealed by Tables 4.1 and 4.2 is three-fold:

Off-balance Sheet Finance As the client's debts are purchased by the factor, the finance provided by him is off the balance sheet and appears in the balance sheet only as a contingent liability in the case of '**recourse factoring**'. In case of non-recourse factoring, it does not appear any where in the financial statements of the borrower. The pre-payment of ₹64 lakh made by the factor goes off the balance sheet getting converted into cash leaving the balance of ₹16 lakh in the balance sheet as due from factor.

Reduction of Current Liabilities From the factoring proceeds of ₹64 lakh, the bank borrowings are liquidated to the extent of ₹40 lakh. The balance of ₹24 lakh can be used by the client for paying off other current liabilities comprising trade creditors for goods and services, creditors and expenses, loan instalments payable, statutory liabilities and provisions. The client may meet any of these obligations with the balance of ₹16 lakh. The net effect is to reduce current liabilities by ₹64 lakh.

Improvement in Current Ratio As the factoring transaction is off-balance sheet, it removes from the asset side the receivables factored to the extent of the pre-payment made and on the liabilities side, the current liabilities are also reduced. The result is a desirable improvement in the current ratio, from 1.33:1 to 1.58:1.

In brief, the effect of factoring is to improve the financial discipline of the firm.

Higher Credit Standing There are several reasons why factoring should improve a client's standing. With cash flow accelerated by factoring, the client is able to meet his liabilities promptly as and when they arise. The factor's acceptance of the client's receivables itself speaks highly for the quality of the receivables. In the case of non-recourse factoring, the factor's assumption of credit risk relieves the client, to a significant extent, from the problem of bad debts. This enables him to minimise his bad debts reserve.

Improved Efficiency In order to accelerate cash flow, it is essential to ensure the flow of critical information for decision making and follow-up and eliminate delays and wastage of man-hours. This requires sophisticated infrastructure for high level specialisation in credit control and sales ledger administration. Small and medium-sized units are likely to face a resource constraint in this area. Factoring is designed to place such units on the same level of efficiency in the areas of credit control and sales ledger administration as more sophisticated large companies.

More Time for Planning, Production, Planning In any business concern, it is inevitable that a certain proportion of management time has to be diverted to credit control. Large companies can afford to have special departments for the purpose. However, smaller sized units cannot afford it. The factor undertakes the responsibility for credit control, sales ledger administration and debt collection problems. Thus, the client can concentrate on functional areas of the business like planning, purchase, production, marketing and finance.

Reduction of Cost and Expenses Since the client need not have a special administrative set-up to look after credit control, he can have the benefit of reduced overheads by way of savings on manpower, time and efforts. With the steady and reliable cash flow facilitated by factoring, the clients have many opportunities to cut costs and expenses like taking supplier's prompt payment and quantity discounts, ordering for materials at the right time and at the right place, avoidance of disruption in the production schedule, and so on.

Additional Source The supplier gets an additional source of funding the receivables which eliminates the uncertainty associated with the collection cycle. More importantly, funds from a factor is an additional source of finance for the client outside the purview of normal bank credit.

Evaluation Framework The distinct advantages of factoring notwithstanding, as a financial service, it involves costs. The evaluation framework should be on a consideration of the relative costs and benefits associated with the two alternatives to receivables management. They are: **(i)** in-house management by the firm itself, **(ii)** factoring service, either recourse or non-recourse. The relevant costs and benefits associated with these are listed on next page.

Costs Associated with In-house Management **(1)** Cash discount, **(2)** Cost of funds invested in receivables, **(3)** Bad debts, **(4)** Lost contribution on foregone sales and **(5)** Avoidable costs of sales ledger administration and credit monitoring.

Costs Associated with Recourse and Non-recourse Factoring **(i)** Factoring commission, **(ii)** Discount charge and **(iii)** Cost of long-term funds invested in receivables.

Benefits Associated with Recourse Factoring They are in the terms of the costs associated with the in-house management alternative with the exception of item (3), namely, bad debt loss.

Benefit Associated with Non-recourse Factoring The above plus the bad debt losses relevant to in-house management of receivables.

The evaluation framework of factoring is elaborated in illustration 4.2.

Illustration 4.2

The Reliable Industries Ltd (RIL) is presently managing its accounts receivables internally by the sales and credit department. Its credit terms for sales are 2/10 net, 30. The past experience of RIL has been that on an average 30 per cent of the customers avail of the discount, while the balance of the receivables is collected on an average 60 days after the invoice date. Further, 2 per cent of the sales turnover results into bad debts.

The firm is financing its investments in receivables through a mix of bank finance and long-term finance in the ratio of 2:1. The effective rate of interest on bank finance is 22 per cent and the cost of own funds is 30 per cent.

The projected sales for the next year is ₹500 lakh. The credit and collection department spends on an average one-fourth of its time on collection of receivables.

A proposal to avail of factoring service from Fairgrowth Factors Ltd (FFL) as an alternative to in-house management of receivables collection and credit monitoring is under the consideration of the Board of Directors of the RIL. If the proposal, details of which are given below, is accepted it is expected that the projected sales for the next year can increase by ₹50 lakh as a result of the diversion of the time of the executives of the sales, credits and collection department to sales promotion. For the type of product that RIL is producing, the gross margin on sales in the past has been 20 per cent. Moreover, there would be a saving in administrative overheads amounting to ₹2.5 lakh due to discontinuance of sales ledger administration and credit monitoring.

According to the factoring proposal, the FFL offers a guaranteed payment of 30 days. The other details are listed below:

The FFL would advance 80 per cent and 85 per cent in case of recourse and non-recourse factoring deal respectively, the balance would be retained as factor reserve. The discount charge in advance (up-front) would be 22 per cent for recourse type and 21 per cent for non-recourse type of service. The FFL would also charge a commission @ 2 per cent (recourse) and 4 per cent non-recourse. The commission is payable up-front.

Before taking a decision on the proposal, the Board seeks your advice, as a financial consultant, on the course of action. What advice would you give? Why?

Solution

Decision-Analysis: In-House Management Alternative

	Relevant costs	*Amount (₹ lakh)*	
1.	Cash discount	3.00	(₹500 × 0.02 × 0.30)
2.	Cost of funds in receivables	15.42	(working note 1)
3.	Bad debt losses	10.00	(₹500 × 0.02)
4.	Lost contribution on foregone sales	10.00	(₹50 × 0.20)
5.	Avoidable administrative overheads	2.500	
	Total	40.92	

Working Notes

Cost of funds invested in receivables:

Average collection period = (10 days × 0.30) + (60 days × 0.70) = 45 days
Cost of bank finance = ₹500 lakh × 2/3 × 45/360 × 0.22 = ₹9.16 lakh **(a)**
Cost of own funds = ₹500 lakh × 1/3 × 45/360 × 0.30 = ₹6.25 lakh **(b)**
Total (*a* + *b*) = ₹15.42 lakh

Decision Analysis: Recourse Factoring Alternative

	Relevant costs	*Amount (₹ lakh)*	
6.	Factoring commission	11.00	(₹550 × 0.02)
7.	Discount charge	7.90	(Working note 2)
8.	Cost of long-term funds invested in receivables	2.97	(₹550 – ₹431.2) × 0.30 × 30 360)
	Total	21.87	

Working Note

Eligible amount of advance = 0.80 × (₹550 – ₹11) = ₹431.2 lakh
Discount charge = ₹431.2 × 0.22 × 30/360 = ₹7.90 lakh

Decision Analysis: Non-recourse Factoring Alternative

	Relevant costs	*Amount (₹ lakh)*	
9.	Factoring commission	22.00	(₹550 × 0.04)
10.	Discount charge	7.85	(Working note 3)
11.	Cost of long-term funds invested in receivables	2.53	(₹550 – ₹448.8) × 0.30 × 30/360
	Total	32.38	

Working Notes

Eligible amount of advance = 0.85 × (₹550 – ₹22) = ₹448.8 lakh
Discount charge = ₹448.8 × 0.21 × 30/360 = ₹7.85 lakh

Decision-Analysis: Cost-Benefit of Recourse Factoring *(₹ lakh)*

Benefits [₹3.00 + ₹15.42 + ₹10.00 + ₹2.50]	30.92
Costs [₹11.00 + ₹7.90 + ₹2.97]	21.87
Net benefit	9.05

Decision Analysis: Cost-Benefit of Non-recourse Factoring *(₹ lakh)*

Benefit [₹3.00 + ₹15.42 + ₹10.00 + ₹10.00 + ₹2.50]	40.92
Cost = [22.00 + ₹7.85 + ₹2.53]	32.38
Net benefit	8.54

As a financial consultant, my advice to the Board of RIL would be to choose recourse factoring due to higher net benefits.

FACTORING IN INDIA

Factoring service is of recent origin in India. It owes its genesis to the recommendations of the Kalyan Sundaram Study appointed by the RBI in 1989. Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990. The first factoring company – SBI Factors and Commercial Ltd (SBI FACS) – started operation in April 1991.

There was no codified legal framework to regulate factoring in India. The legal relationship between the factor and the client was governed by the provisions of the factoring contract. In recognition of the importance of the factoring services in the emerging financial services scenario in the country, the legal framework relating to them has been codified recently. The three elements of the framework are: **(i)** Factoring Regulation Act (FRA) 2011, **(ii)** Registration of Assignment of Receivables (Government) Rules, 2012, and **(iii)** RBI's Non-Banking Financial Company – Factor Directions, 2012. The stipulations relating to factoring services contained in these are discussed in this Section. The organisational profile and the nature of factoring services/operations is also briefly outlined.

Factoring Regulation Act (FRA)

> **Assignment**
> means transfer by agreement of individual interest of any assignor in any receivable due from any debtors in favour of a factor in India or abroad.

The object of the **FRA** is to provide for and regulate **(i)** assignment of receivables through registration and **(ii)** rights and obligations of partners to the contract for assignment of receivables. **Assignment** means transfer by agreement of individual interest of any assignor in any receivable due from any debtors in favour of a factor in India or abroad. However, individual interest would not include creation of rights in receivables as security for loans/advances/other obligations by a bank/financial institution. **Debtor** means any person liable to the assignor to pay any receivables/discharge any obligation in respect of the receivables. The main provisions of the FRA are: **(i)** registration of factors,**(ii)** assignment of receivables, **(iii)** rights and obligations of parties to the contract for assignment of receivables, **(iv)** registration of assignments, **(v)** offences and penalties and **(vi)** miscellaneous.

> **Debtor**
> means any person liable to the assignor to pay any receivables/discharge any obligation in respect of the receivables.

> **Factoring business**
> means the business of acquisition of receivables of **assignor** (i.e. the owner of any receivables) by accepting or financing their assignment by way of loans/advances or otherwise against the security interest over any receivables.

Registration of Factors To commence/carry on factoring business by a factor, a certificate of registration from the RBI is necessary excepting a bank/Government company/company under the Companies Act. **Factoring business** means the business of acquisition of receivables of assignor (i.e. the owner of any receivables) by accepting or financing their assignment by way of loans/advances or otherwise against the security interest over any receivables but excludes **(i)** credit facilities by banks in the ordinary course of business against the security of receivables, and **(ii)** any activity **(a)** as commission agent or otherwise for sale of agricultural produce/goods of any kind, **(b)** relating to production, storage, supply, distribution, acquisition or control of such produce/goods or provision of any services. **Factor** means a RBI-registered NBFC, a body corporate, a bank, a company engaged in factoring business.

An existing NBFC engaged in factoring business would be granted registration by the RBI only if factoring is its **principal business** in terms of at least 50 per cent of its **(i)** assets are financial assets and **(ii)** gross income from factoring business. The provisions of the RBI Act relating to the registration of NBFCs would *mutatis mutandis* apply to factors also. (**These are discussed in Chapter 1)**. All factors would be governed by RBI Act/rules/directions/guidelines. All provisions of Chapter III-B of the RBI Act relating to the NBFCs would apply *mutatis mutandis* to a factor. The RBI may at any time by general/special order direct a factor to furnish statements/information/particulars relating to its business in the specified form/intervals/time. It may also issue directions in the interest of **(a)** business enterprise (i.e. enterprise/medium/micro/small enterprise in terms of Micro, Small and Medium Enterprise Development Act) availing of factoring services, **(b)** factors, **(c)** other stakeholders in respect of any matters relating to/connected with their factoring business.

Assignment of Receivables Any assignor (i.e. owner of the receivables) may by a written agreement assign any receivables due/payable to him by any debtor in favour of a factor as an **assignee** for a mutually agreed consideration. The assignor should disclose to the assignee any defences/rights of set-off available to the debtor. All the rights/remedies and any security interest created over any property exclusively to secure the due payment of the receivables would vest in the assignee who will have an absolute right to recover it and exercise all the rights/

remedies of the assignor. **Property** means **(i)** movable/immovable property, **(ii)** any secured/unsecured debt/right to receive payment of money, **(iii)** receivables, and **(iv)** intangible assets (i.e. know-how, patent, copyright, design, trade mark, licence, franchise or another similar business/commercial right). **Receivables** mean all/part of, or individual interest in, any existing/future/accruing/conditional/contingent right of any person under a contract including international contract to payment of toll or any other monetary sum, by whatever name called, for the use of any infrastructure facility/services. The assignee/factor would pay to a bank/creditor the consideration for assignment of receivables constituting security for repayment of any loan in case the assignor/owner of the receivables has given notice of the encumbrance.

> **Property** means **(i)** movable/immovable property, **(ii)** any secured/unsecured debt/right to receive payment of money, **(iii)** receivables, and **(iv)** intangible assets.

> **Receivables** mean all/part of, or individual interest in, any existing/future/accruing/conditional/contingent right of any person under a contract including international contract to payment of toll or any other monetary sum for the use of any infrastructure facility/services.

A notice of assignment should be given to the debtor by the assignor/assignee with express authority in favour of the assignor to demand/receive payment from the debtor. Payment made to the assignee would fully discharge the debtor from corresponding liability in respect of such payment. Where such a notice is not given, any payment by the debtor to the assignor would be held in trust for the benefit of the assignee and paid forth to him/duly authorised agent.

Rights and Obligations of Parties to Contract for Assignment of Receivables The rights/obligations of the respective parties relate to: **(i)** notice of assignment, **(ii)** liability of debtors, **(iii)** assignors to be trustees of assignee, **(iv)** principle of debtor protection, **(v)** liability of debtor in case of micro/small enterprises, **(vi)** defences and rights of set-off of debtors, **(vii)** modification of original contract and **(viii)** breach of contract.

Notice of Assignment The debtor would have the right to notice of assignment to make payment to the assignee failing which he would be entitled to make payments to the assignor(s) in accordance with the original contract in full discharge of his corresponding liability under the original contract.

Liability of Debtors In case of the notice of assignment, the debtor would be **(i) (a)** obliged to intimate the assignee the details of deposits/advances/payments on account already made to the assignor, **(b)** provide any other information sought by the assignor; **(ii)** entitled to a valid discharge of his liability only by making payment to the assignee.

Assignor to be Trustee of Assignee A payment due on an assigned receivables by a debtor to an assignor would be deemed to be for the benefit of the assignee and as a trustee the assignor should pay the amount to the assignee.

Liability of Debtor in Case of Micro/Small Enterprises In the event of delay in payment of receivables of a micro/small enterprise by a debtor, the assignee would be entitled to interest for the delayed period under the provisions of the Micro/Small and Medium Enterprises Development Act and he should take necessary steps to recover the interest on behalf of the assignor.

Principles of Debtor Protection The rights/obligations of a debtor including the terms/conditions of the contract can be changed only with his written consent. Consequent upon the assignment of receivables, however, no changes can be made in the payment instruction between the debtor and the assignor in regard to the original: **(i)** amount of debt, **(ii)** place of payment, and **(iii)** date of payment/other terms relating to payment.

Defences and Rights of Set-off of Debtor In any claim of payment by any assignee, the debtor may raise all defences/rights of set-off arising from the original contract which he could avail of as if the assignment had not been made and the claim was made by the assignor and not the assignee. The assignee would be entitled to recover from the assignor any loss suffered resulting from the defences/rights of set-off. The debtor may also raise against the assignee any other right of set-off if it was available to it at the time the notice of assignment from the assignor/assignee was received by him.

Modification of Original Contract Any modification in the original contract before notice of assignment of receivables between the assignor and the debtor would be binding on the assignee and he will acquire the modified rights in the assigned receivables. However, any modification made after the notice of agreement adversely affecting the rights of the assignee would be effective against him only with his consent as a reasonable assignee.

Breach of Contract If the assignor commits any breach of the original contract, the debtor would not be entitled to recover from the assignee any sum paid to the assignor/assignee pursuant to the factoring transaction. He would, however, have the right to claim from the assignor any loss/damages caused to him by the breach.

Registration of Assignments For purposes of registration, factors should file the particulars of every transaction of assignment of receivables in his favour with the Central Registry set up under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act within 30 days from the date of assignment in the prescribed manner and on payment of the specified fee. The receivables may be described specifically/generally with reference to the debtor/period to which they relate/other identifiable general description. The central registry would maintain a central register to enter the particulars of the transaction(s) in favour of factor(s). The provisions for registration of transactions contained in the SRFAESI Act/ rules would, *mutatis mutandis*, apply to the record of assignment of receivables in favour of a factor in the Central Register with the Central Registry.[1]

The particulars of transactions of assignment of receivables entered in the Central Register would be open for inspection by any person on payment of the prescribed fee. The provisions for maintenance of Central Register and its public inspection contained in the SRFAESI Act/rule would, *mutatis mutandis* apply.[1]

Offences and Penalties ***Penalties*** **(i)** Default in filing penalties of any transaction with the Central Registry would be punishable with fine upto five thousand rupees for every day of default; **(ii)** Penalty for non-compliance of any direction of the RBI may extend upto five lakh rupees payable within 14 days and upto ten thousand rupees for every day of continuing default. Failure to pay within the specified period would be punishable with a levy/sum specified by the principal civil court/having jurisdiction in the area where the registered office/principal business of the factor is located. The levy would be enforceable in the same manner as if it were a decree made by the court in a civil suit.

Offences Contravention/attempt to contravention/abetment to contravention of the provisions of the Factoring Regulation Act/rules, for which no penalty has been provided, would be punishable with imprisonment upto one year or with fine or with both.

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[1]For details refer to Khan, M Y, *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 11.

In case of an offence by a factor, the factor as well as every person who was in charge of/ responsible to the factor for the conduct of business would be deemed to be guilty of offence and punished accordingly, unless it is proved that the offence was committed without his knowledge and he exercised due diligence to prevent commission of the offence.

Miscellaneous Some other provisions of the **FRA**, namely, confidentiality of information, inapplicability of provisions and stamp duty exemption, are discussed below:

Confidentiality of Information A factor should maintain confidentiality and not disclose to any person information obtained by it from any **(i)** assignor, **(ii)** present/future customers, **(iii)** its commercial/business activities and **(iv)** the term of sale between the assignor and any debtor and other details about the assignor except when required by order of a court/tribunal/other statutory authority.

Inapplicability The provisions of the **FRA** would not apply to any assignment of receivables arising from/under the following transactions:

- Any merger/acquisition/amalgamation of business activities or sale/change in the ownership/legal status of the business.
- Transaction on any stock/commodities exchange.
- Financial contracts governed by netting arrangements except a receivable owed on the termination of all outstanding transactions. **Financial contract** means any spot/forward/ future/option/swap transaction involving interest rates/commodities/currencies/shares/ bonds/debentures/any other financial instrument/any repurchase of securities and lending transactions/any other similar transaction or combination of such transactions entered into the financial markets. **Netting agreement** means any agreement among the system participants for the purpose of determination by the system provider of the amount of money or securities due or payable or deliverable as a result of setting off or adjusting the payment obligations or delivery obligations among the system participants, including the claims and obligations arising out of the termination by the system provider, on the insolvency or dissolution or winding up of any system participant or such circumstances as the system provider, may specify in its rules or regulations or bye-laws (by whatever name called), of the transactions admitted for settlement at a future date so that only a net claim be demanded or a net obligation be owned.
- Foreign exchange transactions except receivables in foreign currency.
- Inter-bank payment system/agreements/clearance and settlement systems relating to securities/other financial assets/instruments.
- Bank deposits.
- A letter of credit/independent guarantee.
- Rights/obligations of any person under the law governing negotiable instruments, negotiable warehouse receipts/instruments negotiable by law/custom or any mercantile document of title to goods.
- Sale of goods/services for personal/family/household use.
- Any assignment of loan receivables by a bank/NBFC to another bank/NBFC.
- Securitisation transactions including assignment of receivables to special purpose vehicles/ trusts that issue securities against such receivables bought from a single/single group of debtors.

The rights/obligations of a consumer/manufacturer/trader/service provider under the provisions of the Consumers Protection Act would in no way be affected by the stipulations of the FRA.

Exemption from Stamp Duty Any agreement or other document for assignment of receivables in favour of any factor would not be liable to duty under the Indian Stamp Act/any other law for the time in force.

Registration of Assignment of Receivables (Government) Rules, 2012

The main features of the rules framed by the Government under the FRA relate to: **(i)** registration of transactions of assignment of receivables, **(ii)** time limit for registration/condonation of delay, (**iii)** inspection of records of central register and **(iv)** fees.

Registration of Transactions Every factor should file particulars of **(i)** assignment of receivables in his favour with the central registry in the prescribed Form I, and **(ii)** satisfaction of any transaction of assignment of receivables on realisation of receivables in full in prescribed Form-II, authenticated by a specified person for such purpose by use of a valid digital signature.

Time Limit The provisions contained in the SRFAESI Act/rules in relation to registration of security interest, time-limit for registration and condonation of delay in registration and all other related matters would apply to registration of receivables in favour of factors under the provisions of the FRA.

Inspection of Records The particulars of any transaction of assignment receivables kept in the central registry would be open for inspection to any person/a person authorised by him through website during the business hours on payment of the specified fee, namely, **(i)** Form-I, five hundred rupees, **(ii)** Form-II, two hundred and fifty rupees, **(iii)** application for information recorded/maintained in the registered by any person, fifty rupees and **(iv)** any application for condonation of delay upto 30 days, two thousand and five hundred rupees.

RBI Non-Banking Financial Company – Factors (NBFC-Factor) Directions, 2016

The RBI had issued the NBFC-Factor Directions in 2012 under the Factoring Regulation Act. The provisions of the RBI 2016 NBFC – ND – SI and NBFC – D **(discussed in Chapter 1)** have been made applicable to the NBFC-Factor also. These also contain some specific directions applicable to the NBFC-Factors. They relate to **(i)** registration, **(ii)** net owned fund, **(iii)** principal business, **(iv)** conduct of business, **(v)** asset classification, **(vi)** risk management and **(vii)** import/export factoring.

Registration Every company intending to undertake factoring business should make an application for grant of certificate of registration (CoR) as NBFC-Factor to the RBI. The existing NBFCs that satisfy all the conditions enumerated in these directions may approach, along with the original CoR issued by the RBI, for change in their classification as NBFC-Factor within six months. Their request must be supported by their statutory auditor's certificate indicating the asset and income pattern. An entity not registered with the RBI may conduct the business of factoring if it is a bank or any corporation or a Government company. A new company should commence business as NBFC-Factor within six months from the date of grant of CoR.

Net Owned Fund Every applicant NBFC-Factor should have a minimum net owned fund (NOF) of five crore rupees.

Principal Business An NBFC-Factor should ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and its income derived from factoring business is not less than 50 per cent of its gross income.

Conduct of Business The NBFC-Factors should conduct the business of factoring in accordance with the Factoring Regulation Act/rules and regulations.

Asset Classification In addition to the prudential norms **discussed in Chapter 1** for a NBFC-Factor, a receivable acquired under factoring which is not paid within 6 months of due date should be treated as NPA irrespective of when it was by the factor or whether factoring was carried out on **with recourse** or **without recourse** basis. The entity on which the exposure was booked should be shown as NPA and provisions made accordingly.

Risk Management Proper and adequate control/reporting mechanism should be put in place before undertaking factoring business. The NBFC-Factor should carry out thorough credit appraisal of the debtors before entering into any factoring arrangement/establishing line of credit with the export factor. Factoring services should be extended in respect of invoices which represent genuine trade transactions. Since under **without recourse** factoring transactions, the NBFC-Factor is underwriting the credit risk on debtor, there should be clearly laid down approved limit for all underwriting commitments. The NBF-Factors and banks should share information about common borrowers. For purpose of exchange of information, the assignor should be deemed to be the borrower. They should ensure to intimate the limits sanctioned to the borrower to the concerned bank(s)/NBFCs and details of debts factored to avoid double financing.

Export/Import Factoring The Foreign Exchange Department (FED) of the RBI gives authorisation to Factors under the Foreign Exchange Management Act (FEMA). Therefore, NBFC-Factors, intending to deal in forex through export/import factoring, should seek necessary authorisation to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA/rules/regulations/notifications/directions/orders.

Organisational Profile

The RBI initially contemplated growth of factoring services on a zonal/regional basis covering the entire country with one/more bank(s) concentrating in one zone at a time. It also preferred factoring services through subsidiaries of nationalised banks. More than one bank can jointly operate in a region forming a subsidiary.

The RBI identified banks region-wise to sponsor subsidiaries and provide factoring to clients in the specified regions: **(1)** State Bank of India for the western region, **(2)** Canara Bank for the south zone, **(3)** Punjab National Bank for the northern region and **(4)** Allahabad Bank for the eastern zone. However, only the first two identified banks sponsored factoring services. Recently, two organisations were set up in the private sector. There are at present four factoring organisations in the country: **(i)** SBI Factors and Commercial Services Ltd, **(ii)** Canbank Factors Ltd, **(iii)** Foremost Factors Ltd and **(iv)** Global Trade Finance (P) Ltd.

SBI Factors and Commercial Services (SBI FACS) Ltd It was floated promoted jointly by the State Bank of India, Union Bank of India and Small Industries Development Bank of India (SIDBI) in March 1991 and commenced operations in April 1991 as the first factoring company. The SBI FACS has become an associate member of the Factors Chain International, based in Amsterdam. It has also joined recently EDIFACT – the communication network of the Factors Chain International for electronic data interchange for speedy communication. With a paid-up capital of ₹25 crore, it has 35 per cent market share in factoring business. Its turnover has increased from ₹30 crore during

1991-92 to ₹606 crore during 2002-03. The debts purchased outstanding and the prepayments outstanding stand at ₹156 crore and ₹108 crore respectively.

Canbank Factors Ltd Jointly promoted by the Canara Bank, Andhra Bank and SIDBI in August, 1992 to operate in the south zone, its ₹10 crore paid-up capital was contributed in the proportion of 60:20:20 by three promoters respectively. The regional restrictions on their operations were subsequently removed by the RBI. They can, therefore, operate over a wider market. With a paid-up capital of ₹20 crore, its factored turnover stood at ₹1,223 crore at the end of March 31, 2003. The outstanding debts factored amounted to ₹315 crore on the same date.

Foremost Factors Ltd (FFL) The FFL was set up as a joint venture with the National Bank of America in 1997 with a paid-up capital of ₹20 crore. It is a member of Factor Chain International. Its current annual turnover is ₹250 crore. The FFL has pioneered export factoring in the country.

Global Trade Finance Ltd (GTF) It has been promoted jointly by Export-Import (EXIM) Bank of India, International Finance Corporation and West LB, Germany. With a paid-up capital of ₹45 crore, the GTF offers, in addition to export factoring, forfaiting.

Nature of Factoring Services/Operations

The salient features of the factoring services in India is terms of the operations of the SBI FACS, the Canbank Factors, the FFL and the GTL are recapitulated below:

Domestic Factoring The type of factoring service is advance recourse factoring. The factors undertake collection and credit service. Deferred credit transaction type of credit sales are not eligible for factoring which is confined to only short-term debt. A seller (client) can have his invoice converted into instant cash upto 80 per cent. They also undertake to maintain sales ledger by using computerised systems monthly sales analysis, overdue invoice analysis and customers payment reports are also provided to clients. Once a line of credit is established availability in cash directly geared to sales. These services are provided against receivables service charges/ fee without guarantee/security being insisted upon. The SBI Facs has recently launched new products, namely, **(i)** domestic factoring without recourse, **(ii)** bill purchase factoring and **(iii)** factoring of invoice drawn under letter of credit/bank guarantee. The Canbank Factors also now deals in undisclosed factoring in respect of companies of very high repute and sound financial base. During 2003, it introduced a variant of invoice discounting, namely, purchase bill factoring.

Export Factoring The RBI has approved the scheme evolved by the Export Credit Guarantee Corporation of India Ltd (ECGC) for providing a non-fund based export factoring service to the exporters who are ECGC policy holders. Under the scheme the ECGC undertakes non-fund based export factoring as an in-house service. It grants by an endorsement to the policy, 100 per cent credit protection for bills drawn on approved overseas buyers.

The ECGC concludes a tripartite agreement with the exporter and his authorised dealer to the effect that:

(a) In the event of non-payment in any factored bill, the ECGC would unconditionally pay the authorised dealer the value of the bill immediately after the expiry of 30 days from the due date of the bill on the bank's advice of non-payment.

(b) In consideration of the above unconditional guarantee, the authorised dealer will discount the bills without recourse to the exporter except as indicated at **(d)** below.

(c) The exporter will authorise the authorised dealer to deduct the ECGC's factoring charges (which should be 1 per cent to 1.5 per cent) from the proceeds of each bills and remit it to the ECGC.

(d) If non-payment of the bill is due to the fault of the exporter, the authorised dealer will still be paid by the ECGC as per the guarantee contained in the tripartite agreement, but the ECGC would have recourse to the exporter.

(e) The exporter, as also this bank, will be associated with the efforts to recover the debt from the foreign buyer and all necessary expenses will be borne by the ECGC.

(f) Till such time the payment is made by the overseas buyer or the ECGC, the interest payment on post-shipment credit would be as per the Reserve Bank's directives issued from time to time.

(g) In the event of failure of the exporter to realise the export proceeds in the stipulated time the ECGC will obtain direction from the Reserve Bank in their turnover entitling them to recover the amount from the foreign party.

The scheme, has, however, not made head-way.

The RBI has recently approved a scheme proposed by the SBI FACS for providing export factoring with recourse basis to its clients. The modalities of the scheme are:

The exporter should submit to SBI FACS a list of his customers (importers) with adequate details together with his credit line requirements which will select an import factor based in the customers country who will rate the importer and intimate the results to it. The Indian exporter would apply for a credit limit in respect of the overseas importer. The import factor will grant the credit line based on the credit worthiness of the overseas importer. The exporter will then enter into an export factoring agreement with the export factor (SBI FACS). All export receivables will be assigned to it who will in turn assign them to the respective import factors. When shipping goods, the exporter should ensure that each invoice is payable to a specific factor in the importer's country. Copies of the invoices and shipping documents will be sent to the import factor through SBI FACS who will make prepayment to the exporter against the approved export receivables. On receipt of sale proceeds from the buyer on the due date of the invoice, the import factor will remit the funds to the SBI FACS. The SBI FACS will convert the foreign currency remittances into rupees and transfer the proceeds to the exporter. A service fee of 0.5-2 per cent of the value of the invoice will be levied. If the importer is unable to pay the proceeds of the goods exported, the import factor will pay the receivables to the export factor, 100 days after the due date. All such incidents are to be reported by the SBI FACS to the RBI in half yearly statements indicating the reasons for delay or non-payment by the importer. The SBI FACS would act only as export factor. It is not authorised to act as import factor.

Clients The domestic factoring by the Canbank Factors and SBI FACS is available to all forms of business organisations engaged in manufacturing, services and trading. They include sole proprietary concerns, partnership firms and corporations, the focus being on profit-making growing concerns.

Credit Limit In order to limit the exposure, a ceiling on credit in terms of the value of the invoice to be purchased is generally fixed for each client for medium/small scale units. Presently, the upper limit is in the range of ₹2-4.5 crore or approximately 15-25 per cent of the networth of the client. The period for which debts are factored ranges between 30-90 days.

Service Fee and Discount Charge There is a credit rating system to evaluate clients on various criteria such as the level of receivables turnover, the quality of the receivables portfolio, anticipated growth in sales, sales turnover and so on. The service fee payable in advance on domestic factoring is at present in the range of 0.5-2 per cent of the invoice value for different category of clients depending on the type of source and volume of business. In addition, the factors also levy a monthly payable usually in arrear discount charge on pre-payment drawn by the client. It normally tallies with the bank lending rate. In the case of high rated clients it is currently one percentage point lower than the rates on the working capital advances under the cash credit system. The cost of funds with recourse option is generally higher by one to two per cent over the cash credit rates. It is much higher in the without recourse option due to higher risk. The service fee and the discount charge, as a price of the service provided by the factors, depend upon their funding cost (the cost of funds raised from different sources) and the operation cost associated with the screening of the proposal, collection and sales ledger administration and other overheads including depreciation.

Funding The main sources of finance of the factors in India at present are: **(i)** equity capital and reserves, **(ii)** line of credit from the sponsoring banks and SIDBI and **(iii)** public deposits.

The factors enjoy line of credit from the banks and the SIDBI. As per RBI guidelines, the banks can lend to the factoring subsidiaries only at the prevailing commercial rate of interest. Such finance to the factors is restricted to one time their net owned funds at par with residuary non-banking finance companies. The line of credit from the sponsoring banks is available in respect of their exposure to non-small scale industrial (SSI) units only. According to RBI guidelines, banks have to ensure that double financing of the same assets through factoring and bank borrowing does not take place. The factors and banks should share information about common borrowers to avoid a situation in which a company may obtain working capital for an asset from a bank and also get it factored with a factor. The banks have to issue letters of disclaimer to the factor on book debts factored to facilitate assignment of debts. A letter of disclaimer indicates the title of the receivable. The factors in turn route the proceeds of prepayment and final adjustment through the borrower's bank. In the case of consortium financing, the proceeds have to be routed through the leader of the consortium. The factor must obtain a no-objection certificate from the borrower bank before factoring receivables. The borrowers should declare separately the extent of book debts proposed to be factored and those against which bank finance is to be obtained in their projection for assessment of bank credit. While arriving at the MPBF, banks can deduct from current assets the receivables proposed to be factored. This has to be done before arriving at the minimum requirement of networking capital and working capital gap. Alternatively, amounts to be received from factor is to be essentially considered as a source of funds while arriving at the '**cash gap**' or '**cash surplus**' portion. The banks have also to obtain from the borrowers periodical certificates regarding factored receivables to avoid double financing. It is also mandatory for factors to intimate the limits sanctioned to the borrower to the concerned banks and details of debts factored. This could be cross-checked with the certificate obtained by banks from borrower. However, the extent of finance obtained from factors does not come within the purview of the credit monitoring arrangement. The SIDBI, on the other hand, extends lien of credit (borrowing facility) to the factors to provide such services to the SSI clients at a pre-determined concessional rate of interest.

The factors can also accept public deposits in terms of the RBI guidelines which presently restricts them to a maximum of 25 per cent of their net worth at par with manufacturing companies.

Thus, the funding of factors is presently dominated by equity capital with severe restrictions on the use of debt.

Operational Problems

The factoring service in India is still at a nascent stage. Its quantitative growth is relatively limited. Its future depends on the removal of a number of genuine operational obstacles which are listed below.

Credit Information The factors do not have access to any authentic common source of information. They have to depend on their own data-base for credit evaluation of clients. The system of multiple data-bases by individual factors is not only expensive but is also devoid of uniformity and obviously is a serious impediment in the growth of factoring service.

As a follow-up to the enabling framework of The Credit Information Companies Act (**discussed in Chapter 1**), there are four CICs in the country. The first CIC, namely, Credit Information Bureau (India) Ltd (CIBIL) was set up in 2007. As business for CICs/credit bureaus is expected to grow given rising defaults and growing risk consciousness, the RBI has permitted the setting up of three more CICs in April 2009. The three new entities are: **(i)** Equifax Credit Information Services, **(ii)** Experian Credit Information Company, and **(iii)** Highmark Credit Information Services.

Banks/financial institutions (FIs)/state financial corporations (SFCs)/non-banking financial companies (NBFCs)/housing finance companies (HFCs) and credit card companies (CCCs) are members of the CIBIL. The 175 credit grantors who have accepted its membership include **(i)** 78 banks accounting for over 90 per cent of the total bank credit outstanding, **(ii)** 18 HFCs accounting for over 70 per cent of the total housing finance outstanding, **(iii)** 10 FIs accounting for over 90 per cent of the total outstanding, **(iv)** two CCCs accounting for over 90 per cent of the total outstanding, **(v)** 7 SFCs and 60 major NBFCs representing a substantial portion of the sector credit outstanding.

As a composite credit bureau, the CIBIL caters to both commercial and consumer segments. While the consumer credit bureau covers credit availed by individuals, the commercial credit bureau covers proprietary concerns/partnership firms/companies.

Consumer Credit Bureau The consumer credit bureau has a database of over 15 crore accounts. The CIBIL's consumer credit information report (CIR) provides factual information on past credit history of borrowers, including amount overdue, suit filed status, to enable credit grantors make informed lending decisions quickly and objectively. Its portfolio review report (PRR) provides a comprehensive view of the borrowers credit relationship across multiple lenders. The PRR is an extremely effective tool to review the risk associated with the existing portfolio of customers, the objective being minimisation of defaults and maximisation of credit penetration and portfolio quality. The CIBIL **TransUnion Personal Loan Score** enables prediction of the likelihood of a customer/applicant becoming more than 91 days delinquent on a personal/consumer loan over the next 12 months. The CIBIL **Market Insight** reports provide an overview of the credit markets geographic, demographic and behavioural borrowing trends. By profiling their customer base across various dimensions, benchmarking their performance with the market and identifying strengths/weaknesses, organisations can take proactive corrective decisions. The CIBILI **Locate Plus** leverages its vast/comprehensive information repository to provide lenders with comprehensive contact information on their customers in a faster and cost effective manner.

Commercial Credit Bureau The CIBIL's commercial credit bureau maintains a vast information database of credit histories of non-individual/commercial borrowers. The database has grown over 40 lakh accounts contributed by 95 members. The CIBIL collates the information received from its members and disseminates them on demand to its members in the form of commercial credit information reports (CIRs) to assist them in their loan appraisal process. The CIR broadly covers information about the borrowing entity and the credt/loan account details including number of credit facilities, credit type, loan amount, outstanding amount, asset classification, willful defaulters and suit-filed Status, and guarantor details. At present, the CIBIL maintains defaulters and suite-filed cases/accounts of ₹1 crore and suit-filed accounts (willful defaulters) of ₹25 lakh and above.

The CIR, however, only provides available factual credit information and not any opinion/comment on whether credit should be granted or not. The credit decisions are taken by the concerned credit grantors. The CIR does not contain any information regarding grant/rejection of loan/credit. Different institutions/lenders may use the CIR differently in terms of its own level of risk appetite based on its credit and risk management policies.

Funding The factors in India are not allowed access to wider funding sources on scales available to other finance companies. Virtual dependence on equity funds does not permit them to have optimal funding. For a cost-effective financing of these companies greater excess to the debt and the money market like the leasing and other finance companies is an urgent necessity.

Limited Coverage At present only domestic factoring of the advance with recourse is permitted and offered in India. Although the ECGC and SBI FACS have initiated measures for export factoring, no headway has been made. It is high time to provide export factoring to Indian exporters.

RECAPITULATION

- Factoring means the sale of receivables (book debts) by a firm (client) to a financial intermediary (factor) who pays when they are collected or in a guaranteed payment date. It basically involves transfer of collection of receivables and the related maintenance of records from the client to the factor. In essence, factoring is a source of financing of receivables and facilitates the process of their collection.
- Depending on the type of factoring, the main functions of a factor, in general terms, are five-fold: **(i)** maintenance of sales ledger, **(ii)** collection of receivables, **(iii)** financing of trade debts, **(iv)** assumption of credit risk/control/protection and **(v)** provision of advisory services. For providing these services, the factors levy two types of charges. The charge for collection of receivables and sales ledger administration in the form of a commission/fee payable in advance expressed as a flat percentage of the value of the debt purchased. The charge for short-term financing in the form of advance part-payment is an interest charge/discount charge for the period between date of advance payment and the date of collection/guaranteed payment date.

- On the basis of the features built into the factoring deal to cater to the varying needs of the trade/clients, there are different types of factoring. The main classification of factoring arrangements are: **(a)** Recourse and non-recourse based on the assumption of credit risk associated with the collection of the receivables, **(b)** Advance, maturing and participation factoring related to the time of payment on account of receivables by the factor to the client, **(c)** Full factoring, **(d)** Disclosed and undisclosed factoring on the basis of the disclosure/non-disclosure of the name of the factor in the invoice, **(e)** Domestic and export/cross-border/international factoring based on the domicile of the parties involved.
- There is no codified legal framework to regulate factoring in India. The legal relationship between the factor and the client is governed by the provisions of the factoring contract.
- Domestic factoring, as a fund-based service, differs from bills discounting and export factoring from forfaiting which finances deferred credit transactions related to exports.
- Factoring offers several advantages to a client including **(1)** off-balance sheet financing, **(2)** reduction in current liabilities, **(3)** improvement in current ratio, **(4)** higher credit standing, **(5)** improved efficiency, **(6)** reduction of costs **(7)** additional sources and of funds so on. However it involves a cost in terms of fee and discount charge and evaluation of factoring should be done as a cost-benefit analysis before resorting to factoring.
- There was no codified legal framework to regulate factoring in India. The legal relationship between the factor and the client was governed by the provisions of the factoring contract. In recognition of the importance of the factoring services in the emerging financial services scenario in the country, the legal framework relating to them has been codified recently. The three elements of the framework are: **(i)** Factoring Regulation Act (FRA) 2011, **(ii)** Registration of Assignment of Receivables (Government) Rules, 2012, and **(iii)** RBI's Non-Banking Financial Company – Factor Directions, 2012.
- The object of the **FRA** is to provide for and regulate **(i)** assignment of receivables through registration and **(ii)** rights and obligations of partners to the contract for assignment of receivables. **Assignment** means transfer by agreement of individual interest of any assignor in any receivable due from any debtors in favour of a factor in India or abroad. **Debtor** means any person liable to the assignor to pay any receivables/discharge any obligation in respect of the receivables. The main provisions of the FRA are: **(i)** registration of factors, **(ii)** assignment of receivables, **(iii)** rights and obligations of parties to the contract for assignment of receivables, **(iv)** registration of assignments, **(v)** offences and penalties and **(vi)** miscellaneous.
- To commence/carry on factoring business by a factor, a certificate of registration from the RBI is necessary excepting a bank/Government company/company under the Companies Act. **Factoring business** means the business of acquisition of receivables of assignor (i.e. the owner of any receivables) by accepting or financing their assignment by way of loans/advances or otherwise against the security interest over any receivables. **Factor** means a RBI-registered NBFC, a body corporate, a bank, a company engaged in factoring business.
- All factors would be governed by RBI Act/rules/directions/guidelines. All provisions of Chapter III-B of the RBI Act relating to the NBFCs would apply *mutatis mutandis* to a factor.
- Any assignor (i.e. owner of the receivables) may by a written agreement assign any receivables due/payable to him by any debtor in favour of a factor as an **assignee** for a mutually agreed consideration. All the rights/remedies and any security interest created over any property exclusively to secure the due payment of the receivables would vest in the assignee who will have an absolute right to recover it and exercise all the rights/remedies of the assignor. **Receivables** mean all/part of, or individual interest in, any existing/future/accruing/conditional/contingent right of any person under a contract including international contract to payment of toll or any other monetary sum, by whatever name called, for the use of any infrastructure facility/services.

- The rights/obligations of the respective parties relate to: **(i)** notice of assignment, **(ii)** liability of debtors, **(iii)** assignors to be trustees of assignee, **(iv)** principle of debtor protection, **(v)** liability of debtor in case of micro/small enterprises, **(vi)** defences and rights of set-off of debtors, **(vii)** modification of original contract and **(viii)** breach of contract.
- The debtor would have the right to notice of assignment to make payment to the assignee.
- In case of the notice of assignment, the debtor would be entitled to a valid discharge of his liability only by making payment to the assignee.
- A payment due on an assigned receivables by a debtor to an assignor would be deemed to be for the benefit of the assignee.
- In the event of delay in payment of receivables of a micro/small enterprise by a debtor, the assignee would be entitled to interest for the delayed period under.
- Consequent upon the assignment of receivables, however, no changes can be made in the payment instruction between the debtor and the assignor in regard to the original: **(i)** amount of debt, **(ii)** place of payment, and **(iii)** date of payment/other terms relating to payment.
- If the assignor commits any breach of the original contract, the debtor would not be entitled to recover from the assignee any sum paid to the assignor/assignee pursuant to the factoring transaction.
- For purposes of registration, factors should file the particulars of every transaction of assignment of receivables in his favour with the Central Registry set up under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act within 30 days from the date of assignment in the prescribed manner and on payment of the specified fee.
- Default in filing details of any transaction with the Central Registry would be punishable with fine upto five thousand rupees for every day of default; **(ii)** Penalty for non-compliance of any direction of the RBI may extend upto five lakh rupees payable within 14 days and upto ten thousand rupees for every day of continuing default. Failure to pay within the specified period would be punishable with a levy/sum specified by the principal civil.
- Contravention/attempt to contravention/abetment to contravention of the provisions of the Factoring Regulation Act/rules, for which no penalty has been provided, would be punishable with imprisonment upto one year or with fine or with both.
- The main features of the rules framed by the Government under the FRA relate to: **(i)** registration of transactions of assignment of receivables, **(ii)** time limit for registration/condonation of delay, (**iii)** inspection of records of central register and **(iv)** fees.
- These directions relate to **(i)** registration, **(ii)** net owned fund, **(iii)** principal business, **(iv)** conduct of business, **(v)** prudential norms, **(vi)** submission of returns, **(vii)** import/export factoring and **(viii)** miscellaneous.
- Every company intending to undertake factoring business should make an application for grant of certificate of registration (CoR) as NBFC-Factor to the RBI.
- Every applicant NBFC-Factor should have a minimum net owned fund (NOF) of five crore rupees.
- An NBFC-Factor should ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and its income derived from factoring business is not less than 50 per cent of its gross income.
- The NBFC-Factors should conduct the business of factoring in accordance with the Factoring Regulation Act/rules and regulations.

- The provisions of the RBI NBFC – SI – ND/NBFC – D directions aply to the NBFC-Factor. Some additional provisions are also applicable to them: **(i)** registration, **(ii)** not owned fund, **(iii)** principal business, **(iv)** conduct of business, **(v)** asset classification, **(vi)** risk management, and **(vii)** import-export factoring.
- NBFC-Factors, intending to deal in forex through export/import factoring, should seek necessary authorisation to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA/rules/regulations/ notifications/directions/orders.
- For an NBFC-Factor, such certificate should indicate the requirement of holding the certificate under the Factoring Act. The certificate should also indicate the percentage of factoring assets and income, the compliance that it fulfils all conditions stipulated under the FRA to be classified as an NBFC-Factor and compliance to minimum capitalisation norms, if FDI has been received. Non-compliance to the provisions of these directions would invite penal action under the Factoring Regulation Act.
- Factoring deals in India encounter serious obstacles which stand in the way of the growth of such services: **(1)** lack of specialised credit information agency/bureau, **(2)** funding limitations and **(3)** limited coverage. If factoring is to grow, a solution to these problems is urgently called for.

SOLVED PROBLEMS

P.4.1 The turnover of R Ltd is ₹60 lakh of which 80 per cent is on credit. Debtors are allowed one month to clear off the dues. A factor is willing to advance 90 per cent of the bills raised on credit for a fee of 2 per cent a month plus a commission of 4 per cent on the total amount of debts. R. Ltd as a result of this arrangement is likely to save ₹21,600 annually in management costs and avoid bad debts at 1 per cent on the credit sales.

A bank has come forward to make an advance equal to 90 per cent of the debts at an annual interest rate of 18 per cent. However, its processing fee will be at 2 per cent on the debts. Would you accept factoring or the offer from the bank?

Solution

Cost of factoring:		
Fee (0.02 × 0.90 × ₹4,00,000)@		₹7,200
Commission (0.04 × ₹4,00,000)		16,000
		23,200
Less: Savings in cost:		
Management costs (₹21,600 ÷ 12)	₹1,800	
Savings in bad debts (0.01 × ₹4,00,000)	4,000	5,800
Net cost of factoring		17,400
Cost of bank advance:		
Interest (0.18 × 1/12 × 0.90 × ₹4,00,000)		5,400
Processing fee (0.02 × ₹4,00,000)		8,000
Bad debts (0.01 × ₹4,00,000)		4,000
		17,400

@(Annual credit sales ₹48 lakh ÷ 12 months)

Note: It is assumed that R Ltd will continue to incur management costs.
Since the costs of both the alternatives are equal, R Ltd is likely to be indifferent between factoring and bank advance.

P.4.2 The Delhi Manufacturers Ltd sells goods on credit. Its current annual credit sales amount to ₹900 lakh. The variable cost ratio is 80 per cent. The credit terms are 2/10, net 30. On the current level of sales, the bad debts are 0.75 per cent. The past experience has been that 50 per cent of the customers avail of the cash discount, the remaining customers pay on an average 50 days after the date of sale.

The book debts (receivables) of the firm are presently being financed in the ratio of 2:1 by a mix of bank borrowings and owned funds which cost per annum 25 per cent and 28 per cent respectively.

As an alternative to the in-house management of receivables, Delhi Manufacturers Ltd is contemplating use of full advance non-recourse factoring deal with the PNB Factors Ltd. The main elements of such a deal structured by the factor are **(i)** factor reserve, 15 per cent; **(ii)** guaranteed payment date, 24 days after the date of purchase; **(iii)** discount charge, 22 per cent and **(iv)** commission for other services (payable up-front), 4 per cent of the value of receivables.

The finance manager of Delhi Manufacturers Ltd seeks your advice, as a consultant, on the cost-benefit of the factoring arrangement. What advice would you give? You can make your own assumptions, where necessary.

Solution

Relevant Costs: In-House Management Alternative

Relevant costs		*Amount (₹ lakh)*
Cash discount	9.00	(₹900 × 0.02 × 0.5)
Cost of funds in receivables	19.50	(*working note 1*)
Bad debt losses	6.75	(₹900 × 0.0075)
Total	35.25	

Working Note

1. Cost of funds invested in receivables:

Average collection period = (10 days × 0.5) + (50 days × 0.5) = 30 days

Average investment in debtors = ₹900 lakh/12 = ₹75 lakh

Cost of bank funds = (₹75 lakh × 2/3 × 0.25) = ₹12.5 lakh

Cost of owned funds = ₹75 lakh × 1/3 × 0.28) = ₹7 lakh

Total cost = ₹12.5 lakh + ₹7 lakh = ₹19.5 lakh

Decision Analysis: Non-recourse Factoring Alternative

Relevant costs		*Amount (₹ lakh)*
Factoring commission	36.00	(₹900 × 0.04)
Discount charge	10.77	(working note 2)
Cost of owned funds invested in receivables	3.09	(₹900 lakh – ₹734.4 lakh) × 0.28 × 24/360
Total	49.86	

Working Note

2. Eligible amount of advance = 0.85 × (₹900 lakh – ₹36 lakh) = ₹734.4 lakh

Discount charge = (₹734.4 lakh × 0.22 × 24/360) = ₹10.77 lakh

Decision Analysis: Cost Benefit of Non-recourse Factoring

	Amount (₹ lakh)
Benefits (savings of cost as per in-house management alternative)	35.25
Cost (of non-recourse factoring alternative)	49.86
Net loss	(14.61)

Recommendation: New Delhi Manufactures Ltd should not go for the factoring alternative.

Mini Case

4.C.1 (Factoring) Sunlight Industries Ltd manages its accounts receivables internally by its sales and credit department. The cost of sales ledger administration stands at ₹9 crore annually. It supplies chemicals to heavy industries. These chemicals are used as raw material for further use or are directly sold to industrial units for consumption. There is good demand for both the types of uses. For the direct consumers, the company has a credit policy of 2/10, net 30. Past experience of the company has been that on average 40 per cent of the customers avail of the discount while the balance of the receivables are collected on average 75 days after the invoice date. Sunlight Industries also has small dealer networks that sell the chemicals. Bad debts of the company are currently 1.5 per cent of total sales.

Sunlight Industries finances its investment in debtors through a mix of bank credit and own long-term funds in the ratio of 60:40. The current cost of bank credit and long-term funds are 12 per cent and 15 per cent respectively.

There has been a consistent rise in the sales of the company due to its proactive measures in cost reduction and maintaining good relations with dealers and customers. The projected sales for the next year are ₹800 crore, up 15 per cent from last year. Gross profits have been maintained at a healthy 22 per cent over the years and are expected to continue in future.

With escalating cost associated with the in-house management of debtors coupled with the need to unburden the management with the task so as to focus on sales promotion, the CEO of Sunlight Industries is examining the possibility of outsourcing its factoring service for managing its receivables. He assigns the responsibility to Anita Guha, the CFO of Sunlight. Two proposals, the details of which are given below, are available for Anita's consideration.

Proposal from Canbank Factors Ltd: The main elements of the proposal are: (i) Guaranteed payment within 30 days (i) Advance, 88 per cent and 84 per cent for the resource and non-recourse arrangements respectively (iii) Discount charge in advance, 21 per cent for with recourse and 22 per cent without recourse (iv) Commission, 4.5 per cent without recourse and 2.5 per cent with recourse.

Proposal from Indbank Factors: (i) Guaranteed payment within 30 days (ii) Advance, 84 per cent with recourse and 80 per cent without recourse (iii) Discount charge upfront, without recourse 21 per cent and with recourse, 20 per cent and (iv) Commission upfront, without recourse 3.6 per cent and with recourse 1.8 per cent.

The opinion of the Chief Marketing Manager is that in the context of the factoring arrangement, his staff would be able to exclusively focus on sales promotion which would result in additional sales of ₹75 crore.

Required The CFO of Sunlight Industries seeks your advice as a financial consultant on the alternative proposals. What advice would you give? Why? Calculations can be upto one digit only.

Solution

Financial Analysis of Receivables Management Alternatives

(₹ crore)

(A) In-house Management:	
Cash discount (₹800 crore × 0.40 × 0.02)	₹6.4
Bad debts (₹800 crore × 0.015)	12.0
Opportunity cost (Foregone contribution on lost sales) [₹75 crore × 0.205 net of bad debts]	15.4
Avoidable administrative and selling expenses	9.0
Cost of investment in receivables@	14.4
Total cost	57.2

@ Average collection period (0.40 × 10 days) + (.60 × 75 days) = 49 days

Investment in debtors = ₹800 crore × 49/360 = ₹108.9 crore

Cost of investment in debtors: (₹108.9 × 0.60 × 0.12) + (₹108.9 × 0.40 × 0.15) = ₹14.4 crore

(B) Canbank Factors Proposal:

	With recourse	Without recourse
Factoring commission (₹875 crore × 0.025)	21.9	—
(₹875 crore × 0.045)	—	39.4
Discount charge (₹750.7* crore × 0.21 × 30/360)	13.1	—
(₹701.9** × 0.22 × 30/360)	—	12.9
Cost of long-term funds invested in debtors:		
[(₹875 crore – ₹750.7 crore) × 0.15 × 30/360]	1.6	—
[(₹875 – ₹701.9 crore) × 0.15 × 30/360]	—	2.2
	36.6	54.5

* Amount of advance = 0.88 × (₹875 crore – ₹21.9 crore) = ₹750.7 crore

** Amount of advance = 0.84 × (₹875 crore – ₹39.4 crore) = ₹701.9 crore

(C) Indbank Factors Proposal:

	With recourse	Without recourse
Factoring commission (₹875 crore × 0.018)	15.7	—
(₹875 crore × 0.036)	—	31.5
Discount charge (₹721.8£ crore × 0.20 × 30/360)	12.0	—
(₹674.8££ crore × 0.21 × 30/360)	—	11.8
Cost of long-term funds invested in debtors:		
[(₹875 crore – ₹721.8 crore) × 0.15 × 30/360]	1.9	—
[(₹875 – ₹674.8 crore) × 0.15 × 30/360]	—	2.5
	29.6	45.8

£ Amount of advance = (₹875 crore – ₹15.7 crore) × 0.84 = ₹721.8 crore

££ Amount of advance = (₹875 crore – ₹31.5 crore) × 0.80 = ₹674.8 crore

Decision Analysis: Recourse Factoring		(₹ *crore*)
Particulars	*Canbank*	*Indbank*
Benefits (₹57.2 – ₹12 Bad debts to be borne by company)	45.2	45.2
Costs	36.6	29.6
Net benefits	8.6	15.6

Decision Analysis: Non-Recourse Factoring		(₹ *crore*)
Particulars	*Canbank*	*Indbank*
Benefits (₹57.2 + ₹1.1 Bad debts loss to be borne by factor)	58.3	58.3
Costs	54.5	45.8
Net benefits	3.8	12.5

Advice: My advice to the CFO of Sunlight Industries would be to accept the proposal of Indbank Factors for recourse factoring.

Comprehensive Case is available in Appendix 4-A on the website. The website address is **http://www.mhhe.com/khanfs9e.**

REVIEW QUESTIONS

4.1 Explain briefly the mechanism of factoring.

4.2 What are the functions of a factor?

4.3 Discuss briefly the various forms of factoring.

4.4 Write a brief note on the contents of a factoring agreement.

4.5 Compare and contrast factoring with forfaiting and bill discounting.

4.6 Discuss the main features of the recently codified legal framework relating to factoring in India in terms of the **(i)** Factoring Regulation Act, **(ii)** Registration of Assignment of Receivables (Government) Rules and **(iii)** RBI NBFC-Factors Directions.

4.7 Explain briefly the nature of factoring services in India. What are the operational obstacles encountered by factoring services in India?

4.8 The Udar Ltd sells all goods on credit. Its current annual credit sales (turnover) amount to ₹800 lakh. The variable cost ratio (ratio of variable costs to sales) is 0.80. The credit terms of the Udar Ltd are 2/10, net 30. On the current level of sales the bad debts are 0.75 per cent. The past experience has been that 50 per cent of the customers avail of the cash discount; the remaining customers pay on an average 45 days after the date of sale.

The book debts (receivables) of Udar Ltd are at present being financed on a 67:33 basis by a mix of bank borrowings and owned funds which cost per annum 25 per cent and 28 per cent respectively.

As an alternative to the in-house management of receivables, the Udar Ltd is contemplating use of full advance non-recourse factoring deal with the Indbank Factors Ltd. The main elements of such a deal structured by the factor are **(i)** factor reserve, 15 per cent;

(ii) guaranteed payment date, 24 days after the date of purchase; **(iii)** discount charge, 22 per cent and **(iv)** commission for other services, 4 per cent of the value of receivables. The finance manager of Udar Ltd. seeks your advice, as a consultant, on the cost-benefit of the factoring arrangement. What advice would you give? You can make your own assumption, where necessary.

4.9 The following facts relate to the Avon Industries Ltd. (AIL):

- Annual credit turnover in the current financial year, ₹1,200 lakh
- Average collection period, 75 days
- Variable cost ratio, 0.75
- Cost of funds, 0.21 per annum
- Annual credit and collection expenditure, ₹250 lakh of which three-fourths is avoidable
- Financing of receivables by bank borrowings, 0.75

The Fairgrowth Factors Ltd offers a factoring deal to the AIL. It proposes to charge a commission as percentage of the value of book debts of 2 per cent for recourse factoring and 3.5 per cent for non-recourse factoring. In addition, it would charge 22 per cent per annum as discount/interest for pre-payments (advance against uncollected and not due receivables) to the extent of 80 per cent of the value of the receivables. The guaranteed payment date/collection period is 60 days.

Making your own assumption where necessary, what advice would you give to AIL: to continue with the in-house management of receivables or accept the factoring arrangement?

ANSWERS

4.8 Cost of non-recourse factoring alternative, ₹44.87 lakh; Cost of in-house management alterative, ₹39.59 lakh. Factoring alterative in recommended.

4.9 Continue with the in-house management of receivables : Net loss with non-recourse factoring (₹6.05 lakh); Net loss with recourse factoring (₹0.07 lakh).

CHAPTER 5

Housing Finance

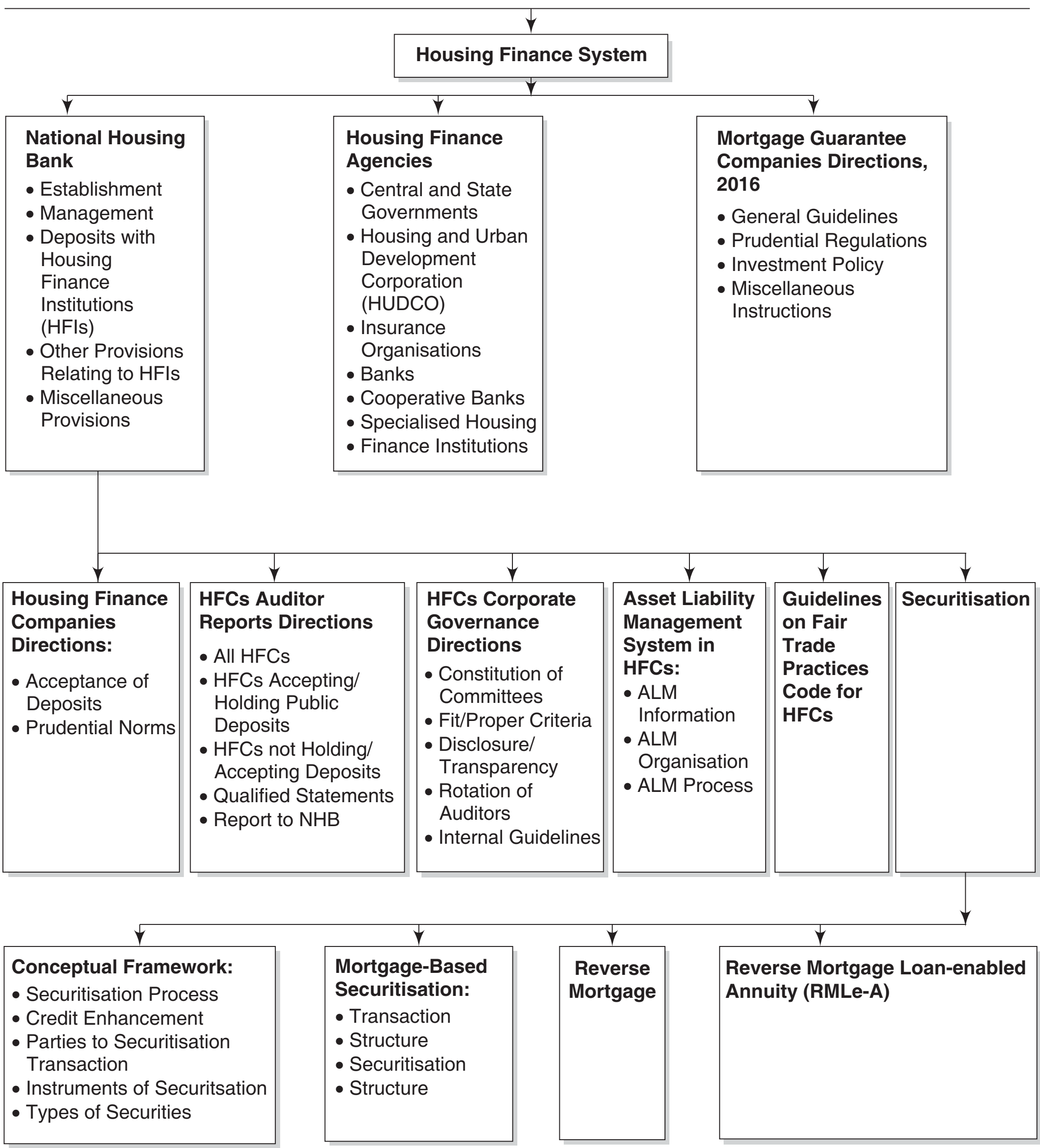
Learning Objectives

- Understand the profile of the National Housing Bank (NHB) as the apex housing finance institution.
- Discuss the three main elements—acceptance of public deposits, prudential norms, and auditors reports—of the NHB's directions relating to housing finance companies (HFCs).
- Review the NHB guidelines for extending equity support to HFCs.
- Explain the NHB guidelines for extending refinance support to HFCs.
- Discuss the main features of NHB's refinance scheme for HFCs.
- Discuss the framework for asset liability management in HFCs.
- Outline the main elements of Fair Practices Code for HFCs.
- Explain the concept of securitisation, securitisation process, credit enhancement, parties to securitisation transaction, assets characteristics and instruments of securitisation.
- Explain and illustrate mortgage-based securitisation.
- Understand the framework of reverse mortgage deals.
- Discuss the guidelines relating to reverse mortgage loan-enabled annuity (RMLe-A).
- Sketch the main agencies/institutions of the housing finance system.
- Examine the RBI directions for mortgage guarantee companies.

INTRODUCTION

The responsibility to provide housing finance largely rested with the Government of India till the mid-eighties. The setting up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India (RBI) in 1988, as the apex institution, marked the beginning of the emergence of housing finance as a fund-based financial service in the country. It has grown in volume and depth with the entry of a number of specialised financial institutions/companies in the public, private and joint sectors, although it is at an early stage of development. **It is portrayed in Exhibit 5.1.** Sections 1-2 of the chapter profile the NHB and the other players in the housing finance system. The NHB housing finance companies (HFCs) directions and guidelines relating to **(i)** acceptance of deposits, **(ii)** prudential norms, **(iii)** directions to auditors, **(iv)** miscellaneous matters are comprehensively covered in Section 3. The asset liability management framework for the housing companies is covered in Section 4. Sections 5-8 discuss securitisation, mortgage-based securitisation and reverse mortgage respectively. **A comprehensive account of the NHB guidelines relating Fair Trade Practices Code for HFCs is given in Appendices 5-A on the website. The address is http://www.mhhe.com/khanfs9e.** Finally, the regulatory frame-work for mortgage guarantee companies is examined in Section 9. The main points are summarised in the last section.

Exhibit 5.1 Organisation of Housing Finance in India



NATIONAL HOUSING BANK (NHB)

The NHB was established in 1988 under the *NHB Act*, 1987, to operate as a principal agency to promote housing finance institutions (HFls), at both local and regional levels, and to provide financial and other support to them. The HFls include institutions, whether incorporated or not, that primarily transact or have as one of their principal objects the transacting of the business of providing finance for housing, either directly or indirectly. The main features of the NHB, as the principal/apex finance agency in India, are discussed below.

Establishment of the NHB and Its Capital

The NHB is a body corporate. It can establish offices/branches/agencies at any place in and, with the RBI's prior approval, outside India. Its authorised and paid-up capital is ₹350 crore, fully subscribed by the RBI. The authorised capital can be increased up to ₹2,000 crore by the Government in consultation with the RBI. The Board of Directors of the NHB may issue the increased authorised capital, on terms and conditions determined from time to time, to the RBI/Government/banks/public financial institutions (PFIs), housing finance institutions/other institutions, as approved by the Government. However, at least 51 per cent of its issued capital would be held by the RBI/Government/public sector banks/PFIs/other institutions owned/controlled by the Government.

Management

The general superintendence, direction and management of the affairs and business of the NHB is vested in its Board of Directors, which exercises all powers and executes all acts and things on its behalf. Subject to the provisions of the *NHB Act*, the Board, while discharging its functions, has to act on business principles, with due regard to public interest. In general, **(a)** the Chairman, if he is a whole-time Director or if he is holding offices both as a Chairman and a Managing Director (CMD) or **(b)** the MD, if the Chairman is not whole-time director or is absent, can also exercise these powers of the Board. The MD has to follow, in the discharge of his powers and functions, all directions given by the Chairman. In the discharge of its functions, the NHB is to be guided by the directions given in writing by the Government in consultation with the RBI, or by the RBI in matters of policy involving public interest.

The Board of Directors of the NHB consists of **(i)** a Chairman and a Managing Director (CMD), **(ii)** two directors from amongst experts in the field of housing, architecture, engineering, sociology, finance, law, management and corporate planning, or in any other field, special knowledge of which is considered useful to the NHB, **(iii)** two directors who are persons with experience in the working of institutions involved in providing finance for housing or engaged in housing development or have experience in the working of financial institutions/banks, **(iv)** two directors elected by shareholders other than the RBI/Government/other institutions owned/controlled by Government, **(v)** two directors from out of the RBI directors, **(vi)** three directors from amongst Central Government officials and **(vii)** two directors from amongst state governments' officials. The CMD an other directors, excepting the RBI's directors and those elected by the shareholders, are appointed by the Government in consultation with the RBI. The RBI nominates its directors on the NHB.

Business

Subject to the provisions of the *NHB Act*, the NHB is authorised to transact all/any of the following kinds of business:

(a) Promoting, establishing, supporting/aiding in the promotion/establishment/ support of housing financing institutions (HFIs);

(b) Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative, agricultural and rural development banks or any other institution/class of institutions notified by the Government;

(c) Subscribing to/purchasing stocks, shares, bonds, debentures and securities of every other description;

(d) Guaranteeing the financial obligations of HFIs and underwriting the issue of stocks/shares/bonds/debentures/other securities of HFIs;

(e) Drawing, accepting, discounting/rediscounting, buying/selling and dealing in bills of exchange/promissory notes, bonds/debentures, hundis, coupons/other instruments;

(ea) Buying/selling, or otherwise dealing in any loans/advances secured by mortgage/charge of immovable property relating to banks/HFIs;

(eb) Creating trust(s) and transferring loans/advances together with/without securities therefrom to HFIs for a consideration;

(ec) Setting aside loans/advances held by the NHB and issuing/selling securities based upon them in the form of debt obligations/trust certificates of beneficial interest/other instruments, and to act as trustee for the holders of such securities;

(ed) Setting up of mutual funds for undertaking housing finance activities;

(ee) Undertaking/participating in housing mortgage insurance;

(f) Promoting/forming/conducting or associating in promotion/formation/conduct of companies/mortgage banks/subsidiaries/societies/trusts/other associations of persons it may deem fit for carrying out all/any of its functions under the *NHB Act;*

(g) Undertaking research and surveys on construction techniques and other studies relating to/connected with shelter/housing and human settlement;

(h) Formulating scheme(s) for purposes of mobilisation of resources and extension of credit for housing;

(i) Formulating scheme(s) for the economically weaker sections of society, which may be subsidised by the Government or any other source;

(j) Organising training programmes/seminars/symposia on matters relating to housing;

(k) Providing guidelines to HFIs to ensure their growth on sound lines;

(l) Providing technical/administrative assistance to HFIs;

(m) Coordinating with the Life Insurance Corporation of India, the Unit Trust of India, the General Insurance Corporation of India and other financial institutions, in the discharge of its overall functions;

(n) Exercising all powers and functions in the performance of duties entrusted to it under the NHB Act or under any other law in force for the time being;

(o) Acting as agent of the Central/State Government/the RBI or of any authority as may be authorised by the RBI;

(p) Any other kind of business which the Government may, on the recommendations of the RBI, authorise;

(q) Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the *NHB Act*.

Borrowing and Acceptance of Deposits For purposes of carrying out its functions, the NHB may:

(a) issue and sell bonds and debentures with or without the guarantee of the Central Government, in such manner and on such terms as may be prescribed;

(b) borrow money from the Central Government, banks, financial institutions, mutual funds and from any other authority or organisation or institution approved by the Government on such terms and conditions as may be agreed upon;

(c) accepting deposits repayable after such period and on such terms as may generally or specially be approved by the RBI;

(d) borrow money from the RBI **(i)** by way of loans and advances and, generally, obtain financial assistance in a manner specified by the RBI; **(ii)** out of the National Housing Credit (long-term operations) Fund established under Section 46-D of the *RBI Act*;

(e) receive, for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges, royalties, premia, licence fees and other considerations of any description;

(f) receive gifts, grants, donations or benefactions from the Government or any other source.

The Central Government may guarantee the bonds and debentures issued by the NHB as to the repayment of the principal and the payment of interest at rate(s) fixed by the Government.

Loans in Foreign Currency The NHB may borrow in foreign currency from any bank/financial institution in India/abroad in such manner and on such conditions as may be prescribed in consultation with the RBI and with the prior approval of Government. The NHB may also provide guarantee as to payment of interest and other incidental charges, as well as repayment of the principal.

Assistance to Borrow Where any person/institution seeks any financial assistance from the NHB on the security of any **(i)** movable property belonging to him/institution or **(ii)** the property of some other person offered as collateral for such assistance, a written declaration would have to be executed in the prescribed form stating the particulars of the security/collateral security and agreeing that the dues relating to the assistance would be a charge on such property. Without prejudice to the rights of any other creditor holding prior charge/mortgage in respect of the specified movable property, the dues of the NHB would be a charge on the property. Such dues would also be a charge on any further immovable property offered as additional security if a fresh declaration in the prescribed form is executed. With the prior approval of the NHB, the above declaration may be varied/revoked at any time by the concerned person/institution. Such a declaration would be deemed to be a document registerable as an agreement under the provisions of the *Registration Act*, and unless registered, they would have no effect.

Amount/Security to be Held in Trust Any sum received by a borrowing institution in repayment/realisation of loans/advances financed/refinanced wholly/partly by the NHB, to the extent of the accommodation granted by it and remaining outstanding, would be deemed to have been received by it in trust and should accordingly be paid by the institution to the NHB. Similarly, where any accommodation has been granted by the NHB to a borrowing institution, all securities held/to be held on account of any transaction, in respect of which such accommodation has been granted, would be held by such an institution in trust for the NHB.

Power to Transfer Rights The rights and interests of the NHB in relation to any loan/advance made or any amount recoverable may be transferred by it wholly or partly in any form. Notwithstanding such transfer, the NHB may act as a trustee for the transferee in terms of Section 3 of the *Indian Trusts Act, 1882*.

Power to Acquire Rights The NHB has the right to acquire, by transfer/assignment, the rights and interests of any institution in relation to any loan/advance made/amount recoverable wholly or partly by the execution/issue of any instrument or by the transfer of any instrument or in any other manner in which the rights and interests in relation to such loan/advance may be lawfully transferred.

Exemption from Registration Subject to Section 17(1) of the *Registration Act*, 1908, **(a)** any instrument in the form of debt obligations/trust certificates of beneficial interest/other instruments, by whatever name called, issued by the NHB to securitise loans granted by HFIs/banks and not creating/declaring/assigning/limiting /extinguishing any right/title or interest to or in immovable property, except in so far as it entitles the holder to an undivided interest offered by a registered instrument, whereby the NHB has acquired the rights/interests in relation to such loans and in securities therefrom or **(b)** any transfer of the above instruments would not require compulsory registration.

Recovery of Dues as Arrears on Land Revenue Where any amount is due under an agreement to it acting as a trustee, or otherwise, in respect of the securitisation of loans of HFIs/banks, in addition to any other mode of recovery, the NHB may approach a state government for its recovery in the same manner as arrears of land revenue.

Power to Impose Conditions To protect its interests, the NHB may impose such conditions as it may think necessary/expedient in respect of any transaction entered into with any borrowing institution.

Power to Call for Repayment Before Agreed Period The NHB has the power to call for repayment before the agreed period of all obligations of institutions if **(a)** false/misleading information in any material particular was given in the application for loan/advance, **(b)** the borrowing institution has failed to comply with any of the terms of the agreement in the matter of the loan/advance, **(c)** there is reasonable apprehension that the institution is unable to pay its debts/proceedings, or its liquidation may be commenced, **(d)** for any reason due to which it is necessary to protect its interests.

Access to Records The NHB would have free access to all such records of the institution/person(s) availing of any credit facilities from it/the institution, the perusal of which may be necessary in connection with the provision of finance or other assistance to the institution/refinance of any loan/advance to such person by the institution. The institution/person concerned would be bound to comply with the NHB's requirement to furnish copies of such records.

Validity of Loans/Advances The validity of any loan/advance by the NHB cannot be questioned merely on grounds of non-compliance with the requirements of any other law/resolution/contract or any instrument relating to the constitution of the borrowing institution. However, a company/cooperative society cannot obtain any loan/advance if it is not empowered to do so by its constitution.

Prohibition on Loans Against Own Bonds/Debentures Loans/advances against the security of its own bonds/debentures, by the NHB, is totally prohibited.

Power to Inspect The NHB has the power to inspect the books/accounts/other documents of any institution to which it has made any loan/advance or granted any other financial assistance on its own or on direction from the RBI. A copy of the inspection report would be supplied to the institution concerned. Every officer/employee/other person(s) in charge of the whole/part of the affairs of the institution is duty bound to produce all books of accounts, other documents and any statement/information relating to the affairs of the institution, within the specified time, to the inspecting officer.

Power to Collect and Publish Credit Information To discharge its functions efficiently, the NHB may direct an institution at any time, to submit to its credit information in the specified form and within the time specified by it from time to time. Credit information refers to any information relating to **(i)** the amount of loans/advances/other credit facilities granted for housing purposes, **(ii)** the nature of security taken for them, **(iii)** the guarantees furnished and **(iv)** any information that which has a bearing on the borrowers' credit worthiness. The institution concerned is bound to comply with such direction under all circumstances. For similar purposes, the NHB may also collect credit and other information from the Government(s), local authorities, the RBI/banks and financial or other institutions specified by the RBI. If considered to be in public interest, the NHB may publish any credit/other information obtained by it in a consolidated/any other form.

Advisory Services The NHB is authorised to provide advisory services to the Government(s), local authorities/other agencies connected with housing in respect of **(a)** formulation of overall policies aimed at promoting the growth of housing and HFI, and **(b)** legislation relating to matters having a bearing on shelter, housing and settlement.

Deposits with Housing Finance Institutions

The provisions relating to HFIs, other than HFIs that are firms/incorporated association of individuals, receiving deposits are discussed below.

Registration and Net Owned Funds To commence/carry on business, every HFI set-up as a company should **(a)** obtain a certificate of registration from the NHB and **(b)** have net owned funds of ₹25 lakh or other such higher amounts as may be specified by the NHB from time to time. **Net owned funds** (NOFs) refer to **(a)** the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the HFI, minus accumulated balance of loss, deferred revenue expenditure and other intangible assets and **(b)** further reduced by the amount representing **(1)** investments in shares of subsidiaries/group companies/all other HFIs that

> **Net owned funds** refer to the **(a)** aggregate of the capital and free reserves minus accumulated losses, deferred revenue expenditure and other intangible assets less **(b)** the amount in excess of 10 per cent of **(a)**, investment in shares/book value of debentures, bonds, advances, deposits in group/subsidiary companies.

are companies and **(2)** book value of debentures/bonds/outstanding loans/advances (including hire purchase and lease finance) made to, and deposits with, subsidiaries and group companies to the extent such amount exceeds 10 per cent of **(a)** above.

While considering applications for registration, the NHB may satisfy itself by an inspection of the books of the applicant or otherwise that the following conditions are fulfilled:

- The HFI is/would be in a position to pay its present/future depositors in full as and when their claims accrue.
- Its affairs are not being/likely to be conducted in a manner detrimental to the interests of its present/future depositors.
- The general character of the management/proposed management of the HFI would not be prejudicial to the public interest/interest of depositors.
- It has adequate capital structure and earnings prospects.
- Public interest would be served by its registration.
- Registration would not be prejudicial to the operation and growth of the housing finance **sector in** the country.
- Any other condition fulfillment which, in its opinion, would be necessary to ensure that commencement/carrying on business would not be prejudicial to the public interest or the interests of the depositors.

On being satisfied about the fulfillment of the above conditions, the NHB may register a HFI, subject to such conditions as it may consider fit to impose.

Cancellation of Registration The registration of a HFI can be cancelled by the NHB if it **(a)** ceases to carry on business, **(b)** has failed to comply with any condition, subject to which the registration was issued, **(c)** at any time fails to fulfil any of the conditions laid down for grant of registration, discussed above, **(d)** fails **(i)** to comply with any direction issued by the NHB **(ii)** to maintain accounts in accordance with the requirement of any law/any order/direction issued by the NHB and **(iii)** to submit/offer for inspection its books of accounts/other relevant documents when so demanded by an inspecting authority of the NHB and **(e)** has been prohibited from accepting deposits by an order made by the NHB, which has been in force for at least three months. Any HFI aggrieved by the order/rejection of application for/cancellation of registration may appeal to the Central Government, whose decision would be final.

Maintenance of Percentage of Assets At least 5 per cent or such higher percentage (not exceeding 25 per cent), as specified by the NHB from time to time of deposits outstanding at the close of business on the last working day of the second preceding quarter (i.e., the period of three months ending on the last day of March, June, September and December) of a HFI should be invested in unencumbered approved securities valued at a price not exceeding their current market price. Included in the unencumbered approved securities are approved securities lodged by the HFI with another institution for an advance/any other arrangement to the extent to which they have not been drawn against/availed of/encumbered in any manner. Approved securities mean securities of any state government/the central government and bonds that are fully and unconditionally guaranteed as to their principal and interest by the Government. The HFls should also maintain in an account with a bank in India in term deposit or certificate of deposit free of charge or lien/deposits with or by way of subscription to bonds issued by the NHB, an amount which at the close of business on any day, together with the investments in the unencumbered approved securities, would not be less than 10 per cent or such higher percentage not exceeding 25 per cent as specified by the NHB from time to time of the deposits outstanding at the close of business on the last working day of the second preceding quarter. Every HFI may be required to furnish to the NHB with a return in a specified form/manner and period. On any shortfall in investment in unencumbered approved securities and deposits, the HFIs would have to pay a panel interest at 3 per cent per annum above the bank rate and if the shortfall continues in subsequent quarter(s), five per cent above the bank rate, within 14 days from the date on which notice issued by the NHB demanding payment is served, failing which the NHB may approach a civil court for direction, which would be enforceable in a manner as if it were a decree made by a court in a suit. However, if the NHB is satisfied that the defaulting HFI had sufficient cause for its failure, it may not demand the payment of penal interest.

Reserve Fund A reserve fund should be created by the HFIs by transfer of a sum not less than 20 per cent of their net profits every year, before payment of any dividend. While reckoning the limit of 20 per cent, any sum transferred by the HFI for the year, if any, to any Special Reserve Fund created and maintained by it under Section 36(1)(viii) of the *Income Tax Act* may be taken into account. Any appropriation of any sum from the reserve fund can be made only for purposes specified by the NHB from time to time and should be reported to it within 21 days from the date of withdrawal, which in any particular case and for sufficient cause may be extended by such further period as the NHB thinks fit or delay in submitting the report may be condoned. In case of HFIs, whose reserve fund together with the amount in share premium account is not less than its paid-up capital, however, the Government on the recommendation of the NHB and with due consideration of the adequacy of the paid-up capital and reserves, may make the requirement of transfer of 20 per cent of profit inapplicable for a specified period.

Issue of Prospectus/Advertisement If considered necessary in public interest, the NHB may by general/special order **(a)** regulate/prohibit the issue, by any HFI, of any prospectus/advertisement soliciting deposits from the public and **(b)** specify the condition subject to which it can be issued.

Determination of Policy and Issue of Directions If satisfied that **(a)** in public interest, **(b)** to regulate the housing finance system of the country to its advantage, **(c)** to prevent the affairs of any HFI being conducted in a manner detrimental/prejudicial to the interest of depositors/HFIs, the NHB may consider it is necessary/expedient, within the framework of Government policy, to determine policy and give directions to HFI(s) relating **(1)** to income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off-balance sheet items and **(2)** to deployment of funds. The HFI(s) would be bound to follow the policy and the directions. In addition, it may give directions in particular as to **(i)** the purpose for which advances/other fund/non-fund based accommodation may not be made and **(ii)** the maximum amount of advance/financial accommodation/investment in shares and other securities that (having regard to its paid-up capital, reserves and deposits and other relevant considerations) may be made by the HFI to any person/company/ group of companies.

Collection of Information About Deposits and Issue of Directions The NHB may at any time direct the HFIs to furnish, in a form at intervals and within time specified by it, statements/information/

particulars relating to, or connected with, deposits received by them and in particular in respect of matters including credit rating, rate of interest payable and the period of deposits. For non-compliance with these directions, the NHB may prohibit the acceptance of deposits by a HFI. If required by the NHB, a HFI has to send, within the specified time, a copy of its annual balance sheet and profit and loss account/other annual accounts, on the last day of the year to which the accounts relate, to person(s) from whom it holds deposits more than an amount specified by it.

Furnishing of Statements All HFIs are required to furnish the statements/information/particulars called for in the form prescribed by the NHB and comply with any direction given to them in relation to acceptance of deposits.

Powers and Duties of Auditors of HFIs The auditors should enquire whether HFIs have furnished the NHB with the statements, information, or particulars relating to, or connected, with deposits received by them, as required under the provisions of the *NHB Act*. Except where satisfied on such enquiry about compliance, they should submit a report to the NHB giving the aggregate amount of deposits held by them. On being satisfied that it is necessary **(a)** in public interest or **(b)** in the interest of the depositors or **(c)** for proper assessment of the books of account, the NHB may issue directions to **(i)** any HFl/group of HFIs/housing finance companies or **(ii)** their auditors with regard to balance sheet, profit and loss account, disclosure of liabilities in the books of account or any other related matters. Where the auditor has made/intends to make a report to the NHB, as specified above, the contents of such a report should be included in his report under Section 27**(2)** of the *Companies Act*. In addition, the NHB, when it is of the opinion that it is necessary in public interest or in the interest of the deposits, may appoint an auditor(s) to conduct a special audit of the accounts of a HFI in relation to any transaction/ class of transaction for period(s) specified by it. The auditor's remuneration is fixed by the NHB after duly considering the nature and volume of work involved in audit, and the expenses of/ incidental to it would have to be borne by the concerned HFI.

Power of the NHB to Prohibit Acceptance of Deposits The NHB may prohibit any HFI from accepting any deposit on violation of provisions or failure to comply with any direction/order given by it in relation to the acceptance of deposits. In addition, it may, if necessary in public/depositors' interest, direct such a HFI not to sell, transfer, create charge/mortgage or deal in any manner with its property and assets without the NHB's prior written permission, for a period not exceeding six months from the date of the order.

Filing of Winding-up Petition On being satisfied that a HFI **(i)** is unable to pay its debt, **(ii)** has become disqualified in terms of registration and net owned funds requirements to carry on business, **(iii)** has been prohibited by the NHB from receiving deposits, by an order in force for a period of at least three months, **(iv)** continuing in business is detrimental to the public interest/interest of depositors, NHB may file an application for its winding-up under the *Companies Act*. The HFI would be deemed to be unable to pay its debt if it has refused/failed to meet any lawful demand made at any of its offices/branches within five working days and the NHB certifies in writing that such a company is unable to pay its debt. A copy of the application would be sent to the Registrar of Companies and all the provisions of the *Companies Act* relating to winding-up would apply to winding-up process initiated by the NHB.

Inspection To verify the correctness/completeness of any statements/ information/particulars furnished to the NHB or to obtain any information/particulars which the HFI has failed to furnish, on being called up, the NHB may conduct an inspection by its officer(s) (inspecting authority). Every Director/member of any committee or other body/any person for the time being vested with the management of the whole/part of the affairs of the HFI and accepting deposits and other officers/employees would be duty bound to produce to the inspecting authority all books, accounts and other documents in custody/power and to furnish any statement/ information related to the business of the HFI, required within the specified time. The inspecting authority may also examine them on oath.

Soliciting Deposits by Unauthorised Persons A person can solicit public deposits on behalf of a HFI either by publishing or by causing to be published any prospectus/advertisement or in any other manner only if **(a)** authorised in writing by the HFI and **(b)** the prospectus/advertisement complies with any order made by the NHB in this regard/any other provision of law for the time being in force and applicable to their publication.

Non-disclosure of Information Any information relating to a HFI **(a)** contained in any statement/return submitted by it or **(b)** obtained through audit/inspection or otherwise by the NHB should be treated as confidential and should not be disclosed. However, the non-disclosure stipulation does not apply to **(i)** any disclosure by the HFI with the prior approval of the NHB, **(ii)** publication by the NHB, in public interest, of any such information in a consolidated form without disclosing the HFI's/borrowers' name, **(iii)** disclosure by the NHB/HFI of any such information to any other HFI, in accordance with the practice and usage customary among them or as permitted under any other law and published accordingly. Yet, if satisfied that it is expedient in the public/depositors'/ HIF's interest or to prevent the affairs of the HFI being conducted in a manner detrimental to the depositors' interest, the NHB, may furnish/communicate, on its own/on being requested, any information relating to the conduct of business by any HFI to any authority constituted under any law. But no court/tribunal/other authority can force the NHB to produce/give for inspection any statement/other material obtained by it under any provision relating to deposit acceptance by HFIs.

Power to Exempt On being satisfied that it is necessary, the NHB, by notification, has the power to exempt any HFl/groups of HFIs from any/all provisions relating to acceptance of deposits, either generally or for specified period, subject to conditions, limitations/restrictions it may think to impose.

Overriding Power These provisions, relating to the acceptance of deposits by HFIs that are companies, would have effect notwithstanding anything inconsistent with them in any other law for the time being in force or any instrument having effect by virtue of any such law.

Power to Order Repayment of Deposits Unless renewed, deposits accepted by the HFIs should be repaid in accordance with their terms and conditions. On failure to repay, an officer with the NHB, authorised for the purpose by Government (ie authorised officer), on his own or on application of a depositor, if satisfied that it is necessary to safeguard the interest of the HFl/depositors or in public interest may, after giving it reasonable opportunity to be heard, direct the HFI to repay the deposit/part of it forthwith/within a specified time and subject to specified conditions.

Nomination by Depositors A depositor(s) may nominate, under Section 45-ZA of the *Banking Regulation Act, 1949* one person to whom, in the event of the death of the sole depositor(s), the amount of deposit may be returned by the HFI(s). The nominee would be entitled to all the rights of the depositor(s) to the exclusion of all other persons. If the nominee is a minor, the depositor(s) can appoint any person to receive the amount of deposit during the minority of the nominee. The payment to the nominee would constitute a full discharge of the HFI's liabilities in respect of the deposit.

Other Provisions Relating to HFIs

Recovery officers are officers of approved institutions appointed by the government in consulation with the NHB to act as trustees or otherwise in a transaction of securitisation of housing mortgage.

They relate to the appointment of recovery officers and appellate tribunals for recovery of dues of approved institutions.

Appointment of Recovery Officers The Government, in consultation with the NHB, may appoint **recovery officer(s)** from amongst officers of approved institutions, that is, a HFI registered with the NHB/bank/NHB acting as trustee or otherwise in a transaction of securitisation of housing mortgages undertaken by it/other institutions notified by the Government in consultation with the NHB. The local limits within which they would exercise their powers and perform their duties would also be specified by the Government.

Application to Recovery Officer(s) When any borrower (ie any person to whom any direct/indirect financial assistance has been given by an approved institution during the course of any house finance activity undertaken by it/for purchase, construction, repairs, extension or renovation of a residential house) defaults in repayment of any assistance/instalment or otherwise fails to comply with the terms of agreement, the approved institution, without prejudice to the provisions of Section 69 of the *Transfer of Property Act*, may approach the concerned recovery officer(s) for the sale of the property pledged/mortgaged/hypothecated or assigned to it as security for the dues, that is, the liability claimed as due, including interest, cost, charges and other amounts payable.

On receipt of the application by the approved institution(s), the recovery officer would send a written notice of demand in the prescribed form, calling upon the borrower to pay the specified amount within 90 days or to show cause as to why the relief prayed should not be granted. He may make an interim order by way of injunction/stay/attachment against the borrower to debar him from transferring/alienating or otherwise dealing with/disposing off the property pledged/hypothecated/mortgaged/assigned as security for the dues. The application made to the recovery officer should be dealt with by him as expeditiously as possible and endeavours should be made by him to dispose it off finally within six months.

Enforcement of the Order of the Recovery Officer If the borrower refuses/fails to comply with the order of the recovery officer(s) for the payment of the dues, within the specified time, the recovery officer(s) may take possession of the property and transfer it by way of sale/lease or otherwise in the prescribed manner. Such a transfer would vest all rights in/or to the property transferred in the transferee, as if the transfer has been made by the owner of the property. The Chief Metropolitan Magistrate/District Magistrate, within whose jurisdiction the property/other related documents are situated/found, would assist the recovery officer(s) in taking charge of property. The money received would be held by the recovery officer in trust to be applied, firstly, in the payment of costs/charges/expenses properly incurred by him, and secondly, in discharge of debts due to the approved institution(s) and the residual paid to the entitled person.

Establishment of Appellate Tribunals The Government would establish appellate tribunals (ATs) to be known as Housing Finance Institutions Debt Recovery Appellate Tribunals (HFIDRATs). They would exercise the jurisdiction, power and authority to entertain appeals against any order of the recovery officer(s). Till the establishment of ATs for any area, the ATs established under Section 8 of the Recovery of Debts Due to Banks and *Financial Institution Act, 1993*, functioning in that area would exercise such jurisdiction, powers and authority. The aggrieved party should file the appeal within 45 days from the date on which a copy of the order by the recovery officer is received by him in the prescribed form. However, the ATs may entertain an appeal after 45 days if satisfied that there was sufficient cause for delay. The ATs can confirm, modify or set aside the order appealed against. The appeal should be dealt with by them as expeditiously as possible and endeavours should be made to dispose it off finally within six months. The borrower's appeal would be entertained only on depositing 75 per cent of the due amount, determined by the recovery officer with the ATs, which may be waived/reduced for the reasons recorded in writing by it.

Procedures and Powers of ATs/Recovery Officers (ROs) The ROs and the ATs would not be bound by the procedure laid down by the Code of Civil Procedure but would be guided by the principles of natural justice and, subject to other provisions of the *NHB Act*/any regulations, they would have powers to regulate their own procedure, including the place(s) of their sitting(s). For discharging their functions, they would have the same powers as are vested in a civil court, under the Code of Civil Procedure, while trying a suit in respect of **(a)** summoning/enforcing the attendance of any person(s) and examining him on oath, **(b)** requiring the discovery and production of documents, **(c)** receiving evidence on affidavits, **(d)** issuing commissioner for the examination of witness(es)/documents, **(e)** reviewing its decisions, **(f)** dismissing an application for default/deciding it ex parte, **(g)** setting aside any order of dismissal of any application for default/passed by it *ex parte* and **(h)** any other prescribed matter.

Any proceeding before the ROs and ATs would be deemed to be a judicial proceeding within the meaning of Sections 193 and 228, and for the purpose of Section 196 of the Indian Penal Code they would be deemed to be a civil court for all purposes of Section 195 and Chapter XXVI of the Code of Criminal Procedure.

Limitation The provisions of the *Limitation Act, 1963* would, as far as possible, apply to an application made to the ROs.

Bar of Jurisdiction Excepting the Supreme Court and High Court(s), no court/authority would have/be entitled to exercise any jurisdiction/powers/authority in relation to the matters pertaining to recovery of dues of HFIs/NHB.

Miscellaneous Provisions

Exemption from Tax The NHB would not be liable to pay income tax/any other tax in respect its income/profits/gains.

Penalties Whoever, in any return/balance sheet/other documents/information required/furnished by/ under/for purposes of any provision of the NHB Act, willfully makes a statement that is false in any material particular, knowing it to be false/omits to make a material statement, would be punishable with imprisonment for a term extending to three years and also liable to fine. In addition, failure to produce any book/account/document or furnish any statement/information would be punishable with fine up to ₹2,000 for each offence, and for continuing failure, with an additional fine up to ₹100 for every day during which the failure continues after the first such failure.

The penalty for contravention of the requirements of registration and net owned funds is **(i)** imprisonment for at least one year and up to five years and **(ii)** fine of not less than ₹1 lakh and up to ₹5 lakh.

An auditor who fails to comply with any direction given/order made by the NHB would be punishable with a fine up to ₹5,000. Any failure to comply with any order by the authorised officer, pertaining to repayment of deposits, would be liable to imprisonment up to three years as also a fine up to ₹5,000.

If any person other than an auditor **(a)** receives any deposits in contravention of/fails to comply with any direction given/order made by the NHB in relation to acceptance of deposits by HFIs, **(b)** issues any prospectus/advertisement in contravention of the provisions of the *NHB Act*, he would be liable to imprisonment up to three years and also fine up to twice the amount of deposit received/called for by the prospectus or advertisement.

The penalty for contravention of any other provision or default in compliance with any other requirement of the *NHB Act*/any order, regulation, direction made or given or condition imposed, would be a fine extending to ₹2,000 and further ₹100 for every day the contravention/default continues.

Offences by Companies Where any offence has been committed by a company under the NHB Act (ie a body corporate, including a firm or other association or persons) with the consent/ connivance of, or is attributable to any neglect on the part of, any Director (Partner)/Manager, Secretary or other officer of the company, he as well as the company would be deemed to be guilty and liable to be proceeded against and punished accordingly.

Power of the NHB to Impose Fine If the contravention/default in respect of the production of books/ accounts/other documents or furnishing of any statement/information is committed by a HFI that is a company, the NHB may impose a fine not exceeding ₹5,000. Where the contravention/ default relates to the requirement of registration with the NHB and net owned funds or acceptance of deposits or directions given by the NHB in respect of acceptance of deposits, a penalty not exceeding ₹5 lakh or twice the amount involved, if the amount is quantifiable, whichever is more, would be imposed. A further penalty of ₹25,000 per day would be imposed if the contravention/default is a continuing one. The penalty imposed by the NHB would be payable within 30 days failing which a further penalty may be levied on the direction of the principal civil court, specifying the sum payable by the HFI.

Power to Make Rules The Government may make/notify rules to carry out the provisions of the NHB Act, providing, inter-alia, for **(a)** qualifications for appointing as ROs, **(b)** salary/ allowances/other terms and conditions of service of the officers and other employees of the ATs

(c) salary/allowances/other terms and conditions of service of Presiding Officers of ATs, and
(d) procedure for investigation of misbehaviour or incapacity of the Presiding Officers of ATs.

Power of Board of Directors of the NHB to Make Regulations With the prior approval of the RBI and in consultation with the Government, the Board of Directors of the NHB may make/notify regulations not consistent with the NHB Act, to provide for all matters for which provision is necessary/expedient for the purpose of giving effect to the provisions of the *NHB Act*. In particular, they may provide, *inter-alia*., for the following matters.

(a) Fees and allowances that may be paid to the directors for attending the meetings of the Board or its committees;
(aa) Manner in which directors would be elected.
(b) Times and places at which the Board may meet, and the rules of procedures that may be followed with regard to the transaction of business.
(c) Number of members that the Executive Committee may consist of, the functions that it may discharge, times and places at which it would meet and the rules of procedure that it may follow in the transaction of business.
(d) Manner and terms of issue and redemption of bonds and debentures.
(e) Manner in which, and the conditions subject to which the NHB may borrow in foreign currency.
(f) Form in which the statements, information, and so on are to be furnished;
(fa) Form of application to recovery officers and documents to be annexed;
(fb) Form in which notice of demand is required to be served on the borrower;
(fc) Manner in which property would be transferred;
(fd) The form in which an appeal can be filed with the Appellate Tribunal and the amount of fee required to be deposited with such appeal.
(g) Special fund, reserve fund and other funds to be created.
(h) Form and manner in which the balance sheet and accounts would be prepared and maintained.
(i) Duties and conduct, salaries, allowances and conditions of service of the officers and other members of staff of the NHB.
(j) Establishment and maintenance of provident fund and any other fund for the benefit of officers and other members of staff of the NHB;
  (i) Manner in which nomination may be made.
(k) Any other matter which is to be, or may be, prescribed.

NHB'S HOUSING FINANCE COMPANIES DIRECTIONS

The NHB had issued the Housing Finance Companies (HFCs) Directions in 1989 in public interest. It had also issued guidelines to them on prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/investments. The NHB Act was amended comprehensively in 2000 to enable the NHB to safeguard the interest of depositories and promote healthy and universal growth of HFCs in the country. In public interest and to regulate the housing finance system of the country to its advantage, the NHB issued consolidated directions in 2001 with a view to safeguarding the interest of depositors and promoting the healthy and universal growth of HFCs.

An HFC means a company incorporated under the *Companies Act* that primarily transacts/has as one of its principal objects the transacting of the business of providing finance for housing, whether directly or indirectly. These are in respect of matters relating to **(a)** acceptance of deposits by HFCs, **(b)** prudential norms to be observed by them, and **(c)** matters ancillary/incidental thereto. These directions have been issued exercising **(i)** the power conferred by Sections 30, 30-A, 31 and 33 of the NHB Act and **(ii)** all the powers enabling it in this behalf.

Acceptance of Public Deposits

Any HFC having NOFs of less than ₹25 lakh cannot accept public deposits. **NOFs** mean net owned fund (NOF) defined under Section 29-A (**discussed earlier**) of the *NHB Act*, including paid-up preference shares compulsorily convertible into equity capital. A public deposit means a deposit but does not include the following:

- **(a)** Amount received from **(i)** the Central Government/a state government, **(ii)** any other source whose repayment is guaranteed by the Central Government or a state government, **(iii)** a local authority/any public housing agency (ie any authority constituted in India by/under any law engaged either for the purpose of dealing with and satisfying the need for housing accommodation/planning, development, or improvement of cities, towns and villages)/a foreign government/any other foreign citizen, authority, and person;
- **(b)** Amount received from the NHB, Industrial Development Bank of India, Life Insurance Corporation of India, General Insurance Corporation of India and its subsidiaries, Small Industries Development Bank of India, Unit Trust of India, National Bank for Agricultural and Rural Development, Electricity Boards, Tamil Nadu Industrial Investment Corporation Ltd, National Industrial Development Corporation Ltd, ICICI Ltd, IFCI Ltd, IIBI Ltd, State Trading Corporation of India Ltd, Rural Electrification Corporation Ltd, Minerals and Metals Trading Corporation of India Ltd, Agricultural Finance Corporation Ltd, State Industrial and Investment Corporation of Maharashtra Ltd, Gujarat Industrial Investment Corporation Ltd, Asian Development Bank, International Finance Corporation, Japan Bank for International Cooperation (JBIC) or Kreditansalt fur Wiederaufbau (Kfw) or any other institution that may be specified by the NHB in this behalf;
- **(c)** Amount received from another company;
- **(d)** Amount received by way of subscription to any shares, stock, bonds, debentures, pending their allotment/calls in advance on shares, in accordance with the articles of association of the HFC, so long as such amount is not repayable to members under its articles of association;
- **(e)** Amount received from a person who at the time of receipt of the amount was a Director of the HFC or amount received from its shareholders by a private HFC that has become a public HFC. However, the Director/shareholder, from whom the money is received, should furnish to the HFC, at the time of giving the money, a declaration in writing to the effect that the amount is not being given out of funds acquired by him by borrowing or accepting from others;
- **(f)** Amount raised by the issue of bonds debentures secured by the mortgage of any immovable property of the HFC/other asset compulsarily convertible into equity shares, provided that the amount does not exceed the market value of the immovable property/other assets;

(g) Amount raised by issuance of non-convertible debentures in accordance with the NHB guidelines with a maturity of more than year and having minimum per investor subscription at ₹1 crore and above;

(h) Amount brought in by the promoters by way of unsecured loan, subject to the conditions that **(i)** the loan is brought in pursuance of the stipulations imposed by the lending public financial institution (ie a public financial institution in terms of Section 4-A of the *Companies Act*/a State Financial or Industrial Corporation/bank/General Insurance Corporation/any other institution notified by the NHB) in fulfilment of the obligation of the promoters to contribute such finance, **(ii)** the loan is provided by the promoters themselves and/or by their relatives, but not from their friends and business associates and **(iii)** the exemption would be available only till the loan of the lending public financial institution is repaid;

(i) Any amount received from mutual funds;

(j) Amount received as hybrid/subordinated debt with a maturity period of at least five years provided there is no option for recall by the issuer during the period,

(k) Amount received from a relative of a director of a HFC.

(l) Amount received by issuance of commercial papers.

Restriction on Acceptance/Renewal of Deposits A HFC having a minimum credit rating of **A** (i.e. minimum investment grade) for fixed deposits from any one of the approved rating agencies, at least once a year as well as complying with all the prudential norms can accept/renew deposits upto five times of its NOF. A copy of the rating should be sent to the NHB. The five approved rating agencies in the country are the: **(i)** CRISIL, **(ii)** ICRA, **(iii)** CARE, **(iv)** FITCH and **(v)** Brickwork Rating. No HFC can have maximum deposits, inclusive of public deposits, together with the amount held by it under clauses **(iii)** to **(vii)** of sub-section 45I of the RBI Act as also loans or other assistance, from the NHB exceeding 16 times its NOF.

In the event of downgradation of rating to any level below **A** from the level earlier held by the HFC, it should **(i)** report the position within 15 working days to the NHB, **(ii)** with immediate effect stop accepting fresh public and **(iii)** reduce such excess deposits by repayment on maturity.

Period of Deposit The HFCs can accept/renew public deposits for a minimum period of 12 months and a maximum period of 120 months. They are prohibited from accepting public deposits repayable on demand/notice. Where a public deposit is in instalments, the period of such deposits would be computed from the date of receipt of the first instalment.

Joint Deposits Deposits may be accepted by HFCs in joint names with/without any of the clauses such as Either or Survivor(s), Number One or Survivor(s) and Anyone or Survivor(s).

Particulars in Application Forms Public deposits can be accepted/renewed by HFCs from the depositors, on the basis of a written application in the prescribed form, containing all the particulars specified in the NBFCs and MNBCs (Advertisement Rules) made under Section 58-A of the Companies Act as will as the particulars of the specific category of depositors, that is, whether the depositor is a shareholder/director/promoter of a HFC or a member of public or a relative of the director of the HFC. The application form should also contain the following:

(a) The credit rating assigned for its deposits and the name of the credit rating agency which rated the HFC.

(b) A statement to the effect that in case of any deficiency of the HFC in servicing its deposits, the depositor may approach the National Consumers Disputes Redressal Forum, the State Level Consumers Disputes Redressal Forum or the District Level Consumers Dispute Redressal Forum for relief.

(c) A statement to the effect that in case of non-repayment of a deposit/a part of it, according to the terms and conditions of the deposit, the depositors may make an application to the authorised officer of the NHB.

(d) A statement to the effect that the financial position of the HFC, as disclosed, and the representations made in the application form are true and correct and that the HFC and its Board of Directors are responsible for their correctness and veracity.

(e) A statement to the effect that the HFC is within the regulatory framework of the NHB. It must, however, be distinctly understood that the NHB does not undertake any responsibility for the **(i)** financial soundness, **(ii)** correctness of any of the statements or the representations made or opinions expressed **(iii)** and for repayment of deposit/discharge of liabilities of/by the HFC.

(f) The information relating to and aggregate dues from both fund and non-fund based extended to and the aggregate dues from companies in the same group/other entities or business ventures in which the directors and/or the HFC are/is holding substantial interest and the total amount of exposure to such entities.

(g) At the end of the application form, but before signature of the depositor, the following verification clause by the depositor should be appended: "I have gone through the financial and other statements, particulars/representations furnished/made by the housing finance company and after careful consideration I am making the deposit at my own risk and volition."

Introduction of Depositors Every HFC should obtain proper introduction of new depositors before opening their accounts/accepting deposits and keep on its records the evidence on which it has relied for the purpose. The introduction/identification may be done **(i)** by one of the existing depositors, **(ii)** on the basis of income tax permanent account number (PAN)/election identity card (ID)/passport/ration card.

Furnishing of Receipts to Depositors Every HFC should furnish to every depositor or his agent a receipt for every deposit that has been/may be received by it, duly signed by an officer entitled to act for the HFC on its behalf, stating the date of deposit, name of depositor, amount in words and figures, rate of interest payable and the date on which the deposit is repayable. However, if such receipt pertains to instalments subsequent to the first instalment of a recurring deposit, it may contain only name of the depositor(s), date and amount of deposit.

Register of Deposits HFCs are required to keep register(s) containing the following particulars:

(a) Name and address of the depositor/group of joint depositors
(b) Date and amount of each deposit
(c) Duration and the due date of each deposit
(d) Date and amount of accrued interest or premium on each deposit
(e) Date and amount of each repayment, whether of principal, interest or premium
(f) Date of claim made by the depositor
(g) Reasons for delay in repayment beyond five working days
(h) Any other particulars relating to the deposits

A register(s) should be kept at each branch in respect of deposit accounts opened by it and a consolidated register for all the branches taken together at the registered office of the HFC and preserved in good order for eight years following the financial year in which the latest entry is made of the repayment/renewal of any deposit of which particulars are contained in the register. However, if the HFC keeps its books of accounts [under Section 209**(1)** of the *Companies Act*] at a place other than the registered office, the register of deposits may also be kept at that place, subject to the condition that the HFC delivers to the NHB also a copy of the notice filed with the Registrar of Companies, within seven days of such filing.

Information to be Included in the Board's Report The report of the Board of Directors of a HFC, laid in a general meeting under Section 217**(1)** of the *Companies Act*, should include information/particulars relating to the total number of accounts/amount of public deposit of the HFC that has not been claimed by the depositors/not paid by the HFC after due date for repayment. These should be furnished with reference to the position as on the last date of the financial year to which the report relates. If the amounts remaining unclaimed/undisbursed exceed rupees five lakh, a statement on the steps taken/proposed to be taken by the Board of Directors for their repayment should also be included in the report.

Ceiling on Interest and Brokerage and Interest on Overdue Public Deposits Any HFC cannot:

(a) invite/accept/renew **(i)** any public deposit on a rate of interest exceeding 12.5 per cent per annum payable/compoundable at rests not shorter than monthly rests, **(ii)** repatriable deposits from NRIs under NR(E) Account Scheme at a rate exceeding the rates specified by the RBI for such deposits with banks for 1-3 years.

(b) pay any broker, on public deposit collected by/through him, **(i)** brokerage, commission, incentive/any other benefit, by whatever name called, in excess of two per cent and **(ii)** expenses by way of reimbursement on the basis of relative vouchers/bills produced by him, in excess of 0.5 per cent of the deposit collected.

Payment of Interest on Overdue Deposit A housing finance company may, at its discretion, allow interest on an overdue public deposit/a portion of it from the date of maturity of the deposit, subject to the conditions that the **(i)** total amount of overdue deposit/a part of the deposit is renewed in accordance with other relevant provisions of these directions, from the date of its maturity till some future date and **(ii)** interest allowed is at the appropriate rate operative on the date of maturity of such overdue deposit, which would be payable only on the amount of deposit so renewed. However, where a HFC fails to repay the deposit along with interest on maturity, on the claim made by the depositor, it would pay interest from the date of claim till the date of repayment at the rate applicable to the deposit.

In regard to payment of interest on deposits which have been **(i)** seized or **(ii)** frozen till further clearance by Government authorities, the HFCs should obtain a request letter from the depositor on maturity indicating also the term for the renewal of the deposit. They should otherwise renew it for a term equal to the original term. New receipt is not required and only suitable note may be made in the deposit records. The rate of interest on the renewal deposit should be communicated to the depositors. The final repayment of the principal and accrued interest should be made only after clearance from the respective Government authorities.

General Provisions Regarding Repayment of Deposits A public deposit cannot be repaid within three months from the date of acceptance. The maximum interest payable on deposits repaid between 3–6 months would be 4 per cent for individual depositors and no interest in case of other depositors. In case of repayment after 6 months but before maturity, the payable interest would be 1 per cent lower than the applicable rate for the period for which the deposit has run or 2 per cent lower than the minimum interest at which the HFC accepts public deposits. Loan upto 75 per cent of the deposit may be given to a depositor after the expiry of three months (i.e. lock-in period) at a rate of interest two percentage point above the interest rate payable on the deposit. It is obligatory for every HFC to intimate the details of the maturity to the depositor at least fourteen days before the date of maturity. All deposits accounts standing in the credit of sole/first-named depositor in the same capacity should be clubbed and treated as one deposit account for the purpose of premature repayment or grant of loan by a problem HFC. However, in the event of the death of a depositor, public deposit may be paid prematurely to the surviving depositor(s) or nominee/legal heir(s) with interest at the contracted rate upto the repayment date.

For the purpose, HFCs are classified into two categories for the purpose of premature repayment of deposits: **(a)** Normally-run HFCs and **(b)** Problem HFCs. A **problem HFC** is one which **(i)** has refused/failed to meet within five working days any lawful demand for repayment of matured public deposits, or **(ii)** intimates the Company Law Board (CLB) under Section 58(AA) of the *Companies Act* about its default to a small depositor in repayment of any public deposit (including interest), or **(iii)** approaches the bank for withdrawal of the liquid assets/securities to meet deposit obligations, or **(iv)** approaches the NHB for any relief/relaxation/exemption from the provisions of the HFCs (NHB) Directions/Prudential Norms Directions for avoiding default in meeting public deposits/other obligations, or **(v)** has been identified by NHB to be a problem HFC either *suo moto* or based on the complaints from the depositors about non-repayment of deposit or on complaints from the lenders of the HFC about non-payment of dues. A normally-run HFC can permit premature repayment of deposit after the lock-in period (i.e. three months) at its sole discretion only and premature closure cannot be claimed as a matter of right by the depositors. The problem-HFCs are prohibited from making premature repayment of any public deposits/granting any loan against any deposit except in the case of the death of the depositor or in the case of tiny deposits upto ₹10,000 in entirety or to enable the depositor to meet expenses of an emergent nature upto ₹10,000. However, in the event of the death of the depositor, the public deposits may be paid prematurely to the surviving depositor(s)/nominees/legal heirs with interest at the contracted rate upto the date of repayment.

> **Problem HFC** is one which **(i)** has refused/failed to meet within five days any lawful demand for repayment of a matured public deposit, or **(ii)** intimates CLB about its default, **(iii)** approaches the bank for withdrawl of liquid amounts to meet deposit obligation, **(iv)** approches NHB for relaxation/ exemption from the provision of its direction or has been identified by the NHB to be a problem HFC

Renewal of Public Deposit before Maturity Where any HFC permits an existing depositor to renew his public deposit before maturity for availing the benefit of higher rate of interest, it would pay him the increase in the rate of interest, provided **(i)** the public deposit is renewed in accordance with the other provisions of these directions for a period longer than the remaining period of the original contract; **(ii)** the interest on the expired period is reduced by one percentage point from the rate which would have ordinarily been paid, had the deposit been accepted for the period for which such public deposit had run. Any interest paid earlier in excess of such reduced rate is recovered adjusted.

Safe Custody of Approved Securities Every HFC should entrust the unencumbered approved securities maintained by it in pursuance of Section 29-B of the NHB Act to a designated bank in the place where the HFC's registered office is situated. However, **(i)** it can entrust these securities to the designated bank at any other place, **(ii)** keep them in the form of constituents of a Subsidiary General Ledger Account with its designated bank, **(iii)** entrust them to the Stock Holding Corporation of India Ltd (SCHI), subject to NHB specified conditions, with the prior written approval of the NHB. Such securities should continue to be entrusted to the designated bank for the benefit of the depositors and not withdrawn/encashed/otherwise dealt with by the HFC except for repayment to the depositors. Nevertheless, the HFCs would be entitled to withdraw a portion of these proportionate to the reduction of their deposits, duly certified by its auditors. They can also substitute them by substitute securities of equal value to the designated bank before such withdrawal.

Creation of Floating Charge All HFCs accepting/holding public deposits should create floating charges on the assets invested by them in favour of their depositors in a manner prescribed by the NHB.

Employee's Security Deposit A housing finance company, receiving any amount in the ordinary course of its business, as security deposit from any of its employee(s) for due performance of his duties, should keep it in a joint account with the employee in a bank or in a post office on the conditions that **(a)** it would not withdraw the amount without the consent, in writing, of the employee and **(b)** the amount would be repayable to the employee along with interest, unless such amount/any part is liable to be appropriated by an HFC for the failure on the part of the employee for due performance of his duties.

Advertisement and Statement in Lieu of Advertisement

1. Every HFC soliciting public deposits should comply with the provisions Non-banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 and also specify the following in every advertisement to be issued: **(a)** the actual rate of return by way of interest, premium, bonus or other advantage to depositors; **(b)** the mode of payment to depositors; **(c)** maturity period of deposit; **(d)** the interest payable on a specified deposit; **(e)** the rate of interest that would be payable to the depositor in case the depositor withdraws the deposit prematurely; **(f)** the terms and conditions subject to which a deposit would be renewed; **(g)** any other special features relating to the terms and conditions subject to which the deposits are accepted/renewed; **(h)** the information relating to the aggregate dues (including the non-based facilities) provided to/from companies in the same group or other entities or business ventures in which the directors/the HFC are holding substantial interest and the total amount of exposure to such entities; and **(i)** deposits solicited are not insured.

   Where a HFC displays any advertisement in electronic media even without soliciting deposits, it should incorporate a caption/band indicating the following:

   "As regards deposit taking activity of the company, the viewers may refer to the advertisement in the newspapers/information furnished in the application form for soliciting public deposits;

The company is having a valid registration certificate from the NHB. However the NHB does not accept any responsibility/guarantee about the present position as to the financial soundness of the company or for the correctness of any statement/representation made/opinions expressed by the company and for repayment of deposits/discharge of the liabilities of the company."

2. Where an HFC intends to accept public deposits without inviting or allowing or causing any other person to invite such deposits, it should, before accepting deposits, deliver to the office of the NHB for registration, a statement in lieu of the advertisement, containing all the particulars required to be included in the advertisement, pursuant to the Non-banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 as also the particulars stated above, duly signed in the manner provided in the aforesaid rules.
3. A statement, delivered under **(2)** above would be valid till the expiry of six months from the date of closure of the financial year in which it is so delivered, or until the date on which the balance sheet is laid before an HFC in general meeting, or where the annual general meeting for any year has not been held, the latest day on which that meeting should have been held in accordance with the provisions of the *Companies Act*, whichever is earlier, and a fresh statement should be delivered in each succeeding financial year before accepting deposits in that financial year.

Full Cover for Public Deposits A full cover for public deposits accepted by the HFCs should be ensured at all times. For the purpose of computing the cover, assets should be valued at the lower of their book or market/realisable value and the value of secured/insecured debentures and other outside liabilities should be deducted.

Prior Approval for Acquisition/Transfer of Control of HFCs The prior written permission of the NHB would be required for **(a)** takeover/acquisition of control, by acquisition of shares/otherwise, **(b)** any merger/amalgamation of a HFC with another entity or of any entity with the HFC that would give the acquirer/another entity control or which would result in acquisition/transfer of more than 10 per cent shareholding (paid-up capital) of the HFC. Prior approval of the NHB would also be required before approaching the court/Company Law Tribunal seeking order for mergers/amalgamations with other companies/HFCs. These provisions are in addition to provisions of other law/regulations/directions.

Closure of Branches Any HFC accepting deposits can close its branch/office after publishing its intention in one national newspaper and in one vernacular newspaper in circulation in the relevant place as also advising the NHB ninety days before the proposed closure.

Prudential Norms

The NHB guidelines to HFCs on prudential norms for income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning requirements, capital adequacy and concentration of credit/investments are discussed below.

Income Recognition Income recognition should be based on recognised accounting principles. Income including interest/discount or any other charges on NPAs should be recognised only when it is actually realised. Any such income recognised before the asset became NPA should be reversed.

Where hire-purchase instalments/lease rentals are overdue for more than twelve months, income should be recognised only when they are actually received. Any such income (hire charges)/net **lease rentals** (i.e. gross lease rentals as adjusted by the lease adjustment account and as reduced by depreciation at the rate applicable under Schedule XVI of the *Companies Act*), taken to the credit of the profit and loss account before the asset become NPA, should be reversed.

Basis of NPA Classification A non-performing asset means:

- An asset in respect of which interest has remained over due for 90 days.
- A term loan (other than to an agriculturist/a person whose income is dependent on the harvest of crops) inclusive of unpaid interest, when the interest is overdue for more than 90 days or on which interest amount remained past due for 90 days.

> **NPA**
> means any credit facility which remains overdue for 90 days.

- A demand/call loan which remained overdue for more than 90 days or on which interest remained overdue for 90 days or more.
- A term loan to an agriculturist/a person whose income is dependent on the harvest of crops if the instalment if the principal/interest remains unpaid for **(a)** two crop seasons beyond the due date if the income of the borrower is dependent on short duration crop (i.e. crop season of upto one year), and **(b)** one crop season beyond the due date if the income of borrower is dependent on long duration crop having a crop season longer than one year.
- A bill of exchange that remains overdue for 90 days.
- The interest in respect of a debt/income on a receivable under the head "other current assets" in the nature of short-term loans/advances, which facility remained overdue for a period of 90 days.
- Any dues on account of sale of assets/services rendered or reimbursement of expenses incurred, which remained overdue for 90 days.
- The lease rental/hire-purchase instalment that has become overdue for a period of more than 90 days.
- An inter-corporate deposit in respect of which interest/principal has remained overdue for 90 days.
- In respect of loans/advances and other facilities (including bills purchased/discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facility becomes NPA. In the case of lease/hire-purchase, a HFC may classify such account on the basis of record of recovery.

Income from Investments Income from dividend on shares of corporate bodies and units of natural funds should be taken into account on cash basis. But when such dividend has been declared in the annual general meeting and the HFC's right to receive payment is established, such income may be taken into account on accrual basis.

Income from bonds/debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis if the interest on these instruments is predetermined, is serviced regularly and is not in arrears. Similarly, where the interest/repayment of principal is guaranteed by any Government, income on securities of corporate bodies/public undertakings may be accounted for on an accrual basis.

Accounting Standards Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI) should be followed in so far as they are not inconsistent with any of these directions.

Accounting for Investments The Board of Directors of HFCs should frame investment policy and implement it. The criteria to classify current and long-term investments should be spelt out in the investment policy. Investments in securities should be classified into current and long-term at the time of each investment. There should be no inter-class transfer on *an ad* hoc basis. Any inter-class transfer should be effected only at the beginning of each half year on April 1/October 1 with the approval of the Board of Directors. The transfer from current to long-term or *vice versa* should be scripwise at the lower of the market value and the book value. Depreciation, if any, in each scrip should be provided for and appreciation should be ignored. Depreciation in one scrip should not be set off against appreciation in another scrip at the time of each inter-class transfer even in respect of the scrips of the same category. The long-term investments should be valued in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI).

Quoted Current Investment Quoted current investments should, for the purposes of valuation, be grouped into the following categories: **(a)** equity shares; **(b)** preference shares; **(c)** debentures and bonds; **(d)** Government securities, including treasury bills; **(e)** units of mutual funds and **(f)** others. Quoted current investments for each category should be valued at cost or market value, whichever is lower. The investments in each category should be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation should be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost, the net appreciation should be ignored. Depreciation in one category of investments should not be set-off against appreciation in another category.

Unquoted Equity Shares in the nature of current investments should be valued at cost or break-up value, whichever is lower. Where the balance sheet of the investee company is not available for two years, such shares should be valued at one rupee only. The **"break-up value"** means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company. If the investee company is a loss making company, the earning value would be taken at zero.

> **Break-up value** means the equity capital and free reserves minus intangible assets and revaluation reserves divided by the number of shares outstanding.

Unquoted Preference Shares in the nature of current investments, should be valued at cost or face value or the net asset value, (ie the latest NAV declared by the concerned mutual fund in respect of that mutual fund), whichever is less. In case the net asset value is negative, or the balance sheet of the investee company is not available for two years, it should be valued at ₹1 per company.

Investments in Unquoted Government Securities or Government Guaranteed Bonds should be valued at carrying cost (ie book value of the assets and interest accrued but not realised).

Unquoted Investments in Units of Mutual Funds This, in the nature of current investments, should be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

Commercial Papers These should be valued at carrying cost.

Unquoted Debentures Such debentures should be treated as term loans/other types of credit facilities depending upon their tenure for income recognition and asset classification.

Policy on Demand/Call Loans The Board of Directors of HFCs should frame and implement policy for demand/call loans, stipulating, *inter-alia*, the following: **(a)** A cut-off date within which the repayment of demand/call loan would be demanded/called up, **(b)** The sanctioning authority should record specific reasons in writing at the time of sanctioning of the loan if the cut-off date is stipulated beyond one year, **(c)** The rate of interest and payable at monthly or quarterly rests, **(d)** The sanctioning authority should record specific reasons in writing at the time of sanction if no interest is stipulated or a moratorium is granted for any period, **(e)** A cut-off date not exceeding six months for review of the performance of the loan, and **(f)** Such loan would not be renewed unless the periodical review has shown satisfactory compliance with the terms of the sanction.

Asset Classification The HFCs should classify their lease/hire purchase assets, loans and advances and any other form of credit into four broad groups: **(i)** standard assets, **(ii)** substandard assets, **(iii)** doubtful assets and **(iv)** loss assets. Broadly speaking, the classification of credit into these categories should be done taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation of dues. The above class of assets should not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

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

Substandard Assets A **substandard asset (i)** is one that has been classified as NPA for a period not exceeding one year; **(ii)** in respect of which the terms of the agreement regarding interest and/or repayment of principal have been renegotiated/rescheduled, after release of any amount of loan or an inter-corporate deposit that has been rolled over, until the expiry of the one year of satisfactory performance under the renegotiated/rescheduled terms. However, where a delay in completion of a project is caused on account of factors beyond the control of the implementing agency, terms of the loan agreement relating to interest and/or principal may be rescheduled once before the completion of the project and such loans may be treated as standard asset subject to the condition that **(a)** the rescheduling is permitted only once by the Board of Directors of the concerned HFC and **(b)** interest on such a loan is paid regularly and there is no default. Similarly, where natural calamities impair the repaying capacity of a borrower, terms of the loan agreement regarding interest and or principal may be rescheduled and not classified as substandard. Their classification thereafter would be governed by the revised terms and conditions.

Substandard asset is an asset classified as NPA upto one year.

Doubtful asset is any asset that remains NPA beyond one year.

Doubtful Assets A **doubtful asset** means a term loan/leased asset/hire purchase asset/any other asset that remains a substandard for a period exceeding one year.

Loss asset is an asset that has been identified as loss asset to the extent not written off or is adversely affected by a potential threat of non-recoverability.

Loss Assets A **loss asset** is one that **(i)** has been identified as such by the HFC or internal/external auditors/the NHB to the extent it has not been written off, **(ii)** is adversely affected by a potential threat of non-recoverability due to the following: **(a)** non-availability of security in case of secured loans/advances, **(b)** erosion in the value of security, **(c)** insurance claim denied/settled in part, **(d)** fraudulent act on the part of the borrower, **(e)** debt becoming time-barred and **(f)** in-choate/defective documentation.

Loan to Value (LTV) Ratio Every HFC should grant loan upto ₹30 lakh and ₹30 and ₹75 lakhs to individuals with LTV ratio not exceeding 90 per cent and 80 per cent respectively. The LTV ratio should not exceed 75 per cent in case of loan above ₹75 lakh. For loans against collateral of gold jewellery, the ratio should not exceed 60 per cent.

Provisioning The HFC should make the following provisions against substandard, doubtful and loss assets, after taking into account the time-lag between an account becoming NPA, its recognition as such, the realisation of the security and the erosion in the value of security charged over a point of time.

Loans, Advances and Other Credit Facilities, Including Bills Purchased and Discounted
The provisioning requirements should be as under:

Loss Assets The entire assets should be written off. If they are permitted to remain in the books for any reason, 100 per cent of the outstandings should be provided for.

Doubtful Assets

(a) 100 per cent provision, to the extent to which the advance is not covered by the realisable value of the security to which an HFC has a valid recourse, should be made. The realisable value is to be estimated on a realistic basis;

(b) in addition, depending upon the period for which the asset has remained doubtful, provision to the extent of 25 to 100 per cent of the secured portion (ie estimated realisable value of the outstandings) should be made on the following basis:

Period for which the asset has been considered as doubtful	*Percentage of provision*
Up to 1 year	25
1 – 3 years	40
Over 3 years	100

Substandard Assets A general provision of 15 per cent of the total outstanding should be made.

Standard Assets **(a)** Standard assets in respect of housing loans at teaser/special rates (i.e. at comparatively lower rates in the first few years after which re-set at higher rates), 2 per cent on the total outstanding amount. The provisioning should be reset after one year at the applicable rates from the date on which the rates are reset at higher rates, **(b)** Standard assets in respect of commercial real estates, 0.75 per cent of the total outstanding for residential housing and 1 per cent in respect of all others, (c) Standard assets in respect of all other loans, a general provision of 0.40 per cent of the total outstanding amount. However, no provision need be made towards the portion of the housing loan guaranteed by the Credit Risk Guarantee Fund Trust for Low Income Housing. The amount outstanding in excess of the guaranteed portion should be provided for as per the provisioning requirement.

Note: Commercial real estate-residential housing (CRE-RH) would consist of loans to builders/developers for residential housing projects (except for captive consumption) and would ordinarily not include non-residential commercial real estate. However, integrated housing projects comprising of some commercial space (e.g. shopping complex/schools) can also be classified under CRE-RH provided it does not exceed 10 per cent of the total floor space index (FSI) of the project.

Other commercial real estate would consist of loans to builders/developers/others for office building, retail space, multi-purpose/tenanted commercial premises, industrial/warehouse space, hotels, land acquisition/development/construction etc. Loans for third dwelling unit onwards to an individual will also be treated as CRE exposure.

Lease and Hire-Purchase Assets The provisioning requirements in respect of hire-purchases and leased assets should be as under:

Hire-Purchase Assets **(i)** In respect of hire-purchase assets, the total dues (overdue and future instalments taken together) as reduced by **(a)** the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges and **(b)** the depreciated value of the underlying asset should be provided for. The depreciated value of the asset should be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of 20 per cent per annum on a straight line method. In case of a second hand asset, the original cost should be the actual cost incurred for its acquisition.

Additional Provision for Hire-Purchase and Leased Assets **(ii)** With respect to hire-purchase and leased assets, additional provision should be made as detailed here.

- **(a)** Where any amounts of hire charges or lease rentals are overdue up to 12 months–*Nil.*
- **(b)** Where any amounts of hire charges or lease rentals are overdue for more than 12 months, but up to 24 months–10 *per cent of the net book value.*
- **(c)** Where any amounts of hire charges or lease rentals are overdue for more than 24 months, but up to 36 months–40 *per cent of the net book value.*
- **(d)** Where any amounts of hire charges or lease rentals are overdue for more than 36 months, but upto 48 months–70 *per cent of the net book value.*
- **(e)** Where amounts of hire charges/lease rentals are overdue for more than 48 months–*100 per cent of the net book value.*

(iii) On the expiry of a period of 12 months after the due date of the last instalment of hire purchased/leased assets, the entire net book value should be fully provided for. Net book value means: **(a)** in the case of hire purchase assets, the aggregate overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as specified above; **(b)** in the case of leased assets, aggregate of the capital portion of overdue lease rentals accounted as receivable and the depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Notes:

(1) The amount of caution money/margin money or security deposit kept by the borrower with the HFC, in pursuance of the hire purchase agreement, may be deducted against the provisions specified above under clause **(i)** if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security may be deducted only against the additional provisions stipulated under clause **(ii)** above.

(2) The amount of security deposit kept by the borrower with the HFC, together with the value of any other security available in pursuance to the lease agreement, may be deducted only against the additional provisions stipulated under clause **(ii)** above.

(3) Income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms should be made on NPAs on total outstanding balance, including the depreciated book value of the relevant lease asset, after adjusting the balance, if any, in the lease adjustment account. The fact that income on NPAs has not been recognised should not be taken as a reason for not making the provision.

(4) A sub-standard asset that has been renegotiated/rescheduled should be a substandard asset or continue in the same category in which it was prior to its renegotiation/reschedulement as a doubtful/loss asset. Necessary provision should be made as applicable to such cases till it is upgraded. In case an asset has been rescheduled on account of impairment of the repaying capacity of the borrower by natural calamities, any provisioning made prior to the rescheduling should neither be written back nor adjusted against any provisioning requirement that may arise in future.

(5) All financial leases attract the provisioning requirements as applicable to hire-purchase assets.

(6) The general provision of 0.40 per cent of the total outstanding amount of loan would not be reckoned for arriving at net NPAs.

(7) The provisions towards standard assets need not be netted from gross advances but shown separately as Contingent Provisions Against Standard Assets in the balance sheet.

Disclosure in the Balance Sheet The HFCs should separately disclose in their balance sheets the outstanding amount and the provisions should be distinctly indicated under separate heads of accounts and individually for each type of assets, such as **(a)** for sub-standard, doubtful and loss assets separately for housing and non-housing finance business along with total, and **(b)** for depreciation in investments. They should not be appropriated from the general provisions and loss reserves held, if any, by a HFC. Such provisions for each year should be debited to the profit and loss account. The excess of provisions, if any, held under the heads of general provisions and loss reserves may be written back without making adjustment against them.

Every HFC should disclose the percentage of outstanding loans granted against the security of gold jewellery to their outstanding total assets.

The HFCs should separately disclose in the **notes on accounts** to the balance sheet in the next annual report **(a)** details of penalty, if any imposed on the HFC by the NHB and **(b)** adverse comments, if any, on the HFC by the NHB in writing on regulatory compliances with specific communication to disclose them to the public.

Capital Adequacy Norms HFCs should maintain a minimum capital ratio consisting of Tier-I and Tier-II capital of at least 12 per cent of their aggregate risk weighted assets and of risk adjusted value of off-balance sheet items. The total of the Tier-II should not exceed 100 per cent of Tier-1 capital.

Tier-I capital means owned funds (ie paid-up equity capital, including preference shares that are compulsorily convertible into equity shares, free reserves, balance in share premium account and capital reserves representing surplus arising out of the sale proceeds of assets, excluding reserves created by revaluation of assets as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any, less investments in shares of other HFCs and in shares, debentures bonds, outstanding loans and advances, including hire-purchase and lease finance made to and deposits with subsidiaries and group companies in excess in aggregate of 10 per cent of the owned fund. Free reserves include the balance in the share premium account, capital and debenture redemption reserve and any other reserve shown/ published in the balance sheet and created through an allocation of profits and excluding **(i)** a reserve created for repayment of any future liability/for depreciation in assets/bad debts, **(ii)** a reserve created by the revaluation of assets.

The **Tier-II Capital** includes the following:

Preference Shares Preference Shares other than those compulsory convertible into equity.

Revaluation Reserves Revaluation Reserves at discounted rate of 55 per cent.

General Provisions and Loss Reserves General Provisions and Loss Reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset, and are available to meet unexpected losses to the extent of 1.25 per cent of risk weighted assets.

Hybrid Debt means capital instruments that possess certain characteristics of equity as well as of debt.

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Subordinated Debt **Subordinated debt** means a fully paid-up capital instrument, unsecured and subordinated to the claims of other creditors, free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the NHB. The book value of such an instrument should be subjected to discounting as provided below.

Subordinated debt means a fully paid-up capital instrument, unsecured and subordinated to the claims of other creditors, free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the NHB.

Remaining maturity of instruments	*Rate of discount*
Up to 1 year	100
1 – 2 years	80
2 – 3 years	60
3 – 4 years	40
4 – 5 years	20

The discounted value of subordinated debt instruments should be limited to 50 per cent of the Tier-I capital.

On Balance Sheet Items—Weighted Risk Assets Degrees of credit risks expressed as percentage weightage should assigned to balance sheet assets. The value of each asset/item should be multiplied by the relevant risk weights to arrive at risk adjusted values of assets. The aggregate should be taken into account for reckoning the minimum capital ratio. The risk weighted assets should be calculated as the weighted aggregate of funded items, as detailed below.

Weighted Risk Assets: On Balance Sheet Items	*Weight (%)*
1. (a) Cash and bank balances, including fixed deposits and certificates of deposits with banks	0
2. Investments:	
(a) Approved securities	0
(b) Bonds of public sector banks and fixed deposits/certificates of deposits/bonds of public financial institutions	20
(c) Units of Unit Trust of India	20
(d) Mortgage backed security/receipt/other security evidencing purchase/ acquisition by HFC of an undivided right/title/interest in any debt/receivables originated by a HFC recognised/supervised by the NHB/a bank and secured by mortgage of residential immovable property	50
(e) Shares of all companies and debentures/bonds/commercial papers of companies other than in **(b)** above/units of mutual funds other than in **(c)** above	100
(f) Investments in innovative perpetual debt of other HFCs/banks/FIs	100
3. (a) Housing/project loans guaranteed by Government 0 (where guarantee has been invoked and the Government has remained in default for 90 days).	100
(b) Housing loans to individuals secured by mortgage of immovable property classified as standard:	
(i) Upto ₹ 30 lakhs with LTV ratio equal to/less than 80 per cent	35
(ii) Above ₹ 20 lakh but below ₹ 75 lakh with LTV ratio between 80 per cent and 90 per cent	50
(iii) Between ₹ 30 – ₹ 75 lakh with LTV ratio equal to or less than 75 per cent	35
(iv) Between ₹ 30 – ₹ 75 lakh with LTV ratio more than 75 per cent and equal to/less than 80 per cent	50
(v) Above ₹ 75 lakh with LTV ratio equal to/less than 75 per cent	75
(vi) Loans given for insurance of property/borrower, same as applicable to respective housing loans	
(c) Other housing loans	100
Note: Loan in **(b)** and **(c)** categories above are exclusive of any portion guaranteed by a mortgage guarantee company/credit risk guarantee trust fund.	
(ca) Any portion of loan in categories **(b)** and **(c)** guaranteed by a mortgage guarantee company, the risk weight would be related to its long-term ratings:	
(i) AAA rating	20
(ii) AA rating	30
(iii) Below **AA**/unrated (as applicable to unguaranteed portion)	
(cb) Any portion in **(b)(i)** and **(c)** guaranteed by credit risk guarantee fund	0
(d) (i) Fund/non-fund based exposures to commercial real estate residential buildings	75
(ii) Fund/non-fund based exposures to all other commercial real estates	100
(iii) Investment in mortgage based securities (MBS) and other securitised exposures	125
(e) Restructured housing loan, additional risk weight	25

4.	Current Assets:	
	(a) Stock on hire (see note 2)	100
	(b) Inter-corporate loans/deposits	100
	(c) Loans and advances fully secured by company's own deposits	0
	(d) Loan to staff	0
	(e) Other secured loans and advances considered	100
	(f) Bills purchased/discounted	100
	(g) Others (to be specified)	100
5.	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture and fixtures	100
	(d) Other fixed assets (to be specified)	100
6.	Other Assets:	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities and approved securities	0
	(d) Others (to be specified)	100

Notes:

(1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

(2) Stocks on hire should be shown net of finance charges, that is, interest and other charges recoverable.

(3) Assets that have been deducted from owned funds to arrive at Tier-I capital would have a weightage of "0".

(4) For being eligible for risk weight of 50 per cent, investment in mortgage-based security/receipt/other security referred to in item (**ca**) should fulfill the following terms and conditions:

(a) The assignment of debt together with the securities and receivables by the originating HFC/bank in favour of the trust/securitisation company under the *Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2000* issuing such receipt/other security is complete and irrevocable.

(b) The trust/securitisation company is holding the debt together with the securities exclusively for the benefit of investors.

(c) The originating HFC/bank participating in the securitisation transaction as a seller/manager/ servicer/provider of credit enhancement or liquidity facilities **(i)** does not own any shares in the capital of the securitisation company or is the beneficiary of the trust, **(ii)** has not named the trust/securitisation company in such manner which implies any connection with it, **(iii)** does not have any director/officer/employer on the Board of the securitisation company unless the Board is made up of at least three members and there is a majority of independent directors and the nominee of the originating company has no veto powers; **(iv)** does not directly/indirectly control the trust/securitisation company, and **(v)** has not agreed to support any losses arising out of the securitisation transaction or to be suffered by the investors involved in it or agreed to bear recurring expenses of the transactions.

(d) Each securitised debt is a loan to an individual for the acquisition/construction of residential immovable property mortgaged in favour of the originating HFC/bank on exclusive basis.

(e) Securitised debt had investment grade rating at the time of assignment to the trust/securitisation company.

(f) Investors are entitled to call upon the issuer-trust/securitisation company to take steps for recovery in the event of default and distribute the net proceeds to the investors as per the terms of the issue of the receipt/other security.

(g) The trust/securitisation company undertaking the issue in which investment has been made is not engaged in any business other than the business of issue and administration of securitisation of housing loans.

(h) The trustees appointed to manage the issue is governed by the provisions of the Indian Trust Act.

Off-Balance Sheet Items **(A) General** The HFCs should calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure will be calculated by means of a two-step process: **(i)** the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and **(ii)** the resulting credit equivalent amount is multiplied by the risk weight applicable, for example, zero per cent for exposure to Government, 20 per cent for banks and 100 per cent for others.

(B) Non-market-Related Off-balance sheet Items The credit equivalent amount in relation to a non-market related off-balance sheet item should be determined by multiplying the contracted amount of the particular transaction by the relevant credit conversion factor (CCF).

Item	*Item description*	*Credit conversion factor*
(i)	Undisbursed amount of housing/other loans	50
(ii)	Financial and other guarantees	100
(iii)	Share/debenture underwriting obligations	50
(iv)	Partly-paid shares/debentures	100
(v)	Bills discounted/rediscounted	100
(vi)	Lease contracts entered into but yet to be executed	100
(vii)	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the HFC.	100
(viii)	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawn down.	100
(ix)	Lending of HFC securities or posting of securities as collateral by HFC, including instances where these arise out of repo style transactions	100
(x)	Other commitments, for example, formal standby facilities and credit lines (including project loans) with an original maturity of:	
	up to one year	20
	over one year	50

(xi)	Similar commitments that are unconditionally cancellable at any time by the HFC without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness	0
(xii)	Take-out finance in the books of taking-over institution:	
	(a) Unconditional take-out finance	100
	(b) Conditional take-out finance	50
	Note: As the counter-party exposure will determine the risk weight, it will be 100 per cent in respect of all borrowers or zero per cent if covered by Government guarantee	
(xiii)	Commitment to provide liquidity facility for securitisation of standard asset transactions	100
(xiv)	Second loss credit enhancement for securitisation of standard asset transactions provided by third party	100
(xv)	Other contingent liabilities (to be specified)	50

Note: (i) Cash margins/deposits should be deducted before applying the conversion factor.
(ii) Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of HFC's on-balance sheet credit exposure. For example, a term loan of ₹100 crore is sanctioned for a large housing project which can be drawn down in stages over a three-year period. The terms of sanction allow draw down in three stages: ₹25 crore in stage 1, ₹25 crore in stage II and ₹50 crore in stage III, where the borrower needs the HFC's explicit approval for draw down under Stages II and III after completion of certain formalities. If the borrower has drawn already ₹10 crore under stage I, the undrawn portion would be computed with reference to stage 1 alone, that is, it will be ₹15 crore. If stage I is scheduled to be completed within one year, the CCF will be 20 per cent and if it is more than one year, the applicable CCF will be 50 per cent.

(C) Market Related Off-Balance Sheet Items

(i) The HFCs should take into account all market related off-balance sheet items (OTC derivatives and securities financing transactions such as repo/reverse repo/CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures.

(ii) The credit risk on market related off-balance sheet items is the cost to an HFC of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument.

(iii) Market related off-balance sheet items would include: **(a)** interest rate contracts, including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures; **(b)** foreign exchange contracts, including contracts involving gold, includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options; **(c)** credit default swaps; and **(d)** any other market related contracts specifically allowed by the NHB which give rise to credit risk.

(iv) Exemption from capital requirements is permitted for **(a)** foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and **(b)** instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.

(v) The exposures to central counter parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. collateralised borrowing and lending obligations, repos) outstanding against them should be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

(vi) A CCF of 100 per cent should be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure should be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight should be 20 per cent for other CCPs, it should be 50 per cent.

(vii) The total credit exposure to a counterparty in respect of derivative transactions should be calculated according to the current exposure method as explained below.

(D) Current Exposure Method The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of **(i)** current credit exposure and **(ii)** potential future credit exposure of the contract. **Current credit exposure** is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The current exposure method requires periodical calculation of the current credit exposure by marking these contracts to market. **Potential future credit exposure** is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit conversion factors for interest rate related, exchange rate related and gold related derivatives

	Credit conversion factors (%)	
	Interest rate contracts	*Exchange rate contracts and gold*
One year or less	0.50	2.00
Over one year to five years	1.00	10.00
Over five years	3.00	15.00

(a) For contracts with multiple exchange of principal, the add-on factors are to be multiplied by the number of remaining payments in the contracts.

(b) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1 per cent.

(c) No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

(d) Potential future exposures should be based on '**effective**' rather than '**apparent notional amounts**'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the lending rate of the HFC would have an effective notional amount of USD 2 million.

(E) Credit Conversion Factors for Credit Default Swaps (CDS) A CDS creates a notional short position for specific risk in the reference asset/obligation for the protection of buyer. This position should attract a credit conversion factor of 100 and a risk weight of 100. The add-on factor may be as 10 per cent (of notional principal of CDS) in relation to potential future exposure.

Restrictions on Investment in Real Estate and Engagement of Brokers

Investment in Land and Buildings Any HFC cannot invest in land/buildings, except for own use, more than 20 per cent of its capital fund (i.e. aggregate of Tier-I capital and Tier-II capital) on the condition that such investment in excess of 10 per cent of its owned fund should be made only in residential units.

Exposure to Capital Market ***Limit on Exposure*** The aggregate fund/non-fund based exposure of a HFC to the capital market should not exceed 40 per cent of its ***net worth*** (i.e. paid-up capital plus free reserves including share premium but excluding revaluation reserves plus investment fluctuation reserve and credit balance in profit and loss account less debit balance in profit and loss account, accumulated losses and intangible assets. Within the overall ceiling, direct investment in shares, convertible bonds/debentures, equity-oriented mutual fund units and all exposures to VCFs should not exceed 20 per cent.

Components of Capital Market Exposure The **capital market exposure** means all fund/non-fund direct/indirect exposure including: **(i)** direct investment in shares, convertible bonds/debentures, and units of equity-oriented mutual funds, **(ii)** advance against shares/bonds/debentures/other securities or clean basis to individuals for investment in instruments in **(i)**, **(iii)**, advances for any other purpose against instrument in **(i)** as primary security, **(iv)** advances for any other purpose to the extent secured by the collateral security of instruments in **(i)**, **(v)** secured/unsecured advances to brokers/guarantees issued on their behalf and market makers, **(vi)** loans sanctioned to corporates against the instruments in **(i)** or on clean basis for meeting promoters contribution, **(vii)** bridge loans to companies against equity flows/issues, **(viii)** underwriting commitments by HFCs, **(ix)** financing to brokers for margin trading and **(x)** all exposures to VCFs.

> **Exposure to capital market**
> means acquisition of shares, convertible debentures of corporates and units of equity-oriented mutual funds.

However, the following intems would be excluded from the aggregate (**40 per cent**) and direct investment (**20 per cent**) exposure: **(i)** Investments in own subsidiaries/joint ventures and those in unlisted shares and convertible bonds/debentures issued by infrastructure financial institutions/ other all-India financial institutions, **(ii)** Tier-I and Tier-II debt instruments issued by other HFCs,

(iii) Certificate of deposits of other HFCs, **(iv)** Preference shares, **(v)** Non-convertible bonds/debentures, **(vi)** Units of debt mutual funds and **(viii)** Shares acquired under a corporate debt restructuring (CDR) mechanism.

Computation of Exposure For computing the capital market exposure, loans/advances sanctioned and guarantees issued for capital market operation would be reckoned with reference to the higher of the sanctioned limit or outstanding.

Engagement of Brokers For engagement of brokers to deal with investment transactions, the HFCs should ensure that transactions should not be put through the broker's accounts. The brokerage on the deal should be clearly indicated on the notes/memorandum put up to the top management seeking approval for putting through the transaction and a separate account of brokerage paid broker-wise should be maintained. The role of the broker should be restricted to bringing the two parties to the deal together. On conclusion of the deal, the broker should disclose the counterparty and his contract note should be directly between the parties and the broker should have no role to play in the process. With the approval of their top management, HFCs should prepare a panel of approved brokers which should be reviewed periodically. Clear-cut criteria including creditworthiness, market reputation and so on should be laid down for their empanelment. Broker-wise details of deals and brokerage paid should be maintained. The HFCs should fix aggregate contract limits for each of the approved brokers. The aggregate upper contract limit for each broker should be five per cent of total transactions (purchases and sales). Specific reasons to exceed the limit should be recorded in writing and the Board should be informed *post facto*. The norm of five per cent would, however, not be applicable if the total annual transactions does not exceed ₹20 crore or dealings take place through primary dealers.

The auditors who audit the treasury operations should scrutinise the business through the brokers and include it in their monthly reports to the CEO of the HFC. The half-yearly review to the Board of Directors should cover the business put through individual broker(s) in excess of the limit. The HFCs should undertake securities transactions through stock brokers only on NSE/BSE/OTCEI.

Concentration of Credit/Investments The HFCs should not lend/invest more than 15 per cent of their owned funds to any single party/in shares of another company and more than 25 per cent to a single group of parties/in shares of a single group of companies. They should not lend and invest (loans/investments taken together) more than 25 per cent of owned fund to a single party and more than 40 per cent to a single group of parties. Within the overall ceiling, investment in the shares of another HFC (other than subsidiaries) should not exceed 15 per cent of the equity capital of the investee company.

Notes: **(a)** For determining these limits, off-balance sheet exposures should be converted into credit risks by applying the relevant conversion factors.

(b) The investments in debentures should be treated as credit and not as investment.

(c) The above ceiling on credit investments are applicable to the own group of the HFC as well as to the other group of borrowers/investee companies.

Partner in Partnership Firms No HFC should contribute to the capital of a firm (including limited liability partnerships) or become its partner. The prohibition will also apply with respect to association of persons, being similar to a firm.

Miscellaneous Matters

Opening of Branches Every HFC should inform the NHB in writing of its intention to open a branch/office. Opening of branches outside India is prohibited. Prior approval in writing of the NHB would be necessary to open a representative office outside India only for liasion work and undertaking market study and research. It cannot undertake any activity involving outlay of funds and no line of credit should be extended to it.

Loans Against Own Shares Prohibited No HFC should lend against its own shares.

Loans for Purchase of Gold The HFCs are prohibited from granting loan/advance **(a)** against bullion/primary gold/gold coins and **(b)** for purchase of gold in any form including primary gold/gold bullion/jewellery/coins, units of exchange traded funds (ETF) and gold mutual fund.

HFCs Failing to Repay Public Deposit Prohibited from Making Loans and Investments A HFC that has failed to repay any public deposit or part thereof, in accordance with the terms and conditions of such deposit, should not grant any loan or other credit facility by whatever name called or make any investment or create any other asset as long as the default exists.

Constitution of Audit Committee A HFC having assets of ₹50 crore and above, as per its last audited balance sheet, should constitute an Audit Committee consisting of not less than three non-executive Directors of the Board.

Accounting Year Every HFC should prepare its balance sheet and profit and loss account as on March 31 every year, with effect from the accounting year ending March 31, 2002.

Copies of Balance Sheet and Account Together with the Directors' Report to be Furnished to the NHB Every HFC should deliver to the NHB an audited balance sheet as on the last date of each financial year and an audited profit and loss account in respect of that year, as passed by it in the General Meeting, together with a copy of the report of the Board of Directors, laid before it in such meeting, in terms of Section 217**(1)** of the *Companies Act*, within 15 days of such meeting, as also a copy of the report and the notes on accounts furnished by its auditors.

Auditor's Certificate A HFC holding/accepting public deposits should furnish to the NHB, along with the copy of the audited balance sheet, a copy of the auditor's report to the Board of Directors and a certificate from its auditors to the effect that the full amount of liabilities to the depositors of the company, including interest payable thereon, are properly reflected in the balance sheet and that the company is in a position to meet the amount of such liabilities to the depositors.

Returns to be Submitted to the NHB Every HFC should submit to the NHB an annual return furnishing the information, specified in Schedule I of these Directions, with reference to its position as on March 31 every year, a half-yearly return furnishing the information, specified in Schedule II of these Directions, with reference to its position as on 30th September and 31st March every year and a quarterly return furnishing the information, specified in Schedule III, with reference to its position as at the end of every calendar quarter.

It should, within one month from the commencement of business, deliver to the NHB, a written statement containing a list of:

(a) The names and official designation of its principal offices;
(b) The complete postal address, telephone number(s) and fax number(s) of the registered/corporate office;

(c) The names and office addresses of the auditors of the company;
(d) The names and the residential addresses of the directors of the HFC and
(e) The specimen signatures of the officers authorised to sign the returns on behalf of the HFC, as specified above.

Any change in the list referred to above should be intimated to the NHB within one month from the occurrence of such change.

Exemptions The NHB may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extension of time to comply with or exempt any HFC or class of HFCs, from all or any of the provisions of these Directions either generally or for any specified period, subject to such conditions as it may impose.

Interpretations For the purpose of giving effect to the provisions of these Directions, the NHB may, if it considers necessary, issue necessary clarifications in respect of any other matter covered herein and the interpretation of any provision of these Directions given by it should be final and binding on all the concerned parties.

AUDITOR'S REPORT DIRECTIONS, 2016

In addition to the report under Section 143 of the Companies Act on accounts of a HFC, the auditor should also make a separate report to its Board of Directors on the matters specified below. The auditor's report should include a statement on the following matters:

In Case of all HFCs

Whether the company **(i)** has obtained a Certificate of Registration (CoR) from the NHB, **(ii)** is meeting the required NOF requirement prescribed under Section 29-A of the NHB Act, including paid-up compulsorily convertible preference shares.

In Case of HFCs Accepting/Holding Public Deposits

Apart from the above matters, the auditor should include a statement on whether the **(i)** HFC has complied with Section 29-C of the NHB Act, **(ii)** public deposits accepted by it **(1)** together with other borrowings **(a)** from public by issue of unsecured non-convertible debentures/bonds, **(b)** from its shareholders (if it is a public limited company), and **(c)** which are not excluded from the definition of '**public deposit**' in the HFC (NHB) Directions are with the admissible limits, **(2)** in excess of the permissible quantum are regularlised in the prescribed manner, **(iii)** HFC is accepting/holding **public deposits** without minimum investment grade credit rating, **(ii)** the credit rating assigned for each of the fixed deposits schemes is in force, and **(iii)** aggregate outstanding deposits as at any point during the year have exceeded specified limit, **(iv)** HFC has defaulted in paying to its depositors the due interest and/or principal amount of the deposit; **(v)** total borrowings of the HFC are within the prescribed limits, **(vi)** HFC has complied with the specified prudential norms on income recognition, accounting standards, asset classification, loan-to-value ratio, provisioning requirements, disclosure in balance sheet, investment in real estate, exposure to capital market and engagement of brokers, and concentration of credit/investments, **(vii)** capital adequacy ratio has been correctly determined and is in compliance with the prescribed minimum CRAR, **(viii)** has furnished to the NHB within the stipulated period the specified returns, **(ix)** has complied with the prescribed liquid assets requirement, **(x)** has furnished to the NHB within the stipulated period the return on statutory liquid assets, **(xi)** has complied with the specified requirements in the case of opening of new branches/offices or in the case of closure of existing branches/offices, **(xii)** has complied with the provision relating to prohibition of loans against own shares/for purchase of gold, **(xii)** violated any provisions contained under restriction on acceptance of public deposits, period of public deposits, joint public deposits, particulars to be specified in application form soliciting public deposits, ceiling on the rate of interest and brokerage and interest on overdue public deposits, renewal of public deposits before maturity.

In Case of HFCs Not Accepting/Holding Public Deposits

Apart from the above matters pertaining to all the HFCs, the auditor should include a statement on whether the **(i)** HFC has complied with Section 29-C of the NHB Act, **(ii)** Board of Directors of the HFC has passed a resolution for non-acceptance of any public deposits, **(iii)** HFC has accepted any public deposits during the relevant period/year, **(iv)** total borrowings of the HFC are within the prescribed limits, **(v)** HFC has complied with the specified prudential norms on income recognition, accounting standards, asset classification, loan-to-value ratio, provisioning requirements, disclosure in balance sheet, investment in real estate, exposure to capital market and engagement of brokers, and concentration of credit/investments, **(vi)** capital adequacy ratio submitted to the NHB has been correctly determined and is in compliance with the prescribed minimum CRAR, **(vii)** HFC has furnished to the NHB within the stipulated period the half-yearly return, **(viii)** HFC **(a)** has furnished to the NHB within the stipulated period the specified return on statutory liquid assets, **(b)** has complied with the prescribed requirements in the case of opening of new or closure of existing branches/offices, **(c)** complied with the provisions relating to prohibition of loan against own shares/for purchase of gold.

Reasons to Be Stated for Unfavourable/Qualified Statements

Where the statement regarding any of the above items is unfavourable/qualified, the auditor's report should also state the reasons. Where the auditor is unable to express any opinion, his report should indicate such fact together with the reasons.

Obligations of Auditor to Report to the NHB

Where the statement regarding any of the items is unfavourable/qualified, or in the opinion of the auditor, the HFC has not complied with: **(a)** the provisions of the NHB pertaining to miscellaneous matters, **(b)** HFCs (NHB) Directions; or **(c)** HFCs Issuance of Non-Convertible Debentures on Private Basis (NHB) Directions, it would be the obligation of the auditor to make a report containing the details of such unfavourable/qualified statements and/or about the non-compliance. The duty of the auditor would be to report only the contraventions of the provisions of NHB Act/directions/guidelines/instructions and the report should not contain any statement with respect to their compliance.

HFCs CORPORATE GOVERNANCE (NHB) DIRECTIONS, 2016

These directions are applicable to every non-public deposit accepting HFC with minimum assets size of ₹ 50 crore and all public deposit accepting/holding HFCs (i.e. **applicable HFCs**). The main elements of the directions are: **(i)** constitution of committees of the Board of Directors, **(ii)** fit/proper criteria, **(iii)** discloures/transparency, **(iv)** rotation of auditors, and **(v)** internal guidelines.

Constitution of Committees

The Board of Directors of the HFCs should constitute the following committees:

Audit Committee The audit committee should consist of at least three members of its Board of Directors. It must ensure that an information system audit of the internal systems and processes is conducted at least once in two years to assess operational risks faced by the HFCs.

Nomination Committee The formation of a nomination committee should ensure '**fit and proper**' status of the proposed/existing directors.

Risk Management Committee To manage the integrated risk, all applicable HFCs should form a risk management committee, besides the asset liability management committee.

Fit and Proper Criteria

All applicable HFCs should:

(i) Ensure that a policy is put in place with the approval of its Board of Directors for ascertaining the fit and proper criteria of the directors at the time of appointment, and on a continuing basis. It should be on the lines of the prescribed guidelines discussed below: The importance of due diligence of directors to ascertain their suitability for the post by way of qualifications, technical expertise, track record, integrity, etc. needs no emphasis for any financial institution. The same guidelines *mutatis mutandis,* should be followed in case of HFCs also. While the NHB carries out due diligence on them before issuing CoR, the HFCs should put in place an internal supervisory process on a continuing basis. In order to streamline and bring in uniformity in the process of due diligence, the HFCs should ensure that the procedures mentioned below are followed and minimum criteria fulfilled by them before they are appointed on the Boards. The HFCs should undertake a process of due diligence to determine the suitability of the person for continuing to hold appointment as a Director on the Board, based on qualification, expertise, track record, integrity and other 'fit and proper' criteria. They should obtain necessary information and declaration from the proposed/existing directors for the purpose in the prescribed format. The process of due diligence should be undertaken by the HFCs at the time of these appointment/renewal. The Boards of the HFCs should constitute nomination committees to scrutinise the declarations. Based on the information provided in the signed declaration, the nomination committees should decide on the acceptance or otherwise of the directors. The HFCs should obtain annually as on March 31 a simple declaration from them that the information already provided has not undergone change and where there is any change, requisite details are furnished by them forthwith. Their Board of Directors must ensure in public interest that the nominated/elected Directors execute in the prescribed format the deeds of covenants.

(ii) Obtain a declaration and undertaking from the directors giving the specified additional information on the directors.

(iii) Obtain, in the specified format, a deed of covenant signed by them.

(iv) Furnish to the NHB a quarterly statement on change of directors, and a certificate from the managing director that the fit and proper criteria in selection of the directors has been followed within 15 days of the close of the respective quarter. The statement for the quarter ending March 31 should be certified by the auditors. If deemed fit and in public interest, the NHB may examine the fit and proper criteria of directors of any HFC irrespective of their asset size.

Disclosure and Transparency

All applicable HFCs should put up to the Board of Directors, at prescribed regular intervals, the following: **(i)** progress made in putting in place a progressive risk management system/policy and strategy followed; **(ii)** conformity with corporate governance standards, that is, in the composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions and so on. They should also disclose the following in their annual financial statements: **(i)** registration/licence/authorisation obtained from other financial sector regulators; **(ii)** ratings assigned by credit rating agencies and migration of ratings during the year; **(iii)** penalties levied by any regulator; **(iv)** information namely, area, country of operation and joint venture partners with regard to joint ventures and overseas subsidiaries and **(v)** asset-liability profile, NPAs and movement of NPAs, details of all off-balance sheet exposures, exposure to real estate/capital market, disclosure of complaints as also securitisation/assignment transactions and other specified disclosures.

Rotation of Partners of the Statutory Auditors/Audit Firm

All applicable HFCs should rotate the partner(s) of the chartered accountant firm conducting audit so that the same partner does not conduct audit continuously for more than three years. However, he will be eligible after an interval of three years. They should incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

Framing of Internal Guidelines

All applicable HFCs should frame their internal guidelines on corporate governance with the approval of their Board of Directors, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and publish it on their webs-site for the information of the various stakeholders.

GUIDELINES FOR EXTENDING EQUITY SUPPORT TO HFCs

The NHB has issued guidelines to HFCs for their growth on sound lines and to be healthy, viable and cost effective. These are available on the website. The website address is **http://www.mhhe.com/khanfs9e**.

GUIDELINES FOR EXTENDING REFINANCE SUPPORT TO HOUSING FINANCE COMPANIES

The NHB has issued Guidelines to Housing Finance Companies (HFCs) that are housing finance institutions within the meaning of Section 2**(d)** of the National Housing Act, 1987 for their growth on sound lines and to be healthy, viable and cost effective. They are applicable to such of those HFCs that desire to avail of refinance facilities from the NHB. These are available on the website. The address is **http://www.mhhe.com/khanfs9e**.

REFINANCE SCHEME FOR HFCs

The main provisions of the NHB's refinance scheme are available on the website. The address is **http://www.mhhe.com/khanfs9e**.

GUIDELINES FOR ASSET LIABILITY MANAGEMENT (ALM) SYSTEM IN HOUSING FINANCE COMPANIES

In the normal course, Housing Finance Companies (HFCs) are exposed to credit and market risks in view of the asset-liability transformation. With liberalisation in Indian financial markets over the last few years and growing integration of the domestic markets with external markets, the risks associated with the operations of an HFC have become complex and large, requiring strategic management. The HFCs are operating in a fairly deregulated environment and are required to determine on their own, interest rates on advances and deposits, subject to the ceiling on maximum rate of interest they can offer on deposits, on a dynamic basis. The interest rates on investment of HFCs in Government and other securities are also now market related. Intense competition for business involving both the assets and liabilities has brought pressure on the managements of HFCs to maintain a good balance amongst spreads, profitability and long-term viability. These pressures call for structured and comprehensive measures and not just *ad hoc* action. The managements of HFCs have to base their business decision on a dynamic and integrated risk management system and process driven by corporate strategy. The HFCs are exposed to several major risks in the course of their business-credit risks, interest rate risk, equity/commodity price risk, liquidity risk and operational risk. It is, therefore, important that HFCs introduce effective risk management systems that address the issues relating to interest rate and liquidity risks.

The HFCs need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. The **ALM,** among other functions, is also concerned with management of risks and provides a comprehensive and dynamic framework for measuring monitoring and managing liquidity and interest rate risks of an HFC that need to be closely integrated with the HFC's business strategy. It involves assessment of various types of risk and altering of the asset-liability portfolio in a dynamic way in order to manage risks.

> **ALM**
> involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

This note lays down broad guidelines for HFCs in respect of systems for management of liquidity and interest rate risk which forms part of the ALM function. The initial focus of the ALM function would be to enforce the discipline of market risk management, namely, managing business after assessing the market risks involved. The objective of a good risk management system should be to evolve into a strategic tool for effective management of HFCs. **The ALM process rests on three pillars:**

- ALM Information System: **(i)** Management information systems and **(ii)** Information availability, accuracy, adequacy and expediency.
- ALM Organisation: **(i)** Structure and responsibilities and **(ii)** Level of top management involvement.
- ALM Process: **(i)** Risk parameters, **(ii)** Risk identification, **(iii)** Risk measurement, **(iv)** Risk management, and **(v)** Risk policies and tolerance levels.

ALM Information System

ALM has to be supported by a management philosophy that clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary supporting information system as the central element of the entire ALM exercise is the availability of adequate and accurate information with expedience. Thus, information is the key to the ALM process. These range from the sample Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement methods. The systems existing in some of the major HFCs do not generate information in the manner required for ALM. Collecting accurate data in a timely manner will be the biggest challenge before the HFCs, particularly those lacking full-scale computerisation. However, the introduction of base information system for risk measurement and monitoring has to be addressed urgently.

The HFCs have heterogeneous organisational structures, capital base, asset sizes, management profile and geographical spread. Some of them have large number of branches and agents/brokers whereas some have unitary offices. Considering the present network of branches and the lack of (an adequate) support system to collect information required for ALM which analyses information on the basis of residual maturity and re-pricing pattern of liabilities and assets, it will take time for HFCs in the present state to get the requisite information. In respect of investment portfolio and funds management, in view of the centralised nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time as the HFC management gain experience of conducting business within ALM framework. The spread of computerisation will also help HFCs in accessing data.

ALM Organisation

Successful implementation of the risk management process would require strong commitment on the part of the senior management in the HFC to integrate basic operations and strategic decision making with risk management. The Board of Directors should have overall responsibility for management of risks and should decide the risk management policy of the HFC and set limits for liquidity, interest rate, exchange rate and equity price risks.

The Asset-Liability Committee (ALCO) consisting of the HFC's senior management including the Chief Executive Officer (CEO) should be responsible for ensuring adherence to the limits set by the Board of Directors as well as for deciding the business strategy for the HFC (on the assets and liabilities sides) in line with the HFCs budget and decided risk management objectives.

The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) reflecting the impact of various possible changes in market conditions on the balance sheet and recommend the action needed to adhere to HFCs internal limits.

The ALCO is a decision-making unit responsible for integrated balance sheet management from risk-return perspective including the strategic management of interest rate and liquidity risks. Each HFC will have to decide on the role of its ALCO, its powers and responsibilities as also the decisions to be taken by it. The business and the risk management strategy of the HFC should ensure that it operates within the limits/ parameters set by the Board of Directors. The business issues that an ALCO would consider will, *inter alia*, include product pricing for both deposits and advances, desired maturity profile, and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer HFCs for similar services/product, etc. In addition to monitoring the risks levels of the HFC, the ALCO should review the results of and progress in implementation of the decision made in the previous meetings. The ALCO would also articulate the current rate view of the HFC and base its decisions for future business strategy on this. In respect of the funding policy, for instance, its responsibility would be to decide on the source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on funding mixes between fixed *vs.* floating rate funds, wholesale *vs.* retail funds, money market *vs.* capital market funding, domestic *vs.* foreign currency funding etc. Individual HFCs will have to decide the frequency of holding their ALCO meeting.

Composition of ALCO The size (number of members) of ALCO would depend on the size of each institution, business mix and organisational complexity. To ensure commitment of the top management and timely response to market dynamics, the CEO/CMD/President or the ED should head the Committee. The Chief of Investment, Credit, Resources Management or Planning, Funds Management/Treasury, International Business and Economic Research can be members of the Committee. In addition, the Head of the Technology Division should also be an invitee for building up of MIS and related computerisation. Large HFCs may even have sub-committees and support groups.

Committee of Directors The Management Committee of the Board of Directors or any other specific committee constituted by the Board should oversee the implementation of the ALM system and review its functioning periodically.

ALM Process

The scope of ALM function can be described as under:

- Liquidity risk management
- Management of market risks
- Funding and capital planning
- Profit planning and growth projection
- Forecasting and analysing what it scenario and preparation of contingency plans.

The guidelines contained in this note mainly address liquidity and interest rate risks.

Liquidity has to be tracked through maturity or cash flow mismatches.

Liquidity Risk Management Measuring and managing liquidity needs are vital for effective operation of HFCs. By assuring an HFC's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. The HFC's management should measure not only the liquidity positions of HFCs on an on going basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that asset commonly considered to be liquid, such as government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, **liquidity** has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of a cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. **The format of the Statement of Liquidity is on the pattern of NBFCs discussed in Chapter 1 of the book**.

The maturity profile could be used for measuring the future cash flows of HFCs in different time buckets. The time buckets may be distributed as under:

(i) 1 day to 30/31 days (one month)
(ii) Over one month and upto 2 months
(iii) Over 2 months and upto 3 months
(iv) Over 3 months and upto 6 months
(v) Over 6 months and upto 1 year
(vi) Over one year and upto 3 years
(vii) Over 3 years and upto 5 years
(viii) Over 5 years and upto 7 years
(ix) Over 7 years and upto 10 years
(x) Over 10 years

The HFCs holding public deposits are required to invest a prescribed percentage of their deposits in approved securities in terms of liquid asset requirement under Section 29-B of the *NHB Act*, 1987. There is no such requirement for HFCs which are not holding deposits. Thus, various HFCs would be holding in their investment portfolio securities which could be broadly classifiable as 'mandatory securities' (under obligation of law) and other 'non-mandatory securities'. The HFCs holding deposits may be given freedom to place the mandatory securities in any time buckets as suitable for them. The listed non-mandatory securities may be placed in any one of the "1 day to 30/31 days (one month)", "over one month and upto 2 months" and "over two months and upto 3 months" buckets depending upon the defeasance period proposed by HFCs. The unlisted non-mandatory securities (e.g., equity shares, securities without a fixed term of maturity, etc.) may be placed in the "over 10 years" bucket, whereas unlisted non-mandatory securities having a fixed term of maturity may be placed in the relevant time bucket as per the residual maturity. The mandatory securities and listed securities may be marked to market for the purpose of the ALM system. Unlisted securities may be valued as per the prudential norms.

Alternatively, the HFCs may also follow the concept of trading book which is as under: **(i)** The composition and volume are clearly defined; **(ii)** Maximum maturity/duration of the trading portfolio are restricted; **(iii)** The holding period does not exceed 90 days; **(iv)** Cut-loss limit(s) is prescribed; and **(v)** Product-wise defeasance periods (i.e. the time taken to liquidate the position on the basis of liquidity in the secondary market) are prescribed. The HFCs which maintain such 'trading books' consisting of securities that comply with the above standards may show the trading securities under "1 day to 30/31 days, one month", "over one month and upto 3 months" and "over 2 months and upto 3 months" buckets on the basis of the defeasance periods. The Board/ALCO of the HFCs should approve the volume, composition, maximum maturity/

duration, holding/defeasance period, cut loss limits, etc., of the 'trading book'. The remaining investments should also be classified as short term and long term investments as required under the prudential norms.

A copy of the policy note recorded by the HFCs on treatment of the investment portfolio for the purpose of ALM and approved by their Board/ALCO should be forwarded to the NHB.

Within each time bucket there could be mismatches depending on the inflows and outflows. While the mismatches upto one year would be relevant since these provide early warning signals impending liquidity problems, the main focus should be on the short-term mismatches viz., 1-30/31 days. The HFCs, however, are expected to monitor their cumulative mismatches (running total) across all time buckets by establishing internal prudential limits with the approval of the Board/Management Committee. The mismatches (negative gap) during 1-30/31 days, in normal course, should not exceed 15 per cent of the cash out flows in this time bucket.

While determining the tolerance levels, the HFC may take into account all relevant factors based on their asset-liability base, nature of business, future strategy, etc. The NHB is interested in ensuring that the tolerance levels are determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

The Statement of Structural Liquidity on the pattern of the NBFCs discussed in Chapter 1 of the book may be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflow while a maturing asset will be a cash inflow. While determining the likely cash inflow/outflows, HFCs have to make a number of assumptions according to their asset-liability profiles. While determining the tolerance levels, the HFCs may take into account all relevant factors based on their asset-liability base, nature of business, future strategies, etc. The NHB is interested in ensuring that the tolerance levels are determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

In order to enable the HFCs to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from one day to six months, HFCs may estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

Floating exchange rate arrangement has brought in its wake pronounced volatility adding a new dimension to the risk profile of HFC's balance sheets having foreign asset or liabilities. The increased capital flows across free economies following deregulation have contributed to increase in the volume of transactions. Larger cross border flows together with the volatility may render the HFC's balance sheets vulnerable to exchange rate movements.

Interest Rate Risk The operational flexibility given to HFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the interest rate risk. **Interest rate risk** is the risk where changes in market interest rates might adversely affect an HFC's financial condition. The immediate impact of changes in interest rates is on HFC's earning (i.e. reported profits) by changing its Net Interest Income (NII). A long-term impact of changing interest rates is on HFC's Market Value of Equity (MVE) or net worth as the economic value of the assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspectives is known as 'earnings perspective' and 'economic value perspective', respectively. The risk from the earnings perspective can be measured as changes in the Net Interest Income (NII) or NET Interest Margin (NIM). There are many analytical techniques for

> **Interest rate risk** is the risk where changes in market interest rates might adverely affect financial condition of a HFC.

measurement and management of interest rate risk. To begin with, the Traditional Gap Analysis is considered to be a suitable method to measure the interest rate risk in the initial phase of the ALM system. It is the intention of NHB to move over to the modern techniques of interest rate risk measurement like Duration Gap Analysis. Simulation and Value at Risk over time when HFCs acquire sufficient expertise and sophistication in acquiring and handling MIS.

The Gap or Mismatch risk can be measured by calculating Gaps over different time intervals as at a given date. **Gap analysis** measures mismatches between rate sensitive liabilities and rate sensitive assets including off-balance sheet positions. An asset or liability is normally classified as rate sensitive if: **(i)** Within the time interval under consideration, there is a cash flow; **(ii)** Interest rate resets/reprices contractually during the interval; **(iii)** It is contractually prepayable or withdrawable before the stated maturities; and **(iv)** It is dependent on the changes in the bank rate by RBI.

Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets.

The Gap Report should be generated by grouping rate sensitive liabilities, assets and off-balance sheet positions into time buckets according to residual maturity or re-pricing period, whichever is earlier. All investments, advances, deposits, borrowings, purchased funds, etc. that mature/re-price within a specified time-frame are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if the HFC expects to receive it within the time horizon. This includes final principal repayment and interim installments. Certain assets and liabilities carry floating rate of interest that vary with a reference rate and, hence, these items get re-priced at pre-determined intervals. Such assets and liabilities are rate sensitive at the time of re-pricing. While the interest rates on term deposits are generally fixed during their currency, the tranches of advances are basically floating. The interest rate on advances could be re-priced any number of occasions, corresponding to the changes in PLR.

The interest rate gaps may be identified in the following time buckets:

(i) 1 day to 30/31 days (one month)
(ii) Over one month and to 2 months
(iii) Over 2 months and to 3 months
(iv) Over 3 months and to 6 months
(v) Over 6 months and to 1 year
(vi) Over 1 year and to 3 years
(vii) Over 3 years and to 5 years
(viii) Over 5 years and to 7 years
(ix) Over 7 years and to 10 years
(x) Over 10 years
(xi) Non-sensitive

The various items of rate sensitive assets and liabilities and off-balance sheet items may be classified into various time-buckets.

The **Gap** is the difference between Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative gap indicates that it has more RSLs. The Gap reports indicate that whether the institution is in a position to benefit from rising interest rate by having a positive Gap (RSA > RSL) or whether it is in position to benefit from declining interest rates by a negative GAP (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Gap is the difference between rate sensitive assets and rate sensitive liabilities for each time bucket.

Each HFC should set prudential limits on individual Gaps in various time buckets with the approval of the Board/Management Committee. Such prudential limits should have a relationship with the total assets, earning assets or equity. In addition to the interest rate gap limits, the HFCs may set the prudential limits in terms of Earnings at Risk (EaR) or Net Interest Margin (NIM) based on their views on interest rate movements with the approval of the Board/ALCO.

General

The classification of various components of assets and liabilities into different time buckets for preparation of Gap reports (Liquidity and Interest Rate Sensitivity) as is the bench mark. The HFCs which are better equipped to reasonably estimate the behavioural pattern of various components of assets and liabilities on the basis of past data/empirical studies could classify them in the appropriate time buckets, subject to approval by the ALCO/Board. A copy of the note approved by the ALCO/Board may be sent to the NHB.

The present framework does not capture the impact of premature closure of deposits and pre-payment of loans and advances on the liquidity and interest rate risks profile of HFCs. The magnitude of premature withdrawal of deposits during the periods of volatility in market interest rates is quite substantial. The HFCs should, therefore, evolve suitable mechanism, supported by empirical studies and behaviorual analysis, to estimate the future behaviour of assets, liabilities and off-balance sheet items to changes in market-variables and estimate the probabilities of options.

A scientifically evolved internal transfer pricing model by assigning values on the basis of current market rates to funds provided and funds used is an important component for effective implementation of ALM system. The transfer price mechanism can enhance the management of margin, i.e., lending of credit spread/the funding or liability spread and mismatch spread. It also helps centralising interest rate risk at one place which facilitates effective control and management of interest rate risk. A well defined transfer pricing system also provides a rational framework for pricing of assets and liabilities.

FAIR TRADE PRACTICES CODE FOR HFCs

While piloting the *Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act* in Parliament, the Finance Minister, by way of moderating the possible misuse of powers under the Act by banks/financial institutions, gave an assurance to bring out a Code of Fair Practices defining lenders liability to the borrowers in respect of loans and advances extended by them. As a follow-up, the RBI had prepared in 2006 the broad guidelines to be adopted by banks/financial institutions with the approval of their Board of Directors. The NHB has issued similar guidelines for the HFCs. **These are given in Appendix 5-A on the website. The website address is http://www.mhhe.com/khanfs9e.**

> **Securitisation** is the process of pooling and repackaging of homogeneous illiquid financial assets (debt) into marketable securities that can be sold to investors.

SECURITISATION

Concept

Securitisation is the process of pooling and repackaging of homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool, of assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured, for example, credit card debt and consumer loans.

Securitisation Process

The securitisation process is listed below:

1. Asset are originated through receivables, leases, housing loans or any other form of debt by a company and funded on its balance sheet. The company is normally referred to as the "originator".
2. Once a suitably large portfolio of assets has been originated, the assets are analysed as a portfolio and then sold or assigned to a third party, which is normally a special purpose vehicle company ("SPV") formed for the specific purpose of funding the assets. It issues debt and purchases receivables from the originator. The SPV is owned by a trust/the originator.
3. The administration of the asset is then subcontracted back to the originator by the SPV. It is responsible for collecting interest and principal payments on the loans in the underlying pool of assets and transfer to the SPV.
4. The SPV issues tradable securities to fund the purchase of assets. The performance of these securities is directly linked to the performance of the assets and there is no recourse (other than in the event of breach of contract) back to the originator.
5. The investors purchase the securities because they are satisfied that the securities would be paid in full and on time from the cash flows available in the asset pool. The proceeds from the sale of securities are used to pay the originator.
6. The SPV agrees to pay any surpluses which, may arise during its funding of the assets, back to the originator. Thus, the originator, for all practical purposes, retains its existing relationship with the borrowers and all of the economies of funding the assets.
7. As cash flow arise on the assets, these are used by the SPV to repay funds to the investors in the securities.

Credit Enhancement

Investors in securitised instruments take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the originator. Hence, they seek additional comfort in the form of **credit enhancement**. It refers to the various means that attempt to buffer investors against losses on the asset collateralising their investment. These losses may vary in frequency, severity and timing, and depend on the asset characteristics, how they are originated and how they are administered. The credit enhancements are often essential to secure a high level of credit rating and for low cost funding. By shifting the credit risk from a less-known borrower to a well-known, strong, and larger credit enhancer, credit enhancements correct the imbalance of information between the lender(s) and the borrowers. They are either external (third party) or internal (structural or cash-flow-driven).

Credit enhancement refers to the various means that attempt to buffer investors against losses on the asset collateralising their investment.

External Credit Enhancements They include insurance, third party guarantee and letter of credit.

Insurance Full insurance is provided against losses on the assets. This tantamounts to a 100 per cent guarantee of a transaction's principal and interest payments. The issuer of the insurance looks to an initial premium or other support to cover credit losses.

Third-Party Guarantee This method involves a limited/full guarantee by a third party to cover losses that may arise on the non-performance of the collateral.

Letter of Credit For structures with credit ratings below the level sought for the issue, a third party provides a letter of credit for a nominal amount. This may provide either full or partial cover of the issuer's obligation.

Internal Credit Enhancements Such form of credit enhancement comprise the following:

Credit Tranching (Senior/Subordinate Structure) The SPV issues two (or more) tranches of securities and establishes a predetermined priority in their servicing, whereby first losses are borne by the holders of the subordinate tranches (at times the originator itself). Apart from providing comfort to holders of senior debt, credit tranching also permits targeting investors with specific risk-return preferences.

Over-collateralisation The originator sets aside assets in excess of the collateral required to be assigned to the SPV. The cash flows from these assets must first meet any overdue payments in the main pool, before they can be routed back to the originator.

Cash Collateral This works in much the same way as the over-collateralisation. But since the quality of cash is self-evidently higher and more stable than the quality of assets yet to be turned into cash, the quantum of cash required to meet the desired rating would be lower than asset over-collateral to that extent.

Spread Account The difference between the yield on the assets and the yield to the investors from the securities is called **excess spread**. In its simplest form, a spread account traps the excess spread (net of all running costs of securitisation) within the SPV up to a specified amount sufficient to satisfy a given rating or credit equity requirement. Only realisations in excess of this specified amount are routed back to the originator. This amount is returned to the originator after the payment of principal and interest to the investors.

> **Excess spread** is the difference between the yield on the assets and the yield to the investors form the securities.

Triggered Amortisation This works only in structures that permit substitution (for example, rapidly revolving assets such as credit cards). When certain preset levels of collateral performance are breached, all further collections are applied to repay the funding. Once amortisation is triggered, substitution is stopped and the early repayment becomes an irreversible process. The triggered amortisation is typically applied in future flow securitisation.

Parties to a Securitisation Transaction

The parties to securitisation deal are **(i)** primary and **(ii)** others. There are three primary parties to a securitisation deal, namely, originators, special purpose vehicle (SPV) and investors. The other parties involved are obligors, rating agency, administrator/servicer, agent and trustee, and structurer.

Originator This is the entity on whose books the assets to be securitised exist. It is the prime mover of the deal, that is, it sets up the necessary structures to execute the deal. It sells the assets on its books and receives the funds generated from such sale. In a true sale, the originator transfers both the legal and the beneficial interest in the assets to the SPV.

Originator is the entity on whose books the assets to be securitised exist.

SPV An issuer, also known as the SPV, is the entity, which would typically buy the assets to be securitised from the originator. An SPV is typically a low-capitalised entity with narrowly defined purposes and activities, and usually has independent trustees/directors. As one of the main objectives of securitisation is to remove the assets from the balance sheet of the originator, the SPV plays a very important role in as much as it holds the assets in its books and makes the upfront payment for them to the originator.

SPV is the entity which would buy the assets to be securitised from the originator.

Investors The investors may be in the form of individuals or institutional investors like FIs, mutual funds, provident funds, pension funds, insurance companies and so on. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per agreed pattern.

Obligor(s) The obligors are the originators-debtors (borrowers of the original loan). The amount outstanding from an obligor is the asset that is transferred to an SPV. The credit standing of an obligor(s) is of paramount importance in a securitisation transaction.

Obligors are the borrowers of the original loan.

Rating Agency Since the investors take on the risk of the asset pool rather than the originator, an external credit rating plays an important role. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.

Administrator or Servicer It collects the payment due from the obligor(s) and passes it to the SPV, follows up with delinquent borrowers and pursues legal remedies available against the defaulting borrowers. Since it receives the instalments and pays it to the SPV, it is also called the Receiving and Paying Agent (RPA).

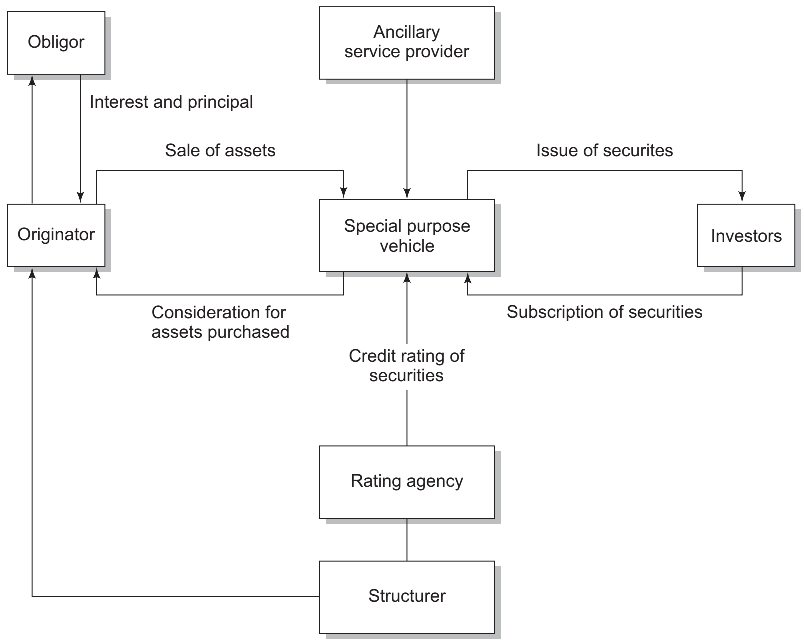
Agent and Trustee It accepts the responsibility for overseeing that all the parties to the securitisation deal perform in accordance with the securitisation trust agreement. Basically, it is appointed to look after the interest of the investors.

Structurer Normally, an investment banker is responsible as structurer for bringing together the originator, the credit enhancer(s), the investors and other partners to a securitisation deal. It also works with the originator and helps in structuring deals.

Structurers bring together all the parties to a securitisation deal.

The different parties to a securitisation deal have very different roles to play. In fact, firms specialise in those areas in which they enjoy competitive advantage. The entire process is broken up into separate parts with different parties specialising in origination of loans, raising funds from the capital markets, servicing of loans and so on. It is this kind of segmentation of market roles that introduces several efficiencies securitisation is so often credited with. **The securitisation process is depicted in Fig. 5.1.**

Exhibit 5.2 Securitisation Process



Asset Characteristics

The assets to be securities should have the following characteristics.

Cash Flow A principal part of the assets should be the right to receive from the debtor(s) on certain dates, that is, the asset can be analysed as a series of cash flows.

Security If the security available to collateralise the cash flows is valuable, then this security can be realised by a SPV.

Distributed Risk Assets either have to have a distributed risk characteristic or be backed by suitably-rated credit support.

Homogeneity Assets have to relatively homogenous, that is, there should not be wide variations in documentation, product type or origination methodology.

No Executory Clauses The contracts to be securitised must work even if the originator goes bankrupt.

Independence from the Originator The ongoing performance of the assets must be independent of the existence of the originator.

Instruments of Securitisation

Securitisation can be implemented by three kinds of instruments differing mainly in their maturity characteristics. They are: **(i)** Pass through certificates, **(ii)** Pay through securities, **(iii)** Stripped securities.

Pass Through Certificates (PTCs) The cash flows from the underlying collateral are "passed through" to the holders of the securities in the form of monthly payment of interest, principal and pre-payments. In other words, the cash flows are distributed on a pro-rata basis to the holders of the securities. The pre-payments occur when the holder of the underlying asset prepays the remaining principal before the final scheduled payment month. Any pre-payment is also proportionately passed on to the security holders leading to the quicker retirement of their underlying principal. Critical to pricing of pass through are the specific features of that particular collateral. All the securities are terminated simultaneously as the last payment on the pool leads to its complete amortisation. Some of the main features of PTCs are:

> **PTCs**
> involve distribution on pro-rata basis of cash flows to the holders of securities.

- They reflect ownership rights in the assets backing the securities.
- Pre-payment precisely reflects the payment on the underlying mortgage. If it is a home loan with monthly payments, the payments on securities would also be monthly but at a slightly less coupon rate than the loan.
- As underlying mortgage is self-amortising. Thus, by whatever amount it is amortised, it is passed on to the security holders with repayment.
- Pre-payment occurs when a debtor makes a payment, which exceeds the minimum scheduled amount. It shortens the life of the instrument and skews the cash flows towards the earlier years.

Pay Through Security (PTS) The PTS structure overcomes the single maturity limitations of the pass through certificates. Its structure permits the issuer to restructure receivables flow to offer a range of investment maturities to the investors associated with different yields and risks. The issuer of assets-backed debt are thus freed from the limitations imposed by the pass through structure which simply provides a conduit for sale of ownership interest in the receivables. By contrast, in a PTS structure, the issuer typically owns the receivables and simply sells the debt that is backed by the assets. As a result, the issuer of debt is free to restructure the cash flow from the receivable into payments on several debt tranches with varying maturities.

> **PTS**
> permits the issuer to restructure receivables flow to offer a range of investment maturities to the investors associated with different yields and risks.

A key difference between PTC and PTS is the mechanics of principal repayment process. In PTC, each investor receives a *pro-rata* distribution of any principal and interest payment made by the borrower. Because these assets are self-amortising assets, a pass through, however, does not occur until the final asset in the pool is retired. This results in large difference between average life and final maturity as well as a great deal of uncertainty with regard to the timing of the return of the principal. The PTS structure, on the other hand, substitutes a sequential retirement of bonds for the pro-rata principal return process found in pass through. Cash flows generated by the underlying collateral is used to retire bonds. Only one class of bonds at a time receives principal. All principal payments go first to the fastest pay trance in the sequence then becomes the exclusive recipients of principal. This sequence continues till the last tranches of bonds is retired.

Stripped Securities Under this instrument, securities are classifies as "Interest only" (IO) or Principally only (PO) securities. The IO holders are paid back out of the interest income only while the PO holders are paid out of principal repayments only. However, these securities are highly volatile by nature and are least preferred by the investors. Normally, PO securities increase in value when interest rates go down because it becomes lucrative to prepay existing mortgagor and undertake fresh loans at lower interest rates. As a result of prepayment of mortgages, the maturity period of these securities goes down and investors are returned the money earlier than they anticipated. In contrast, IOs increase in value when interest rates go up because more interest is collected on underlying mortgages. However, in anticipation of a decline in the interest rates, prepayments of mortgages declines and maturities lengthen. These are normally traded by speculators who make money by speculating about interest rate changes.

Types of Securities

The securities fall into two groups:

Asset Backed Securities (ABS) The investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (the originator), or the entity issuing the securities (the SPV). Clearly, classifying securities as 'asset-backed' seeks to differentiate them from regular securities, which are the liabilities of the entity issuing them. An example of ABS is credit card receivables. Securitisation of credit card receivables is an innovation that has found wide acceptance. Although the average tenure of credit available to a credit card holder is generally very short, it is revolving by nature. The lacuna of short tenor of the receivables is, hence, overcome by 'substitution', whereby collections are used for fresh purchases of receivables. Thus, a securitisable asset of marketable tenure comes into being. The structure in the case is generally 'Pay Through', since it is impossible to match the payment made by the card-holder with the payment to the investor.

> **ABS**
> are securities in which investors rely on the performance of the assets that collateralise the securities.

> **MBS**
> are securities backed by the mortgage loans.

> **Securitisation of mortgages**
> is the packaging of designated pool of mortgage loans originated by a primary lending institution/housing finance company (HFC) and the subsequent sale of these packages to the investors in the form of securities which are collateralised by the underlying mortgages and associated income streams.

Mortgage Backed Securities (MBS) The securities are backed by the mortgage loans, that is, loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults.

MORTGAGE-BASED SECURITISATION

Securitisation is a process of converting loans/future receivables into tradebale securities/assignable debt. This process involves packaging designated pools of loans and receivables and selling these packages to various investors in the form of securities which are collatarised by the underlying assets and their associated income streams. **Securitisation of mortgages** is the packaging of designated pool of mortgage loans originated by a primary lending institution/housing finance company (HFC) and the subsequent sale of these packages to the investors in the form of securities which are collateralised by the underlying mortgages and associated income streams.

A typical process of securitisation involves sale of specific loans to a trust/special purpose vehicle (SPV) which in turn issues securities (e.g. promissory notes, participation certificates or other debt instruments) to the investors. The securities are rated by an independent rating agency. On the recommendation of the rating agency, additional credit support other than the obligation of the borrowers is provided in order that the instrument may receive the desired level of rating. Typically, the seller of the loans continues to service them. The excess cash flows (remaining after deducting the interest and principal and other obligations payable to the investors and other fees) accrue to the seller. The features of securitisation transactions include:

- Legal true sale of assets to a SPV with narrowly defined purposes/activities;
- Issuance of securities collateralised by the underlying assets by the SPV to the investors;
- Reliance by the investors on the performance of the assets for repayment rather than the credit of the originator (i.e. seller) or the issuer (i.e. SPV);
- Consequent to the above, 'bankruptcy remoteness" from the originator.
- Administration of the asset by the originator including continuation of relationship with the obligors (i.e. the borrowers of the original loans);
- Support for timely interest payments and principal repayments, *inter alia*, in the form of suitable credit enhancement.

Support to MBS has been a major policy initiative of the Government as manifested in the National Housing and Habitat Policy, 1998. It has enjoined upon the NHB to play a lead role in starting MBS and development of a secondary mortgage market in the country. In accordance with this role, it has been the NHB's endeavour to set up a conducive policy environment and operational mechanism for MBS. It placed the first ever MBS issue successfully in Indian capital market during August 2000. The first two pilot issues of MBS comprised 11,106 individual housing loans involving ₹135 crore, originated by two HFCs, namely, HDFC Ltd and LIC Housing Finance Ltd (LICHFL) in two separate tranches. Following the success of the first pilot issue, the NHB placed its next two pilot issues of MBS during May 2001, comprising 8,549 individual housing loans involving ₹138 crores originated by LICHFL and Canfin Homes Ltd (CFHL) in two separate tranches. The fifth issue of pilot MBS comprised of 4,526 individual loans amounting to ₹85 crore originated by CFHL. The MBS is illustrated in this Section with reference to the sixth issue of pilot MBS originated by the BOB Housing Finance Ltd (BOBHFL) in April 2003. They are available on the website. The website address is **http://www.mhhe.com/khanfs9e**.

REVERSE MORTGAGE LOAN (RML): OPERATIONAL GUIDELINES

The NHB guidelines are available on the website. The website address is **http://www.mhhe.com/khanfs9e**.

REVERSE MORTGAGE LOAN-ENABLED ANNUITY (RMLE-A)

The NHB guidelines are available on the website. The website address is **http://www.mhhe.com/khanfs9e**.

HOUSING FINANCE AGENCIES

The implementation of housing finance policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid-eighties in as much as it had not been integrated with the main financial system of the country. The setting-up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India, as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in India. The system has also been characterised by the emergence of several specialised financial institutions that have considerably strengthened the organisation of the housing finance system in the country. At present, there are about 320 housing finance companies, of which 26 are registered with the NHB and which account for 98 per cent of the total housing loan disbursed. A brief account of some of the institutions/agencies is given below.

Central and State Governments

Till the mid-eighties, the responsibility to provide housing finance rested, by and large, with the government. The Central and state governments indirectly support the housing building effort. The Central Government has introduced, from time to time, various social housing schemes. The role of the Central Government *vis-à-vis* these schemes is confined to laying down broad principles, providing necessary advice and rendering financial assistance in the form of loans and subsidies to the state governments and union territories. The Central Government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programmes, development of land for satellite towns, besides setting up of a building materials industry.

The Central Government provides equity support to the HUDCO and guarantees the bonds issued by it. Apart from this, both Central and state governments provide house building advances to their employees. While the Central Government formulates housing schemes, the state governments are the actual implementing agencies.

Housing and Urban Development Corporation (HUDCO)

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

(i) To provide long-term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.
(ii) To finance or undertake the setting-up of new satellite towns.
(iii) To finance or undertake the setting-up of the building materials industries.
(iv) To administer the monies received, from the Government of India and other such grants, for purposes of financing or undertaking housing and urban development programmes.
(v) To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities and so on, specifically for the purpose of financing housing and urban development programmes.

In brief, the principal mandate of the HUDCO was to ameliorate the housing conditions of the low income group (LIG) and economically weaker sections (EWS).

Resource Base The HUDCO was established with an equity base of ₹2 crore. Over the years, the equity base has been expanded by the Government. It has further been able to mobilise resources from institutional agencies like LIC, GIC, UTI, banks, international assistance (KfW, OECF, ODA, USAID), as well as through public deposits.

Form of Assistance The HUDCO extends assistance, benefiting masses in urban and rural areas, under a broad spectrum of programmes given below.

Housing Rural housing, cooperative housing, urban employment through housing and shelter upgradation.

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

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

Training Training in human settlements and technical assistance to all borrowing agencies.
Financial assistance from the HUDCO for these projects is made available to agencies that include state housing boards, rural housing boards, slum clearance boards, development authorities, improvement trusts, municipal corporations, primary cooperative societies and so on.

It follows a differential interest rate policy for various categories of households, with overriding emphasis on a concessional rate of lending for EWS and LIG families. Such a differential rate policy provides an incentive for the executing agencies to promote housing for the less privileged and help reduce the loan repayment by the families to bring it within affordable limits. The repayment period is 10—15 years.

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

Income category	*Extent of financing of the house cost (percentage)*
Economically weaker section (EWS)	90
Low income groups (LIG)	85
Middle income groups (MIG)	75
High income group (HIG)	60

Urban Infrastructure The HUDCO has also been entrusted with the responsibility of financing urban infrastructure projects with additional equity support provided by the Ministry of Urban Development, Government of India. The infrastructure projects cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars/terminals, commercial and social infrastructure, roads/bridges, area development projects and so on.

The HUDCO plans to stress, in future, on expansion of urban infrastructure lending, housing delivery through expanded avenues including retail financing, increased consultancy assistance, services for projects in India and abroad, impetus to building, technology transfer initiatives and in-house research and training programmes with national/international working.

Insurance Organisations/Corporations

The LIC and GIC support housing activity both directly and indirectly. Besides subscribing to bonds of the HUDCO and state housing boards, LIC grants loans to the states for their rural housing programmes and to public sector companies for construction of staff quarters. Though the LIC has been granting loans directly to individuals, the thrust to housing finance was provided when, in June 1989, it promoted a subsidiary for the purpose, namely the LIC Home Finance Ltd.

The GIC supports housing almost exclusively, indirectly, by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called the GIC Housing Finance Ltd. in July 1990, to enable it to lend directly to individuals.

Commercial Banks

The trend of commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the *Role of Banking System in Providing Finance for Housing Schemes*. (R C Shah Working Group, the RBI, 1978). They have been lending to the housing sector based on annual credit allocations made by the RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate 1.5 per cent of their incremental deposits for disbursing as housing finance every year. Of this allocation, 20 per cent has to be by way of direct housing loans of which again at least half, that is, 10 per cent of the allocation has to be in rural and semi-urban areas. Another 30 per cent could be for indirect lending by way of term loans to housing finance institutions (HFIs), housing finance companies (HFCs) and public housing agencies for the acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to the HUDCO, and the NHB bonds.

Cooperative Banks

The cooperative banking sector consists of state cooperative banks (SCBs), district central cooperative banks (DCBs) and primary urban cooperative banks (PUCBs). The first set of comprehensive guidelines for these cooperative banks were issued in 1984 by the RBI. Cooperative banks finance individuals, cooperative group housing societies, housing boards and others who undertake housing projects for the EWS, LIGs, and MIGs.

Specialised Housing Finance Institutions (HFIs)

There are certain institutions termed as 'Specialised HFIs', which cater only to the needs of the housing sector. They can further be classified as housing finance companies (HFCs) promoted in the public/joint/private sectors and cooperative housing finance societies. A lead player in the HFC category is the HDFC Ltd. It lends mainly for new residential housing to individuals, group of individuals and individual members of cooperative societies.

Besides the HDFC, a number of HFCs have been sponsored by banks such as the SBI Home Finance Ltd, Canfin Homes Ltd, Indbank Housing Finance Ltd, Citihome and so on.

RBI MORTGAGE GUARANTEE COMPANIES (MGCS) DIRECTIONS, 2016

A **MCG** means a company registered with the RBI which primarily transacts the business of providing **mortgage guarantee** for the repayment of outstanding **housing loan** (for construction/repair/upgradation or acquisition of a house/residential property or both) to a **credit institution** (bank/HFC) on the occurrence of a **trigger event** (i.e. classification of the account of the borrower as NPA in the books of the credit institution). The main elements of the Directions are: **(a)** general guidelines, **(b)** prudential regulations, **(c)** investment policy, and **(d)** miscellaneous instructions.

General Guidelines

The main elements of the general guidelines **(i)** registration with the RBI, **(ii)** other activities, **(iii)** features of mortgage guarantee, and **(iv)** funding operations are discussed below.

Registration A MGC should commence business after **(i)** obtaining a certificate of registration (CoR) from the RBI; and **(ii)** having a minimum net owned fund of ₹100 crore. The application for registration should be made in RBI-specified form. For considering the application for registration, the RBI should be satisfied that the following conditions are fulfilled: **(i)** the MGC **(a)** would primarily transact the business of providing mortgage guarantee, that is, at least 90 per cent of its business turnover/gross income is from mortgage guarantee business. **Business turnover** means total mortgage contract (i.e. tripartite contract among the borrower/creditor institution/MGC) entered during the year together with the volume of business arising out of specially permitted other activities undertaken during the year,**(b)** would be in a position to pay its liabilities arising from the contracts of guarantee it may enter into, **(c)** has adequate capital structure (discussed later) and earning prospects from mortgage guarantee business; **(ii)** the general character of its management/proposed management would not be prejudicial to the public interest; **(iii)** its Board of Directors does not consist of more than half of its total number of directors who are either nominees of any shareholder with substantial interest or associated in any manner with them or any of the subsidiaries of the shareholder with substantial interest if such a shareholder is a company; **(iv)** the MGC would **(a)** have a well diversified shareholding, **(b)** not be a subsidiary of any other company including a company registered outside India. No individual/association/body of individuals whether incorporated or not/partnership firm/company would, directly or indirectly, have any controlling interest in it; **(v)** the eligible foreign direct investment in the equity of the MGC should have the prior approval of Foreign Investment Promotion Board (FIPB). If the foreign entity which has received FIPB/FED approval is having substantial interest in the applicant MGC, it should be regulated by a home country financial regulator and should itself preferably be a MGC and have a good track record. However, this would not be applicable if the investor of a MGC is international financial institution; **(vi)** the public interest would be served by the grant of CoR to commence/carry on the business in India. The grant of CoR would not be prejudicial to the operation and growth of the housing finance sector of the country; **(vii)** the MGC is compliant with the applicable norms for foreign investment; and **(viii)** any other condition, fulfilment of which, in the opinion of the RBI, would be necessary to ensure that the commencement of/carrying on the business in India by a MGC would not be prejudicial to the public interest and the housing finance sector in India.

After being satisfied that the specified conditions are fulfilled, the RBI would grant the CoR subject to conditions which it may consider fit to impose. The MGC would be under the regulatory and supervisory jurisdiction of the RBI. It may cancel a CoR, if the company **(i)** ceases to carry on its business; or **(ii)** has failed to comply with any condition subject to which the CoR has been issued; **(iii)** has failed to honour, in a timely manner, the claims arising from the contract of guarantee it has entered into/may enter into; **(iv)** at any time fails to fulfil any of the above specified conditions; **(v)** fails to **(1)** comply with any direction issued by the RBI, **(2)** maintain accounts, publish and disclose its financial position in accordance with the requirements of any law/direction/order issued by the RBI, **(3)** submit or offer for inspection its books of account/ other relevant documents when demanded by the RBI.

Other Activities A MGC can take up any activity up to 10 per cent of its total assets. If it undertakes any other business within the permitted limit, the prescribed prudential norms for valuation of investments, asset classification and provisioning should be followed.

Essential Features of a Mortgage Guarantee The essential features of a mortgage guarantee contract should be as follows: It should be **(a)** a contract of guarantee, **(b)** unconditional and irrevocable and free from coercion/undue influence/fraud, misrepresentation, and/or mistake under the Indian Contract Act, **(c)** guarantee the repayment of the principal and interest outstanding in the housing loan account of the borrower, up to the amount of guarantee. The guarantor should pay the guaranteed amount on invocation without any adjustment against the realisable value of the mortgage property. It should be a tri-partite contract among the borrower/creditor institution/ MGC. It should not carry on insurance business.

Funding Options The MGCs would not **(i)** accept public deposits, **(ii)** avail external commercial borrowings.

Prudential Regulation

The MGCs would be required to comply with various prudential guidelines including those relating to **(i)** minimum capital, **(ii)** capital adequacy, **(iii)** income recognition, **(iv)** asset classification, **(v)** accounting year, **(vi)** concentration of credit/investment, **(vii)** creation/maintenance of reserves, **(viii)** accounting standards, **(ix)** accounting of unearned premium, **(x)** provisioning, **(xi)** disclosure in balance sheet, **(xii)** transaction in Government securities, **(xiii)** classification and valuation of investments and prudential exposures issued by the RBI.

Minimum Capital Requirement The MGC should have a minimum net owned fund of ₹ 100 crore at the time of commencement of business, which would be reviewed for enhancement after 3 years. It should maintain **(i)** a capital adequacy ratio consisting of Tier-I and Tier-II capital of not less than 10 per cent of its aggregate risk weighted assets of on balance sheet and of risk adjusted value of off-balance sheet items or any other percentage prescribed by the RBI, **(ii)** at least 6 per cent as Tier-I capital. The total of Tier-II capital should not exceed 100 per cent of Tier-I capital.

Income Recognition The MGCs should book income/dividend on **(i)** securities of corporate books/ public sector undertaking, **(ii)** shares of corporate bodies, **(iii)** Government securities/bonds/ debentures of corporate bodies, **(iv)** units of mutual funds on the same basis as are applicable to the HFCs (**discussed in the earlier Section**). Their income including interest/discount/other charges on NPA/NPA taken over from creditor institution on happening of trigger event should be recognised only on cash basis. It should account the premium/fee on the mortgage guarantee contracts as an income in the profit and loss account in accordance with the accounting standards issued by the Institute of Chartered Accountants of India (ICAI). The amount of unearned premium should be shown as a separate line on the liability side of the balance sheet. Income from any other business should be recognised as per income recognition norms prescribed for them.

Asset Classification/Accounting Year/Concentration of Credit/Investment The norms applicable to the HFCs (**discussed in earlier Section**) are applicable to the MGCs also.

Creation and Maintenance of Contingency Reserves A MGC should create and maintain a contingency reserve on an ongoing basis. It should appropriate each year at least 40 per cent of the premium/fee earned or 25 per cent of the profit, after provision and tax, whichever is higher, to the reserves. In case of inadequate profits, the appropriation would result in/increase the amount of carry forward loss. It may appropriate a lower percentage (24 per cent) when the provisions towards losses on account of settlement of mortgage guarantee claims exceeds 35 per cent of the premium/fee earned. It should **(i)** ensure that the reserves is built up to at least 5 per cent of the total outstanding mortgage guarantee commitments, **(ii)** retain the appropriate amount for a minimum period of 7 subsequent years, **(iii)** utilise the reserve without the RBI's prior approval solely for meeting and making good the losses suffered by the mortgage holders only after exhausting all other avenues and options to recoup the losses. In all other cases of its utilisation, its prior approval should be obtained, **(iv)** show the amount of reserve as a separate line item on the liability side of the balance sheet. However, it may be treated as **free reserves** for the purpose of net owned fund.

Accounting of Unearned Premium A MGC should account the premium/fee on the mortgage guarantee contracts as an income in the profit and loss account in accordance with the accounting standards issued by the ICAI. The amount of unearned premium should be shown as a separate line on the liability side of the balance sheet.

Provisioning Requirements relate to **(i)** losses on invoked guarantees, **(ii)** incurred but not-reported (IBNR) losses, **(iii)** mortgage guarantee assets.

Provision for Losses on Invoked Guarantee A MGC is exposed to a potential loss when its guarantee is invoked. It should hold provisions for losses in respect of the invoked guarantees pending recovery of assets equal to the contract-wise aggregate of **amount of invocation** after adjusting the realisable value of the assets held in respect of each housing loan where the guarantee has been invoked. In case the realisable value of the assets is more than the amount of invocation, the excess should not be adjusted against the shortfall in other invoked guarantees. In case the provision already held is in excess of the amount as computed above, the excess provision may be reversed after full recovery or closure of the invoked guarantee amount or after the account becomes standard. The provisions made each year should be shown as a separate line item in the profit and loss account. The provisions held for losses on settlement of invoked guarantee should be shown as a separate line item on the liability side of the balance sheet.

Provision for Incurred But-Not-Reported (IBNR) Losses A MGC is exposed to a potential loss when there is a default in a housing loan guaranteed by it. It should hold provisions in respect of them where the trigger event is yet to occur/guarantee is yet to be invoked. The potential loss to which it is exposed to is referred to as **IBNR losses**. The provisions required should be arrived at on an actuarial basis depending upon the estimates of loss frequency/severity derived from historic data, trends, economic factors and other statistical data in relation to the paid claims, the provisions held for claims settled, risk statistics and so on. In case of provisions already held in excess of the above amount, the excess should not be reserved. The provisions should be shown as a separate line item in the profit and loss account. The amount of provision held for IBNR losses should be shown as a separate line item on the liability side of the balance sheet.

Mortgage Guarantee Assets The provisions requirement in respect of mortgage guarantee assets classified as loss, doubtful, substandard and standard are the same as are applicable to the HFCs (**discussed in the earlier Section**).

Disclosure in the Balance Sheet Every MGC should separately disclose in its balance sheet the provisions without netting them from the income or against the value of assets. They should be distinctly indicated under separate heads of account separately for mortgage guarantee business and others and individually for each type of assets for bad and doubtful debts and depreciation in investments and made from the profit and loss account.

Transactions in Government Securities Every MGC may undertake transactions in Government securities through the CSGL account or its demat account only.

Investment Policy

Included in the investment policy are the **(i)** instruments, **(ii)** pattern of investments and **(iii)** accounting for investments.

Instruments A MGC should invest only in the following instruments: **(i)** Government securities, **(ii)** Government guaranteed securities of corporate bodies/public sector undertakings, **(iii)** Fixed deposit/certificate of deposits/bonds of banks/public financial institutions (PFIs), **(iv)** Listed and rated corporate debentures/bonds, **(v)** Fully debt-oriented mutual fund units, and **(vi)** Unquoted Government securities and guaranteed bonds. However, it may hold investments in quoted or unquoted equity shares of company or other unquoted investments acquired in satisfaction of its debt which should be disposed of within 3 years/period extended by the RBI, from the date of such acquisition.

Pattern of Investments A MGC should hold atleast 25 per cent of its total investment portfolio in Central/State Government securities. The remaining investments may be invested as its Board of Directors considers prudent, with a ceiling of 25 per cent in any one category, that is, listed and rated corporate bonds/debentures or debt-oriented mutual fund units and so on. Its Board of Directors may fix an appropriate sub-limit for individual investments within each category. The minimum investment grade rating assigned by the SEBI-registered rating agencies would be required for investment by it in bonds/debentures and debt-oriented mutual funds.

Accounting for Investments Quoted investments should, for the purpose of valuation, be grouped into the following categories **(1)** Government securities including treasury bills, **(2)** Government guaranteed bonds/securities, **(3)** bonds of banks/PFIs, **(4)** debentures/bonds of corporate, and **(5)** units of mutual fund. They should be valued at the lower of the cost or market value, except Government securities/guaranteed bonds/securities which may be treated as **held to maturity** (**HTM**) for the purpose of valuation. The MGC can effect the transfer of the Government security from **HTM** category to **AFS** (available for sale) category at the beginning of each half year, on April 1 or October 1, with the approval of its Board of Directors provided the principal amount is reinvested in another Government security. The investment classified under HTM need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. The book value of the security should continue to be reduced to the extent of the amount amortised during the relevant accounting period. However, if any security out of this bouquet is traded before maturity, the entire category will be treated as securities held for trade/AFS and will have to be mark to marked (MTM). The investments in each category should be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value is less than the aggregate cost, the net depreciation should be provided for or charged to the profit and loss account. If the aggregate market value exceeds the aggregate cost, the net appreciation should be ignored. Depreciation in one category of investments should not be set off against appreciation in another category. All other investments should be MTM.

Unquoted investments acquired in satisfaction of its debts should be valued as under: **(i)** units of mutual funds at the net asset value (NAV) declared by the mutual fund in respect of each particular scheme; **(ii)** equity shares at cost or breakup value, whichever is lower. However, the MGC may substitute fair value for the breakup value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, its shares would be valued at rupee one per company; **(iii)** preference shares at cost or face value, whichever is lower. Unquoted debentures should be treated as term loans or other type of credit facilities depending upon their tenure for income recognition and asset classification.

The MGCs with the approval of their Board should frame an investment policy in tune with these directions.

Miscellaneous Instructions

The main elements of the RBI instructions to the MGC are: **(i)** maintenance of register of guarantees, **(ii)** obligations, **(iii)** due diligence, **(iv)** information relating to change of address/directors/auditors, **(v)** prohibitions, **(vi)** constitution of audit committees, **(vii)** policy for grant of guarantee, **(viii)** scheme of mortgage guarantee, and **(ix)** counter guarantee.

Maintaining Register of Guarantees Every MGC should keep register(s) to enter the particulars of guarantee provided, namely, **(a)** name and address of the borrower/co-borrower, **(b)** date and amount of loan sanctioned, **(c)** brief description of the property including its site/location, **(d)** nature of security available for the loan, **(e)** tenure of the loan, **(f)** amount of each instalment and due date for its payment, **(g)** name and addresses of the bank/HFC to whom the guarantee has been provided, **(h)** date and amount of the guarantee, and **(i)** duration of the guarantee.

Obligation of MGC Its liability would be as stipulated in the contract of guarantee entered into by and between the MGC/creditor institution/borrower. On any day after a trigger event, the concerned creditor institution would be entitled to invoke the guarantee. It should make good the guarantee liability without demur as and when a notice of demand for its payment is received by it. If a housing loan turns into a NPA and the creditor institution prefers first to realise the loan by resorting to speedy recovery procedures prescribed in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, and realises some amount of the loan from the borrower, the liability of the MGC will stand reduced to that extent. The LTV (loan to value) ratio for a MGC for loans below and above ₹ 20 lakh would be 90 and 80 per cent respectively.

Due Diligence Before offering to provide a guarantee for repayment of a housing loan, the MGC should satisfy themselves, *inter-alia*, that the **(i)** loans are secured by a valid mortgage, **(ii)** creditor institution has verified **(a)** title to/marketability of the property and creditworthiness of the borrower, **(b)** use of the land on which the house/residential property is/proposed to be constructed out of the loan obtained from it, and **(c)** obtained a copy of the permission obtained by the borrower from the proper authorities for the purpose of construction of the house/residential property, and **(iii)** loan granted by a creditor institution to a borrower is not more than 90 per cent of the value of the property.

Information Every MGC should communicate to the RBI within one month from the occurrence of any change in the **(a)** complete postal address, telephone/fax number(s) of its registered/corporate office; **(b)** names and residential addresses of its directors, and official designations of its principal officers, **(c)** names and office addresses of its auditors, and **(d)** specimen signatures of the officers authorised to sign on its behalf.

Prohibitions A housing loan which is not secured by a valid mortgage of the house/residential property that is/proposed to be acquired would not be eligible for a mortgage guarantee. The MGC should not **(i)** pay commissions/rebates/other inducements for referral of mortgage guarantee business to any person, **(ii)** provide guarantees on mortgage originations of promoters/subsidiaries/associates and related parties/subsidiaries/associates and related parties of the MGC including companies where it has a material investment/interest of 5 per cent or more of the shareholding, **(iii)** invest in notes or other evidences of indebtedness secured by a mortgage or other lien upon real property. No MGC should lend against its own shares.

Constitution of Audit Committee A MGC should constitute an audit committee consisting of at least 3 non-executive directors of its Board of Directors, at least one of whom should be a chartered accountant. It would have the same powers, functions and duties as laid down in the Companies Act.

Policy for Grant of Guarantee The Board of Directors of a MGC should frame a policy for providing mortgage guarantee to creditor institution stipulating **(a)** the fee/premium chargeable based on specific identified criteria including the quantum of loan, LTV ratio, credit quality of the borrower, credit appraisal/risk management skills of banks/HFC, **(b)** delegation of powers for **(i)** providing a mortgage guarantee and to enter into a contract of guarantee, **(ii)** taking a decision to make good the claims received from banks/HFCs and **(iii)** initiating proceedings for the recovery of its dues from the borrowers.

Scheme of Mortgage Guarantee The MGC should prepare a detailed scheme duly approved by its Board of Directors containing, *inter-alia*, the **(a)** quality of a housing loan, **(b)** maximum portion of a housing loan that may be covered under the contract of guarantee, **(c)** minimum/maximum LTV ratio of a housing loan proposed to be covered under the contract of guarantee, **(d)** fee/premium charge indicating the manner for their payment in consideration for the contract of guarantee, **(e)** its liability as to whether the liability will be co-extensive with that of the borrower or otherwise, and **(f)** conditions governing the issue as to which party of the MGC or bank/HFC would be required to effect recoveries from the borrower after the mortgage guarantee is invoked and the guarantee liability is made good by the MGC to the bank/HFC.

Counter-guarantee Whenever a MGC obtains counter-guarantee cover in respect of the housing loans guarantee by it from another MGC, the MGC and the counter-guarantee company should establish and maintain the required reserves in appropriate proportions in relation to the risk retained by the original MGC and ceded to be assuming counter-guarantee company so that the total reserves would not be less than the required reserves under Indian law. In case the counter-guarantee company is not regulated by the regulator(s) in India, the MGC guaranteeing the claim would hold the relevant reserves and provisions in respect of all the outstanding mortgage guarantee contract issued by it.

RECAPITULATION

- The responsibility to provide housing finance largely rested with the Government of India till the early eighties. The setting up of the NHB in 1988 as the apex/principal housing finance institution marked the beginning of the emergence of housing finance as a fund-based financial service in the country. With the entry of a number of specialised HFIs/HFCs/MGCs, it has grown in volume and depth.
- A diversified housing finance system has emerged in the country. The main components of the system are: **(i)** a large number of HFCs/HFIs, **(ii)** mortgage guarantee companies (MGCs) and **(iii)** the NHB.
- A diversified structure of HFCs/HFIs has emerged in the country. It comprises the HUDCO, insurance organisations, commercial and cooperative banks and specialised HFIs in the public, private and/or joint sectors such as HDFC, SBI Home Finance, Canfin Home, LIC Housing Finance, Indbank Housing Finance, Citihome, Dewan Housing Finance and so on.
- The NHB is the principal housing finance agency in the country. The part played by it in the supply of housing finance falls into three categories: **(i)** promotional **(ii)** regulatory and **(iii)** financial. The promotional role includes promotion of HFCs/HFIs, coordination with the Government and other agencies in securing necessary amendments to the existing laws to remove impediments in the housing sector and encouragement to participation of NGOs and social action groups in housing development. The regulatory powers exercised earlier by the RBI relating to HFCs are now the domain of the NHB. The MGCs are however, regulated by the RBI. The NHB regulates them through directions/guidelines. The financial support by the NHB to the HFCs is in the form of capital and refinance, promotion of loan-linked savings instruments and mortgage-based securitisation.
- The NHB is a body corporate. To carry out its functions, it may borrow money and accept deposits. It may also borrow in foreign currency. It may approach a state government for the recovery of its dues from HFIs/banks in the same manner as arrears of land revenue. To protect its interest, the NHB may call for prepayment before the agreed period of all obligations of the HFCs/banks. Loans/advances against the security of its own bonds by the NHB is totally prohibited. The NHB has the power to inspect the books/accounts/ other documents of any institution to which it has made any loan/advances/any other financial assistance. To discharge its functions effectively, the NHB has power to collect and publish credit information. It is authorised to provide advisory services to the Government/local authorities/other agencies in respect of formulation of policies to promote the growth of housing/HFIs, and legislation relating to matters having a bearing on shelter, housing and settlement.
- To commence/carry on business the HFCs should be registered with the NHB. They should have a minimum NOF of ₹25 lakh and satisfy conditions such as adequate capital structure and earnings prospects, registration is in public interest and would not be prejudicial to the operation and growth of the housing finance sector and so on. Their registration can be cancelled in specified circumstances. At least 5 per cent of the outstanding deposits of the HFCs should be invested in unencumbered approved securities. A reserve fund should be created by them by transfer of at least 20 per cent of their net profits every year. In public interest, it may regulate/prohibit soliciting of deposits by HFCs. It may also determine policy and issue directions to them. Similarly, it may collect information about deposits from them and issue appropriate directions. The auditors of HFCs are obliged to include in their report whether they have furnished the NHB with the statements/information/ particulars relating to, connected with, deposits received by them. The NHB may prohibit any HFC accepting deposits. It may

file an application for winding up of a HFC under the Companies Act. It may also carry out inspection of a HFC. On failure to repay a deposit, the NHB may direct it to repay the deposit.

- The Government in consultation with the NHB may appoint recovery officers for the recovery of dues of HFCs from borrowers who default in repayment of any assistance/instalment or fails to comply with the terms of the agreement.
- With a view to safeguarding the interest of the depositors and promoting the healthy and universal growth of the HFCs, the NHB has issued the **HFCs Directions**. These relate to **(i)** acceptance of deposits by HFCs, **(ii)** prudential norms to be observed by them and **(iii)** matters to be included in the auditors report by their auditors. The main elements of these directions are broadly similar to the RBI directions applicable to the NBFCs (**discussed in Chapter 1 of this book**).
- The ALM process rests on three pillars: ALM Information system, ALM organisation and ALM process. The main elements of the ALM information system are the **(i)** management information system and **(ii)** information availability, adequacy and expending. The ALM organisation consists of structure and responsibilities and levels of top management involvement. The ALM process comprises of risk parameters, risk identification, risk measurement, risk management and risk policies and tolerance levels. The NHB's guidelines relating to the ALM framework of HFCs are broadly similar to the RBI framework applicable to the NBFCs (**discussed in Chapter 1 of this book**).
- Securitisation is the process of pooling and repackaging of homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing assets or pool of assets. the pool of assets collatorises securities.
- Investors in securitised instruments take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the originator. Hence, they seek additional comfort in the form of credit enhancement in terms of the various means that attempt to buffer investors against losses on the asset collateraising their investment. They are either external (third party) or internal (strucutural cashflow-driven). The external credit enhancements include insurance, guarantee and letter of credit. The internal credit enhancements comprise of credit tranching, over collaterisation, cash collateral, spread account and triggered amortisation.
- The parties to a securitisation transaction are the originator, SPV, investors, obligors, rating agency, servicer, trustee and structure.
- The instruments of securitisation are pass through certificates and pass through security. The securities fall into two groups: asset-based and mortgage-based.
- Reverse mortgage seeks to monetise the house as an asset and specifically the owners equity in the house. The major elements of the NHB's operational guidelines relating to reverse mortgage are primary lending institutions, eligible borrowers, eligibility and amount of loan, nature of payment, end-use of funds, period of loan, security, valuation of property, rights to recession, loan disbursement, settlement of loan, prepayment of loan, loan covenants, foreclosure, and counselling of borrowers.
- The main elements of the RBI MCG Directions are: **(a)** general guidelines, **(b)** prudential regulations, **(c)** investment policy, and **(d)** miscellaneous instructions.
- The main elements of the general guidelines relate to **(i)** registration with the RBI, **(ii)** other activities, **(iii)** features of mortgage guarantee, and **(iv)** funding operations.
- The MGCs would be required to comply with various prudential guidelines including those relating to **(i)** minimum capital, **(ii)** capital adequacy, **(iii)** income recognition, **(iv)** asset classifi-

cation, **(v)** accounting year, **(vi)** concentration of credit/investment, **(vii)** creation/maintenance of reserves, **(viii)** accounting standards, **(ix)** accounting of unearned premium, **(x)** provisioning, **(xi)** disclosure in balance sheet, **(xii)** transaction in Government securities, **(xiii)** classification and valuation of investments and prudential exposures issued by the RBI.

- Included in the investment policy are the **(i)** instruments, **(ii)** pattern of investments and **(iii)** accounting for investments.
- The main elements of the RBI instructions to the MGC are: **(i)** maintenance of register of guarantees, **(ii)** obligations, **(iii)** due diligence, **(iv)** information relating to change of address/directors/auditors, **(v)** prohibitions, **(vi)** constitution of audit committees, **(vii)** policy for grant of guarantee, **(viii)** scheme of mortgage guarantee, and **(ix)** counter guarantee.
- Reverse mortgage is a loan against residential mortgage for senior citizens who may not be eligible for any form of mortgage loan. Conceptually, reverse mortgage loan-enabled annuity (RMLe-A) seeks to monetise the owner's equity in the house. This involves senior citizen borrower(s) mortgaging thier house to a lender, who then makes periodic payments to the borrower(s) during the latter's lifetime. The borrower(s) need not repay the principal and interest to the lender during their life time, as long as they are alive and in occupation of the property. On borrower's death or on his leaving the house permanently, the loan along with accumulated interest is settled through sale of the house. After adjusting the principal amount of the loan and accumulated interest, surplus, if any, will go to the estate of the deceased. The borrower(s)/heir(s) can also repay or prepay the loan with interest during the currency of the loan or later and release the mortgage without sale of property without any prepayment charge. The annuity payments are sourced from a life insurance company by the lending institution on behalf of the borrowers. The lender makes periodic annuity payments to the borrower through his or her life time, on behalf of the insurance company. The maximum period of loan is the residual lifetime of the borrower.
- The main elements of the NHB's operational guidelines are **(i)** primary lending/annuity sourcing institutions, **(ii)** eligible borrowers, **(iii)** eligible amount of loan, **(iv)** nature of payment, **(v)** redemption reserves, **(vi)** period of loan, **(vii)** interest, **(viii)** security, **(ix)** valuation of property, **(x)** taxation, **(xi)** right to rescission, **(xii)** loan disbursement, **(xiii)** upfront charges, **(xiv)** service charges, **(xv)** settlement of loan, **(xvi)** prepayment of loan, **(xvii)** loan covenants, **(xviii)** title indemnity, **(xix)** foreclosure, **(xx)** payment adjustments, and **(xxi)** counselling of borrowers.
- The primary lending institutions **(PLIs)** are banks/HFCs, and the annuity-sourcing institutions are life insurance companies.
- The eligible borrowers are **(i)** seior citizen above 60 years of age, **(ii)** married couples as joint borrowers, and **(iii)** blood relatives of senior citizens who are joint owners. They should be clear owners of the self-occupied/acquired house. The house should be free from encumberances, have a minimum value of ₹5 lakh and residual life of at least 20 years.
- The maximum loan to value ratio would range between 60 and 75 for different age group of borrowers ranging between 60 and 80, with an upper limit discretion of 10 per cent.
- The nature of payment may be **(i)** periodic: monthly/quarterly/half-yearly/annual **(ii)** lump-sum, **(iii)** line of credit, **(iv)** any combination of the above.
- The PLIs may set aside a part of the loan as reverse mortgage redemption reserve to be used for settlement of the loan dues on the closure of the RML subject to a maximum of 5 per cent and 10 per cent of property value in case RML-A with and without return of purchase price respectively.
- The eligible end-use of funds are: **(i)** upgradation/renovation/extension/improvement/maintenance/insurance of house, **(ii)** medical purposes/increased hiring expenses/other consumption.
- The maximum loan disbursement tenure would be till the demise of the borrower.

- Fixed/floating rates may be fixed in the usual manner based on risk perception, loan pricing policy and so on.
- The RMLe–A should be secured by way of mortgage of house property.
- The market value of property should be determined through external approved valuers at least once every 5 years. In-house valuers may also be used subject to adequate disclosure of the methodology.
- While all payments under RML are exempt from tax, periodic annuity payments are taxable in the hands of the recipients.
- According to the right of rescission the senior citizens should be given upto 3 days to cancel the transaction after execution of documents and finalisation of loan.
- The PLI will make all the RMLe–A payments directly to bank account of the borrower.
- The PLIs can charge upfront one-time loan processing charge not exceeding the cost paid by the lender/charged to the lender by the providers of services such as appraisal/inspection, property verification/examination, survey and so on.
- The PLIs would be entitled to receive on-going service charges upto 1 and 1.5 per cent of loan in case of with/without return of purchase price respectively.
- The settlement of loan would be met by the proceeds from the sale of the house. The RMRR would be closed and the proceeds directly adjusted with the loan account. Any return from the insurance company would be used for partial settlement of the loan. However, borrowers would have the first right to settle the loan without sale of property. Any surplus would be passed on to the legal heirs/estate beneficiaries of the borrowers.
- The borrower should have the option to prepay the loan at any time during the loan tenure without penalty/charge.
- The PLI should obtain legal opinion for ensuring clarity on the title of the residential property
- The loan would be liable for foreclosure due to occurrences such as **(i)** the borrower has not stayed in the property continuously for one year or fails to pay taxes/maintenance/repair/insurance, **(ii)** the property is donated/abandoned by the borrower, **(iii)** changes in the property affecting the security of the loan, **(iv)** fraud/representation, **(v)** acquisition of the property by the Government and so on.
- The PLI should **(i)** observe/maintain high standard of conduct in its dealings and treat the senior citizens with special care, **(ii)** clearly and accurately disclose the terms of the RMLe-A, the valuation methodology, determination of eligible quantum of loan and so on.

REVIEW QUESTIONS

5.1 Write a brief note on the National Housing Bank as the apex housing finance institution in India.

5.2 Explain briefly the main features of NHB's directions to housing finance companies relating to:
- Acceptance of public deposits
- Prudential norms
- Auditors report

5.3 Explain the features of the corporate governance directions applicable to the HFCs.

5.4 What is securitisation? Discuss briefly the main features of securitisation.

5.5 **(a)** Define mortgage-based securitisation (MBS).
(b) Explain the process with reference to a MBS originated by the NHB recently.

5.6 What are the main features of RBI Directions relating to MCGs?

CHAPTER 6

Insurance Services and Products

Learning Objectives

- Describe the framework of insurance services contained in the Insurance Act.
- Outline the organisation, functions and powers of the Insurance Regulatory and Development Authority (IRDA).
- Review the important regulations issued by the IRDA as a framework for the insurance services/products in India.
- Explain the available insurance products and services in the country in terms of the fundamental principles of insurance, life insurance products and general insurance products.

INTRODUCTION

Insurance is pooling of risks. In a contract of insurance, the insurer (insurance company) agrees/undertakes, in consideration of a sum of money (premium), to make good the loss suffered by the insured against a specified risk such as fire and any other similar contingency or compensate the insured/beneficiaries on the happening of a specified event such as accident or death. Thus, there are two parties to an insurance contract: **(i)** insurer/assurer/underwriter and **(ii)** insured/assured/ beneficiary. The document laying down the terms of the contract is called (insurance) **policy**. The property which is insured is the **subject-matter of insurance**. It may be insured against loss arising from uncertain events/casualties/perils in the form of destruction of, or damage to, the property or death/disablement of a person. The interest which the insured has in the subject-matter of insurance is known as *insurable interest*. Depending on the subject-matter, the types of insurance include, *inter-alia*, the following:

- Life insurance, under which a specified amount becomes payable on the death of the insured or upon the expiry of a specified period of time, whichever is earlier.
- General insurance, which covers losses caused by fire, accident and marine adventures and so on.

The life insurance and general insurance differ in important respects which have significant bearing on the nature of the insurance service/cover. The main points of distinction are listed below:

(i) There is absolute certainty as to the happenings of the event insured against in life insurance. The uncertainty is only about the timing of the event/happening (death). The insurer has, therefore, a fixed obligation to compensate the insured. In the case of general insurance, the event insured against may not happen and the insurance company does not have necessarily to always compensate the other party to the contract.

(ii) The contract of life insurance is not a contract of indemnity. The insurance may be for any amount for which no proof of actual loss is necessary presumably because loss of human life cannot be measured in terms of money. In contrast, in the event of loss in general insurance, as a contract of indemnity, the assured can only recover the actual loss subject to the maximum amount of the policy.

(iii) Insurable interest of the assured in the subject matter in the general insurance must be amenable to monetary measurement which is not possible in life insurance. Moreover, the insurable interest must be present both at the time of contract as well as at the time of loss in fire insurance; but only at the time of loss in marine insurance. The life insurance stipulates such interest only at the time of the contract.

(iv) A contract of the general insurance is an annual contract (fire, accident and so on) or for a particular period/voyage (marine). The life insurance contract is a continuing contract and comes to an end only on default in payments of premium.

This chapter dwells on the nature and types of insurance, as a fund-based financial services. Until 1999, the insurance organisation in India comprised two state-owned monolithic institutions, namely, the Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC) and its four subsidiaries. In order to improve the quality of insurance services in the country, the Malhotra Committee (1993) had recommended a comprehensive framework of reform in the insurance sector. The insurance sector/industry in the country is emerging in response to the follow-up action on the recommendations of the Committee. **The main elements of the framework are the *Insurance Act, 1938, Insurance Regulatory and Development Authority of India Act, 1999,* and the regulations framed under it by the Insurance Regulatory and Development Authority of India (IRDA)**. Reflecting the growth of a diversified insurance sector comprising both public sector institutions and private sector institutions, a wide variety of products/policies are available now. **The organisation of the insurance services sector in India is portrayed in Exhibit 6.1.** Sections 1 – 4 discuss the different facets of the emerging scenario. The last section contains some concluding observations.

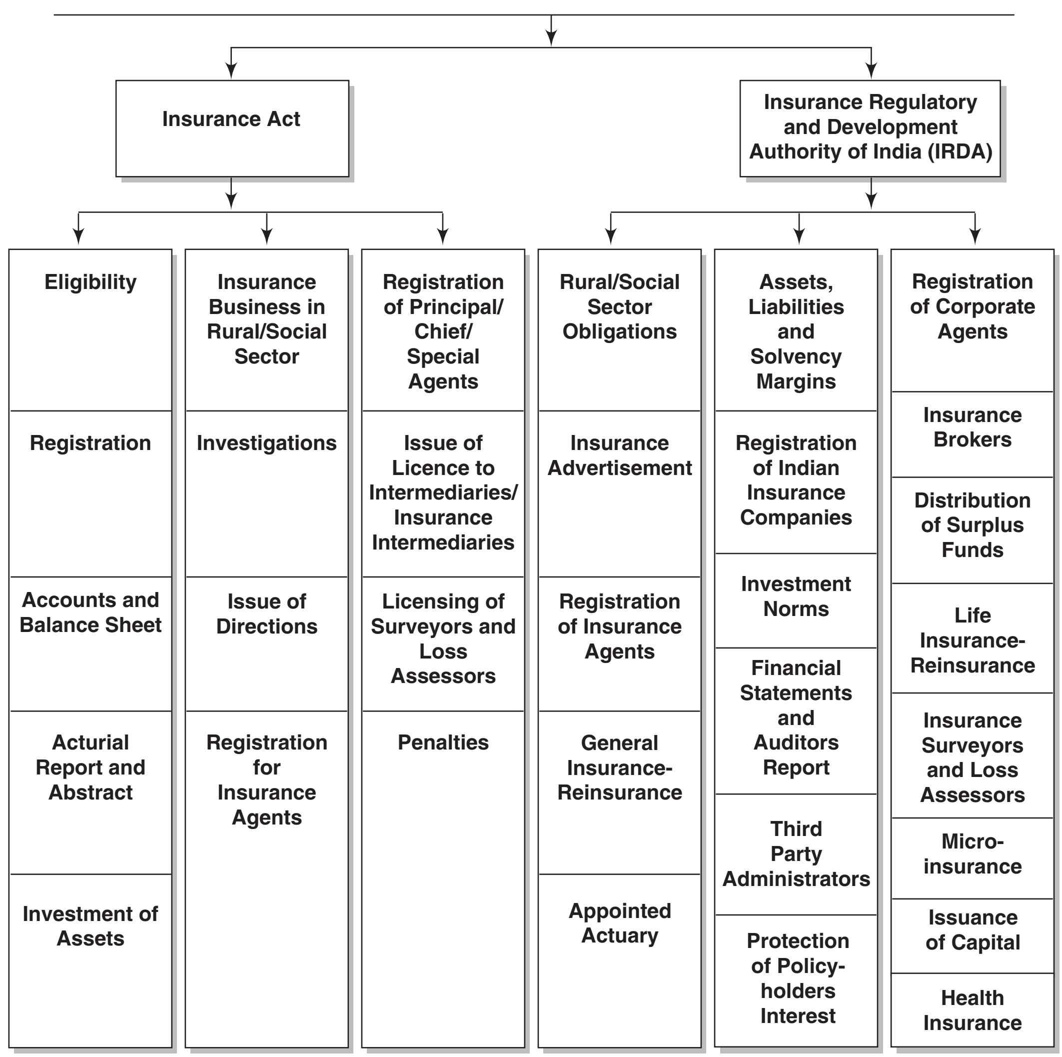
INSURANCE ACT, 1938

The Insurance Act provides the broad framework for the insurance sector/industry/services in the country. This section focuses on some important aspects of the framework contained in the Act.

Eligibility

Any class of insurance business in India can be carried out only by **(i)** a public company **(ii)** a cooperative society **(iii)** an insurance cooperative society, having paid-up capital of ₹100 crore, in which no body corporate holds more than 26 per cent of its paid-up capital and whose sole purpose is to carry on insurance business in India **(iv)** a body corporate other than a private company incorporated in any country outside India. However, only Indian insurance companies are permitted to carry out any class of insurance business after the enactment of the IRDA Act, 1999. An **Indian insurance company** is defined as a company formed/registered under the Companies Act, in which the aggregate holding of equity shares by a foreign investor including

Exhibit 6.1 Insurance Services Organisation in India



portfolio investors does not exceed 49 per cent paid-up equity capital, which is Indian owned and controlled in the prescribed manner and whose sole purpose is to carry on life/general/reinsurance/health business. **Control** includes the right to appoint a majority of the directors or to control the management/policy decisions including by virtue of their shareholding/management rights/shareholders agreement/voting agreements. **Life business** means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of

Life business means the business of effecting contracts of insurance upon human life.

premiums for a term dependent on human life, and should be deemed to include **(a)** grant of disability and double/triple indemnity accident benefits, **(b)** grant of annuities upon human life and **(c)** grant of superannuation allowance/benefits payable out of any fund applicable solely to the relief and maintenance of persons engaged; or who have been engaged in any particular profession/trade/employment; or of the dependents of such persons. **General insurance** business is defined to mean fire, marine/miscellaneous insurance business whether carried on singly or in combination with one/more of them. **Fire insurance** business means the business of effecting, other than incidental, to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies.

Marine insurance business means the business of effecting contracts of insurance upon vessels of any description including cargos, freights and other interests which may be legally insured in or in relation to such vessels, cargos and freights, goods/wares/merchandise/property of whatever description insured for any transit by land or water or both and whether or not including warehouse risks or similar risks in addition or as incidental to such transit, and includes any other risks customarily included among the risks insured in marine insurance policies.

Miscellaneous insurance business means the business of effecting contracts of insurance which is not principally or wholly of any kind/kinds included in fire, life, and marine insurance.

Health insurance business means contracts which provide for sickness/medical/surgical/hospital expenses benefits whether in/out-patient travel/personal accident cover.

Registration

To carry on business, insurance companies should be registered with the IRDA. The application for registration should be made in a manner and accompanied by documents as may be specified by its regulations.

On being satisfied that **(i)** the financial condition and the general character of the management of the applicant are sound; **(ii)** the volume of its business, capital structure and earnings prospects would be adequate; **(iii)** the interests of the general public would be served and **(iv)** it has complied with the provision of **Section 2–C** (eligibility of the applicant discussed earlier), **Section 5** (restriction on name of insurer) and **Section 31-A** (provision relating to managers) and has fulfilled all the requirements of registration applicable to him, may register the applicant and grant a certificate of registration. The IRDA will prefer that applicants carry on life/general insurance business for providing health cover to individuals/groups of individuals. The IRDA may refuse registration for recorded reasons. Within 30 days, and aggrieved party may appeal to the SAT. If satisfied that an insurer having joint venture with a person having its principal place of business outside India/a foreign company engaged in re-insurance business through an Indian branch has been debarred by law/practice of that country to carry on insurance business, the IRDA may withhold registration already made.

Cancellation of Registration The IRDA will suspend/cancel the registration of an insurer if **(i)** he is in liquidation or adjudged an insolvent, **(ii)** he fails to comply with the requirement relating to sufficiency of assets (in terms of excess of assets over liabilities), **(iii)** his business has been transferred to any other person/amalgamated with any other insurer, without the IRDA's approval **(iv)** he defaults in complying with or contravenes any requirement of the Insurance Act/any rule/regulation/order made or direction issued thereunder, **(v)** the IRDA has reasons to believe that any claim on the insurer in India under any insurance policy remains unpaid for three months after final court judgement, **(vi)** he carries on any other business, **(vii)** he defaults in complying with any directions issued/order made by the IRDA, and **(viii)** he fails to pay the required annual fee, and **(ix)** he is convicted for any offence, **(x)** he defaults in complying with the directions/orders of IRDA, and **(xi)** a cooperative society contravenes any provision of the applicable laws.

Payment of Fee The registered insurer(s) have to pay in the IRDA-specified manner the specified annual fee failing which the registration would be liable to be cancelled.

Restriction on Name An insurer cannot be registered in a name identical to that of an existing insurer. The restriction also applies when the name very nearly resembles the existing name to rule out deceipt except when the insurer in existence is in the course of being dissolved and signifies his consent to the IRDA.

Capital Requirement The paid-up equity capital of an insurance company applying for registration to carry on **(i)** life/general/health insurance and **(ii)** reinsurance business should be ₹100 crore and ₹200 crore respectively. The minimum net worth requirement of an insurer is ₹5,000 crore. The capital of life insurance companies should consist of only ordinary shares, each of which has a single face value and other forms of specified capital. The paid-up amount should be the same for all shares. The voting right of every shareholder should be restricted to equity shares. The company should, in addition to register of members, maintain a register of shares containing the name, occupation and address of the beneficial owner of each share, together with any change of beneficial owner within 15 days of declaration. For registering any transfer of share, the transferee should furnish a declaration in the prescribed form stating if he proposes to hold the shares for his own benefit or as a nominee, and address and the extent of beneficial interest of each. In a post-transfer scenario, the IRDA's prior approval would be essential if the holding of the transferee is likely to exceed 5 per cent of the paid-up capital. Similarly, prior approval of the IRDA would be required where the nominal value of shares intended to be transferred by any individual, firm, group, constituents of a group or body corporate under the same management, jointly or otherwise exceeds one per cent of the paid-up capital of the insurance company.

Accounts and Balance Sheet

At the end of each financial year, insurers are required to prepare a balance sheet, a profit and loss account, a separate account of receipts and payments and a revenue account in accordance with the IRDA regulations. They should keep separate accounts relating to the funds of shareholders and policy-holders.

Actuarial Report and Abstract

Every insurer carrying on life insurance business should have an investigation by an actuary into its financial conditions including a valuation of liabilities at least once every year. Depending on the circumstances of a particular insurer, the IRDA may allow him to have the investigation every two years. An abstract of the report of the actuary should be made in the manner specified by the IRDA. A statement in the form and manner specified by the IRDA should be appended to every such abstract at least once every three years.

Investment of Assets

The **assets** of insurers for investment purposes mean all the assets at their carrying value excluding **(i)** assets specifically held against any fund/a portion in respect of which the IRDA is satisfied that it is regulated outside India, **(ii)** miscellaneous expenditure and **(iii)** in respect of which the IRDA is satisfied that its inclusion would not be in the best interest of the insurer. Under Section 27 of the Insurance Act, the assets of all insurers equivalent to **(a)** liabilities to holders of life insurance policies in India on account of matured claims, **(b)** amount required to meet the liability on policies of life insurance maturing for payment in India less premiums due but not paid and loans within the surrender value of policies should be invested in the following manner: **(1)** 25 per cent in Government securities and additional not less than 25 per cent in Government securities/other **approved** securities (i.e., Government/guaranteed fully as regards principal and interest; securities; debentures/other securities issued under the authority of an Act by/on behalf of a port trust/municipal corporation/city improvement trust; shares of a corporation established by law and guaranteed fully by the Government), **(2)** the balance in any approved investments specified by the IRDA regulations. The applicable percentages for general insurance business are 20 per cent and 10 per cent respectively.

The assets specified by the IRDA would be deemed to be approved investments. However, any excess investment made with reference to any foreign currency to meet liabilities in the concerned currency would not be taken into account.

Where an insurer has accepted reinsurance of any life insurance policy issued by another insurer and maturing for payment in India or has ceded reinsurance to another insurer any policy issued by him, the above percentage shares would be increased by the amount of the liability involved in such acceptance and decreased to the extent of the liability involved in the cession.

The Government/other approved securities should be held by the insurer free of encumbrance/charge/hypothecation/lien.

The assets invested by an insurer incorporated/domiciled outside India (i.e., whose one-third capital is owned by, or one-third of members of whose governing body is, domiciled outside India) excluding foreign assets should be held in India in trust for the discharge of liabilities and vested in IRDA-approved resident trustees. The instrument of trust should be executed by the insurer with the IRDA's approval and define the manner in which alone the subject-matter would be dealt with.

Further Provisions Regarding Investments A life insurer can invest up to 15 per cent of his controlled fund in investments other than the approved investments. Such investments should be made with the consent of all the directors present at the meeting and with voting rights, special notice of which has been given to the letter. They should also report to the IRDA about any investments in which any director is interested. An insurer can invest in shares of a banking company or shares/debentures of a company upto the amount specified by the SEBI regulations. Investment in private limited companies is prohibited. All assets forming the controlled fund/assets other than government/other approved securities should be held free of any encumberance/charge/hypothecation/lien. However, 10 per cent of these assets may be offered as security for loan taken for any investment subject to the prescribed conditions/restrictions.

Controlled fund means (a) in case of an insurer carrying on life insurance business (i) all his funds, (ii) all the funds in India pertaining to his life insurance business if he carries on some class of insurance business, (b) in case of any other insurer carrying on life insurance business, (i) all his funds in India, (ii) all the funds in India pertaining to life business if he carries on other class of insurance business excluding any fund/portion in respect of which the IRDA is satisfied that it is regulated outside India/it would not be in the interest insurer to include.

If any of the investments, consisting of an insurer-controlled fund are considered unsuitable/undesirable by the IRDA at any time, the letter may, after hearing the insurer, direct him to realise the investment(s) and he should comply within such time as may be specified by the IRDA. However, moneys relating to the provident fund of an employee/security taken from any employee would be held under the respective Act governing their investments.

Provisions Regarding Investments of Assets of Insurers Carrying on General Insurance Business Under Section 27-B, all their assets would be deemed to invested subject to prescribed conditions in approved investments specified in Section 27 (**discussed above**). They should be held free of any encumbrance/charge/hypothecation/lien. However, subject to the prescribed conditions/restrictions, upto 10 per cent may be offered as a security for loan for investments/payment of claims or kept as security deposit with banks for acceptance of policies.

Investment by Insurer in Certain Cases Under Section 27-C, upto 5 per cent of the controlled fund/assets may be invested, subject to the IRDA-specified conditions, in companies belonging to the promoters.

Manner and Conditions of Investment Under Section 27-D**,** the IRDA may **(i)** in the interest of the policy-holders specify the time, manner and other conditions of investment by insurer, **(ii)** give specific directions applicable to all insurers for the time, manner and other conditions subject to which the policyholders' funds should be invested in the infrastructure and social sectors and **(iii)** after taking into account the nature of business and to protect the interest of the policy-holders, issue directions to insurers relating to time, manner and other conditions of investments provided the latter are given a reasonable opportunity of being heard.

Prohibition for Investment (Section 27-E) The funds of the policyholders are prohibited from being directly/indirectly invested outside India.

Statement and Return of Investments of Assets Every insurer should submit returns giving details of investments in the IRDA-specified form/time/manner including its authentication.

Prohibition of Loans Under Section 29, loans/temporary advances on hypothecation of property/personal security (except loans on life policies within their surrender value) to director/manager/actuary/auditor/officer of the insurer or to any other company/firm in which they hold similar position is prohibited. However, loans to banks and subsidiaries/holding companies with the IRDA's prior approval are permitted. Loans within the surrender value to a director of an insurance company can be granted on the security of a policy issued to him on his own life on which the insurer bears the risk.

Loans specified by the IRDA regulations including those sanctioned as part of salary package of full time employees duly approved by the Board of Directors may be granted by the insurer. Temporary advances upto the maximum renewal commission earned by him during the immediately preceding year may be granted to any insurance agent to facilitate his functions.

Liability of Directors If contravention of any of the provisions relating to investment of assets/controlled fund contained in Sections 27/27-A/27-B/27-C/27-D or 29 results in loss to the insurer/policyholders, directors/ managers/officers/partners who are knowingly a party to such contravention would, in addition to other penalties under the Insurance Act, be jointly/severally liable to make good the loss.

Keeping Assets of Insurers The assets in India of an insurer, except those required to be vested in trustees, should be kept in the name of the IRDA-approved public officer/in the corporate name of the undertaking (company/cooperative society). However, endorsement in favour of a bank of any security/document solely for collection/realisation of interest/bonus/dividend are permitted.

Insurance Business in Rural/Social Sector

All insurers are required to undertake such percentage of their life/general insurance business, in the rural and social sector as specified by the IRDA. They should discharge their obligations to providing life/general insurance policies to persons residing in the rural sector, workers in the unorganised/informal sector or to economically vulnerable/backward classes of society and other categories of persons as specified by the IRDA.

Power of Investigation/Inspection

The IRDA may conduct an investigation in the affairs of an insurer (including all subsidiaries and branches), intermediary/insurance intermediary by any person(s) or investigating officer, who may employ any auditor or actuary or both for assisting him it. The investigating authority (officer) may also carry out inspection of any insurer and his books of accounts. A copy of the inspection report would be supplied by the investigating authority to the insurer. A manager or an officer of the insurer is duty-bound to produce for investigation all such books of accounts, registers, statements and information in his custody or power as date to the affairs of the insurer within the specified time. The investigating authority may also examine on oath any such manager or officer in relation to the insurer's business. On receipt of the investigation/inspection report, the IRDA may **(i)** require the insurer to take such action as it may think fit or **(ii)** cancel the registration or **(iii)** direct any person to go to court for its winding up. The investigation report may be published in part by the IRDA. It may be specify **(a)** the minimum information to be maintained by the insurers in their books, **(b)** the manner in which such information should be maintained, **(c)** the checks and other verifications to be adopted by insurers in that connection, and **(d)** all other matters incidental thereto as are necessary to enable the investigating authority to carry out its task.

Power to Issue Directions

The IRDA may, from time to time, issue such directions as it deems fit **(i)** in public interest, **(ii)** to prevent the affairs of any insurer being conducted in a manner detrimental to the interest of the policyholders/ insurers, **(iii)** generally to secure the proper management of any insurer, it is necessary to issue directions to insurers generally or to any insurer in particular. The insurers would be bound to comply with such directions.

Control Over Management The appointment, reappointment or termination of managing or fulltime director, manager or chief executive officer (CEO) (by whatever name called) would require prior approval of the IRDA. Any director or CEO may be removed from office by the IRDA **(i)** in public interest, **(ii)** for preventing the affairs of an insurer being conducted in a manner detrimental to the interest of the policyholders, or **(iii)** for securing proper management of the insurer after proposed order.

He would cease to be a director/CEO and should not in any way, directly/indirectly, be concerned with or take part in the management for such period not exceeding five years as specified in the order. However, if in its opinion, any delay is detrimental to the interest of the insurer/his policyholders, the IRDA may, pending consideration of such representation, direct the manager/CEO concerned to not **(i)** act as director/ CEO, **(ii)** in any way, directly/indirectly, be concerned with/take part in management of the insurer. Any contravention would be punishable with a fine of up to ₹1,00,000 for each day of contravention or ₹1 crore whichever is less.

The IRDA may appoint in consultation with the Government a suitable person as additional directors in place of the director/CEO removed from his office who would **(i)** hold office, subject to the pleasure of the IRDA for a period not exceeding three years or such further periods not exceeding three years at a time as specified by it and **(ii)** not incur any obligation/liability by reason only of his being a director/CEO or for anything done/omitted to be done in good faith in the execution of his duties, **(iii)** not be required to hold qualification shares of the insurer.

Appointment of Insurance Agents

An **insurance agent** is an agent who receives/agrees to receive payment by way of commission/other remuneration in consideration of his soliciting/procuring insurance business, including continuance, renewal or revival of policies. An insurer may appoint an insurance agent to solicit/procure insurance business. He can act only for one general/life/health insurer. The IRDA regulations must ensure that no conflict of interest is allowed to arise for any agent in representing two/more insurers.

> **Insurance agent** solicits/procures insurance business in consideration for commission/other remuneration.

Qualifications The agent should not **(i)** be minor, **(ii)** have been found of unsound mind by a court of competent jurisdiction, **(iii)** have been found guilty of criminal misappropriation/breach of trust; or cheating/forgery; or an abatement of, or attempt to, commit any such offence by a court of competent jurisdiction. However, if at least five years have lapsed since the completion of the sentence imposed, the IRDA should ordinarily declare that the conviction of the person would cease to be a disqualification, **(iv)** have not been found in the course of **(a)** any judicial proceeding relating to any insurance policy/winding up of an insurance company **(b)** an investigation of the affairs of an insurer who has been guilty of, or has knowingly participated in or connived against committing fraud/dishonesty/misrepresentation against an insurer/insured. Moreover, they should **(a)** possess the requisite qualification and practical training for a period not exceeding 12 months, **(b)** have passed an examination prescribed by the IRDA, and **(c)** not violate the code of conduct as specified by the IRDA. If an individual or director/partner of a company/firm is unable to fulfill these requirements, the IRDA would, in addition to other penalty to which he may be liable under the Insurance Act, cancel his licence.

Any individual who acts as an agent in contravention of the provisions of the Insurance Act and the insurer who appoints him would be punishable with a fine of up to ₹10,000 and ₹1 crore respectively. The insurer will be responsible for all acts/omissions of the agents including code of conduct and liable to a penalty upto ₹1 crore.

Issue of Registration to Intermediary/Insurance Intermediary

The IRDA or an officer authorised by it issues a registration on payment of the prescribed fee to someone who wants to be an intermediary/insurance intermediary. The period of validity of registration, its renewal eligibility criteria (disqualification), penalty for contravention/violation and issue of duplicate licence are identical to those applicable to insurance agents (as discussed earlier). The IRDA may specify the requirements of their capital, form of business and other conditions.

Surveyors and Loss Assessors

To act as a surveyor/loss assessor, a person should **(a)** possess IRDA-specified academic qualifications under the Insurance Act, **(b)** be a member of the Indian Institute of Insurance Surveyors and Loss Assessors. In the case of a firm/company, all the partners/directors/other persons who may be called upon to make a survey or assess reported loss, should fulfil these requirements. the surveyors/loss assessors should comply with the IRDA-specified regulations in respect of their duties/responsibilities/other professional requirements.

No claim in respect of a loss which has occurred to be paid/settled in India equal to/exceeding an amount specified by the IRDA should be admitted for payment or settled by an insurer unless he has obtained a report on the loss from approved surveyor/loss assessor. However, the insurer would have the right to pay/settle any claim at any amount different from the amount assessed by him. The IRDA may in respect of such a claim call for an independent report from another surveyor/loss assessor within specified/reasonable time and the cost of, incidental to the report, would be borne by the insurer. On receipt of the report, it may issue necessary directions with regard to the settlement of the claim including settlement at a figure less/more than at which it was settled/is proposed to settled. The insurer would be duty-bound to comply with the direction.

Insurers can pay any fee/remuneration for surveying/verifying/reporting on a claim of loss only to approved surveyors/loss assessors. Where the IRDA is satisfied that in case of any class of claims, it is customary to entrust the work of survey/loss assessment to any other person or it is not practicable to make any survey/loss assessment, it may grant exemption from appointment of an approved surveyor/loss assessor.

Reinsurance

Every insurer should reinsure with Indian reinsurers such percentages, not exceeding 30 per cent, of the sum assured on each policy as may be specified by notification in the official gazette after consultation with the Advisory Committee by the IRDA with the previous approval of government. Different percentages may, however, be specified for different classes of insurance. The proportion in which the specified percentage should be allocated among the Indian reinsurers should also be notified. An insurer carrying on fire insurance business may alternatively reinsure such amount out of the first surplus as he thinks fit so that the aggregate premium in any year is not less than the specified percentage of the premium (without taking into account premiums on reinsurance ceded/accepted) in respect of such business during that year. The notification by the IRDA may also specify the terms and conditions in respect of any business of reinsurance which would be binding on Indian and other reinsurers. However, an insurer can reinsure the entire sum assured on any policy/any portion thereof in excess of the percentage specified by the IRDA.

Penalties

Penalties can be imposed for various offences under the Insurance Act as summarised below.

Default in Compliance with/Act in Contravention of the Insurance Act A person who fails to: **(i)** comply with the requirements under the Insurance Act to furnish any document, statement, return, report to the IRDA, **(ii)** comply with its directions, **(iii)** maintain solvency margin, **(iv)** comply with the directions on insurance treaties would be liable to a penalty of up to ₹1 lakh for each such failure or ₹1 crore whichever is less.

Carrying on Business in Contravention of Requirement of Registration The penalty for carrying on insurance business without registration certificate from the IRDA would be a fine upto ₹25 crores and imprisonment upto 10 years.

Penalty for Non-compliance If a person fails to comply with the provisions relating to **(i)** investment of assets, **(ii)** further provisions regarding investments, **(iii)** investment of assets of general insurers, **(iv)** manner/conditions of investments, and **(v)** prohibiting investment of funds outside India, he would be liable to a penalty of up to ₹25 crores.

Wrongfully Obtaining/Withholding Property The penalty for wrongfully obtaining possession of any property/applying to any purpose of the Insurance Act by any managing director/director/ manager/other officer/ employee of an insurer would be up to ₹1 crore.

Offences by Companies Where any offence under the Insurance Act has been committed by a company (i.e. body corporate, including a firm and association of persons, or a body of individuals whether incorporated or not), every person who, at the time the offence was committed, was in charge of and responsible to, the company for the conduct of business of the company as well as the company, would be deemed to be guilty and liable to be proceeded against and punished. However, if he proves that the offence was committed without his knowledge or that he had exercised all diligence to prevent the commission of such offence, the person concerned would not be liable to any punishment. Where an offence has been committed by a company with the consent/connivance of or is attributable to any neglect on the part of any director (including partner in a firm and any member controlling the affairs of an association/body of individuals), manager, secretary, or other officer of the company, he/she would be deemed to be guilty and punished accordingly.

Failure to Comply With the provisions of the Insurance Act relating to insurance business in the social sector/rural or unorganised sector and backword classes would invite a penalty of up to a maximum of ₹25 crores.

Power to Call for Information The chairperson of the IRDA (Controller of Insurance) may require any insurer to supply him with any information relating to insurance business within a specified period certified by a principal officer/auditor.

Power of Government to Make Rules

The Government may makes rules to carry out the purpose of the Insurance Act to, *inter-alia*, prescribe:

- **(a)** The manner of ownership of Indian insurance company
- **(b)** The manner to determine which transactions of an insurer are deemed to be insurance business transacted in India
- **(c)** The form incorporating the declaration stating that all amounts received have been shown in the revenue amount
- **(d)** The manner in which the prospectuses and tables would be published and the form in which they would be drawn up
- **(e)** The contingencies on the happening of which money may be paid by provident fund societies
- **(f)** The matters on which provident fund societies would make rules
- **(g)** Fees payable and the manner of their collection

(h) The conditions and the matters which may be prescribed relating to liquidation of a society
(i) The manner of inquiry relating to adjudication
(j) The form in which an appeal may be preferred with the Securities Appellate Tribunal, the fee payable and the procedure for filing/disposing of an appeal
(k) Any other matter which is/may be prescribed

Power of IRDA to Make Regulations

The IRDA may make regulations (listed in the Act) consistent with the Insurance Act/rules/ regulations to carry out its provisions. The IRDA regulations are comprehensively covered in the next Section of the Chapter.

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (IRDA)

Following the recommendations of the Malhotra Committee, pending the enactment of a comprehensive legislation, on January 23, 1996, the Government of India to regulate the insurance sector approved the setting up of the interim Insurance Regulatory Authority (IRA) that would replace the controller of Insurance (COI) and be under the overall control of the Ministry of Finance. It had been entrusted with the task of preparing a comprehensive legislation to establish a statutory, autonomous IRA on the pattern of the Securities and Exchange Board of India (SEBI).

Salient Features of Interim IRA

The chairman of the IRA was the ex-officio COI under the Insurance Act, 1938, and exercised all powers vested with the COI. The interim IRA was authorised to examine the powers withdrawn from the COI or modified through government notifications issued from time to time or delegated to the LIC/GIC under nationalising enactments of the insurance business that needed to be restored to the COI. While undertaking this exercise, the IRA had to bear in mind the possibility of privatisation of the insurance industry, wholly/ partially and make appropriate recommendations regarding the role and powers which it would need in such a scenario. It could also examine the powers of the government under the Insurance Act, 1938, which could be transferred to the IRA as and when it would be set up. The government could assign such additional nonstatutory functions as may be considered necessary to the interim IRA to enable it to effectively regulate, promote and ensure the orderly growth of the industry.

Insurance Regulatory and Development Authority of India (IRDA) Act, 1999

In order to provide better insurance cover to citizens and also to augment the flow of long-term sources of financing infrastructure, the government reiterated its announcement of 1996 in its budget speech, 1998, to open up the insurance sector and also set up a statutory IRDA. The IRDA Act was enacted in 1999 to provide for the establishment of the IRDA to protect the interests of policy holders, to regulate, promote and ensure orderly growth of the industry and for matters connected therewith/incidental thereto and also to amend the Insurance Act, 1938, the LIC Act, 1956, and the General Insurance Business (Nationalisation) Act, 1972.

Composition of IRDA The IRDA would consist of a chairperson and not more than nine members of whom not more than five would be full-time members, to be appointed by the government from amongst persons of ability, integrity and standing who have knowledge/experience of life insurance/general insurance/actuarial service, finance/economics/law/accountancy/ administration/any other discipline which in the opinion of the government would be useful to it. Between the chairperson and the full-time directors, at least one person each is required to have knowledge/experience of life, general insurance or actuarial science respectively.

Duties/Powers/Functions of IRDA ***Duties*** The duty of the IRDA is to regulate, promote and ensure orderly growth of the insurance and reinsurance businesses.

Powers and Functions The powers and functions of the IRDA, inter-alia, are stated below:

(a) Issue to the applicant a certificate of registration; to renew, modify, withdraw, suspend or cancel such registration; preference in registration to be given to companies providing with health insurance

(b) Protection of the interests of policyholders in matters concerning assigning of policy, nomination by policy-holders, insurable interest, settlement of insurance claim, surrender value of policy, and other terms and conditions of contracts of insurance

(c) Specifying requisite qualifications and practical training for insurance intermediaries and agents

(d) Specifying the code of conduct for surveyors and loss assessors

(e) Promoting efficiency in the conduct of insurance business

(f) Promoting and regulating professional organisations connected with the insurance and reinsurance business; levying fees and other charges for carrying out the purposes of the IRDA Act

(g) Calling for information from, undertaking inspection of, conducting enquiries and investigations, including audit of insurers, insurance, intermediaries and other organisations connected with the insurance business

(h) Control and regulation of the rates, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under Section 64U of the Insurance Act, 1938

(i) Specifying the form and manner in which books of account would be maintained and statement of accounts rendered by insurers and insurance intermediaries

(j) Regulating investment of funds by insurance companies; regulating maintenance of margin of solvency

(k) Adjudication of disputes between insurers and intermediaries or insurance intermediaries (i.e., insurance brokers, reinsurance brokers, insurance consultants, corporate agents, third party administrators, surveyor and loss assessors, other IRDAI-notified entities)

(1) Supervising the functioning of the Tariff Advisory Committee

(m) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to above

(n) Specifying the percentage of life insurance and general insurance business to be undertaken by the insurer in the rural or social sector

(o) Exercising such other powers as may be prescribed

The powers and functions mentioned above would enable the IRDA to perform the role of an effective watchdog and regulator for the insurance sector in India.

Issue of Directions The IRDA would be bound by the directions of the Government on questions of policy, other than those relating to technical and administrative matters, in writing from time to time. The decision of the Government, whether a question is one of policy or not, would be final.

Supersession The government may, by notification and for specified reasons supersede the IRDA for a period not exceeding six months in circumstances specified below and during the period of supersession appoint a person to act as the Controller of Insurance (COI) under the Insurance Act, 1938:

(i) On account of circumstances beyond its control, the IRDA is unable to discharge its functions/ perform its duties

(ii) Persistent default by it in complying with any direction given by the government under the IRDA Act or in discharge of functions/performance of duties imposed on it by/under the provisions of IRDA Act and as a result of such default the financial position of the IRDA has suffered

(iii) Circumstances exist which render it necessary in public interest to do so

Insurance Advisory Committee The IRDA may constitute a 25-member Insurance Advisory Committee (IAC) to represent the interest of commerce, industry, transport, agriculture, consumer fora, surveyors, agents, intermediaries, including brokers, consultants and loss assessors, organisations engaged in safety and loss prevention, research bodies and employees' associations in the insurance sector, to advise it on matters relating to making regulations by it and on such other matters as may be prescribed.

Amendment of LIC Act, 1956 According to this amendment, the exclusive privilege (monopoly) of the LIC ceases so as to enable other Indian insurance companies to do life insurance business. An Indian insurance company is a company registered under the Companies Act, **(i)** in which the aggregate equity holdings of a foreign company as defined in Section 2(23-A) of Income-tax Act, 1961, by itself or through subsidiaries/nominees does not exceed 26 per cent of the paid-up capital, and **(ii)** whose sole purpose is to carry on general/life business.

Amendment of General Insurance Business (Nationalisation) Act, 1972 The amendment provides that the exclusive privilege (monopoly) of the GIC and its four subsidiaries would cease and the other Indian insurance companies can carry on non-life insurance business.

Amendments to Insurance Act, 1938 To update certain outdated provisions and for an efficient and smooth regulation of the opened up insurance sector, consequential amendments have been introduced in the Insurance Act. The main provisions relating to these amendments are listed below.

Transfer of Powers All the powers of the erstwhile COI under the IRDA Act are transferred to, and are now vested with, the IRDA.

Delegation of Powers The powers of the central government relating to the undermentioned activities/operations of insurance companies have been delegated to the IRDA.

- Investment of assets including additional provisions (Sections 27, 27-A and 27-B)
- Maintaining the assets of insurers (Section 31)
- Prohibition of common officers and requirements as to whole-time officers (Section 32-A)
- Limitation of expenditure on commission (Section 40-A)
- Provisions regarding directors (Section 48-B)
- Executive committees of the Life Insurance/General Insurance Councils (Section 64-F), resignation and filling of casual vacancies (64-G), powers of executive committees of the Life Insurance Council to hold examinations of insurance agents (64-1), functions of executive committees of Life Insurance Council (64-J), functions of the executive committee of the General Insurance Council (64-L), general powers of Life Insurance/General Insurance Councils (64-R), powers of advisory committees to regulate rates, advantage, terms and conditions (64-UC), and licensing of surveyors and loss assessors (64-UM)

- Acquisitions of surrender values by policy-holders (Section 113)
- Alteration of forms (Section 115)

Other Provisions/Amendments In addition to the above, some important amendments in the Insurance Act provide for the following.

Section 2-C (Prohibition of Transaction of Insurance Business) On or after the commencement of the IRDA, only Indian insurance companies can carry out any class of insurance business in India.

Section 3 (Registration)

(i) Every application for registration to carry on insurance business should be made in such manner as may be determined by regulations made by the IRDA; preference in registration would be given to companies providing health insurance

(ii) The registration fee would be determined by the IRDA regulations not exceeding ₹50,000 for each class of business

(iii) Registration can be cancelled if the insurer defaults in complying with or acts in contravention of any requirement of: **(a)** the Insurance Act or any rule/regulation/order made or any directions issued under it; **(b)** the Companies Act, LIC Act, General Insurance Business (Nationalisation) Act and Foreign Exchange Regulation (Management) Act; and **(c)** directions made/issued by the IRDA under the IRDA Act

(iv) The cancelled registration can be revived if the IRA is satisfied, inter alia, that the insurer has complied with any requirement of the Insurance Act or the IRDA Act or of any rule/ regulations/order made or directions issued under these Acts,

(v) The IRA may suspend/cancel any registration in such manner as may be determined by the regulations made by it

(vi) The IRA may, on payment of fee not exceeding ₹5,000 as may be determined by the regulations, issue a duplicate certificate of registration to replace a certificate lost/destroyed/ mutilated or in any other case where the IRDA is of the opinion that the issue of duplicate certificate is necessary

Section 3-A (Renewal of Registration) An insurer, who has been granted a certificate of registration, should have the registration renewed annually with each year ending on March 31 after the commencement of the IRDA Act. The application for renewal should be accompanied by a fee as determined by IRDA regulations, not exceeding one-fourth of one per cent of the total gross premium income in India in the preceding year or ₹5 crore or whichever is less, but not less than ₹50,000 for each class of business.

Section 6 (Requirements as to Capital) The minimum paid-up equity capital (excluding required deposits with the RBI and any preliminary expenses in the formation/registration of the company) requirement of an insurer would be ₹100 crore to carry on life/general insurance business and ₹200 crore to exclusively do reinsurance business.

Section 6-A (Requirements as to Capital Structure/Voting Rights/Registers of Beneficial Owners) Prior approval of the IRDA is must in the case of transfer of shares, where after transfer, the total paid-up holding of the transferee in the shares of the company is likely to exceed 5 per cent of its paidup capital and 2.5 per cent if the transferee is a banking/investment company. The IRDA's okay is also essential where the nominal value of the shares to be transferred by any individual/firm/group/ constituents of a group/body corporate under the same management jointly or severally exceeds 1 per cent of paid-up capital of the insurer.

Section 6-AA (Divesting of Excess Shareholding) A promoter cannot hold more than 26 per cent or such other percentage as may be prescribed of the paid-up capital in an Indian insurance company. If, however, the promoters hold more than 26 per cent of the paid-up capital where an Indian company starts insurance business, they would have to divest the excess in a phased manner after a period of 10 years from the date of commencement of business or within such period as may be prescribed by the government. The manner and procedure for divesting the excess share capital would be specified by IRDA regulations. However, if the promoters are a foreign company, FIIs, NRIs/OBCs they will not be allowed to hold more than 26 per cent under any circumstance.

Section 7 (Deposits) Every insurer in India has to keep a deposit in respect of the insurance business with the RBI for and on behalf of the government in cash/approved securities estimated at the market value on the day of deposit. This is 1 per cent and 3 per cent of his total gross premium written in India in any financial year but not exceeding ₹10 crore in case of life insurance and general insurance businesses, respectively. In case of reinsurance business, the deposit requirement is ₹20 crore.

Section 27-C (Investment of Funds Outside India) The funds of policy-holders cannot be invested by insurers outside India.

Section 27-D (Manner and Conditions of Investment) In addition to the requirements of Sections 27, 27-A and 27-B, the IRDA may, in the interest of the policy-holders, specify the time, manner and other conditions of investment of assets held by an insurer for the purpose of the Insurance Act. Taking into account the nature of business and to protect the interest of the policy-holders, the IRDA may also issue directions to insurers relating to the time, manner and other conditions of investment of assets held by them.

Section 31-B (Power to Restrict Payment of Excessive Remuneration) The IRDA may issue appropriate direction to insurers who are paying remuneration by way of commission or otherwise on a scale disproportionate to normal standards prevailing in insurance business/resources of the insurer. The insurer has to comply with these directions within six months. Every insurer should, before the close of the month following every year, submit to it a statement in the form as specified by the IRDA in its regulations of remuneration paid to any person in excess of ₹5,000 in that year.

Section 32-B (Insurance Business in Rural/Social Sector) After the commencement of the IRDA Act, 1999, every insurer would have to undertake such percentage of life/general insurance business in the rural/ social sector as may be specified by the IRDA in this behalf. It is mandatory for the new companies to meet the obligations relating to the rural and unorganised sector.

Section 33 (Power to Investigation/Inspection) The IRDA may, at any time, order in writing a person as investigating authority to investigate the affairs of any insurer and report to it.

Section 40-A (Limitation of Expenditure on Commission) No person can pay to an insurance agent remuneration by way of commission an amount exceeding 15 per cent of the premium payable on the policy relating to fire/marine/miscellaneous insurance.

Section 102 (Penalty for Default) If any person required under the Insurance Act/rules/regulations fails to: **(i)** furnish any document/statement/account/return/report to the IRDA, **(ii)** comply with its directions, **(iii)** maintain solvency margin, **(iv)** comply with directions on the insurance treaties would be liable to a penalty of up to ₹25 lakh for each such failure and punishable with fine.

Section 103 (False Statement) If a person makes a false statement/furnishes any false document, statement, account, return or report knowingly or does not believe to be true, he would be: **(i)** liable to a penalty up to ₹25 lakh for each such failure; and **(ii)** punishable with imprisonment which may extend to three years or with fine for each such failure.

Section 104 (Penalty for Non-compliance) The penalty for non-compliance of the provisions of the Insurance Act relating to investment of assets is ₹25 lakh for each failure.

Section 105 (Wrongly Obtaining/Withholding Property) The penalty for each failure by any director/managing director/manager/other officer(s)/employee(s) of an insurer wrongfully obtaining possession of any property or applying to any purpose of the Insurance Act would be up to ₹25 lakh.

Section 105-B (Failure to Comply) If an insurer fails to comply with the provisions of Section 32-B relating to insurance business in the rural/social sector, he would be liable to a penalty up to a maximum of ₹25 lakh for each such failure. He would also be punishable with imprisonment up to three years or with fine.

Section 114-A (Power to Make Regulations) The IRDA may make regulations consistent with the Insurance Act/rules/regulations to carry out its provisions to provide, in particular, for all or any of the following:

(i) Matters relating to registration of insurers
(ii) The manner of suspension or cancellation of registration
(iii) Such fee, not exceeding ₹5,000, as may be determined by the regulations for the issue of a duplicate certificate of registration
(iv) Matters relating to renewal of registration
(v) The manner and procedure for divesting excess share capital
(vi) Preparation of the balance sheet, profit and loss account and a separate account of receipt and payments and revenue account
(vii) The manner in which an abstract of the report of the actuary is to be specified
(viii) The form and the manner in which the statement of business in force should be appended
(ix) The time, manner and the other conditions of investment of assets held by an insurer
(x) The minimum information to be maintained by an insurer in their books, the manner in which such information should be maintained, the checks and other verifications to be adopted by insurers in that connection and all other matters incidental thereto
(xi) The manner of making an application, the manner and the fee for issuing a licence to act as an insurance agent
(xii) The fee and the additional fee to be determined for renewal of licence of an insurance agent
(xiii) The requisite qualifications and practical training to act as an insurance agent
(xiv) The passing of examination to act as an insurance agent
(xv) The code of conduct of an insurance agent
(xvi) The fee not exceeding ₹50 for the issue of a duplicate licence
(xvii) The manner and the fees for the issue of a licence to any intermediary or an insurance intermediary
(xviii) The fee and the additional fee to be determined for the renewal of licence of intermediaries or insurance intermediaries
(xix) The requisite qualifications and practical training of intermediaries or insurance intermediaries

(xx) The examination to be passed to act as an intermediary or insurance intermediary
(xxi) The code of conduct for an intermediary/insurance intermediary
(xxii) The fee for the issue of a duplicate licence
(xxiii) Such matters as relating to the Tariff Advisory Committee
(xiv) Matters relating to the licensing of surveyors and loss assessors, their duties, responsibilities and other professional requirements
(xxv) Such other asset or assets as may be specified for evaluating the purposes of ascertaining sufficiency of assets
(xxvi) The valuation of assets and liabilities
(xxvii) Matters relating to the sufficiency of assets
(xxviii) Matters relating to reinsurance
(xxix) Matters relating to the redressal of grievances of policy-holders to protect their interest and to regulate, promote and ensure orderly growth of the insurance industry
(xxx) Any other matter which is to be, or may be, specified by the IRDA regulations or in respect of which provisions are to be made or may be made by the regulations.

IRDA REGULATIONS

The IRDA regulations covered in this Section are:

(i) Rural/social sector obligations
(ii) Insurance advertisement and disclosures
(iii) Licensing of insurance agents
(iv) General insurance –reinsurance
(v) Appointed actuary
(vi) Asset, liabilities and solvency margins
(vii) Registration of Indian insurance companies
(viii) Investment norms
(ix) Preparation of financial statements and auditors reports
(x) Third party administrators
(xi) Protection of policyholders interest
(xii) Corporate/Composite corporate agents
(xii) Insurance brokers
(xiv) Distribution of surplus funds
(xv) Life insurance-reinsurance
(xvi) Insurance surveyors and loss assessor
(xvii) Micro-insurance.
(xviii) Corporate Governance Guidelines
(xix) Issuance of Capital by Life Insurance Companies
(xx) General Insurance-Reinsurance
(xxi) Health Insurance
(xxii) Issue of Capital by General Insurance Companies
(xxiii) Licensing of Banks and Insurance Brokers
(xxiv) Life-Insurance—Reinsurance
(xxv) Linked Insurance Products
(xxvi) Non-linked Insurance Products

Rural/Social Sector Obligations

The rural and social sector obligations of **(1)** new and **(2)** existing insurers are discussed below:

New Insurers Every new insurer, for the purposes of Sections 32-B and 32-C of the Insurance Act, has to undertake during the first five financial years the following obligations pertaining to persons in **(a)** rural and **(b)** social sectors.

Rural Sector The rural sector means the places/areas classified as rural by the population census of India. The percentages in respect of a life insurer and general insurer in the rural sector are specified below:

Life Insurer Of the total policies written in that year, **(i)** first financial year, 7 per cent, **(ii)** second financial year, 9 per cent, **(iii)** third financial year, 12 per cent, **(iv)** fourth financial year, 14 per cent **(v)** fifth financial year, 16 per cent., and **(iv)** sixth year, 18 per cent.

General Insurer The percentage share in the first two financial years should be 2 and 3 per cent respectively and thereafter 5 per cent of total gross premium income written direct in that year.

Social Sector The **social sector** includes unorganised sector, informal sector, economically vulnerable or backward classes (i.e. persons below the poverty line) and other categories of persons [i.e. persons with disability as defined in the Persons with Disabilities (Equal Opportunities, Protection of Rights and Full Participation) Act and who may not be gainfully employed and also includes guardians who need insurance to protect spastic persons/persons with disability.]

Social sector includes unorganised/informal/economically vulnerable/backward classes.

The unorganised sector includes self-employed workers such as agricultural labourers, bidi workers, brick-kiln workers, carpenters, cobblers, construction workers, fishermen, hamals, handicraft artisans, handloom and khadi workers, lady tailors, leather and tannery workers, papad makers, powerloom workers, physically disabled self-employed persons, primary milk producers, rickshaw pullers, safai karamcharis, salt growers, sericulture workers, sugarcane cutters, tendu leaf collectors, toddy tappers, vegetables vendors, washerwomen, working women in the hills or such other categories. Included in the informal sector are small scale, self-employed workers typically at low level of organisation and technology, with the primary objective of generating employment and income with heterogeneous activities like retail trade, transport, repairs and maintenance, construction, personal and domestic services, and manufacturing with the work mostly labour-intesive having often unwritten and informal employee-employer relationship. All categories of insurers are obliged to insure 5, 7, 10,15, 20 and 25 thousand lives in the first 6 financial years respectively. However, where an insurance company is in operation for more than 6 months in a financial year, no rural/social sector obligations would be applicable and the annual obligations would be reckoned from the next financial year (i.e. the first full year of operation). Where an insurance company commences cooperation in the first half of the financial year, the applicable obligations for the first year would be 50 per cent of the annual obligation. However, in the case of general insurers, these obligations would also include crop insurance.

Every new issuer should ensure that he undertakes the following obligations during the sixth financial year of operations: **(i)** in respect of life insurers, 18 per cent of the total policies written direct would be in the rural sector, **(ii)** in case of non-life insurance, 5 per cent of the total gross premium income written direct should be in the rural sector, and **(iii)** 25,000 new lives should covered in the social sector in respect of all insurers.

Obligations After the Sixth Financial Year: **(a) Rural Sector: (i)** in respect of life insurer, of the total written direct in that year, 18 per cent, 19 per cent and 20 per cent in the 7th, 8th, 9th, and 10th year and beyond respectively, **(ii)** in respect of general insurer, of the total gross premium income written direct in that year, 5 per cent, 6 per cent and 7 per cent in the 7th, 8th and 9th and 10th financial years and beyond respectively; **(b) Social Sector**: in respect of all insurers, 25,000, 35,000, 45,000 and 55,000 lines in 7th, 8th, 9th and 10th financial year and beyond respectively.

Existing Insurers The obligations of existing insurers (i.e. the LIC and GIC) would be decided by the IRDA in consultation with them but the quantum of insurance business to be done pertaining to rural and social sectors would not be less than what has been recorded by them for the accounting year ended March 31, 2002. The IRDA would review the quantum periodically and give directions to them for achieving the specified targets.

The obligations towards the rural/social sectors from the financial year 2007-08 to 2009-10 and beyond are as follows:

(a) LIC: The rural sector obligations are 24 per cent (2007-08) and 25 per cent (2008-09, 2009-10 and beyond, of the total policies written in that year. The social sector obligations are 20 lakh lives in the financial year 2007-08 and beyond.

(b) General Insurers: **(a) Rural Sector:** 6 per cent and 7 per cent of the total gross premium income written direct in that year respectively in 2007-08 and 2008-09 and beyond; **(b) Social Sector:** For the financial years 2008-09 and 2009-10 and beyond, the obligations would increase by 10 per cent over the previous year(s).

The term '**lives**' refer to human lives insured as at the end of each financial year. The re-insurance premium should not be included while calculating the obligations of the insurers in respect of the rural and social sectors. The IRDA may prescribe/revise these obligations from time to time. The compliance with these obligations towards the rural/social sectors should be based on the sale of products in a way that the stipulations as to the minimum amount of cover as laid down in the IRDA Micro-Insurance Regulations. Every insurer should submit a return to the IRDA disclosing the level of compliance during the year in respect of these obligations.

Insurance Advertisement and Disclosure

> **Insurance advertisement** is any communication related to an insurance policy to sell/solicit a policy from public.

An **insurance advertisement** means/includes any communication directly/indirectly related to an insurance policy and intended to result in the eventful sale/solicitation of a policy from public. It includes all forms of printed/published materials or any material using the print and/or electronic medium for public communication such as **(i)** newspapers, magazines and sales talk; **(ii)** bill boards, hoardings, panels; **(iii)** radio, television, website, e-mail, portals; **(iv)** representations by intermediaries; **(v)** leaflets; **(vi)** description literature/ circulars; **(vii)** sales and flyers; **(viii)** illustrations from letters; **(ix)** telephone solicitations; **(x)** business cards; **(xi)** videos; **(xii)** faxes; **(xiii)** any other communication with a prospect (i.e. any party that enters/proposes to enter into an insurance contract directly or through an insurance intermediary)/policy-holder who urges him to purchase/renew/increase/retain/modify a policy.

However, the following would not constitute an advertisement: **(i)** materials used by an insurance company within its own organisation and not meant for distribution to public; **(ii)** communication with policy-holders other than materials urging them to purchase/increase modify/surrender/retain a policy; **(iii)** material used solely for training, recruitment and education of an insurer's personnel, intermediaries, counsellors, solicitors; and **(iv)** any general announcement by a group policy-holder to members of the eligible group that a policy has been written/arranged. The insurance advertisement and disclosure requirements (regulations) by the IRDA are briefly analysed in this section

Compliance and Control Every insurer/intermediary/insurance agent should comply with the following:

(a) Have a compliance officer to oversee the advertising programme. His name and official position in the organisation should be communicated to the IRDA

(b) Establish and maintain a system of control over the content, form and method of dissemination of all advertisements concerning its policies

(c) Maintain a register at its corporate office which must include **(i)** a specimen of every advertisement disseminated/issued or a record of any broadcast/telecast and so on, **(ii)** a notation attached to each advertisement indicating the manner, extent of distribution and form number of any policy advertised

(d) Maintain a specimen of all advertisements for a minimum of three years

(e) File a copy of each advertisement with the IRDA as soon as it is first issued together with **(i)** an identification number for the advertisement, **(ii)** the form number(s) of the policy(ies) advertised and when the products were approved by the IRDA, **(iii)** a description of the advertisement and how it is used and **(iv)** the method/media used for dissemination of advertisement

(f) File a certificate of compliance with their annual statement to the effect that, to the best of its knowledge, the advertisements disseminated by the insurer/its intermediaries during the preceding year comply with the IRDA regulations and the advertisement code in terms of the recognised standards of professional conduct as prescribed by the Advertisement Standard Council of India (ASCI).

The advertisement register would be subject to inspection and review by the IRDA for content/ context/ prominence and position of required disclosures, omissions of required information and so on.

Changes in Advertisement Any change in an advertisement would be considered a new advertisement and all the provisions of regulations discussed above relating to an advertisement would apply mutatis mutandis to a change in an advertisement. The IRDA should be informed at the time of filing the advertisement of the extent of change in the original advertisement.

Insurance Company Advertisements Every insurance company is required to promptly disclose in the advertisement and that part of the advertisement which is to be returned to the company/ insurance intermediary/agent by any party that enters/proposes to enter into an insurance contract directly/through an insurance agent (i.e. prospect) or the insured the full particulars of the insurance company and not merely any trade name/monogram/logo. Where benefits are more than briefly described, the form number of the policy and the type of coverage should also be disclosed fully.

Advertisements by Insurance Agents All advertisements by insurance agents affecting an insurer must have its prior written approval from the insurance company. While granting approval, the insurer must ensure that all advertisements pertaining to it/ its products/its performance comply with the IRDA regulations and are not deceptive/misleading.

An unfair/misleading advertisement means/includes any advertisement that **(i)** fails to clearly identify the product as insurance; **(ii)** makes claims beyond the ability of the policy to deliver or beyond the reasonable expectation of performance; **(iii)** describes benefits that do not match the policy provisions; **(iv)** uses words or phrases in a way which hides or minimises the costs of the hazard insured against or the risks inherent in the policy; **(v)** omits to disclose or discloses insufficiently important exclusions, limitations and conditions of the contract; **(vi)** gives information in a misleading way; **(vii)** illustrates future benefits on assumptions which are not realistic nor realisable in the light of the insurer's current performance; **(viii)** does not guarantee the benefits nor says so as explicitly as stating the benefits or says so in a manner or form that it could remain unnoticed; **(ix)** implies a group or other relationships like sponsorship, affiliation or approval that does not exist; and **(x)** makes unfair or incomplete comparisons with products which are not comparable or disparages competitors.

However, written prior approval of the issuer need not be acquired for **(i)** advertisements developed by the insurer and provided to the agent; **(ii)** generic advertisements limited to information such as the agent's name, logo, address and phone number; and **(iii)** advertisements that consist only of simple and correct statements describing the availability of the lines of insurance, references to experience, service and qualifications of agents but making no reference to specific policies, benefits, costs or insurers.

Advertisement by Insurance Intermediaries Only properly licensed intermediaries are permitted to advertise/solicit insurance through advertisements.

Advertising on the Internet Every insurer or intermediary's website or portal should **(i)** include disclosure statements which outline the site's specific policies vis-a-vis the privacy of personal information for the protection of both their own business and the consumer they serve; and **(ii)** display their registration/licence number on their websites.

For the purposes of these regulations, except where otherwise specifically excluded or restricted, no form or policy otherwise permissible for use would be deemed invalid or impermissible if such form or policy accurately reflects the intentions of the parties as published or transmitted electronically between them.

Identity of Advertisers Every advertisement for insurance should state **(i)** clearly and unequivocally that insurance is a subjectmatter of solicitation; and **(ii)** the full registered name of the insurer/intermediary/insurance agent.

Endorsement and Other Third Party Involvement A third party, group or association should not:

- Distribute information about an insurance policy, intermediary or insurer on its letterhead
- Allow an insurance intermediary/insurer to distribute information about an insurance policy, insurance or insurance company on its letterhead
- Distribute information about an individual insurance policy, or about an intermediary or insurer in its envelopes, unless **(a)** the third party is providing only a distribution service for the insurance advertisement and is not itself soliciting the coverage, and **(b)** the insurance information is a piece separate from any other information distributed by the third party and clearly indicates its origin
- Recommend that its members purchase specific insurance products
- Imply that a person must become a member of its organisation to purchase the policy
- Imply that a purchaser of a policy, by becoming a member of a limited group of persons, would receive special advantages from the insurer not provided for in the policy.

A third party, group or association may, however, **(i)** enclose an insurance company's or intermediary's product and provide truthful statements, quotes, and testimonials endorsing the insurance products to the insurance company for use in the company's advertisements. The condition is that the language does not convey directly or indirectly a recommendation that members of the organisation purchase the products.

Procedure for Action in Case of Complaint If an advertisement is not in accordance with these regulations, the IRDA may make action in one or more of the following ways:

(i) Issue a letter to the advertiser seeking information within a specific time, not exceeding 10 days from the date of issue of the letter

(ii) Direct the advertiser to correct or modify the advertisement already issued in a manner suggested by the IRDA, with a stipulation that the corrected or modified advertisement would receive the same type of publicity as the earlier one

(iii) Direct the advertiser to discontinue the advertisement forthwith

(iv) Any other action deemed fit by the IRDA, keeping in view the circumstances of the case, to ensure that the interests of the public are protected

The advertiser may seek additional time from the IRDA to comply with the directions justifying the reasons there for. It may, however, refuse to grant such extension if it feels that the advertiser is seeking time only to delay the matter. Any failure on the part of the advertisers to comply with the IRDA directions may entail it to take such action as deemed necessary, including levy of penalty.

Adherence to Advertisement Code Every insurer or intermediary should follow recognised standards of professional conduct as prescribed by the Advertisement Standards Council of India (ASCI) and discharge its functions in the interest of the policyholders.

Statutory Warning Every proposal for an insurance product must carry the following stipulation, as prescribed in Section 41 of the Insurance Act, 1938: **"No person shall allow or offer to allow, either directly or indirectly, as an inducement to any person to take out or renew or continue an insurance in respect of any kind of risk relating to lives or property in India, any rebate of the whole or part of the commission payable or any rebate of the premium shown on the policy, nor shall any person taking out or renewing or continuing a policy accept any rebate, except such rebate as may be allowed in accordance with the published prospectus or tables of the insurer."** If any person fails to comply with the above, he would be liable to payment of a fine which may extend to ₹500.

Appointment of Insurance Agents Regulations 2016

The main elements of these regulations are: appointment of insurance agents, insurance agency examination, code of conduct, right to inspect, suspension/cancellation of appointment and general conditions of appointment.

Insurance agent means an individual appointed for soliciting/procuring insurance business including business relating to a continuance/renewal/revival of insurance policies.

Appointment of Insurance Agents An applicant seeking appointment as an insurance agent should submit an application in the prescribed form to the designated official of the insurer. **Insurance agent** means an individual appointed for soliciting/procuring insurance business including business relating to a continuance/renewal/revival of insurance policies. **Designated official** is an officer appointed by the insurer to make appointment of an individual as an insurance agent. The designated official would satisfy himself

Designated official is an officer appointed by the insurer to make appointment of an individual as an insurance agent.

that the applicant has/does **(a)** furnished the prescribed agency application complete in all respects; **(b)** submitted the PAN details, **(c)** passed the specified insurance examination, **(d)** not suffer from any of the disqualifications, **(e)** the requisite knowledge to solicit and procure insurance business; and capable of providing the necessary service to the policyholder. The IRD may exempt, on fulfilment of certain conditions, one or more of the above conditions for applicants to be appointed to distribute only particular type insurance product(s) having fixed premium and/or benefits such as motor third party insurance.

The designated official should exercise due diligence in verifying the agency application and ascertaining that the applicant does not hold agency appointment for more than one life/general/health insurer and one each of the **mono-line insurers** (i.e. an insurer carrying on one particular specified line of business such as agricultural insurance/export credit guarantee business and is not in the centralised list of **black-listed agents** (i.e. list of agent maintained by the IRDA whose appointment is cancelled/suspended by a designated official of an insurer on ground of violation of code of conduct and/or fraud).He should also verify the centralised list of **(a)** agents maintained by the IRDA containing all details of agents appointed by all insurer with PAN number of the applicant to ascertain the above information, **(b)** black-listed agents maintained by the IRDA to ascertain that the applicant is not black listed. On satisfying himself that the applicant has complied with all the stipulated conditions and also does not suffer from any disqualification, may process the agency application and grant appointment as an insurance agent by issuing an appointment letter within 15 days of receipt of all the documents. He should allot an agency code number to the appointed agent prefixed by the abbreviation of the insurer's name. He may refuse/reject an application if he/she feels that the grant of appointment may be against public interest.

Mono-line insurers means insurer carrying on one particular specified line of business such as agricultural insurance/export credit guarantee business.

Black-listed agent means list of agents maintained by the IRDA whose appointment is cancelled/suspended by a designated official of an insurer on ground of violation of code of conduct and/or fraud.

The agency appointment letter should lay down the terms of appointment covering all conditions governing appointment and functioning of the applicant as insurance agent and the specified code of conduct. The letter of appointment should be dispatched not later than 7 days after the appointment of the agent. The appointed applicant as an insurance agent should be provided an identity card, by the insurer to identify the agent with the insurer whom he/he is representing as an agent. The designated official should enter and update the agency data of the applicant appointed as an insurance agent in the agency portal maintained by the IRDA through online mode immediately after his/her appointment. The online updation of agency database records by the insurer is to maintain the updated centralised list of agents maintained by the IRDA. The designated official would be responsible to ensure that the centralised list of agents is up to date and accurate. He may refuse to grant agency appointment to any applicant if he does not fulfil any of the specified conditions. He should communicate the reasons for refusal for appointment as agent to the applicant in writing, within 21 days of receipt of the application. An applicant who is aggrieved by the decision of the designated official, may submit a review application to the appellate officer designated by the insurer for review of the decision. He should consider the application and communicate the final decision in writing within 15 days of receipt of the review application.

Appointment of Composite Insurance Agent An applicant seeking appointment as composite insurance agent should make an application to the designated official of the respective life, general, health insurer or mono-line insurer, in the prescribed composite agency application form. They should deal with the application in the manner and procedure outlined above. A **composite insurance agent** means an individual appointed as insurance agent by two/more insurers subject to the condition that he would not act as an agent for more than one life/general/health insurance and one each of mono-line insurers.

> **Composite insurance agent** means an individual appointed a insurance agent by two/more insurers subject to the condition that he would not act as an agent for more than one life/general/health insurance and one each of mono-line insurers.

Insurance Agency Examination An applicant should pass in the insurance agency examination conducted by the examination body in the subjects of life, general, health insurance as per the syllabus prescribed by the IRDA to be eligible for appointment as an insurance agent. The insurer should provide the necessary assistance and guidance to the candidates to equip them with adequate insurance knowledge required to qualify in the agency examination. The applicant who has successfully passed the insurance agency examination should be issued a pass certificate by the examination body, which would be in force for 12 months, for the purpose of seeking appointment as an agent with any insurer for the first time. Only candidates who have qualified in the insurance agency examination and who hold a valid pass certificate issued by the examination body would be eligible to be considered for appointment as agents.

Disqualification to Act as an Insurance Agent The conditions for disqualification would be as stipulated under Section 42(3) of the Insurance Act **(discussed in Section of the Chapter 1).**

Code of Conduct Every agent should adhere to the code of conduct specified below.

- Every insurance agent should **(i)** identify himself and the insurer of whom he is an insurance agent; **(ii)** show the agency identity card to the prospect, and also disclose the agency appointment letter to the prospect on demand; **(iii)** disseminate the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan; **(iv)** where the insurance agent represents more than one insurer offering the same line of products, he should dispassionately advice the policyholder on the products of all insurers and the product best suited to the specific needs of the prospect; **(v)** disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect; **(vi)** indicate the premium to be charged by the insurer for the insurance product offered for sale; **(vii)** explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract; **(viii)** bring to the notice of the insurer every fact about the prospect relevant to insurance underwriting, including any adverse habits or income inconsistency of the prospect, within the knowledge of the agent, in the form of a report called **Insurance Agent's Confidential Report** along with every proposal submitted to the insurer wherever applicable, and any material fact that may adversely affect the underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect; **(ix)** obtain the requisite documents at the time of filing the proposal form with the insurer, and other documents subsequently asked for by the insurer for completion of the proposal; **(x)** advise every prospect to effect nomination under the policy; **(xi)** inform promptly the prospect about the acceptance or rejection of the proposal by the insurer; **(xii)** render necessary assistance and advise to every policyholder introduced through him/her on all policy servicing matters including assignment of policy, change of address or exercise of options under the policy or any other policy service, wherever necessary; **(xiii)** render necessary assistance to the policyholders/claimants/beneficiaries in complying with the requirements for settlement of claims by the insurer.

- No insurance agent should **(a)** Solicit/procure insurance business without being appointed by the insurer; **(b)** induce the prospect to **(i)** omit any material information **(ii)** submit wrong information in the proposal form/documents submitted to the insurer; **(c)** resort to multilevel marketing for soliciting and procuring insurance policies and/or induct any prospect/policyholder into a multilevel marketing scheme; **(d)** behave in a discourteous manner with the prospect; **(e)** interfere with any proposal introduced by any other insurance agent; **(f)** offer different rates, advantages, terms and conditions other than those offered by his insurer; **(g)** demand/receive a share of proceeds from the beneficiary under an insurance contract; **(h)** force a policyholder to terminate the existing policy and to effect a new policy from him within three years from the date of the termination of the earlier policy; **(i)** apply for fresh agency appointment to act as an insurance agent, if his appointment was earlier cancelled by the designated official, before five years from the date of the cancellation; **(j)** become or remain a director of any insurer.
- Every insurance agent should, with a view to conserve the insurance business already procured through him, make every attempt to ensure remittance of the premium by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing.
- Any person who acts as an insurance agent in contravention of the provisions of the Insurance Act/regulations would be liable to a penalty which may extend to ₹ 10,000 and any insurer/any person acting on his behalf, who appoints any person as an insurance agent not permitted to act/transact any insurance business in India through him would be liable to penalty which may extend to one crore rupees.
- The insurer would be responsible for all acts and omissions of its agents including violation of code of conduct and would be liable to a penalty which may extend to one crore rupees.

Right to Inspect The IRDA may appoint its officers as an investigating officer to undertake inspection of affairs of an insurance agent, to ascertain and see whether the business is carried on by him/her as per the Insurance Act/regulations and the instructions issued by it and also to inspect his books of account, records and documents.

The investigating officer may, during the course of the inspection, examine on oath the insurance agent/any person who is found to be in possession/control of books, accounts/other documents, and any statement made by the insurance agent/person during the examination may thereafter be used as evidence in any proceedings. The IRDA may also call for any information from the insurance agent which should be submitted within the specified limit time. The purpose of inspection may include but are not limited to: **(a)** monitoring compliance with the provisions of the Insurance Act/regulations etc. **(b)** investigation of complaints of serious nature received from any insured/insurers/other stakeholder/other individual on any matter having a bearing on his insurance-related activities; and **(c)** investigating into the affair of the insurance agent in the interest of orderly development of insurance business/in protection of policyholders' interest.

Suspension of Appointment of an Agent The appointment of an agent may be cancelled/suspended after due notice and after giving him/her a reasonable opportunity of being heard if he/she: **(a)** violates the provisions of the Insurance/IRDA Act/rules/regulations; **(b)** attracts any of the specified disqualifications; **(c)** fails to comply with the stipulated code of conduct and directions issued by the IRDA; **(d)** violates terms of appointment; **(e)** fails to furnish any information relating to his/her activities as an agent as required by the insurer or the IRDA; **(f)** fails to comply with the directions issued by the IRDA; **(g)** furnishes wrong/false information/conceals or fails to disclose material fact in the application submitted for appointment of insurance agent or during the period of its validity; **(h)** does not submit periodical returns as required by the insurer/IRDA; **(i)** does not co-operate with any inspection/enquiry conducted by the IRDA; **(j)** fails to resolve the complaints of the policyholders or fails to give a satisfactory reply to the IRDA in this behalf; **(k)** directly/indirectly involves in embezzlement of premiums/cash collected from policyholders/prospects on behalf of the insurer. An agent cannot collect cash/premium without specific authorisation by the insurer.

Manner of Holding Enquiry The appointment of an insurance agent would be cancelled on the basis of an enquiry in accordance with the specified procedure. The insurer should appoint an officer as an enquiry officer within 15 days of the issue of the suspension order who should issue a show cause notice to the insurance agent at his registered address calling for all information/data as deemed necessary to conduct the enquiry. The insurance agent may, within 21 days from the date of receipt of the notice, furnish to the enquiry officer a reply to the show cause notice together with copies of documentary or other evidence relied on by him or sought by the enquiry officer, who would give a reasonable opportunity of hearing to the insurance agent to enable him to make submission in support of his/her reply. He may appear in person or through any duly authorised person to present his case. However, the prior approval of the insurer should be obtained for the appearance of the 'authorised person'. If considered necessary, the enquiry officer may **(i)** require the insurer to present its case through one of its officers, **(ii)** call for **(a)** feedback/information from any other related entity during the course of enquiry, **(b)** additional papers from the insurance agent. He should make all necessary efforts to complete the proceeding at the earliest but in no case beyond 45 days of the commencement of the enquiry. The enquiry officer after taking into account all relevant facts and submissions made by the insurance agent, should furnish a report making him/her recommendations to the designated official, who would pass a final order in writing with reasons. On the issue of final order for cancellation, he/she would cease to act as an insurance agent from the date of the final order.

Publication of Order of Suspension/Cancellation The order of suspension/cancellation of appointment of the insurance agent should be displayed on the website of the insurer and updated in centralised list of agents maintained by the IRDA, so that registration of new business by the suspended/cancelled agent is stopped forthwith by the insurer.

On and from the date of suspension/cancellation of the agency, he would cease to act as an insurance agent. The insurer should **(i)** recover the appointment letter and identity card from the agent within 7 days of the issuance of final order, **(ii)** black list him and enter his detail into the black listed and the centralised list of agents database maintained by the IRDA, in online mode, immediately. The insurer should also inform other general/health insurer/mono-line insurers with whom he/she is acting as an agent, of the action taken against him for their records and necessary action. The IRDA may also initiate penal action keeping in mind the extent and level of violation as per the provisions of the Insurance Act/regulations/rules. An agent who is aggrieved by the order of cancellation can appeal to the insurer within 3 months. The insurer should appoint an appellate officer to examine the appeal and give his decision in the matter in writing within 30 days of the receipt of the appeal.

An insurance agent can surrender his appointment letter and identity card to the designated official of the insurer. The cessation certificate should be issued within 15 days from the date of registration/surrender of appointment.

General Conditions for Appointment of Agents by the Insurer The insurer should frame a `Board-Approved Policy' covering specified matter and file the same with the IRDA before March 31 every year. No individual can act as an insurance agent for more than one life/general/health insurer and one each of mono-line insurers. The penalty for contravention of the provisions of the Insurance Act may extend to ₹ 10,000. Any insurer/representative, who appoints an individual as an insurance agent not permitted to act as such or transact any insurance business in India would be liable to penalty which may extend to one crore rupees. No person should directly/indirectly allow or offer to allow or as an inducement, to any person to take out/renew/continue an insurance policy through multilevel marketing scheme. The IRDA may through an authorised officer, make a complaint to the appropriate police authorities relating to the entity/persons involved in the multi-level marketing scheme. Every insurer/designated official should maintain a register showing the name and address of every insurance agent appointed by him and the date on which his appointment began and the date, if any, on which his appointment ceased for 5 years from the cessation of appointment.

General Insurance—Reinsurance

The IRDA regulations relating to reinsurance are briefly examined in this Section.

Procedure for Reinsurance Arrangement

- The objective of reinsurance would continue to be **(a)** maximising retention within the country, that is, the amount which an insurer assumes for his own account. In proportionate contracts, the retention may be a percentage of the policy limit. In case of loss contracts, the retention is the amount of loss; **(b)** developing adequate capacity; **(c)** securing the best possible protection for the reinsurance costs incurred; and **(d)** simplifying the administration of business.
- All insurers should maintain the maximum possible retention, commensurate with its financial strength and volume of business. The IRDA may require them to justify their retention policy and may give such directions as considered necessary in order to ensure that the Indian re-insurer (i.e. an insurer who carries on exclusively reinsurance business and is approved as such by the government) is not merely fronting for a foreign insurer.
- They should cede such percentage of the sum assured on each policy for different classes of insurance written in India to the Indian insurer as specified by the IRDA according to the provisions of Part IVA of the Insurance Act. The term cession means the unit of insurance passed to a reinsurer by the insurer which issued a policy to the original insured and, accordingly, a cession may be the whole or a portion of a single risks, defined policies/divisions of business as agreed in the reinsurance contract
- The reinsurance programme should commence from the beginning of every financial year and every insurer should submit to the IRDA his reinsurance programme for the forthcoming year, 45 days before the commencement of the financial year
- Within 30 days of the commencement of the financial year, every insurer should file with the IRDA a photocopy of every reinsurance treaty slip and excess of loss cover note in

respect of that year together with the list of reinsurers and their shares in the reinsurance arrangement

- The IRDA may call for further information or explanation in respect of the reinsurance programme of an insurer and may issue such direction, as it may consider necessary
- The insurers should place their reinsurance business outside India with only those reinsurers who have over a period of five years, counting from the year preceding the one in which the business has to be placed, enjoyed a rating of at least **BBB** (with Standard & Poor) or equivalent rating of any other international rating agency. The placements with other reinsurers would require approval of the IRDA The insurers may also place reinsurances with Lloyd's syndicates taking care to limit placements with individual syndicates to such shares as are commensurate with the capacity of the syndicate
- The Indian reinsurer should organise domestic pools (i.e. joint underwriting operation of insurance/ reinsurance in which the participants assume a predetermined and fixed interest in all business written) for reinsurance surpluses in fire, marine, hull and other classes in consultation with all insurers on basis, limits and terms which are fair to all insurers and assist in maintaining the retention of business within India as close to the level achieved for the year 1999-2000 as possible. The arrangements so made should be submitted to the IRDA for approval
- The surplus, over and above the domestic reinsurance arrangements class-wise, can be placed by the insurer independently with any of the eligible reinsurers subject to a limit of 10 per cent of the total reinsurance premium ceded outside India being placed with any one reinsurer. Where it is necessary in respect of specialised insurance to cede a share exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of the IRDA giving reasons for such cession
- Every insurer should offer an opportunity to other Indian insurers, including the Indian reinsurer, to participate in its facultative and treaty surpluses before placement of such cessions outside India. The term facultative means the reinsurance of a part or all of a single policy in cession is negotiated separately and that the reinsurer and the insurer have the option of accepting or declining each individual submission, while the term treaty refers to a reinsurance arrangement between the insurer and the reinsurer usually for one year or longer which stipulates the technical particulars and financial terms applicable to the reinsurance of some class/classes of business
- The Indian reinsurer should retrocede at least 50 per cent of the obligatory cessions received by it to the ceding insurers after protecting the portfolio by suitable excess of loss covers. Such retrocession should be at original terms plus an over-riding commission to the Indian reinsurer not exceeding 2.5 per cent. The retrocession to each ceding insurer should be in proportion to its cessions to the Indian reinsurer. The term retrocession is defined as the transaction whereby a reinsurer cedes to another insurer/reinsurer all/part of the reinsurance it has previously assumed
- Every insurer would be required to submit to the IRDA statistics relating to its reinsurance transactions in such forms as it may specify, together with its annual accounts

Inward Reinsurance Business Every insurer wanting to write inward reinsurance business should have a well-defined underwriting policy for such business. He should ensure that decisions on acceptance of reinsurance business are made by persons with necessary knowledge and experience. He should file with the IRDA a note on its underwriting policy stating the class of business, geographical scope, underwriting limits and profit objective. He should also file any changes to the note whenever he makes then the underwriting policy.

Outstanding Loss Provisioning The insurers have to make provisions for outstanding claims for every reinsurance arrangement accepted on the basis **(i)** of loss of information advice received from brokers/cedants or **(ii)** actuarial estimation. In addition, they should make an appropriate provision for incurred but not reported (IBNR) claims on its reinsurance-accepted portfolio on actuarial estimation basis.

Appointed Actuary

To carry on insurance business, including reinsurance, in India, insurers should appoint an actuary. A life insurer can not transact without an appointed actuary. This Section dwells on the IRDA regulations relating to the appointed actuary.

Procedure for Appointment The insurer should seek the approval of the IRDA for the appointment of the actuary. An applicant is eligible to be appointed as actuary if he: **(i)** is ordinarily a resident in India, **(ii)** is a Fellow/Affiliate Member in accordance with the Actuaries Act with specialisation as evidence by qualification and/or working experience in life/general/health insurance. However, the syllabus and reading material constituting element of study for such specialisation and the requirements for issuing the certificate of practice for appointed actuaries should be to the satisfaction of the IRDA, **(iii)** is an employee of the life insurer in case of life insurance business, **(iv)** is a full time employee of the general insurer in case of general/health insurance business, **(v)** has not committed any breach of professional conduct, **(vi)** a person against whom no disciplinary action by the Acturial Society of India or any other acturial professional body is pending, **(vii)** is not an appointed actuary of another insurer, **(viii)** possesses a Certificate of Practice issued by the Actuarial Society of India and **(ix)** is not over the age of 65 years, **(x)** has **(1)** minimum of 10 years relevant experience, of which at least two years of post-qualified (fellowship in the specialised subject) experience, **(2)** handled suitably responsible positions immediately prior to the application for appointed actuary and **(3)** at least two years of recent relevant experience out of the 10 years in the respective field for which the position is sought for.

Cessation of Appointment An appointed actuary would cease to be so, if he or she has been given notice of withdrawal of approval by the IRDA on the following grounds: **(a)** he or she ceases to be eligible in accordance with the eligibility conditions, **(b)** he or she has, in the opinion of the IRDA, failed to perform adequately and properly the duties and obligations of an appointed actuary under these regulations. The IRDA should give an appointed actuary a reasonable opportunity of being heard, if he or she has been given a notice of withdrawal of approval by it. If, however, a person ceases to be an appointed actuary of an insurer otherwise than on the grounds mentioned in above, the insurer and the appointed actuary should intimate the IRDA the reasons there for within 15 days of such a cessation.

Powers An appointed actuary should have access to all information or documents in possession, or under control, of the insurer if such access is necessary for the proper and effective performance of his functions and duties. He may seek any information for the above purpose from any officer or employee of the insurer. He should be entitled to **(a)** attend all meetings of the management, including the directors of the insurer; **(b)** speak and discuss on any matter, at such meeting that **(i)** relates to the actuarial advice given to the directors; **(ii)** may effect the solvency of the insurer; **(iii)** may effect the ability of the insurer to meet the reasonable expectations of policy-holders; or **(iv)** necessitates actuarial advice; and **(c)** attend **(i)** a meeting of the shareholders or the policy-holders of the insurer; or **(ii)** any other meeting of the members of the insurer at which the insurer's annual accounts or financial statements are to be considered or at which any matter in connection with the appointed actuary's duties is discussed.

Duties and Obligations The interests of the insurance industry and the policy-holders, the duties and obligations of an appointed actuary of an insurer include:

(a) Rendering actuarial advice to the management of the insurer, particularly in the areas of product design and pricing, insurance contract wording, investments and reinsurance
(b) Ensuring the solvency of the insurer at all times
(c) Complying with the provisions of Section 64-V of the Insurance Act in regard to certification of the assets and liabilities that have been valued in the required manner
(d) Complying with the provisions of Section 64-VA of the Insurance Act in regard to maintenance of required solvency margin in the required manner
(e) Drawing the attention of management of the insurer, to any matter on which he or she thinks that action is required to be taken by the insurer to avoid **(i)** any contravention of the Insurance Act or **(ii)** prejudice to the interests of policyholders
(f) Complying with the IRDA's directions from time to time
(g) If the insurer is also conducting life insurance business, he has:
- **(i)** to certify the actuarial report and abstract and other returns as required under Section 13 of the Insurance Act,
- **(ii)** to comply with the provisions of Section 21 of the Insurance Act in regard to further information required by the IRDA,
- **(iii)** to comply with the provisions of Section 40-B of the Insurance Act in regard to the bases of premium,
- **(iv)** to comply with the provisions of the Section 112 of the Insurance Act in regard to recommendation of interim bonus or bonuses payable by life insurer to policy-holders whose policies mature for payment by reason of death or otherwise during the inter-valuation period,
- **(v)** to ensure that all the requisite records have been made available to him or her for the purpose of conducting actuarial valuation of liabilities and assets of the insurer,
- **(vi)** to ensure that the premium rates of the insurance products are fair,
- **(vii)** to certify that the mathematical reserves have been determined taking into account the guidance notes issued by the Actuarial Society of India and any directions given by the IRDA,
- **(viii)** to ensure that the policyholders' reasonable expectations have been considered in the matter of valuation of liabilities and distribution of surplus to the participating policyholders who are entitled to a share of the surplus, and
- **(ix)** to submit the actuarial advice in the interests of the insurance industry and the policy-holders

(h) An insurer, carrying on general insurance business, has to ensure **(i)** that the rates are fair in respect of those contracts that are governed by the insurer's in-house tariff, **(ii)** that the actuarial principles, in determination of liabilities, have been used in the calculation of reserves for incurred but not reported claims (IBNR) and other reserves where actuarial advice is sought by the IRDA **(i)** Informing the IRDA, in writing of his or her opinion, within a reasonable time, whether **(i)** the insurer has contravened the Insurance Act or any other Acts, **(ii)** the contravention is of such a nature that it may affect significantly the interests of the owners or beneficiaries of policies issued by the insurer, **(iii)** the directors of the insurer have failed to take such action as is reasonably necessary to enable him to exercise his or her duties and obligations under this regulation or **(iv)** an officer/employee of the insurer has engaged in conduct calculated to prevent him or her exercising his or her duties and obligations under this regulation.

Absolute Privilege An appointed actuary should enjoy absolute privilege to make any statement—oral or written—so that he can perform his functions. This is in addition to any other privilege conferred upon him under any other regulations. Any provision of his letter of appointment which restricts or prevents his duties, obligations and privileges under these regulations, would be of no effect.

The regulation's relating to appointed actuary would apply to reinsurers carrying on business in India.

Conflict of Interest The appointed actuary should not function in any other capacity which could result in conflict of interest in performing his/her role.

Assets, Liabilities and Solvency Margins

This section discusses the valuation of assets, determination of amount of liabilities and solvency margin of insurers in India.

Valuation of Assets Every insurer has to prepare a statement of the value of its as detailed below.

Values of Assets The following assets should be placed with value zero: **(a)** agent's balances and outstanding premiums in India, to the extent they are not realised within a period of 30 days; **(b)** agent's balances and outstanding premiums outside India, to the extent they are not realisable; **(c)** sundry debts, to the extent they are not realisable; **(d)** advances of unrealisable character; **(e)** furniture, fixtures, dead stock and stationery; **(f)** deferred expenses; **(g)** profit and loss appropriation account balance and any fictitious assets other than pre-paid expenses; **(h)** reinsurer's balances outstanding for more than three months; **(i)** preliminary expenses in the formation of the company.

The value of computer equipment, including software, should be computed as under: **(i)** 75, 50 and 25 per cents of its cost in the first, second, and the third year of purchase respectively and **(ii)** zero per cent thereafter.

All other assets of an insurer have to be valued in accordance with the IRDA Preparation of Financial Statements and Auditor's Report of Insurance Companies Regulations, 2000.

Statement of Assets Every insurer should prepare a statement of assets as given below.

Statement of Assets

Item (1)	*Category of assets* (2)	*Policyholders' funds* (3)	*Shareholders' funds* (4)
01	Approved securities		
02	Approved investments		
03	Deposits		
04	Non-mandated investments@		
05	Other assets (specify)		
06	Total		
07	Fair value change account		
08	Adjusted value of assets [(6) – (7)]		

@Investments that are neither approved investments nor approved securities.

Determination of Amount of Liabilities All insurers have to prepare a separate statement of the amount of liabilities for life insurance and general insurance.

Valuation of Liabilities—Life Insurance Business The main elements of the valuation of liabilities of a life insurer are specified below.

Method of Determination of Mathematical Reserves Such reserves should be determined separately for each contract by prospective method of valuation in accordance with the following:

The valuation method should take into account **(i)** all prospective contingencies under which any premiums (by the policy-holder) or benefits (to the policy-holder/beneficiary) may be payable under the policy, as determined by the policy conditions. The level of benefits should take into account the reasonable expectations of policy-holders (with regard to bonuses, including terminal bonuses, if any) and any established practices of an insurer for payment of benefits, **(ii)** the cost of any options that may be available to the policy-holder under the terms of the contract.

The determination of the amount of liability under each policy should be based on prudent assumptions of all relevant parameters. The value of each such parameter should be based on the insurer's expected experience and include an appropriate margin for adverse deviations (MAD) that may result in an increase in the amount of mathematical reserves.

The amount of mathematical reserve in respect of a policy, determined above may be negative ('negative reserves') or less than the guaranteed surrender value available ("guaranteed surrender value deficiency reserves") at the valuation date. The appointed actuary should, for the purpose of Section 35 of the Insurance Act, use the amount of such mathematical reserves without any modification and for the purpose of Sections 13, 49,64-V and 64-VA, set the amount of such mathematical reserve to zero, in case of negative service, or to the guaranteed surrender value, in case of such guaranteed surrender value deficiency reserves.

The valuation method outlined above should be called 'Gross Premium Method (GPM)'. If the appointed actuary feels another method (other than the GPM) is to be used, then other approximation (e.g. Retrospective Method) may be used. However, the amount of calculated reserve is expected to be at least equal to the amount that would be produced by the application of the GPM.

The method of calculation of the amount of liabilities and the assumptions for the valuation parameters should not be subject to arbitrary discontinuities from one year to the next.

The determination of the amount of mathematical reserves should take into account the nature the term of the assets representing those liabilities and the value placed upon them and include prudent provision against the effects of possible future changes in the value of assets on the ability of the insurer to meet its obligations arising under policies as they arise.

Policy Cash Flows The gross premium method of valuation should discount the following future policy cash flows at an appropriate rate of interest:

(a) Premiums payable, if any, and benefits payable, if any, on death; benefits payable, if any, on survival; benefits payable, if any, on voluntary termination of contract; and the following, if any: **(i)** basic benefits, **(ii)** rider benefits, **(iii)** bonuses that have already been vested at the valuation date, **(iv)** bonuses as a result of the valuation at the valuation date, and **(v)** future bonuses, (one year after valuation date) including terminal bonuses, (consistent with the valuation rate of interest)

(b) Commission and remuneration payable, if any, in respect of a policy be based on the current practice of the insurer. No allowance should be made for non-payment of commission in respect of the orphaned policies

(c) Policy maintenance expenses, if any, in respect of a policy, as provided above

(d) Allocation of profit to shareholders, if any, where there is a specified relationship between profits attributable to shareholders and the bonus rates declared for policy-holders. However, allowance must be made for tax, if any.

Policy Options Where a policy provides built-in options, that may be exercised by the policyholders, such as conversion or addition of coverage at future date(s) without any evidence of good health, annuity rate guarantees at maturity of contract, and so on, the cost of such options should be estimated and treated as special cash flows in calculating the mathematical reserves.

Valuation Parameters The valuation parameters should constitute the basis on which the future policy cash flows should be computed and discounted. Each parameter would have to be appropriate to the block of business to be valued. An appointed actuary must take into consideration the following:

(a) The value(s) of the parameter should be based on the insurer's experience study, where available. If reliable experience study is not available, the value(s) can be based on the industry study, if available and appropriate. If neither is available, the values may be taken from the basis used for pricing the product. In establishing the expected level of any parameter, and likely deterioration in, experience should be taken into account

(b) The expected level, as determined above, should be adjusted by an appropriate margin for adverse deviations (MAD), the level of MAD being dependent on the degree of confidence in the expected level, and such MAD in each parameter should be based on the Guidance Notes, issued by the Actuarial Society of India, with the concurrence of the IRDA

(c) The values used for the various valuation parameters should be consistent among themselves

The mortality rates should find their reference in a published table, unless the insurer has constructed a separate table based on his own experience. However, **(i)** such published table should be made available to the insurance industry by the Actuarial Society of India, with the concurrence of the IRDA, **(ii)** such rates determined by reference to a published table should not be less than 100 per cent of that published table; they may be less than 100 per cent of that published table if the appointed actuary can justify a lower per cent.

The policy maintenance expenses would depend on the manner in which they are analysed by the insurer, namely—fixed expenses and variable expenses. The variable expenses should be related to the sum assured or premiums or benefits. The fixed expenses may be related to the sum assured and premiums or benefits or per policy expenses. All expenses should be increased in future years for inflation, the rate of inflation assumed should be consistent with the valuation rate of interest.

The valuation rates of interest, to be used by an appointed actuary:

(a) Should be not higher than the rates of interest, for the calculation of the present value of policy cash flows referred to above, determined from prudent assessment of the yields from existing assets attributable to blocks of life insurance business, and the yields which the insurer is expected to obtain from the sums invested in the future, and such assessment shoud take into account **(i)** the composition of assets supporting the liabilities, expected cash flows from the investment on hand, the cash flows from the block of policies to be valued, the likely future investment conditions and the reinvestment and disinvestment strategy to be employed in dealing with the future net cash flows, **(ii)** the risks associated with investment in regard to receipt of income on such investment or repayment of principal and **(iii)** the expenses associated with the investment functions of the insurer

(b) Should not be higher than, for the calculation of present value of policy cash flows in respect of a particular category of contracts, the yields on assets maintained for the purpose of such category of contracts

(c) Should, respect of non-participating business, recognise the risk of decline in the future interest rates

(d) Should, respect of participating business, be based on the assumption (with regard to future investment conditions) that the scale of future bonuses used in the valuation is consistent with the valuation rate of interest

(e) Should, respect of single premium business, take into account the effect of changes in the risk free interest rates.

(f) Should, take into account other parameters, depending on the type of policy. In establishing the values of such parameters, the considerations set out above should be taken into account.

Applicability to Reinsurance The above stipulations also apply to the valuation of business in the books of reinsurers. As regards the business ceded by insurers, the stipulations are applicable to the net sums at risk retained by the insurer. The reinsurance arrangement with an element of borrowing in the form of deposit or credit of any kind, from insurer's reinsurers without the prior approval of the IRDA should not be treated as credit for reinsurance for the purpose of determination of required solvency margin.

Additional Requirements for Linked Business The reserves in respect of linked business should consist of two components, namely, unit reserves and general fund reserves. The unit reserve should be calculated in respect of the units allocated to the policies in force at the valuation date (i.e. in relation to an actual investigation, the date to which the investigation relates) using unit values at the valuation date. The general fund reserves (non-unit reserves) should be determined using a prospective valuation method set out in the preceding discussion, which should take into account the following, namely: **(a)** premiums, if any, payable in future, **(b)** death benefits, if any, provided by the general fund (over and above the value of units), **(c)** management charges paid to the general fund, **(d)** guarantees, if any, relating to surrender values or minimum death and maturity benefits, **(e)** fund growth rates and management charges, **(f)** negative reserves, if any.

Additional Requirements for Provisions Where it is not possible to calculate mathematical reserves for each policy, in the determination of mathematical reserves, the appointed actuary should make aggregate provisions in respect of the following:

(a) Policies in respect of which extra premiums have been charged on account of underwriting of under-average lives that are subject to extra risks such as occupation hazards, overweight, under-weight, smoking history, health, climatic or geographical conditions

(b) Lapsed policies not included in the valuation but under which a liability exists or may arise

(c) Options available under individual and group insurance policies

(d) Guarantees available to individual and group insurance policies

(e) The rates of exchange at which benefits in respect of policies issued in foreign currencies have been converted into Indian rupees and what provision has been made for possible increase in mathematical reserves arising from future variations in rates of exchange

(f) Others, if any.

Statement of Liabilities An insurer should furnish a statement of liabilities in accordance with the IRDA Actuarial Report and Abstract Regulations, 2000.

Valuation of Liabilities—General Insurance The main elements of the valuation of liabilities of general insurers are specified below.

Determination of Liabilities An insurer should:

(I) Place a proper value in respect of the following items, namely: **(a)** provision for bad and doubtful debts, **(b)** reserve for dividends declared or recommended, and outstanding dividends in full, **(c)** amount due to insurance companies carrying on insurance business, in full, **(d)** amount due to sundry creditors, in full, **(e)** provision for taxation in full, and **(f)** foreign exchange reserve.

(II) Determine the amount of following reserves, in the manner specified below:

- **(a)** reserve for unexpire risks, in respect of **(i)** fire business, 50 per cent, **(ii)** miscellaneous business, 50 per cent, **(iii)** marine business other than marine hull business, 50 per cent; and **(iv)** marine hull business, 100 per cent of the premium, net of re-insurances, received or receivable during the preceding twelve months
- **(b)** reserve for outstanding claims should be determined in the following manner: **(i)** where the amounts of outstanding claims of the insurers are known, the amount is to be provided in full; **(ii)** where the amounts of outstanding claims can be reasonably estimated according to the insurer, he may follow the 'case by case method' after taking into account the explicit allowance for changes in the settlement pattern or average claim amounts, expenses and inflation.
- **(c)** reserve for claims incurred but not reported (IBNR) should be determined using actuarial principles. In such determination, the appointed actuary should follow the Guidance Notes issued by the Actuarial Society of India, with the concurrence of, and any directions issued, by the IRDA, in this behalf.

Statement of Liability Every general insurer should prepare a statement of liabilities as shown below, certified by an auditor approved by the IRDA in accordance with Section 64-A of the Insurance Act, and also certified by its appointed actuary in respect of IBNR reserves. The statement should be furnished to the IRDA along with the returns mentioned in Section 15 of the Insurance Act.

Statement of Liabilities:

Item	*Description*	*Reserves for unexpired risks*	*Reserves for outstanding claims*	*IBNR reserves*	*Total reserves*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
01	Fire				
02	Marine: Marine cargo, Marine hull				
03	Miscellaneous: Motor engineering, Aviation, Rural insurance, Others				
04	Health insurance				
05	Total liabilities				

Determination of Solvency Margin The statement of solvency margin should be separately prepared for life insurance business and general insurance business.

For Life Insurance Business Every insurer should determine the required solvency margin, the available solvency margin (i.e. the excess of value of assets over the value of insurance liabilities and other liabilities of policy holders/shareholders funds) and the solvency rates (i.e. the ratio of the amount of available solvency margin to the amount of required solvency margin) as specified under the IRDA Actual Report and Abstract Regulations, 2000.

For General Insurance Business Every insurer is required to determine the required solvency margin, the available solvency margin and the solvency ratio as shown in Exhibits 6.2 and 6.3.

Exhibit 6.2 Solvency Margin-Based on Net Premium and Net Incurred Claims

Item (1)	*Description (class of business)* (2)	*Gross premiums* (3)	*Net premiums* (4)	*Gross incurred claims* (5)	*Net incurred claims* (6)	*RSM-1* (7)	*RSM-2* (8)	*RSM* (9)
01	Fire							
02	Marine: Marine cargo							
03	Marine hull							
04	Miscellaneous: Motor							
05	Engineering							
06	Aviation							
07	Liability							
08	Rural insurance							
09	Others							
10	Health insurance							
12	Total							

Notes: (1) RSM-1 means Required Solvency Margin based on net premiums, and should be determined as 20 per cent of the amount which is the higher of the gross premiums multiplied by Factor A as specified below and the net premiums.

(2) RSM-2 means Required Solvency Margin based on net incurred claims, and should be determined as 30 per cent of the amount which is the higher of the gross net incurred claims multiplied by a Factor B as specified below and the net incurred claims:

Item (1)	*Description (class of business)* (2)	*A* (3)	*B* (4)
01	Fire	0.5	0.5
02	Marine: Marine cargo	0.7	0.7
03	Marine hull	0.5	0.5
04	Miscellaneous: Motor	0.85	0.85
05	Engineering	0.5	0.5
06	Aviation	0.9	0.9
07	Liability	0.85	0.85
08	Rural insurance	0.5	0.5
09	Others	0.7	0.7
10	Health	0.85	0.85

(3) RSM means Required Solvency Margin and should be the higher of the amounts of RSM-1 and RSM-2.

Exhibit 6.3 Available Solvency Margin and Solvency Ratio

Item (1)	*Description (2)*	*Notes (3)*	*Amount (4)*
01	Available assets in policyholders' funds		
	Deduct:		
02	Liabilities		
03	Other liabilities		
04	Excess in policyholders' funds (01 – 02 – 03)		
05	Available assets in shareholders funds		
	Deduct:		
06	Other liabilities		
07	Excess in shareholders' funds: (05 – 06)		
08	Total ASM (04) + (07)		
09	Total RSM		
10	Solvency ratio (Total ASM/Total RSM)		

Notes:
1. Item 01 is the amount of the adjusted value of assets in respect of policyholders' funds.
2. Item 02 is the amount of total liabilities.
3. Item 03 is the amount of other liabilities arising in respect of policyholders' funds.
4. Item 05 is the amount of the total assets in respect of shareholders' funds.
5. Item 06 is the amount of other liabilities arising in respect of shareholders' funds.

Health Insurance Business Where the insurer transacts health insurance business, providing health covers, the amount of liabilities should be determined in accordance with the principles specified above under these regulations.

Business Outside India Where the insurer transacts insurance business in a country outside India, and submits statements or returns or any such particulars to a public authority of that country, he should enclose the same along with the details specified in accordance with these regulations and the IRDA Actuarial Report and Abstract Regulations, 2000. However, if the appointed actuary is of the opinion that it is necessary to set additional reserves over and above the reserves shown in the statements/returns/any such particulars submitted to the public authority of a country outside India, he may set such additional reserves.

Furnishing of Forms The details of assets and liabilities should be furnished separately for business within India and total business transacted by the insurer.

Personal Visit of Appointed Actuary The IRDA may, if considered necessary and expedient, ask the appointed actuary to make personal visits to its office to elicit from him any further information.

Registration of Indian Insurance Companies Regulations 2016

The registration of Indian insurance companies is discussed below with reference to **(i)** registration, **(ii)** application for registration, **(iii)** annual fee, and **(iv)** action in case of default.

Procedure for Registration of Indian Insurance Company/Statutory Body to Carry on Insurance Business To carry on insurance business, an application should be made to the IRDA for issuance of requisition for registration application. It may require the applicant to furnish further information/clarifications regarding the matters relevant to the application. It may, by recording the reasons in writing, reject the application. The applicant aggrieved by the decision of the IRDA may, within 30 days appeal to the Securities Appellate Tribunal (SAT). An applicant, whose requisition for registration application has been accepted should make an application in the prescribed form for grant of **certificate of registration**. The requisition for registration application should be for life/general/health insurance business exclusively or reinsurance business.

An applicant would not be eligible to apply for the requisition in the circumstances where **(i)** the requisition for registration application has been rejected by the IRDA or withdrawn; **(ii)** the foreign investors or Indian promoter of the exited venture have exited or application for registration has been rejected by the IRDA or withdrawn by the applicant for any reason at any time during the preceding two financial years from the date of requisition for registration application; **(iii)** certificate of registration has been cancelled by the IRDA; **(v)** the name of the applicant does not contain the words 'insurance' or 'assurance'.

The requisition for registration application should be accompanied by **(i)** a certified copy of the **(a)** memorandum and articles of association, where the applicant is a company or **(b)** Act of Parliament setting up the statutory body to carry on insurance business; **(ii)** the name, address and the occupation of the directors; **(iii)** a certified copy of the annual report of Indian promoters and the foreign investors for the last five years preceding the year of filing of requisition of registration application; **(iv)** a certified copy of the shareholders' agreement between Indian promoter and foreign investors of the applicant; **(v)** projections of business for 5 years duly approved by the Board of Directors of the applicant. **Indian promoter** means a **(i)** company which is not a subsidiary of another company, **(ii)** banks excluding foreign banks/branches functioning in India, **(iii)** core investment company, **(iv)** public financial institution, **(v)** cooperative society, **(vi)** limited liability partnership (LLP) and **(vii)** any other person/entity allowed by the IRDA. **Foreign investors** mean all eligible non-resident entities/persons resident outside India investing in equity shares of an Indian insurance company permitted through the foreign direct investment (FDI) and foreign portfolio investment (FPI) windows under the FEMA regulations. The **FDI** means/includes investment by non-resident entities/persons resident outside India and other eligible entities. It includes investment by foreign venture capital investors. The **FPI** means/includes by FIIs, FPIs, NRIs, QFIs and other eligible portfolio investor entities/persons.

> **Indian promoter** means a (i) company which is not a subsidiary of another company, (ii) banks excluding foreign banks/branches functioning in India, (iii) core investment company, (iv) public financial institution, (v) cooperative society, (vi) limited liability partnership (LLP) and (vii) any other person/entity allowed by the IRDA.

> **Foreign investors** mean all eligible non-resident entities/persons resident outside India investing in equity shares of an Indian insurance company permitted through the foreign direct investment (FDI) and foreign portfolio investment (FPI) windows under the FEMA regulations.

> **FPI** means/includes by FIIs, FPIs, NRIs, QFIs and other eligible portfolio investor entities/persons.

The IRDA may require the applicant to furnish further information/clarification regarding the matter relevant to consider the requisition for registration application. It would take into account all matters relating to carrying on of the business of insurance by the applicant. In particular and without prejudice to the generality of the foregoing, it would consider the following matters: **(i)** general track record of conduct and performance of each of the Indian promoter and foreign investor in the fields of business/profession they are engaged in; **(ii)** record of conduct and performance of their directors and persons in management and the applicant; **(iii)** capital structure of the applicant; **(iv)** ability to meet the obligation to provide life/general/health insurance to the persons residing in the rural sector, workers in the unorganised sector or informal sector or for economically vulnerable or backward classes of the society and other categories of persons specified by the IRDA; **(v)** ability to meet the obligation to underwrite insurance business in third party risks of motor vehicles as specified by the IRDA in respect of general insurance companies; **(vi)** planned infrastructure of the applicant; **(vii)** proposed business expansion plan for 5 succeeding years, including establishment of place of business in rural areas, to effectively carry out the insurance business; and **(viii)** other relevant matters for carrying out the provisions of the Insurance Act. On being satisfied with the information submitted and on verification that the **(a)** requisition is complete in all respects and is accompanied by all the required documents; and **(b)** the applicant would carry on all specified functions in respect of the insurance business including management of investments within India, the IRDA may accept the requisition and issue the application for grant of certificate of registration to the applicant.

Where the above requirements are not complied with, the IRDA may, after giving the applicant a reasonable opportunity of being heard, reject the application. The order rejecting the application should be communicated within 30 days of such rejection to the applicant in writing stating the grounds on which the application has been rejected. An applicant aggrieved by the decision may appeal to the Securities Appellate Tribunal.

Application for Registration An applicant, whose requisition has been accepted, make an application in the prescribed form for grant of certificate of registration. The applicant should be accompanied by **(a)** evidence of having minimum **(i)** ₹100 crore and **(ii)** ₹200 crore paid-up equity share capital in case of applications respectively for life/general/health and re-insurance business; **(b)** an affidavit by the promoters and foreign investor certifying that the requirements of Insurance Act to the effect that the paid-up capital is adequate after excluding any **preliminary expenses** (i.e. expenses relating to its formation including legal/accounting/share issue expenses and expenses incurred prior to grant of CoR) of the company have been satisfied; **(c)** a statement indicating the distinctive numbers of shares issued to each Indian promoter and investor in respect of its share capital; **(d)** an affidavit by the managing director, chief executive officer or whole-time director of the Indian promoters and the foreign investors certifying that the holding of the prescribed foreign paid-up equity capital is calculated in accordance with the prescribed regulations and does not exceed 49 per cent of the total paid-up capital of the applicant-company. In case of Indian promoter being limited liability partnership, the affidavit should be signed by the designated partner; **(e)** in case of there being foreign investment in the applicant, an affidavit by the managing director, chief executive officer or whole-time directors and the Indian promoters and foreign investor certifying that the company is **Indian owned and controlled** (i.e. controlled by resident Indian citizens/Indian companies owned/controlled by the resident Indian citizens); **(f)** where the foreign direct investment is more than 26 per cent, a certified copy of the approval given by FIPB; **(g)** a certified copy of the published **(1)** prospectus **(2)** standard forms of the insurer and statements of the assured rates, advantages, terms and conditions to be offered in connection with insurance policies together with a certificate by an actuary in case of life insurance business that they are workable and sound, **(3)** memorandum of understanding/management agreement/shareholders agreement/voting rights agreements/any other agreements entered into between the Indian promoters and the foreign investors or amongst the promoters as a whole

> **Indian owned and controlled** means controlled by resident Indian citizens/Indian companies owned/controlled by the resident Indian citizens.

including details of the support/comfort letters exchanged between the parties; **(h)** proof in support of payment of the non-refundable fee of ₹ 5 lakh; **(i)** a certificate from a practicing chartered accountant/company secretary certifying that all the requirements relating to registration fees, equity shares capital, and other requirements of the Insurance Act have been complied with; **(j)** any other information required by the IRDA during the processing of the application for registration. The holding of equity shares by foreign investors in the applicant company would be aggregate of the **(i)** quantum of paid-up equity share capital held by them including foreign venture capital investors and **(ii)** proportion of the paid-up capital held/controlled by it either by itself or through its subsidiary companies in the Indian promoter(s)/investor(s).

Every insurer who has been granted registration should within 45 days of the end of every quarter, furnish to the IRDA a statement indicating changes exceeding 1 per cent of the paid-up capital of the promoter. However, any change in excess of 5 per cent should be reported immediately.

Consideration of Application The IRDA would take into account, for considering the grant of certificate, all matters relating to carrying on the business of insurance by the applicant. In particular and without prejudice to the generality of the foregoing and without in any manner affecting its powers, it would consider the **(a)** nature of insurance products; **(b)** level of actuarial, accounting and other professional expertise within the management of the applicant; **(c)** organisation structure of the applicant to carry on all functions in respect of the insurance business including management of the investments within its own organisation; **(d)** all other relevant matters for carrying out the provisions of the Insurance Act.

Where an application for registration is not complete in all respects and does not conform to the specified regulations/instructions in the prescribed form and after considering the relevant matters and on being satisfied that it is not desirable to grant a certificate, the IRDA, may reject the application. The rejection should be communicated to the applicant in writing stating the ground on which the application has been rejected. An aggrieved applicant may within 30 days appeal to the Securities Appellate Tribunal. The applicant, whose application for registration has been rejected, would not be entitled to a certificate of registration. The non-refundable fee of ₹5,00,000 for registration should be remitted to the IRDA.

Grant of Certificate of Registration The IRDA after making such inquiry as it deems fit and on being satisfied that the **(a)** application is eligible, and in its opinion, is likely to meet effectively its obligations imposed under the Insurance Act; **(b)** financial conditions of the promoters, foreign investors and the general character of the management of the applicant are sound; **(c)** volume of business likely to be available to, and the capital structure and earning prospects of the applicant, will be adequate; **(d)** interests of the general public will be served if the certificate is granted; and **(e)** applicant has complied with, and has fulfilled, all the requirements of the Insurance Act relating to **(i)** prohibition of transaction of insurance business by certain persons, **(ii)** restriction on name of insurer, **(iii)** provision pertaining to managers and **(iv)** prohibition of common officers and requirement as to whole-time officers, may register the applicant as an insurer for the class of business for which it is found suitable and grant of applicant the certificate in the prescribed form. It may impose such conditions as may be deemed fit. The applicant would be bound by them. The applicant granted the CoR should commence business within 12 months. This may be extended upto 24 months by the IRDA.

Annual Fee An insurer who has been granted CoR should pay for every financial year to the IRDA before January 31 of the preceding financial year the annual fee which would be the higher of **(a)** ₹ 5,00,000 or **(b)** one-twentieth of 1 per cent of total gross premium written direct by an insurer in India during the financial year preceding the year in which the annual fee is required to be paid, or rupees ten crore whichever is less. However, in the case of an insurer carrying on solely re-insurance business, the total premium in respect of facultative reinsurance accepted by it in India would be taken into account. If the insurer fails to deposit the annual fee before the specified date, the IRDA may accept the payment of annual fee along with an additional fee by way of penalty of **(a)** 2 per cent of the annual fee if the fee is paid within 30 days after the expiry of the last date of payment of annual fee; or **(b)** 10 per cent of the annual fee if the fee is paid after 30 days from the expiry of the last date of payment, but before the end of financial year in which the annual fee was required to be paid. Where the insurer has failed to pay the fee before the end of the financial year, its certificate of registration is liable to be cancelled.

Procedure for Action in Case of Default Without prejudice to any penalty which may be imposed/action taken under the provisions of the Insurance Act, the registration of an Indian insurance company/insurer may be suspended for a specified period by the IRDA under the following circumstances: **(i)** the insurer fails, at any time, to comply with the provisions relating to the excess of the value of its assets over the amount of its liabilities, **(ii)** it is in liquidation or is adjudged as an insolvent, **(iii)** its business has been transferred to any person/amalgamated with the business of any other insurer without the approval of the IRDA, **(iv)** defaults in complying with, or acts in contravention of, any requirement of the Insurance Act/regulation, direction/order issued by the IRDA, particularly if the insurer **(a)** conducts its business in a manner prejudicial to the interest of the policyholders; **(b)** fails to furnish any information as required by the IRDA relating to its insurance business; **(c)** does not submit periodical returns as required under the Insurance Act or by the IRDA; **(d)** does not cooperate in any inquiry conducted by the IRDA; **(e)** indulges in manipulating practices; **(f)** indulges in unfair trade practices; **(g)** fails to make investment in the specified infrastructure or social sector, **(v)** the IRDA has reasons to believe that any claim upon the insurer arising in India under any policy of insurance remains unpaid for three months after final judgment in regular court of law, **(vi)** the insurer carries on any business other than insurance business or any prescribed business, **(vii)** the insurer defaults in complying with any direction issued or order made by the IRDA, under the IRDA Act, **(viii)** the insurer defaults in complying with, or acts in contravention of, any requirement of the Companies Act/the General Insurance Business (Nationalisation) Act/the Foreign Exchange Management Act/Prevention of Money Laundering Act, **(ix)** the insurer fails to pay the required fee, or **(x)** he is convicted for an offence under any law for. The IRDA for reasons to be recorded in writing may, in case of repeated defaults of the type mentioned above, may impose penalty of cancellation of CoR. On and from the date of suspension/cancellation of CoR, the insurer would cease to transact new insurance business. The IRDA may direct the insurer to continue to service the existing policyholders for specified period.

Investment Regulations/Norms

The IRDA norms relate to **(a)** regulation of investments and **(b)** exposure/prudential norms.

Regulation of Investments The regulations/norms pertain to investment assets of **(1)** life/pension/group/annuity and unit linked business and **(2)** general insurance business. The investment assets in case of a life insurer means all investments made out of **(i) shareholders fund**, representing solvency margin, non-unit reserves of unit linked insurance business and participating/non-participating funds of policyholders at their carrying value and **(ii)** policyholders pension, annuity and group business at their carrying value and **(iii)** their unit reserves of unit linked business at market value.

Life Business Subject to the provisions of Section 27-A of the Insurance Act, a life insurer should invest its investment assets forming part of the controlled fund of life business, one-year renewable pure group term assurance business (OYRGTA) and non-unit reserves of unit linked insurance business as specified below:

Types of investment	*Percentage of fund*
(i) Government securities, Not less than	25
(ii) Government/other approved securities including (i) above, Not less than	50
(iii) Approved investments@ specified in Section 27-A of the Insurance Act and other investments specified in Section 27-A(2) taken together subject to specified exposure/prudential norms not exceeding	50
(iv) Other investments specified under Section 27-A(2) of the Insurance Act subject to exposure prudential norms, Not exceeding	15
(v) Investment in housing and infrastructure by way of subscription/purchase of:	
(A) Investment in Housing **(a)** Bonds/debentures of HUDCO and NHB, **(b)** Bonds/debentures of housing finance companies (HFCs) duly accredited by NHB/guaranteed by Government or carrying a minimum of **AA** rating by a SEBI-registered agency, and **(c)** Asset backed securities with underlying housing loans, satisfying the IRDA-specified norms.	
(B) Investment in infrastructure (i.e. subscription/purchase of bonds/debentures, equity and asset backed securities with underlying infrastructure assets), categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, not less than	15

@ List of Approved Investments Included in approved investments for life business are the following:

1. All investments specified in Section 27-A of the Insurance Act (**discussed in an earlier Section of this Chapter**) excepting **(a)** securities of, or guaranteed as to principal and interest by, the Government of the United Kingdom, **(b)** first mortgage on immovable property situated in India/any other country where the insurer is carrying on business provided the property mortgaged is not a leasehold property with an outstanding term of at least 30 years and the value of the property exceeding by one-third, or if it consists of buildings, exceeds by one-half, the mortgage money and **(c)** immovable property situated in India/any other country provided the property is free of all encumbrances.
2. The additional investments notified by the IRDA as approved investments under Section 27-A (1)(S) of the Insurance Act, namely:
   (a) All secured loans/debentures/bonds, and other rated debt instruments@@, equity/preference shares and debt instruments issued by all-India Financial Institutions (FIs) recognised by the RBI. Such investments should be made in terms of investment policy, guidelines, benchmarks, exposure norms, and limits approved by the Board of Directors of the insurer.

(b) Bonds/debentures of companies rated not below **AA**/equivalent and **P1**/equivalent ratings for short-term bonds/debentures/CDs/CPs by a SEBI-registered rating agency.
(c) Subject to norms/limits approved by the Board of Directors of the insurers, deposits (including CDs) with banks and Primary Dealers (PDs) duly recognised by the RBI.
(d) Collateralised borrowing and lending obligations (CBLOs) created by the Clearing Corporation of India Ltd/recognised by the RBI, and exposures to Gilt, G-Sec and liquid mutual funds and money market instruments/investments.
(e) Asset backed securities underlying housing loans/infrastructure assets.
(f) Commercial papers of companies/FIs recognised by the RBI rated by a SEBI-registered agency.
(g) Money market instruments with maturity of less than one year comprising of rated CDs/CPs, Repos/Reverse repos, T-bills, Call/notice/term money, CBLOs and any other instrument prescribed by the IRDA.

@@ Rating of Instruments All investments in assets/instruments capable of being rated as per market practice should be made by an insurer only on the basis of their rating by a SEBI-registered rating agency. Investments in such unrated instruments are prohibited. The minimum acceptable rating for long-term debt instruments of companies/FIs would be **AA**/its equivalent and **P1**/its equivalent for short-term instruments. In case investments in FIs of this grade are not available to meet the requirements of the insurer, its Investment Committee, if fully satisfied, may approve investments in instruments carrying at least **A+**/equivalent rating. The reasons for such investments should be recorded in its minutes. The instruments downgraded below the minimum rating should be automatically reclassified under **other investment**. Investments in listed shares should be made only in actively traded and liquid instruments, that is, those other than thinly traded in terms of SEBI regulations and guidelines applicable to mutual funds. Not less than 75 per cent and 65 per cent of debt instruments (including Government and other approved securities in case of life business and in case of general business respectively) should be in sovereign debt having a rating of **AAA**/equivalent for long-term and **P1**+/equivalent for short-term instruments. This is applicable to segregated funds in case of unit linked funds also. Not more than 5 per cent (life insurer) and 8 per cent (general insurer) of funds in debt instruments should have a rating of **A**/below or equivalent rating for long-term. No investments on be made in other investments out of funds of the unit reserve position of all categories of unit linked funds. Investments in debt instruments rated **AA**-minus or below would be part of other investments.. Nevertheless, rating should not replace appropriate risk analysis and management on the part of the insurer. He should conduct risk analysis commensurate with the complexity of the product(s) and the materiality of their holdings. They could also refrain from such investments.

Pension and General Annuity Business Funds belonging to the pension and general annuity business should be invested in the following manner:

Type of investment	*Percentage of fund*
(i) Government securities, Not less than	20
(ii) Government/other approved securities including (i) above, Not less than	40
(iii) Approved investments, subject to exposure/prudential norms, Not exceeding	60

Investments in the category of **other investments** under Section 27-A(2) of the Insurance Act are prohibited for such funds. Funds pertaining to group insurance business excepting One-year Renewable Pure Group Term Assurance Business (**OYRGTA**) would form part of pension and general annuity fund. But the OYRGTA funds should be invested on the pattern of the life business.

Unit Linked Insurance Business The segregated fund of the unit linked business should be invested as per the pattern of investments offered to, and approved by, the policyholders where the units are linked to categories of marketable and easily realisable assets. However, the investment in approved investments should not be less than 75 per cent of such funds in each segregated fund.

General Insurance Business Subject to the provisions of Section 27-B of the Insurance Act, the investment assets (i.e. shareholders funds representing solvency margin and policyholders funds at their carrying value) of general insurance companies should be invested in the manner set out below:

Type of investment		*Percentage*
(i)	Central Government securities, Not less than	20
(ii)	Government/Other approved securities including **(i)** above, Not less than	30
(iii)	Approved investments specified in Section 27-B and other investments specified in Section 27-B(3) taken together subject to exposure/prudential norms, Not exceeding.	
(iv)	Other investments specified under Section 27-B(3) subject to a exposure/prudential norms, Not exceeding	70 25
(v)	Housing and loans to state Governments for housing/fire fighting equipment by way of subscription to/purchase of:	
	(A) Investment in Housing: **(a)** Bonds/debentures of HUDCO/NHB, **(b)** Bonds/debentures of HFCs duly accredited by NHB/guaranteed by Government or carrying a minimum **AA** rating from a SEBI-registered agency, and **(c)** Asset backed securities (ABS) with underlying housing loans satisfying the specified norms, Total investment in categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, Not less than	5
	(B) Investment in infrastructure including subscription/purchase of bonds/debentures, equity shares and ABS with underlying infrastructure assets, Total investment in categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, Not less than	10

@@List of Approved Investments The approved investments for general business comprise of the following two categories.

1. All investments specified in Section 27-B (**discussed earlier in this Chapter**) excepting **(a)** United Kingdom Government/Government guaranteed securities, **(b)** immovable property situated in another country, and **(c)** first mortgage on immovable property situated in India/any other country provided the property mortgaged is not leasehold property with outstanding term of less than 15 years and the value of the property exceeds by one-third or if it consists of buildings, exceeds by one-half the mortgage money.
2. The additional approved investments specified by the IRDA under Section 27-B(1) of the Insurance Act are the same as under Section 27-A(1) applicable to life business (**discussed earlier**). All other conditions are also similarly applicable.

Re-insurance Business Until separate norms/regulations are prescribed by the IRDA, the investment assets of re-insurance business should be invested on the pattern of general business.

Exposure/Prudential Norms Subject to provisions of Sections 27-A and 27-B of Insurance Act, investments of insurance companies should be based on the exposure/prudential norms set out below. The maximum exposure limit for a single investee company from all investment assets should not exceed the lower of the following: **(i)** 10 per cent of investment assets of life/general insurers and **(ii)** aggregate amount calculated under **(a)** and **(b)** of the following table:

Types of investment	*Limits for investee company*	*Limit for the entire "group" of the investee company*	*Limits for industry sector (other than infrastructure sector) to which the investee company belongs*
(1)	*(2)*	*(3)*	*(4)*
(a) Investments in equity/preference shares/debentures	10@ per cent of outstanding equity shares (face value) or 10 per cent of the amount under **(1)** all funds of life insurance/pension, annuity and group business and unit reserve portion of all categories of unit linked funds, **(2)** general/insurance/reinsurance business which ever is lower.	Not more than **(i)** 15 per cent of the amount under life/pension/unit linked business or general business or **(ii)** 15 per cent of investment assets in all companies belonging the group whichever is lower.	Not more than **(i)** 15 per cent in case of life/pension/unit linked business or general insurance or **(ii)** 15 per cent of the investment assets whichever is lower.
(b) Investments in debt/loans/any other permitted investment by the Insurance Act/regulations other than item **(a)** above	10@ per cent of the paid-up capital, free reserves (excluding revaluation reserves) and debentures/bonds of the investee company or 10 per cent of respective fund/investment assets whichever is lower	—	Exposure to infrastructure investments are subject to Notes 1, 2, 3 and 4 given below

@In case of life and general insurers having assets of the undermentioned size, the limit would be as mentioned below:

Investment assets	*Limit for investee company*			
	Equity		*Debt*	
1. ₹2,50,000 crore or more	15 per cent	[of outstanding equity shares (face value)]	15 per cent	[of paid up capital, free reserves (excluding revaluation) and debentures/bonds]
2. ₹50,000 – ₹2,50,000 crores	12 per cent		12 per cent	
3. Less than ₹50,000 crores	10 per cent		10 per cent	

Notes:

1. Industry sector norms would not apply for investment made in **infrastructure** facility.
2. Investments in infrastructure debt fund approved by the IRDA would be reckoned on a case to case basis for investments in infrastructure.

3. Exposure to a public limited infrastructure investee company would be the lower of **(i)** 20 per cent of equity shares (face value) in case of equity or **(ii)** 20 per cent of equity plus free reserves (excluding revaluation reserves) plus debentures/bonds taken together in case of debt. With the prior approval of the Board of Directors, an additional 5 per cent can be invested in debt instruments alone. The outstanding tenure of debt instruments beyond the permissible exposure should be at least five years at the time of investment. The dividend track record as per Sections 27-A(1)(l) and 27-B(1)(h) of the Insurance Act in the case of primary issuance of a wholly owned subsidiary of a corporate/PSU would apply to the holding company. However, all investments in infrastructure investee company would be subject to **group** (two/ore individuals, associations of individuals, firms, trusts, trustee, body corporates/any combination which exercises/is established to be in a position to exercise significant influence/control, use of common brand names directly/indirectly over any associate in Accounting Standard (AS-23), body corporate, firm/trust/associated person as stipulated by the IRDA) and promoter group exposure norms.
4. Subject to group/promoter group exposure norms, an insurer can invest a maximum of 20 per cent of the project cost of a public limited special purpose vehicle (SPV) engaged in infrastructure sector as part of approved investment provided **(i)** such investment is in debt, **(ii)** the parent company guarantees the entire debt and the interest of the SPV. Such guarantee should be limited to 20 per cent of the networth, **(iii)** the principal/interest if not paid within 90 days of the due date would be classified as other investment, **(iv)** the latest instruments of the parent company has rating not below **AA** grade, **(v)** the networth of the parent company should not be less than ₹ 500 crore (if unlisted) and ₹ 250 crore (if listed).
5. Investments in securitised assets (mortgage/asset based, securing receipts) in total (both approved and others) should not exceed 10 per cent and 5 per cent of investment assets in case of life and general insurance companies respectively. Similar limits would also apply to approved mortgaged/asset based investments with underlying housing/infrastructure assets. If downgraded below **AAA**/equivalent, they should be reclassified as other investments.
6. Investment in immovable property would be limited to 5 per cent of investment assets in case of all insurers.
7. Subject to exposure limits, total investments of all insurers in all companies belonging to the promoter group should not be more than 5 per cent in aggregate. Such investments cannot be by way of private placement or in unlisted instruments.
8. The exposure limits for financial/insurance activities should stand at 25 per cent of investment assets of all insurers. Investments in certificate of deposit/fixed deposit would not be deemed as a part of this exposure.

Additional Information The IRDA may, by general/special order, require from the insurers specified information in the specified manner at specified intervals and time limit.

Reporting of Extraordinary Events Every insurer should report to the IRDA immediately the effect/probable effect of any event coming to his knowledge which could have material impact on the investment portfolio and consequently on the security of policyholders benefits/expectations.

Investment Management ***(A) Constitution of Investment Company*** Every insurer should constitute an investment committee consisting of a minimum of two non-executive directors of the insurer, the CEO, the Chiefs of finance/investment division and the Appointed Actuary. Its decisions should be recorded/open to inspection by the IRDA.

(B) Investment Policy All insurers should **(i)** draw up an annual investment policy (fund-wise in case of unit linked business), **(ii)** have a model code of conduct to prevent insider/personal trading of officers involved in various levels of investment operations in compliance with the

SEBI Prohibition of Insider Trading Regulation approved by its Board of Directions who should, while formulating such policy, ensure compliance with the following:

- Issues relating to liquidity, prudential norms, exposure limits, stop loss limits including securities trading, management of all risks/assets and liabilities, scope of internal/concurrent audit of investments and investment statistics and all other internal controls of investment operations, the provisions of the Insurance Act, IRDA investment regulations/guidelines/circulars;
- Ensuring adequate return on policyholders/shareholders funds consistent with the protection, safety and liquidity of the fund(s).
- The investment policy approved by the Board of Directors should be implemented by the investment committee and the Board should review on a quarterly basis the monitoring of fund-wise product-wise performance.
- The Board should review the investment policy and its implementation on an half-yearly basis or at short intervals and make necessary modifications to bring it in line with the investment provisions in the Insurance Act/regulations keeping in mind protection of policyholders interest and pattern of investment laid down in these regulations or in terms of the agreement with the policyholders in the case of unit linked business. The details of the investment policy/its periodical review should be made available to the internal/concurrent auditors whose comments on the review and its impact on the investment operations, systems and procedures should be placed before the Audit Committee of the Board.

(C) Investment Operations The funds should/continue to be invested in equity shares/equity-related instruments and debt instruments rated by a SEBI-registered agency. The Board of Directors should lay down clear norms for investing in **other investments** specified in Sections 27-A(2) and 27-B(3) of the Insurance Act by the investment committee taking into account the safety and liquidity of the policyholders funds and protection of their interest. In order to ensure proper internal control of investment functions/operations, the insurer should clearly segregate the functions/operations of front, mid and back office and no function should be outsourced. Also the primary data server of the computer application used for investment management should remain within the country.

(D) Processing of Unit Linked Business Applications and Delcaration of NAV

- All applications received for premium payment (as also other than premium payment) switches, redemption, surrender, maturity claim and so on should be time-stamped and dated.
- Whereas for applications with local cheques/cash/demand draft payable at the place of the receipt of the premium received **(a)** before **(b)** after cut-off time (3 P.M.), the applicable NAV would be the closing NAV of the same day and the next business day respectively, the NAV of the day on which the cheque/demand draft is reclaimed would be applied.
- Every insurer should reconcile the premium received net of charges and benefits paid under each product (Unique Identification Number – UIN) with value of all the segregated funds (segregated fund identification number – SFIN) net of fund management charges held under a single UIN on a day-to-day basis. The UIN-wise reconciliation and the value of policy-wise units held by the policyholders should be disclosed on the insurers website and the fund-wise NAV (SFIN-wise) on the website of the insurers as well the life council website on the same day. The internal/concurrent auditor should submit a report on a quarterly basis.

- The applicable NAV for applications received before and after 3 P.M. on the last business day of the financial year would be of the last business day or the immediate next business respectively.
- For allotment of units, the applicable NAV would be as per the date of commencement of policy for new policy contracts and date of receipt of premium for renewals.

(E) Risk Management Systems

- The Board of Directors should implement the IRDSAI-mandated investment risk management system and process. Its implementation should be certified by a CA firm.
- The system should be reviewed in the beginning of every second financial year/or at shorter frequency by a CA firm and the certificate should be filed with the IRDA along with the first quarter return.

(F) Audit and Reporting to Management

- The audit committee constituted by the Board of Directors of the insurer should be headed by a chartered accountant (CA) member.
- The investment transactions covering the shareholders/policyholders funds should be audited through internal/concurrent auditor on a quarterly basis. The details of investment policy, implementation status of investment risk management system/process or its review should be available to them who should comment on them in their report to the audit committee of the Board of Directors.

(G) Category of Investments Funds of insurers should be invested only within the exhaustive category listed in the IRDA guidelines.

(H) The IRDA may call for further information from time to time as it deems necessary and in the interest of policyholders and issue directions to insurers as it thinks fit.

Dealings in Financial Derivatives All insurers may deal in **financial derivatives** [i.e. a derivative defined by the Securities Contracts (Regulation) Act and includes a contract which derives its value from interest rates of underlying debt securities and other derivatives contracts stipulated by the IRDA] only to the extent permitted and in accordance with the IRDA guidelines. Any margin/unamortised premium paid by an insurer in connection with the financial derivatives to the extent they are reflected as asset position in the balance sheet of the insurer in accordance with the IRDA guidelines would be treated as **Approved Investments** only to the extent the derivative position constitutes a hedge for the underlying investment/portfolio which itself is treated as an approved investment. All other margins/unamortised premium paid to the extent reflected in the balance sheet of the insurer in accordance with the IRDA guidelines would be treated as other investment.

PREPARATION OF FINANCIAL STATEMENTS AND AUDITOR'S REPORT

The IRDA regulations relating to the preparation of financial statements, management report and auditor's report of insurance companies are examined in this section for life and general insurance companies.

Life Insurance Companies The compliance requirements are detailed in **Appendix 6-A on the website. The website address is http://www.mhhe.com/khanfs9e.**

General Insurance/Reinsurance Companies The compliance requirements for general insurance companies are detailed in **Appendix 6-B on the website. The website address is http://www.mhhe.com/khanfs9e.**. Until separate regulations are made, the requirements applicable to general insurance companies would apply mutatis mutandis to reinsurers.

Auditors' Report The matters to be specified by the auditors' report in their report are given in **Appendix 6-C on the website. The website address is http://www.mhhe.com/khanfs9e.** The IRDA may from time to time issue separate guidelines in matters of appointment continuance/ removal of auditors, their qualification and experience, periods of appointment and rotation and so on.

Third Party Administrators (TPAs)—Health Services

The main elements of the IRDA regulations are: **(1)** licensing of TPAs, **(2)** revocation/cancellation of their licence, **(3)** code of conduct for them, **(4)** maintenance/confidentiality of information and **(5)** miscellaneous provisions.

> **TPA** is a company which provides health services for a fee to an insurance company.

Licensing of TPAs An IRDA-licensed **TPA** registered as a company under the Companies Act provides health services for fee/ remuneration specified in an agreement entered into with an insurance company. It prescribes the terms/ conditions of health services which may be rendered to and/or received by each of the parties to the agreement. The main/primary objective of the company should be to carry on business as a TPA in health services and it should not engage itself in any other business. It should have a minimum **(i)** paid-up equity capital and **(ii)** working capital (i.e. current assets less current liabilities) of ₹1 crore. At least one of its Directors should be a qualified medical doctor registered with the Medical Council of India. Not more than 26 per cent of its equity shares can be held by a foreign company. It should seek prior approval of the IRDA for change in shareholding exceeding 5 per cent of its paid-up capital by way of transfer of existing shares or fresh issue of shares to new/existing shareholders.

The application for licence as TPA to the IRDA should be in the specified form together with a nonrefundable processing fee of ₹20,000. It would be incumbent on applicant-TPA to furnish within the specified time such information/document(s) as the IRDA may deem fit. On being satisfied that the applicant is eligible to function as TPA, it would issue a licence on payment of a licence fee of ₹30,000. An applicant whose application is rejected can apply again after two years.

Within 15 days of the execution of the agreement between TPA and the insurance company or its modification, a copy should be filed with the IRDA. However, a TPA can serve more than one insurance company. Similarly, an insurance company can engage more than one TPA. The parties to the agreement should agree on the scope of the contract and the facilities that have to be provided. The agreement should also provide the remuneration payable to the TPA by the insurance company. An insurance company can cancel or modify for good and sufficient reasons an agreement entered into by it with a TPA.

For proper day to day administration of its activities, the TPA should appoint, with due intimation to the IRDA, a Chief Administrative Officer (CAO) or Chief Executive Officer (CEO) from amongst its Directors/senior employees and inform the IRDA within 30 days of the date of appointment. It should also intimate the opening/closing of branches or change of registered/branch office within 15 days from the date of change. He should possess the following educational qualifications, namely, **(a)** degree in arts/ science/commerce/management/health/ hospital administration/medicine, **(b)** a pass in the Associateship examination conducted by the Insurance Institute of India/an equivalent examination recognised by the IRDA, and **(c)** completion of practical training specified by the IRDA not exceeding 1100 hours with an institution recognised by the IRDA for the purpose. In addition, he should also undergo a specified period ‘ of training with an institution recognised by the IRDA. Moreover, the CEO/CAO should not be: **(i)** a person of unsound mind, **(ii)** an undischarged insolvent, and **(iii)** a person subjected to imprisonment for a term of 3 months by a court of competent jurisdiction on grounds of misconduct, misfeasance, forgery and so on.

Any licence granted to a TPA or its renewal would be valid for 3 years unless revoked/ cancelled earlier by the IRDA. The licence would be renewed on payment of a renewal fee of ₹15,000 on an application submitted at least 30 days before its expiry. A delayed application, stating the reasons for the delay and accompanied by a late fee of ₹100, may also be accepted by the IRDA. A lost/multilated license may be replaced by the IRDA on payment of ₹1,000.

Revocation/Cancellation of Licence The licence granted to any TPA may, after due notice, be revoked or cancelled by the IRDA for one/more of the following reasons:

- On the basis of **(i)** information received, **(ii)** its own enquiry/investigation, IRDA is of the opinion that the TPA is functioning improperly and/or against the interest of the insured/ policyholders/insurance company;
- On the basis of information in its possession, it is of opinion that the financial condition of the TPA has deteriorated and it cannot function effectively or it has committed breach of the regulations pertaining to **(i)** its character and ownership, **(ii)** obtaining of licence on the basis of fraud/misrepresentation of facts, **(iii)** breach in following the procedure/ acquiring qualification laid down for CAO/ CEO, and **(iv)** any violation of any directions issued by the IRDA;
- After enquiry/upon information, it is of the pinion that the character/ownership of the TPA has changed significantly;
- The licence/its renewal was on the basis of fraud/misrepresentation of facts;
- There is a breach on the part of the TPA in following the procedure or acquiring qualifications laid down for CAOs/CEOs;
- The TPA is subject to winding up proceedings;
- There is breach of code of conduct (discussed subsequently);
- There is violation of any directions issued by the IRDA under the Insurance Act/Regulations.

Before revoking/cancelling the licence of a TPA, the IRDA would give it a reasonable opportunity of being heard. The aggrieved TPA may file a review application with the IRDA within 30 days of the revocation/cancellation of the licence. The IRDA would dispose it of within 90 days.

Code of Conduct A TPA should, as far as possible, act in the best possible professional manner. In particular, every TPA/its CAO/its CEO/its employees or representatives would be duty bound to:

(a) Establish its/his/their identity to the public and the insured/policyholder and that of the insurance company with which it has entered into an agreement;

(b) Disclose its licence to the insured/policyholder/prospect;

(c) Disclose the details of the services it is authorised to render in respect of health insurance products under an agreement with an insurance company;

(d) Bring to the notice of the insurance company with whom it has an agreement, any adverse report on inconsistencies or any material fact that is relevant for the insurance company's business;

(e) Obtain all the requisite documents pertaining to the examination of an insurance claim arising out of insurance contract concluded by the insurance company with the insured/ policyholder;

(f) Render necessary assistance specified under the agreement and advice to policyholders/ claimants/ beneficiaries in complying with the requirements for settlement of claims with the insurance company;

(g) Conduct itself/himself in a courteous and professional manner;

(h) Refrain from acting in a manner, which may influence directly or indirectly the insured/ policyholder of a particular insurance company to shift the insurance portfolio from the existing one to another one;

(i) Refrain from trading on information and the records of its business;

(j) Maintain the confidentiality of the data collect by it in the course of its agreement;

(k) Refrain from resorting to advertisements of its business or the services rendered by it on behalf of a particular insurance company, without its prior written approval;

(1) Refrain from including an insured/policyholder to omit any material information, or submit wrong information;

(m) Refrain from demanding/receiving a share of the proceeds/indemnity from the claimant under an insurance contract;

(n) Follow the guidelines/directions issued by the IRDA from time to time.

Maintenance and Confidentiality of Information Every TPA is required to maintain, in accordance with the accepted professional standards of record keeping for at least 3 years, proper records/ documents/evidence and books of all transactions carried out by it on behalf of an insurance company in terms of its agreement. They should be available to the insurance company(ies)/ IRDA and access cannot be denied by the TPA on any ground. While maintaining the records, the TPAs should follow strictly the professional confidentiality between the concerned parties. However, they can part with the relevant information to any court/tribunal/government/IRDA **(i)** in case of any investigation by the IRDA against the insurance company/TPA/any other person or **(ii)** for any reason.

On cancellation/revocation of its licence, the data collected and books/records/documents and so on relating to its business, complete in all respects should be handed over by the TPA to the insurance company immediately.

Miscellaneous To look into proper and efficient performance of any TPA(s), the IRDA may from time to time constitute committees consisting of members from various sources including the TPA(s)/insurance companies/IRDA or any other person. Every TPA should furnish to the insurance company(ies)/IRDA **(i)** an annual report duly verified by a Director/CAO/CEO within 60 days of the end of its financial year/or such extended time as it may grant and **(ii)** any other return on its activities as required by the IRDA. It should file monthly information relating to claims data within 15 days from end of each month. The TPAs should also make available to the IRDA for inspection copies of all contracts with the insurance company(ies).

General Any change in the agreement between a TPA and an insurer should be filed with the IRDA. The TPA should not charge any separate fee from policyholders which it serves under the terms of agreement with the insurance company. Failure to furnish any document/statement/ return and so on to the IRDA by any person would be construed as non-compliance of the Insurance Act.

Protection of Policyholders Interest Regulations

These regulations are in addition to any other regulations made by the IRDA which may, inter alia, provide for protection of the interest of the policy-holders. They apply to all insurers, insurance agents, insurance intermediaries and policy-holders. Their main elements are: **(1)** point of sale, **(2)** proposal for insurance, **(3)** grievance redressal procedure, **(4)** matters to be stated in life insurance policy, **(5)** matters to be stated in general insurance policy; **(6)** claims procedures in respect of life insurance policy, **(7)** claims procedures in respect of general insurance policy, **(8)** policy-holders' servicing and **(9)** general.

Point of Sale A prospectus (i.e. a document issued by an insurer or in its behalf to the prospective buyer of insurance containing such particulars as are mentioned in Rule 11 of Insurance Rules and includes a brochure/leaflet. It should also specify the type and character of riders on the main product indicating the nature of benefits following thereupon) of an insurance product should clearly state the scope of benefits, the extent of insurance cover (i.e. an insurance contract whether in the form of a policy/cover note/certificate of insurance/any other form prevalent in the industry to evidence the existence of an insurance cover) and in an explicit manner explain the warranties/exceptions/conditions of the insurance cover and, in case of life insurance, whether the product is participating (with benefits) or non-participating (without benefits). The allowable rider(s) on the product should clearly spell out with regard to their scope of benefits and, in no case, the premium relatable to health-related or critical illness riders in case of term/ group products should exceed 100 per cent of premium under the basic product. All other riders put together should be subject to a ceiling of 30 per cent of the premium of the basic product. Any benefit arising under each of the riders should not exceed the sum assured under the basic product. However, the benefit amount should be subject to Section 2 (11) of the Insurance Act.

An insurer/its agent/other intermediary should provide all material information in respect of a proposed cover to the prospect to enable him to decide on the best cover that would be in his/ her interest. Where the prospect depends upon their advice, they must advice him dispassionately. If, for some reason, the proposal and other connected papers are not filled by the prospect, a certificate may be incorporated at the end of the proposal form [i.e. a form to be filled in by the proposer for insurance for furnishing all material information (that is, all important, essential and relevant information in the context of underwriting the risk covered by the insurer) required by the insurer in respect of a risk in order to enable the insurer to decide whether to accept or decline to undertake the risk and in the event of acceptance of the risk, determine the rates/ terms/ conditions of a cover to be granted] from the prospect that the contents of the form and documents have been fully explained to him and that he has fully understood the significance of the proposed contract.

In the process of sale, the insurer/its agent/any other intermediary should act according to the code of conduct prescribed by **(i)** the IRDA, **(ii)** Councils established under Section 64-C of the Insurance Act and **(iii)** the recognised professional bodies/association of which they are members.

Proposal for Insurance Except in cases of marine insurance cover, where current market practice do not insist on a written proposal form, in all cases, a proposal for grant of a cover, either for life business or for general business, must be evidenced by a written document. An insurer should furnish a copy of the proposal form to the insured free of charge, within 30 days of the acceptance of a proposal. The forms and documents used in the grant of cover may, depending upon the circumstances of each case, be made available in languages recognised under the Constitution of India. In filing the form of proposal, the prospect is to be guided by the provisions of Section 45 of the Insurance Act. Any proposal form seeking information for grant of life cover may prominently state the requirements of Section 45 of the Insurance Act. Where a proposal form is not used, the insurer should record the information obtained orally or in writing, and confirm it within 15 days with the proposer and incorporate the information in its cover note or policy. The onus of proof would rest with the insurer in respect of any information not so recorded, where the insurer claims that the proposer suppressed any material information or provided misleading or false information on any matter material to the grant of a cover.

Wherever the benefit of nomination is available to the proposer, in terms of the Insurance Act or the conditions of policy, the issuer should draw the attention of the proposer to it and encourage the prospect to avail the facility. The proposals should be processed by the insurer with speed and efficiency and all decisions should be communicated by it in writing within a reasonable period not exceeding 15 days from receipt of proposals by the insurer.

Grievance Redressal Procedure Every insurer should have in place proper procedures and effective mechanism to address complaints and grievances of policyholders efficiently and with speed and the same along with the information in respect of Insurance Ombudsman should be communicated to the policyholder(s) along with the policy document and as may be found necessary.

Matters to be Stated in Life Insurance Policy A life insurance policy should clearly state:

(a) The name of the plan governing the policy, its terms and conditions;
(b) Whether it is participating in profits or not;
(c) The basis of participation in profits such as cash bonus, deferred bonus, simple or compound reversionary bonus;
(d) The benefits payable and the contingencies upon which these are payable and the other terms and conditions of the insurance contract;
(e) The details of the riders attaching to the main policy;
(f) The date of commencement of risk and the date of maturity or date(s) on which the benefits are payable;
(g) The premium payable, periodicity of payment, grace period allowed for payment of the premium, the date of the last instalment of premium, the implication of discontinuing the payment of an instalment(s) of premium and also the provisions of a guaranteed surrender value;
(h) The age at entry and whether the same has been admitted;
(i) The policy requirements for **(a)** conversion of the policy into paid-up policy, **(b)** surrender, **(c)** nonforfeiture and **(d)** revival of lapsed policies;
(j) Contingencies excluded from the scope of the cover, both in respect of the main policy and the riders;
(k) The provision for nomination, assignments and loans on security of the policy and a statement that the rate of interest payable on such loan amount would be as prescribed by the insurer at the time of taking the loan;

(l) Any special clauses or conditions, such as, first pregnancy clause, suicide clause and so on;
(m) The address of the insurer to which all communications in respect of the policy should be sent;
(n) The document that are normally required to be submitted by a claimant in support of a claim under the policy.

While forwarding the policy to the insured, the insurer should inform him that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy, and where he disagrees to any of those terms or conditions, he has the option to return the policy stating the reasons for his objection, when he would be entitled to a refund of the premium paid, subject only to a deduction of a proportionate risk premium for the period on cover and the expenses incurred by the insurer on medical examination of the proposer and stamp duty changes. In respect of a unit linked policy, in addition to the above deductions, the insurer would also be entitled to repurchase the unit at the price of the units on the date of cancellation. In respect of cover, where premium charged is dependent on age, the insurer should ensure that the age is admitted as far as possible before issuance of the policy document. In case, where age has not been admitted by the time the policy is issued, the insurer should make efforts to obtain proof of age and admit the same as soon as possible.

Matters to be Stated in General Insurance Policy A general insurance policy should clearly state

(a) The name(s) and address(s) of the insured and of any bank(s) or any other person having financial interest in the subject matter of insurance;
(b) Full description of the property or interest insured;
(c) The location(s) of the property or interest insured under the policy and, where appropriate, with respective insured values;
(d) Period of insurance;
(e) Sums insured;
(f) Perils covered and not covered;
(g) Any franchise or deductible applicable;
(h) Premium payable and where the premium is provisional subject to adjustment, the basis of adjustment of premium be stated;
(i) Policy terms, conditions and warranties;
(j) Action to be taken by the insured upon occurrence of a contingency likely to give rise to a claim under the policy;
(k) The obligations of the insured in relation to the subject matter of insurance upon occurrence of an event giving rise to a claim and the rights of the insurer in the circumstances;
(l) Any special conditions attaching to the policy;
(m) Provision for cancellation of the policy on grounds of misrepresentation, fraud, non-disclosure of material facts or non-cooperation of the insured;
(n) The address of the insurer to which all communications in respect of the insurance contract should be sent;
(o) The details of the riders attaching to the main policy; and
(p) Proforma of any communication the insurer may seek from the policyholders to service the policy.

Every insurer should inform and keep informed periodically the insured on the requirements to be fulfilled by him regarding lodging of a claim arising in terms of the policy and the procedures to be followed by him to enable the insurer to settle a claim early.

Claims Procedure of a Life Insurance Policy A life insurance policy should state the primary documents which are normally required to be submitted by a claimant in support of a claim. Upon receiving a claim, it should process the claim without delay. Any queries or requirement of additional documents, to the extent possible, should be raised all at once, within a period of 15 days of the receipt of the claim. A claim should be paid or disputed giving all the relevant reasons, within 30 days from the date of receipt of all relevant papers and clarifications required. Where, in the opinion of the insurance company, the circumstances of a claim warrant an investigation, it should initiate and complete such investigation at the earliest, and in any case not later than 6 months from the time of lodging the claim.

Subject to the provisions of Section 47 of the Insurance Act, where a claim is ready for payment but the payment cannot be made due to any reasons of a proper identification of the payee, the life insurer should hold the amount for the benefit of the payee and such an amount would earn interest at the rate applicable to a savings bank account with a scheduled bank (effective from 30 days following the submission of all papers and information). Where there is a delay on the part of the insurer in processing a claim for a reason other than the one covered above, it should pay interest on the claim amount at a rate which is 2 per cent above the bank rate prevalent at the beginning of the financial year in which the claim is reviewed by it.

Claim Procedure in Respect of a General Insurance Policy An insured or the claimant should give notice to the insurer of any loss arising under contract of insurance at the earliest or within such extended time as may be allowed by the insurer. On receipt of such a communication, a general insurer should respond immediately and give clear indication to the insured on the procedures that he should follow. In cases where a surveyor has to be appointed for assessing a loss/claim, it should be done within 72 hours of the receipt of intimation from the insured. Where the insured is unable to furnish all the particulars required by the surveyor or where the surveyor does not receive the full cooperation of the insured, the insurer/surveyor should inform in writing the insured about the delay that may result in the assessment of the claim. The surveyor would be subjected to the code of conduct laid down by the IRDA while assessing the loss, and should communicate his findings to the insurer within 30 days of his appointment with a copy of the report being furnished to the insured, if he so desires. Where, in special circumstances of the case, either due to its special and complicated nature, the surveyor should under intimation to the insured, seek an extension from the insurer for submission of his report. In no case should a surveyor take more than six months from the date of his appointment to furnish his report.

If an insurer, on the receipt of a survey report, finds that it is incomplete in any respect, he should require the surveyor under intimation to the insured, to furnish an additional report on certain specific issues as may be required by the insurer. Such a request may be made by the insurer within 15 days of the receipt of the original survey report. However, the facility of calling for an additional report by the insurer cannot be resorted to more than once in the case of a claim. The surveyor on receipt of this communication should furnish an additional report within three weeks of the date of receipt of communication from the insurer. On receipt of the survey/additional survey report, an insurer should, within a period of 30 days, offer a settlement of the claim to the insured. If the insurer, for any reasons to be recorded in writing and communicated to the insured, decides to reject a claim under the policy, it should do so within a period of 30 days from the receipt of the survey/additional survey report. Upon acceptance of an offer of settlement by the insured, the payment of the amount due should be made within 7 days from the date of acceptance of the offer by the insured. In case of delay in payment, the insurer would be liable to pay interest at a rate 2 per cent above the bank rate prevalent at the beginning of financial year in which the claim is reviewed by it.

Policyholder's Servicing An insurer carrying on life or general business, should at all times, respond within 10 days of the receipt of any communication from its policyholders in all matters, such as:

(a) Recording change of address;
(b) Noting of new nomination or change of nomination under a policy;
(c) Noting an assignment on the policy;
(d) Providing information on the current status of a policy indicating matters, such as, accrued bonus, surrender value and entitlement to a loan;
(e) Processing papers and disbursal of a loan on security of policy;
(f) Issuance of duplicate policy;
(g) Issuance of an endorsement under the policy; noting a charge of interest or sum assured or perils insured, financial interest of a bank and other interests; and
(h) Guidance on the procedure for registering a claim and early settlement thereof.

General The requirements of disclosure of 'material information' regarding a proposal or policy apply, under these regulations, both to the insurer and the insured. The policyholder should assist the insurer, if the latter so requires, in the prosecution of a proceeding or in the matter of recovery of claims which the insurer has against third parties. He should furnish all information sought by the insurer and also any other information which the insurer considers as having a bearing on the risk to enable the latter to assess properly the risk sought to be covered by a policy. Any breach of obligation cast on an insurer or insurance agent or insurance intermediary in terms of these regulations may enable the IRDA to initiate action against each or all of them, jointly or severally, under the Insurance Act and/or the IRDA Act.

Registration of Corporate Agents Regulation 2015

A **corporate agent** means a company, limited liability partnership, cooperative society, bank, corresponding ban, regional rural bank, NGOs/micro-lending financial institutions, any other person recognised by IRDA) for soliciting, procuring and servicing of insurance business of life, general and health insurer during the validity of certificate of registration. A **corporate agent (life)** may have arrangements with a maximum of three life insurers to solicit, procure and service their insurance products. A **corporate agent (general)** may have arrangements with a maximum of three general insurers to solicit, procure and service their insurance products. Further, he should solicit, procure and service retail lines of general insurance products and commercial lines of such insurers having a total sum insured not exceeding rupees five cores per risk for all insurances combined. A **corporate agent (health)** may have arrangements with a maximum of three health insurers

> **Corporate agent** means a company, limited liability partnership, cooperative society, bank, corresponding ban, regional rural bank, NGOs/micro-lending financial institutions, any other person recognised by IRDA) for soliciting, procuring and servicing of insurance business of life, general and health insurer during the validity of certificate of registration.

to solicit, procure and service their insurance products. In case of **corporate agent (composite)**, the conditions as specified in clause **(a)** to **(c)** would apply. Any change in their arrangement with the insurance companies would be done only with the prior approval of the IRDA and with suitable arrangements for servicing existing policyholders. While **corporate agents (life, general and health)** solicit/service insurance business for life, general and health insurers respectively, a **composite corporate agent** solicit/services all the three or a combination of any two insurance business. The main elements of these regulations are discussed below.

> **Composite corporate agent** solicits/services all the three or a combination of any two insurance business.

Registration An applicant desiring to obtain a CoR to act as a corporate agent is either an entity whose principal business is **(i)** other than distribution of insurance products and insurance distribution is a subsidiary activity, **(ii)** to exclusively carry on insurance intermediation. The application should be made in the prescribed form accompanied by the requisite non-refundable application fee of ₹10,000 and registration fee of ₹25,000 plus applicable taxes. The fee for renewal of registration would be ₹25,000 plus applicable taxes. An application, not complete in all respects and not conforming to the specified instructions and these regulations, would be rejected. The IRDA may require an applicant to furnish any further information or clarification for the purpose of disposal of the application, and, thereafter, in regard to any other matter as may be deemed necessary. The applicant/its **principal officer** (i.e. director/partner/any designated officer/employee and approved by the IRDA exclusively appointed to supervise the activity of corporate agent and who possesses the requisite qualifications/practical training and has passed the required examination) should, if so required, appear before the IRDA for a personal representation in connection with its application.

> **Principal officer** means director/partner/any designated officer/employee and approved by the IRDA exclusively appointed to supervise the activity of corporate agent and who possesses the requisite qualifications/practical training and has passed the required examination.

Consideration of Application The IRDA, while considering an application for grant of registration, would take into account all matters relevant for carrying out the activities of a corporate agent. Without prejudice to the above, in particular, it would take into account whether applicant **(a)** **(i)** is not suffering from any of the specified disqualifications under the Insurance Act, **(ii)** has the necessary infrastructure, such as, adequate office space, equipment and trained manpower on its rolls to effectively discharge its activities; **(b)** any person, directly or indirectly connected (i.e. an associate/subsidiary/interconnected undertaking/group company) with the applicant, has been refused in the past the grant of licence/registration by the IRDA; **(c)** principal officer of the applicant is a graduate and has received at least 50 hours of theoretical and practical training from an **approved institution** (i.e. any IRDA-approved institution engaged in education/training particularly in the area of insurance sales/marketing including the **Insurance Institute of India**) according to a syllabus approved by the IRDA, and has passed an examination, at the end of the period of training, conducted by the examination body. Where the principal officer of the applicant is an associate/fellow of the Insurance Institute of India/CIL, London/Institute of Actuaries of India/ holds any post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad, the theoretical and practical training would be 25 hours; **(d)** principal officer, directors and other employees of the applicant have not violated the specified code of conduct during the last three years; **(e)** applicant, in case the principal business of the applicant is other than insurance, maintains an arms-length relationship in financial matter between its activities as corporate agent and other activities; **(g)** principal officer/director(s)/partner(s)/specified persons is/are fit and proper based on the specified statement; and **(h)** IRDA is of the opinion that the grant of registration will be in the interest of policyholders.

The **specified persons** (i.e. an employee of a corporate agent responsible for soliciting/procuring insurance business on its behalf fulfilling the specified requirements of qualification/training/examination) of the applicant should fulfil the following requirements: **(a)** have **(i)** passed minimum of 12th class or equivalent examination from a recognised board/institution, **(ii)** undergone at least 50 hours of training, for the specified category of life, general, health for which registration is sought for and have passed the examination conducted by the examination body, **(iii)** corporate agent (composite) should have undergone at least 75 hours of training from an approved institution and have passed the examination conducted by the examination body; **(b)** have valid certificate issued by the IRDA. The certificate should be valid for three years from the date of issue subject to the valid registration of the corporate agent; **(c)** a specified person of a corporate agent wishes to switch over to any other corporate agent, should applying to the IRDA through the new corporate agent along with a **no objection certificate** issued by the present corporate agent.

Specified person means an employee of a corporate agent responsible for soliciting/procuring insurance business on its behalf fulfilling the specified requirements of qualification/training/examination.

Capital Requirement An applicant exclusively doing insurance distribution should have a minimum equity share capital or contribution and net worth of rupees ₹ 50,00,000. In case of applicant exclusively doing insurance distribution, the aggregate holdings of equity shares or contribution by a foreign investor, including portfolio investors, would be as prescribed by the Central Government.

Procedure for Registration The IRDA, on being satisfied that the applicant fulfils all the specified conditions, would grant a registration subject to the applicant adhering to the conditions and the specified code of conduct. A corporate agent registered for a specified category may also apply for the grant of registration by the IRDA for any other category by fulfilling the prescribed requirements. However, such application should be made only after completion of one year from the grant of a registration in the first instance. A registration would be valid for three years from the date of it issue. A corporate agent may, within thirty days before the expiry of the registration, make an application in the prescribed form along with requisite fee for renewal of registration. A corporate agent is permitted to submit the application for renewal of registration 90 days prior to the expiry of the registration. The principal officer and specified persons before seeking a renewal of registration should have completed at least 25 hours of theoretical and practical training imparted by an approved institution. On being satisfied that the applicant fulfils all the specified conditions, the IRDA would renew the registration for three years. Where an application for grant of a registration does not satisfy the specified conditions, the IRDA may refuse to grant or renew the CoR.The refusal should be communicated within thirty days stating the grounds on which the application has been rejected. Any applicant aggrieved by the decision of the IRDA may make an appeal to Securities Appellate Tribunal, within 45 days from the date on which a copy of the order is received by it. On and from the date of the receipt of the communication cease to act as a corporate agent.

Conditions of Grant of Registration The registration/renewal would, *inter alia*, be subject to the following conditions. The corporate agent should/would **(i)** be permitted to solicit and service specified insurance business only; **(ii)** comply with the provisions of the Insurance Act, IRDA Act/regulations/circulars/guidelines and any other instructions; **(iii)** forthwith inform the IRDA in writing, if any information or particulars previously submitted to the IRDA by them are found to be false or misleading in respect of any material particular or if there is any material change in the information already submitted; **(iv)** take adequate steps for redressal of grievances of its client within 14 days of its receipt such complaint and keep the IRDA informed about the number, nature and other particulars of the complaints received in the prescribed format and manner; **(v)** solicit and procure reasonable number of insurance policies commensurate with their resources and the number of specified persons they employ; **(vi)** maintain records in the specified format which would capture policy-wise and specified person-wise details specified person except for those products which are simple, sold over-the-counter and specifically approved by the IRDA; **(vii)** under no circumstances undertake multi-level marketing for solicitation of insurance products; **(viii)** ensure compliance of code of conduct applicable to its directors, principal officer and specified persons; **(ix)** maintain separate specified books of account for their corporate agency business. In the event of a certificate of registration being lost or destroyed or mutilated, a corporate agent should submit to the IRDA an application with a declaration giving full details along with a fee of ₹ 1000 plus applicable taxes for issue of a duplicate certificate. Notwithstanding and without prejudice to initiation of any criminal proceedings against any person, who acts as a corporate agent without holding a valid registration, the IRDA may invoke penal action under the IRDA Act or any other law for the time being in force. Without prejudice to any other proceedings which may be taken by the IRDA against the company or firm or body corporate, every director, manager, secretary, other/every partner who is knowingly a party to such contravention would also be liable to be proceeded against.

Requirement of Professional Indemnity Insurance Policy Every corporate agent, where the revenues from their insurance intermediation activities is more than 50 per cent of total revenue from all the activities, should take out and maintain at all times a professional indemnity insurance cover throughout the validity of the period of its registration. The limit of indemnity would be 2 times the total annual remuneration of the corporate agent derived from their insurance intermediation activities in a year subject to a minimum of ₹15,00,000 and a maximum of ₹10 crore.

Board Approved Policy for Open Architecture Every corporate agent should file, at the time of seeking registration, with the IRDA, a Board or its equivalent approved policy on the manner of soliciting and servicing insurance products. It should address the manner of adopting the philosophy of open architecture and going forward in implementing the same. It should, *inter alia*, include the approach to be followed in having single/multiple tie-ups, partners, the business mix, type of product sold, grievance redressal mechanism and reporting requirements. The corporate agents should furnish half-yearly returns to the IRDA insurer-wise business placed separately in respect of life, general and health insurance, in the specified format, before October 31 and April 30 every year.

Conflict of Interest While soliciting/procuring business, the corporate agents should disclose to the prospective customer(s) the list of insurers, with whom they have arrangements to distribute their products and provide them with the details such as scope of coverage, term of policy, premium payable, premium terms and any other information which the customer seeks on all products available with them. The scale of commission should also be disclosed. Where the insurance is sold as an ancillary product along with a principal business product, the corporate agent or its shareholder or its associates should not compel the buyer of the principal business product to necessarily buy the insurance product through it. The principal officer and CFO (or its equivalent) of the corporate agent should file with the IRDA a certificate in the specified format on half-yearly basis, certifying that there is no forced selling of an insurance product to any prospect. No insurer should require the corporate agent to insure every client with it.

Disclosures An applicant-corporate agent should disclose to the IRDA at the time of filing application all material facts relevant for consideration of application on its own. In case of any change in the information, subsequent to filing/during the processing of application, the changes should be disclosed voluntarily by the applicant for consideration of the IRDA. Similarly, a corporate agent who holds a valid registration should disclose to the IRDA voluntarily any change in material facts, based on which a registration was made to them, within 30 days of the change. The IRDA may seek any clarification/issue directions as it deem fit. A corporate agent should also disclose to the IRDA proceedings initiated against them by other regulatory/ Government bodies within 30 days from the initiation of the proceedings. Any action/direction issued by them should also be disclosed within the 30-day time limit. The IRDA may require, from time to time, the corporate agent to furnish information/return as deemed appropriate. The corporate agent should disclose to the IRDA the details of its offices in which they propose to distribute insurance products and details of the specified persons along with their certificate number issued by the IRDA. Further, any opening or closure of an office by a corporate agent should be informed to the IRDA. Failure to adhere to the above conditions would attract regulatory actions such as suspension/cancellation of registration, imposition of monetary penalty/any other action deemed fit.

Arrangements with Insurers for Distribution of Products Corporate agents should enter into arrangements for minimum one year with insurers for distribution of their products which should be disclosed to the IRDA within 30 days. No corporate agent should promise nor any insurer should compel it to distribute the products of a particular insurer. The arrangements should have provisions to include duties and responsibilities of corporate agents towards the policyholders, duties and responsibilities of insurers and corporate agents, terms and conditions for termination of arrangements. No arrangement should be made against the interest of policyholder. To terminate arrangement with any insurer, the corporate agent should inform the insurer and the IRDA the reasons for termination of arrangement. They should ensure that the policies solicited and placed with the insurer are serviced till the expiry of policies, or six months, whichever is earlier within which time they should make suitable arrangements with the concerned insurer. An insurer can terminate the arrangement with any corporate agent after informing it and the IRDA the reasons for termination of arrangement. The concerned insurer should take the responsibility of servicing the policies procured by it and inform the policyholder concerned of the changes made in servicing arrangements. No insurer should pay and no corporate agent should receive any signing fee or any other charges, except those permitted by the IRDA for becoming its corporate agent. The insurers should not directly pay incentives (cash or non-cash) to the principal officer, specified persons and other employees of the corporate agent. The IRDA may direct any insurer/corporate agent to terminate the distribution arrangement by recording the reasons therefor.

Servicing of Policyholders A corporate agent would have the duty to service its policyholders during the entire period of contract. Servicing includes assisting in payment of premium, providing necessary assistance and guidance in the event of a claim, providing all other services and guidance on issues which arise during the course of an insurance contract.

Sale of Insurance by Tele-marketing Mode and Distance Marketing Activities of a Corporate Agent A corporate agent who intends to engage the services of a **telemarketer** (i.e. an entity registered with **TRAI** to conduct business of sending commercial communication and holding a certificate from the IRDA) or engage in distance marketing activities for the purpose of distribution of insurance products should follow the specified instructions. Without prejudice to above, it should comply with the following additional conditions. The telemarketer should comply with various circulars and/or guidelines or any other direction issued by the TRAI in the matter. A corporate agent intends to undertake telemarketing activities for insurance intermediation should seek prior approval of the IRDA. He should file with the IRDA the names of authorised verifiers engaged/proposed to be engaged by the telemarketer in the specified form. In case an authorised verifier intends to switch to another telemarketer who is also dealing with insurance intermediation, they should obtain a **No Objection Certificate** from the erstwhile telemarketer and submit the same to the IRDA for issuing a fresh certificate. The application for removal/addition of authorised verifier should be made by the corporate agent concerned through the principal officer. In case the corporate agent registers as telemarketer with TRAI, he should act as telemarketer for only those insurers with whom he was arrangements. No corporate agent/telemarketer should make outbound calls to any person unless he or she has shown interest in buying an insurance policy by making enquiries to that effect. They should maintain their database and the enquiry made for verification and checking by the IRDA or any person authorised by it. The telemarketer should disclose to the prospective customer the following information: **(a)** name of the corporate agent they represent, **(b)** registration number of the corporate agent, **(c)** contact number of the telemarketer and/or corporate agent in case the customer desires to call back or verify the telesales information, **(d)** name and identification number of the person (authorised verifier) making the tele-call. A corporate agent should enter into an agreement with the telemarketer providing the details such as source of the database, duties and responsibilities, payment details, period of agreement, actions to be taken in case of violation of the Insurance Act/regulations/guidelines/circulars/directions/code of conduct of authorised verifiers. It should be made available to the IRDA or any person authorised by it for verification. Every telemarketer and the authorised verifier should abide by the code of conduct applicable to corporate agents. The IRDA would have the power to inspect the premise of the telemarketer of any other promises, which it feels necessary for the verification of records/documents and seek any document/record, record statements of any employee of the telemarketer or make copies of any documents/records at its discretion. The telemarketer would have to comply with any other terms and conditions prescribed by the IRDA from time to time in the matter. A telemarketer should not be engaged with more than three insurers/insurance-related entities.

> **Telemarketer** means an entity registered with TRAI to conduct business of sending commercial communication and holding a certificate from the IRDA.

Code of Conduct for Corporate Agents Every corporate agent should abide by the specified code of conduct. He would be responsible for all the acts and omissions of its principal officer, specified persons and other employees including violation of specified code of conduct and liable to a penalty which may extend to one crore rupees.

Inspection of Corporate Agent The IRDA has the power to inspect the records of a corporate agent and performance of its activities any time and in case of any deficiency observed, it may take appropriate disciplinary action.

Suspension/Cancellation/Surrender of Registration The procedure for suspension, cancellation or surrender of registration would be as stipulated in the IRDA regulations.

Change in Ownership and/or Shareholding In case of a corporate agent, which is incorporated exclusively for the purpose of insurance intermediation, no change in ownership and/or shareholding exceeding 25 per cent, would be carried out without the prior approval of the IRDA.

Maintenance of Records A corporate agent should maintain the following records including in electronic for and make them available as and when required by the IRDA: **(i) Know Your Client** (KYC) records of the client, **(ii)** Copy of the proposal form duly signed by the client and submitted to the insurer with ACR signed by the specified person of corporate agent, **(iii)** A register containing **(a)** list of clients, details of policy such as type of policy, premium amount, date of issue of the policy, charge or fees received, **(b)** details of complaints received which include name of the complainant, nature of complaint, details of policy issued/solicited and action taken, **(c)** name, address, telephone number, photograph, date of commencement of employment, date of leaving the service monthly remuneration paid to the specified person, **(iv)** copies of correspondence with the IRDA ad **(v)** any other specified record.

Maintenance of Books of Accounts, Records A corporate agent incorporated exclusively for insurance intermediation should prepare the following books of account for every financial year: **(i)** balance sheet/statement of affairs as at the end of each accounting period, **(ii)** profit and loss account for that period, **(iii)** statement of cash/fund flow, **(iv)** additional statements required by the IRDA from time to time. The financial year would be of 12 months and the accounts should be maintained on accrual basis. There should be a schedule to their financial statements providing the details of all the incomes received from insurers and insurer's group companies, insurer-wise, by the corporate agent, and also the details of payments received by the group companies and/or associates from any insurer and its details. A copy of the audited financial statements along with the auditor's report should be submitted to the IRDA before September 30 every year along with the remarks/observations of the auditors. Within 90 days from the date of the Auditor's report, necessary steps to rectify any deficiencies should be made and informed to the IRDA. All the books of account, statements, documents should be maintained at the head office of the corporate agent or other designated branch office and notified to the IRDA, and be available on all working days to such officers of the IRDA, and authorised in this behalf for inspection. They should be retained for minimum ten years from the end of the year to which they relate. However, the documents pertaining to the case where claims are reported and the settlement is pending for a decision from court, the documents are required to be maintained till the disposal of the cases by the court.

Corporate agents whose principal business is other than insurance intermediation, should maintain segment-wise reporting capturing the revenues received for insurance intermediation and other income from insurers.

Every insurer who is engaging the services of a corporate agent should file with the IRDA a certificate in the prescribed format to be signed by the CEO and CFO. A similar certificate from the principal officer and CFO (or it equivalent) of the corporate agent specifying the commission/remuneration received from the insurer should be filed with the IRDA.

Distribution of Surplus Regulations

A life insurer should maintain separately **(a)** a life fund for participating policyholders (i.e. the holders of L 'par policies' and policies with deferred participation in profits) and **(b)** a life fund for non-participating policyholders who hold non-par policies as defined in IRDA Actuarial Report and Abstract Regulations. Failure to comply with this requirement would mean that the life fund maintained by the insurer would be for the benefit of the first category of policyholders only.

Procedure for Distribution On the advice of the appointed actuary, a life insurer may reserve a part of actuarial valuation surplus arising out of a valuation of assets and liabilities made for a financial year according to the Actuarial Report and Abstract Regulation to its shareholder. It should be **(a)** 100 per cent in case of a life fund maintained for non-participating policyholders and **(b)** one-ninth of the surplus allocated to the policyholders in case of life fund maintained for participating policyholders. An insurer would have to obtain prior approval of the IRDA when the allocation is not one-ninth of the surplus. However, an insurer cannot allocate/reserve in excess of 10 per cent of the actuarial surplus to its shareholders.

Life Insurance–Reinsurance

Procedure Every life insurer should draw up a programme of reinsurance in respect of lives covered by him. The profile of the programme, duly certified by the Appointed Actuary, which should include the name(s) of the reinsurer(s) with whom the insurer proposes to place business, should be filed by the insurer with the IRDA at least 45 days before the commencement of each financial year. The IRDA may also elicit additional information, if necessary. It would scrutinise the programme and may suggest changes which must be incorporated forthwith in the programme.

An insurer should retain the maximum premium earned (i.e. the amount of risk which he assumes for his own account) in India commensurate with his financial strength and volume of business. The reinsurer should have a credit rating of a minimum BBB (Triple-B) of Standard and Poor or equivalent rating of an international rating agency. The placement of business by the insurer with any other reinsurer would require prior approval of the IRDA. Similarly, any programme of reinsurance on original premium basis would also require IDRA's approval. A life insurer can have reinsurance treaty arrangement with its promoter/ associate/group company only on commercially competitive terms in the market with the prior approval of the IRDA. He should submit to the IRDA statistics relating to reinsurance transactions in the prescribed form together with its annual accounts.

Inward Reinsurance Business An insurer who wants to write inward reinsurance business should adopt a well-defined underwriting policy and ensure that decision on acceptance of reinsurance business are made by persons who have adequate knowledge and experience preferably in consultation with the Appointed Actuary. He should file with the IRDA at least 45 days before the commencement of each financial year a note on its underwriting policy indicating the class(es) of business, geographical scope, underwriting limits and profit objective. He should also file any change in the note as and when a change in underwriting policy is made.

Insurance Brokers

The IRDA regulations relating to insurance brokers are discussed below.

Functions/Categories An **insurance broker** means a person (i.e. a company, a cooperative society, a limited liability partnership or any other person recognised by the IRDA) licensed by the IRDA who for remuneration arranges insurance contracts with insurance/reinsurance" companies on behalf of his clients. There are five categories of insurance brokers: **(i)** direct (life), **(ii)** direct (general), **(iii)** direct (life and general) **(iv)** rein-insurance and **(v)** composite. Their functions are outlined below.

> **Insurance broker** arranges insurance contracts with insurance companies on behalf of his clients.

Direct Broker A direct broker is an insurance broker who carries out the functions specified below in the field of general/life insurance or both:

(a) Obtaining detailed information of the client's business and risk management philosophy;
(b) Familiarising himself with the client's business and underwriting information so that this can be explained to an insurer and others;
(c) Rendering advice on appropriate insurance cover and terms;
(d) Maintaining detailed knowledge of available insurance markets, as may be applicable;
(e) Submitting quotation received from insurer(s) for consideration of a client;
(f) Providing requisite underwriting information as required by an insurer in assessing the risk to decide pricing terms and conditions for cover;
(g) Acting promptly on instructions from a client and providing him written acknowledgements and progress reports;
(h) Assisting clients in paying premium under Section 64 (VB) of Insurance Act, 1938;
(i) Providing services related to insurance consultancy and risk management;
(j) Assisting in the negotiation of the claims; and
(k) Maintaining proper records of claims.

Reinsurance Broker A reinsurance broker is an insurance broker who arranges reinsurance for direct insurers with insurance/reinsurance companies. His functions include the following:

(a) Familiarising himself with the client's business and risk retention philosophy;
(b) Maintaining clear records of the insurer's business to assist the reinsurer(s) or others;
(c) Rendering advice based on technical data on the reinsurance covers available in the international insurance and the reinsurance markets;
(d) Maintaining a database of available reinsurance markets, including solvency ratings of individual reinsurers;
(e) Rendering consultancy and risk management services for reinsurance;
(f) Selecting and recommending a reinsurer or a group of reinsurers;
(g) Negotiating with a reinsurer on the client's behalf;
(h) Assisting in case of commutation of reinsurance contracts placed with them;
(i) Acting promptly on instructions from a client and providing it written acknowledgements and progress reports; and
(j) Collecting and remitting premiums and claims within such time as agreed upon;
(k) Assisting in the negotiation and settlement of claims;

(l) Maintaining proper records of claims; and

(m) Exercising due care and diligence at the time of selection of reinsurers and international insurance brokers having regard to their respective security rating and establishing respective responsibilities at the time of engaging their services.

(n) Creation of market capacity/facility for new/stressed/emerging/existing business/asset class for/from both direct insurers/reinsurers;

(o) Render preliminary loss advice (PLA) within reasonable time;

(p) Given the nature of business, separate norms need to be followed for inward/outward business: **(a)** Inward business **(i)** broker to have adequate specific knowledge of the country whose business is being offered like political stability, economic position, local regulations, tax laws and so on, **(iii)** Introduce new business/products depending on the reinsurers business plan and risk appetite, **(b)** Outward business: rating and market credibility of the insurer.

(q) To ensure prompt collection and remittance of funds, follow-up for funds to be initiated sufficiently before due dates for settlement from cedant to reinsurer and from reinsurer to cedant as relevant.

> **Composite broker** arranges both direct insurance and reinsurance.

Composite Broker A **composite broker** means an insurance broker who arranges insurance for clients with insurance companies and/or reinsurance for his client(s). He performs the functions of both the direct broker as well as the reinsurance broker.

Grant of License An insurance broker should obtain a license from the IRDA. The application should be made in the prescribed form together with the specified non-refundable fee: **(i)** For direct broker, ₹20,000; **(ii)** For reinsurance broker, ₹25,000 and **(iii)** For composite broker, ₹40,000. The IRDA may require **(i)** the applicant to furnish further information and/or clarification and/or may direct the applicant to comply with certain requirements in regard to any matter or **(ii)** the applicant or its principal officer (i.e. proprietor/partner/director/chief executive officer appointed exclusively to carry out the functions of an insurance broker) for personal representation before it. The applicant may bring to the notice of the IRDA on its own further information/clarification having a bearing on consideration of application.

While considering the application for grant of license, the IRDA would take into account all relevant matters. In particular, it would take into account the following:

(A) The applicant does not suffer from any of the disqualifications specified under Section 42-D(5) of the Insurance Act (discussed in an earlier Section);

(B) The applicant has the necessary infrastructure, such as, adequate office space, equipment, trained manpower, to effectively discharge his activities. There should be atleast one such person in each branch and one each in life and general insurance.

(C) The applicant has in his employment a minimum of two persons who have the necessary qualifications specified in clause (F) below and experience to conduct the business of insurance broker;

(D) Any person, directly or indirectly connected (i.e. relative/associate, subsidiary, interconnected company, group company of the applicant) with the applicant, has been refused in the past the grant of a license by the IRDA.

(E) The applicant fulfills the capital, networth and deposit requirements specified below:

- **(i)** Capital Requirement: For direct broker, ₹50 lakh; For reinsurance broker, ₹200 lakh; and For composite broker, ₹250 lakh. While the capital of a cooperative society/company should be in the form of equity shares, it should be brought in cash in case of other applicants. A broker should provide information regarding its capital structure and details of shareholding annually on/before June 30 every year. Any change should also be reported within 30 days. Upto 26 per cent of the capital can be held by a non-Indian interest. The shares of the broken cannot be pledged and should always be unencumbered.
- **(ii)** Networth requirement: Not below 100 per cent of the minimum capital.
- **(iii)** Deposit Requirement: A sum equivalent to 20 per cent of the initial capital in fixed deposit with a bank to be released only with the prior permission of the IRDA. The IRDA may impose a separate limit of deposit upto ₹100 lakh for a person recognised to act as insurance broker.

(F) The principal officer of the applicant **(i)** possess the minimum qualification of:

- **(a)** Bachelors degree in arts, science, or social sciences or commerce or engineering, or law, or MBA or its equivalent from any institution/University recognised by any State Government or the Central Government; or
- **(b)** Associate/Fellow of the Insurance Institute of India, Mumbai; or
- **(c)** Associate/Fellow of the Institute of Risk Management, Mumbai; or
- **(d)** Any post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad; or
- **(e)** Associate/Fellow of the Institute of Chartered Accountant of India, New Delhi; or
- **(f)** Associate/Fellow of the Institute of Costs and Works Accountants of India, Kolkatta; or
- **(g)** Associate/Fellow of the Institute of Company Secretaries of India, New Delhi; or
- **(h)** Associate/Fellow of the Actuarial Society of India; or
- **(i)** Certified Associateship of the Indian Institute of Bankers, Mumbai; or
- **(j)** Any other qualification specified from time to time by the IRDA under these regulations; and

(ii) has completed at least 50 hours of theoretical and practical training from an institution recognised by the IRDA from time to time. However, where the principal officer of the applicant: **(a)** has been carrying on reinsurance related activity or insurance consultancy for a continuous period of 7 years, preceding the year in which such an application is made; or **(b)** has for a period of, not less than 7 years prior to the application has been made, a principal underwriter or has held the position of a manager in any one of the nationalised insurance companies in India; or **(c)** is an Associate/Fellow of the Insurance Institute of India, Mumbai; or Associate/Fellow of the Institute of Risk Management, Mumbai; or Associate/Fellow of the Actuarial Society of India; or has a post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad, the theoretical and practical training from an institution recognised by the IRDA from time to time according to a syllabus approved by it would be 25 hours.

(iii) has passed an examination, at the end of the period of training mentioned above, conducted by the National Insurance Academy, Pune or any other examining body recognised by the IRDA.

(G) In the opinion of the IRDA, the principal officer is suitable to be appointed keeping in view his experience, preferably in the insurance sector.

(H) The principal officer/director(s)/promoter(s)/shareholder(s)/partner(s)/key management personnel are fit and proper person and comply with the IRDA guidelines.

(I) The principal officer has not violated the code of conduct as specified by the IRDA (discussed subsequently).

(J) The applicant is not engaged in any other business other than the main objects of the applicant; and

(K) The IRDA is of the opinion that the grant of license would be in the interest of policyholders.

The promotor(s) shareholder(s) partner(s) are of sound financial position.

Any employee responsible for soliciting and procuring insurance business on behalf of an insurance broker would also have to fulfil the requirements mentioned above and a list of such employees need to be provided to the IRDA and acknowledged by it.

On being satisfied that the applicant fulfils all the conditions, the IRDA would grant the licence which would be valid for 3 years. Within 30 days before its expiry, the applicant should apply for its renewal on payment of the specified licence fee of ₹1,000. Every broker would pay annual license fee, namely, 0.50 per cent of the remuneration earned in the preceding financial year subject to a minimum and maximum of ₹25,000 and ₹10,00,000 for direct broker; ₹75,000 and ₹30,00,000 for re-insurance broker; and ₹1,25,000 and ₹50,00,000 for composite broker. In addition, an insurance broker should complete at least 25 hours of theoretical and practical training imparted by an institution recognised by the IRDA.

Remuneration For life and general insurance, the remuneration of a broker including royalty/license fee/administration charges/in any other form cannot exceed the limit as specified/notified by the IRDA. No brokerage can be paid where agency commission is payable and *vice versa*.

For reinsurance business, the remuneration should be paid as per market practices. The brokerage charged may be disclosed on request to the insurer before building cover. Payments of all nature in respect of the particular account such as risk inspection/management fee/administration charges should be aggregated.

The settlement of accounts by insurers in respect of brokers remuneration should be done on a monthly basis and there should be no cross settlement of outstanding balances.

Sale of Insurance Online Insurance brokers may enter into an agreement with insurers for sale of insurance products online by linking to their web portals subject to the following conditions:

(1) The website developed by the insurance broker should carry the name of the insurance broker as licensed by the IRDA and usage of any other name or linkage to any other website is prohibited.

(2) The insurance brokers should prominently display on their website the information relating to their licence number, date of licence and its validity, the category of licence, name of the principal officer and its contact details, composition of the board, and other relevant information.

(3) The website should be used exclusively for web aggregation and comparison and of insurance products and online sale of insurance products of the concerned insurers.

(4) The insurance broker should not publish, advertise, or provide for display or sale, any other products of any nature or type, other than the insurance products by the concerned insurer.

(5) The website should provide a link to the website of the concerned insurer and the insurer and the online sale by the insurance broker should be executed only through the website of the insurer.

(6) The insurance broker should ensure that the customer has the choice of viewing products of at least five insurers who are offering similar products for online sale, and selecting the insurer and products of his choice. He is permitted only to offer the following ranges of products online or any other products range as approved from time to time by the IRDA: **(i)** Life: **(a)** whole life policies, **(b)** term insurance products, **(c)** endowment products, **(d)** health insurance products, **(e)** retirement-immediate annuities, **(f)** retirement-deferred annuities, and **(g)** children's products; **(ii)** Non-Life: **(a)** home insurance, **(b)** motor insurance, **(c)** health insurance, **(d)** travel insurance, **(e)** personal accident insurance, and **(f)** rural insurance.

(7) The insurance broker should display only those features of the products which are approved under File and use Guidelines of the IRDA. Any information which is detrimental to the interests of the policyholder or is misleading and is not approved by the IRDA should not be displayed on their websites and while displaying the product features of various insurers should not favour any one insurer.

(8) The templates which are displayed on the insurance broker's website should be mutually agreed to, between him and the insurers whose products are compared.

(9) Product comparisons that are displayed should be up to date and reflect a true picture of the products.

(10) The insurance brokers should **(a)** display product information purely on the basis of the information obtained from insurers, **(b)** and not **(i)** display any information pertaining to products or services of other financial institutions/FMCG or any product or service on the website, **(ii)** display advertising of any sort, either pertaining to any product or service including insurance product or service, other financial products or service/or any other product or service on the website, and **(iii)** operate multiple websites or tie-up with other approved/unapproved/unlicensed entities/websites for lead generation/comparison of product and so on *subject to the following exceptions*, namely, using multiple domain names or same domain names with suffixes such as **.com** or **.in** or **.co.in** for the primary website of the insurance broker used for display of insurance products is allowed provided **(a)** the domain names of primary or secondary product category specific websites or mobile sites are owned and registered in the name of the insurance brokers. **(b)** he informs the IRDA in writing about the date of registration/launching of domain names of such websites or mobile sites in the application for grant of licence and thereafter within 15 days from the date of domain name registration and launching respectively in case of any change in the name(s) of the existing websites or new websites.

(11) The insurance broker should **(i)** not charge any additional fees from insurers for displaying their products on their websites, **(ii)** may enter into an agreement with the insurer for extending services to his customer/clients and the agreement should be available with both the insurer and the insurance broker for inspection by the IRDA.

(12) The broker who has entered into an agreement with the insurer may be allowed to collect renewal premiums online through the websites of the insurers for the policies procured and serviced by him only.

(13) The manner of payment of premiums for online sale should be by way of credit/debit card/net banking or any other mode as permitted by the RBI through a payment gateway normally used by the insurer for online sale of insurance policies. The premium has to be directly credited to the insurers premium collection account of a designated bank and not routed through the bank account of the insurance broker in any manner. The insurance brokers should not accept any cash payments towards premiums for this purpose.

(14) On completion of online transaction, for payment of premium and sale of the policy, the insured should be able to generate and save/print the premium receipt and preferably policy document also immediately. Alternatively, the policy document may be delivered by email/or in hard copy as opted by the insured.

(15) The agreement entered into with the insurers for integrating their web portals for sale of products or receipt of premium online should not be in any way detrimental to the interests of the policyholders. The insurance brokers should not make any promise or commitment to insures for sale of their products.

(16) The insurance broker should ensure that the directions issued by the IRDA or any other authority for compliance of anti-money laundering matters are adhered to. The insurer should incorporate the necessary rules and applicable clauses in the agreement to be signed with the insurance broker to this effect.

(17) The insurers as well as the insurance broker should be jointly and severally liable for any breach of provisions of the agreement entered into for this purpose.

(18) They should abide by the provisions of the Insurance Act, the IRDA Act, and/or any other act and regulations/guidelines/circulars/directions issued by the IRDA while selling the insurance products online.

Sale of Insurance by Tele-marketing Mode An insurance broker who intends to engage the services of telemarketer for distribution of insurance products of various companies should abide by the IRDA Guidelines on Distance Marketing of Insurance Products. He should also comply with the following additional conditions:

- The telemarketer should **(i)** comply with various circulated guidelines/directions issued by the Telecom Regulatory Authority of India (TRAI) and **(ii)** not engage with any other insurer/insurance related entity;
- An insurance broker registered with the TRAI should do telemarketing for its own entity only and not for any other entity;
- Authorised verifiers employed by the telemarketer/broker would have to undergo statutory training and pass examination as required for insurance broker (**discussed in an earlier Section of this Chapter**);
- A copy of the agreement between the broker and the telemarketer should be filed with the IRDA together with the specified undertakings in the prescribed form copies of which should be in the possession of the broker for inspection by the IRDA/other regulatory bodies;

- The IRDA would have power to inspect the premises of telemarketer/other premises necessary for verification of records/documents and seek any document/record, record statement of any employee of the telemarketer and make copies of documents /records at its direction;
- The telemarketer would have to comply with any other terms/conditions prescribed by the IRDA.

Ceiling on Business from a Single Client An insurance broker should carry out its business in such a manner that 50 per cent of the premium (i.e. quantum/receipt) in a financial year onwards does not emanate from any single client (including an associate, subsidiary, a group concern under the same management). The 50 per cent ceiling would not include reinsurance premium as well as premium emanating from government/public sector undertaking. For group insurance companies, not more than 2.5 per cent of the insurance handled by the insurance broker in any financial year should be placed with the promoter group separately for life and general business.

Code of Conduct Every insurance broker should abide by the code of conduct specified below. The composite/reinsurance broker should abide by the additional code of conduct.

1. Professional Conduct Every insurance broker should follow recognised standards of professional conduct and discharge his functions in the interest of the policyholders.

2. Conduct of Matters Relating to Clients Relationship Every insurance broker should:

(a) Conduct its dealings with clients with utmost good faith and integrity at all times;
(b) Act with care and diligence;
(c) Ensure that the client understands his relationship with the broker and on whose behalf the broker is acting;
(d) Treat all information supplied by the prospective clients as completely confidential to themselves and to the insurers) to which the business is being offered;
(e) Take appropriate steps to maintain the security of confidential documents in their possession;
(f) Hold specific authority of client to develop terms;
(g) Understand the type of client it is dealing with and the extent of the client's awareness of risk and insurance;
(h) Obtain written mandate from client to represent the client to the insurer and communicate the grant of a cover to the client after effecting insurance;
(i) Obtain written mandate from client to represent the client to the insurer/reinsurer; and confirm cover to the insurer after effecting reinsurance, and submit relevant reinsurance acceptance and placement slips;
(j) Avoid conflict of interest;
(k) Obtain necessary documents required under KYC norms.

3. Conduct of Matters Relating to Sales Practices Every insurance broker should:

(a) Confirm that it is a member of the Insurance Broker Association of India or such a body of brokers as approved by the IRDA which has a memorandum of understanding with it.
(b) Confirm that he does not employ agents or canvassers to bring in business;
(c) Identify itself and explain as soon as possible the degree of choice in the products that are on offer;

(d) Ensure that the client understands the type of service it can offer;
(e) Ensure that the policy proposed is suitable to the needs of the prospective client;
(f) Give advice only on those matters in which it is knowledgeable and seek or recommend other specialist for advice when necessary;
(g) Not make inaccurate or unfair criticisms of any insurer or any member of the Insurance Broker Association of India or member of such body of brokers as approved by the IRDA;
(h) Explain why a policy or policies are proposed and provide comparisons in terms of price, cover or service where there is a choice of products;
(i) State the period of cover for which the quotation remains valid if the proposed cover is noteffected immediately;
(j) Explain when and how the premium is payable and how such premium is to be collected, where another party is financing all or part of the premium, full details should be given to the client including any obligations that the client may owe to the party; and
(k) Explain the procedures to follow in the event of a loss;
(l) Not indulge in any sort of money laundering activities;
(m) Not indulge in sourcing of business by themselves/through call centres by way of misleading/spurious calls.

4. Conduct of Relation to Furnishing of Information Every issuance broker should:
(a) Ensure that the consequences of non-disclosure and inaccuracies are pointed out to the prospective client;
(b) Avoid influencing the prospective client and make it clear that all the answers or statements given are the latter's own responsibility. Ask the client to carefully check details of information given in the documents and request the client to make true, fair and complete disclosure where it believes that the client has not done so and in case further disclosure is not forthcoming it should consider declining to act further;
(c) Explain to the client the importance of disclosing all subsequent changes that might affect the insurance throughout the duration of the policy; and
(d) Disclose on behalf of its clients all material facts within its knowledge and give a fair presentation of the risk.

5. Conduct in Relation to Explanation of Insurance Contract Every insurance broker, should:
(a) Provide the list of insurer(s) participating under the insurance contract and advice any subsequent changes thereafter;
(b) Explain all the essential provisions of the cover afforded by the policy recommended by him so that, as far as possible, the prospective client understands what is being purchased;
(c) Quote terms exactly as provided by the insurer;
(d) Draw attention to any warranty imposed under policy, major or unusual restrictions, exclusions under the policy and explain how the contract may be cancelled;
(e) Provide the client with prompt written confirmation that insurance has been effected. If the final policy wording is not included with this confirmation, the same should be forwarded as soon as possible;
(f) Notify changes to the terms and conditions of any insurance contract and give reasonable notice before any changes take effect;

(g) Advise its clients of any insurance proposed on their behalf which would be effected with an insurer outside India, where permitted, and, if appropriate, of the possible risks involved.

6. Conduct in Relation to Renewal of Policies Every insurance broker should:

(a) Ensure that its clients is aware of the expiry date of the insurance even if it chooses not to offer further cover to the client;

(b) Ensure that renewal notices contain a warning about the duty of disclosure including the necessity to advise changes affecting the policy, which have occurred since the policy inception or the last renewal date;

(c) Ensure that renewal notices contain a requirement for keeping a record (including copies of letters) of all information supplied to the insurer for the purpose of renewal of the contract;

(d) Ensure that the client receives the insurer's renewal invitation well in time before the expiry date.

7. Conduct in Relation to Claim by Client Every insurance broker should:

(a) Explain to its clients their obligation to notify claims promptly and to disclose all material facts and advise subsequent developments as soon as possible;

(b) Request the client to make true, fair and complete disclosure where it believes that the client has not done so. If further disclosure is not forthcoming, it should consider declining to act further for the client;

(c) Give prompt advice to the client of any requirements concerning the claim;

(d) Forward any information received from the client regarding a claim or an incident that may give rise to a claim without delay, and in any event within three working days;

(e) Advice the client without delay of the insurer's decision or otherwise of a claim; and give all reasonable assistance to the client in pursuing his claim. However, the insurance broker should **(i)** not take up recovery assignment on a policy contract **(ii)** not work as a claims consultant for a policy which has not been serviced through him.

8. Conduct in Relation to Receipt of Complaints Every insurance broker should:

(a) Ensure that letters of instruction, policies and renewal documents contain details of complaints handling procedures;

(b) Accept complaints either by phone or in writing;

(c) Acknowledge a complaint within 14 days from the receipt of correspondence, advise the member staff who would be dealing with the complaint and the time-table for dealing with it;

(d) Ensure that response letters are sent and inform the complainant of what he may do if he is unhappy with the response;

(e) Ensure that complaints are dealt with at a suitably senior level;

(f) Have in place a system for recording and monitoring complaints.

9. Conduct in Relation to Documentation Every insurance broker should:

(a) Ensure that any documents issued comply with all statutory or regulatory requirements from time to time in force;

(b) Send policy documentation without avoidable delay;

(c) Make available, with policy documentation, advice that the documentation should be read carefully and retained by the client;

(d) Not withhold documentation from its clients without their consent, unless adequate and justifiable reasons are disclosed in writing and without delay to the client. Where documentation is withheld, the client must still receive full details of the insurance contract;

(e) Acknowledge receipt of all monies received in connection with an insurance policy;

(f) Ensure that the reply is sent promptly or use its best endeavours to obtain a prompt reply to all correspondence;

(g) Ensure that all written terms and conditions are fair in substance and set out, clearly and in plain language, client's rights and responsibilities; and

(h) Subject to the payment of any monies owned to it, make available to any new insurance broker instructed by the client all documentation to which the client is entitled and which is necessary for the new insurance broker to act on behalf of the client.

10. Conduct in Matters Relating to Advertising Every insurance broker should conform to the relevant provisions of the IRDA (Insurance Advertisements and Disclosure) Regulations, 2000, and:

(a) Ensure that statements made are not misleading or extravagant;

(b) Where appropriate, distinguish between contractual benefits which the insurance policy is bound to provide and non-contractual benefits which may be provided;

(c) Ensure that advertisements would be restricted to the policies of one insurer, except where the reasons for such restrictions are fully explained with the prior approval of that insurer;

(d) Ensure the advertisements contain nothing which is in breach of the law nor omit anything which the law requires;

(e) Ensure that advertisement does not encourage or condone defiance or breach of the law;

(f) Ensure that advertisements contain nothing which is likely, in the light of generally prevailing standards of decency and propriety, to cause grave or widespread offence or to cause disharmony;

(g) Ensure that advertisements are not so framed as to abuse the trust of clients or exploit their lack of experience or knowledge;

(h) Ensure that all descriptions, claims and comparisons, which relate to matters of objectively ascertainable fact shall be capable of substantiation.

11. Conduct in Matters Relating to Receipt of Remuneration Every insurance broker should:

(a) Disclose whether in addition to the remuneration prescribed under these regulations, he proposes to charge the client, and if so in what manner;

(b) Advise the client in writing of the insurance premium and any fees or charges separately and the purpose of any related services;

(c) If requested by a client, disclose the amount of remuneration or other remuneration it receives as a result of effecting insurance for that client. This would include any payment received as a result of securing on behalf of the client any service additional to the arrangement of the contract of insurance; and

(d) Advise its clients, prior to effecting the insurance, of their intention to make any deductions from the amount of claim collected for a client, where this is a recognised practice for the type of insurance concerned.

12. Conduct in Relation to Matters Relating to Training Every insurance broker should:

(a) Ensure that its staff are aware of, and adhere to, the standards expected of them by this code;

(b) Ensure that staff are competent, suitable and have been given adequate training;

(c) Ensure that there is a system in place to monitor the quality of advice given by its staff;

(d) Ensure that members of staff are aware of legal requirements including the law of agency affecting their activities; and only handle classes of business in which they are competent;

(e) Draw the attention of the client to Section 41 of the Insurance Act, which prohibits rebating and sharing of commission.

13. Information and Education Common to Direct and Reinsurance Brokers The insurance broker should **(a)** support industry education initiatives aimed at explaining insurance to consumers/community, **(b)** make readily available to client **(i)** upto-date information on insurance, **(ii)** information to assist insured to determine the level of insurance cover they may require, and **(iii)** information about insurance products and services and **This Code**.

14. Every insurance broker should display, in every office where it is carrying on business and to which the public have access, a notice to the effect that a copy of the code of conduct is available upon request and that if a member of the public wishes to make a complaint or requires the assistance of the IRDA in resolving a dispute, he may write to it.

15. An insurance broker should not act as an insurance agent of any insurer under Section 42 of the Insurance Act.

16. Every insurance broker should abide by the provisions of the Insurance Act, IRDA Act, rules and regulations made thereunder which may be applicable and relevant to the activities carried on by them as insurance brokers.

Additional Code of Conduct for Reinsurance Broker and Composite Broker

1. General (Applicable to all Contracts of Reinsurance) **(a)** A composite insurance/reinsurance broker should **(i)** not enter the reinsurance markets either to develop terms for reinsurance cover or to place reinsurance on any risk without the specific written authorisation of the insurer insuring the risk or insurer/reinsurer who has been asked to quote terms for the risk, **(ii)** not block reinsurance capacity in anticipation of securing an order to place reinsurance, **(iii)** provide to the insurer/reinsurer, a true and complete copy of the reinsurance placement slip to be used, before entering the market and incorporate any modifications or corrections proposed by the insurer/reinsurer in the placement slips, **(iv)** put up to the insurer/reinsurer, all the terms (including the reinsurance commission and brokerage allowed) obtained by it from various reinsurers and indicate the share the lead reinsurer is willing to write at those terms and the expectation of the insurance broker about placement of the required reinsurance at the terms quoted with acceptable reinsurance security, **(v)** furnish to the insurer/reinsurer, a true copy of the placement slip signed by the lead reinsurer quoting terms, indicating the signed line of the reinsurer.

(b) Where reinsurance on a risk is proposed to be placed with different reinsurers at different terms, the fact that terms for all reinsurers are not uniform, should be disclosed to reinsurers suitably.

(c) Once the insurer/reinsurer has accepted the quoted reinsurance terms, he should place the required reinsurance cover and keep the insurer/reinsurer informed about the progress of placement from time to time. In selecting the reinsurers to whom the risk is offered, the insurance broke should be mindful of the need to use only such reinsurers who are rated **BBB** or higher by a recognised credit rating agency. Where the reinsurance is over placed, the signing down should be done in consultation with the insurer/reinsurer in a manner consistent with good market practice.

(d) Immediately after completion of placement of reinsurance, the insurance broker may issue a broker's cover note giving the terms of cover and the names of reinsurers and the shares placed with each of them. It may contain a listing of all important clauses and conditions applicable to the reinsurance and where the wordings of clauses are not market standard, they should be attached to the insurance broker's cover note.

(e) The insurance broker should **(i)** follow up the cover note by a formal signed reinsurance policy document or other acceptable evidence of the reinsurance contract signed by the reinsurers concerned, within one month of receipt of reinsurance premium, **(ii)** have a security screening procedure in-house or follow credit ratings given by recognised credit rating agencies and answer without any delay, any questions raised by the insurer about the credit rating of one or more reinsurers. Where the insurer/reinsurer declines to accept a particular reinsurer for whatever reason and asks the insurance broker to replace the security before commencement of risk, he should do so promptly and advise the insurer/reinsurer of the new reinsurer brought on the cover.

2. Placement of Proportional/Non-proportional Treaty

(a) A composite insurance or reinsurance broker invited to place a proportional treaty should prepare the treaty offer slip and supporting information with the cooperation of the insurer and secure his concurrence to the slip and information before entering the market.

(b) Where a reinsurance treaty is placed at different terms with different reinsurers, the fact that such is the practice should be made known to all the reinsurers suitably.

(c) Where a reinsurer accepts a share in a treaty subject to any condition, the conditions should be made known to the ceding insurer and its agreement obtained before binding the placement.

(d) The insurance broker should advise the progress of placement of the treaty from time to time. Immediately after completion of placement, he should issue a cover note setting out the treaty terms and conditions and list of reinsurers with their shares. Where a treaty is overplaced, the insurance broker should sign down the shares in consultation with the insurer in a manner consistent with good market practice.

(e) The insurance broker should **(i)** secure signature of formal treaty wordings or other formal reinsurance contract documentation within three months of completion of placement, **(ii)** have a security screening procedure in-house or follow credit ratings given by recognised credit rating agencies and answer without any delay, any question raised by the credit insurer about the credit rating of one or more reinsurer. Where the insurer declines to accept a particular reinsurer for whatever reason and ask the insurance broker to replace the security before commencement of the reinsurance period, the insurance broker should do so promptly and advise the insurer of the new reinsurer brought on the cover.

3. Placement of Foreign Inward Reinsurance

(a) The reinsurance broker should **(i)** ensure that Indian reinsurer(s) receive the reinsurance premium from the overseas insurer as per the premium payment condition stipulated in the reinsurance contract, **(ii)** not enter the Indian reinsurance markets either to develop terms for reinsurance cover or to place reinsurance on any risk without the specific written authorisation of the overseas insurer insuring the risk or insurer who has been asked to quote terms for the risk, **(iii)** provide to the reinsurer in India, a true and complete copy of the placement slip to be used, before committing any terms to the overseas client. He should incorporate any modifications or corrections proposed by the reinsurer in the placement slip, **(iv)** put up the overseas insurer, all the terms (including the reinsurance commission and brokerage allowed) obtained by it from various Indian reinsurers and indicate the share the reinsurer(s) is willing to write at those terms and the expectation of the insurance broker about placement of the required reinsurance at the term quoted, with acceptable reinsurance security, **(v)** furnish to the overseas insurer, a true copy of the placement slip signed by the Indian reinsurer quoting terms, indicating thereon, the signed line of the reinsurer.

(b) Where reinsurance on a risk is proposed to be placed with different reinsurers at different terms, the fact that terms for all reinsurers are not uniform, should be disclosed to reinsurers suitably.

(c) The insurance broker should provide complete information as desired by the Indian reinsurer(s) to process the claim arising out of any inwards business.

4. Reinsurance Business Placed with Overseas Reinsurers **(a)** The reinsurance broker should ensure **(i)** that business is placed with only those overseas reinsurers which are registered with the IRDA, **(ii)** the compliance of any taxation, foreign exchange, anti-money laundering or any other applicable statutory laws at the time of placing the reinsurance business.

5. Responding to Catastrophes and Disasters **(a)** The reinsurance broker should respond to catastrophes and disasters, such as floods, earthquakes, cyclones, severe storms and hail which result in a large number of claims, in a timely, professional and practical way and in a compassionate manner.

6. Conduct in Relation to Explanation of Reinsurance Contract Every reinsurance broker should:

(a) provide the list of reinsurer(s) participating under the reinsurance contract and advise any subsequent changes;

(b) explain all the essential provisions of the cover afforded by the policy recommended by him so that, as far as possible, the prospective client understands what is being purchased;

(c) quote terms exactly as provided by reinsurer;

(d) draw attention to any warrant imposed under the policy, major or unusual restrictions, exclusions under the policy and explain how the contract may be challenged;

(e) provide the insurer/reinsurer with prompt written confirmation that reinsurance has been affected. If the final policy wording is not included with the confirmation, the same should be forwarded as soon as possible;

(f) notify changes to the terms and conditions of any reinsurance contract and give reasonable notice before any changes take effect.

Segregation of Insurance Money The provisions of Section 64-VB of the Act would continue to determine the question of assumption of risk by an insurer. In the case of reinsurance of contracts, it may be agreed between the parties specifically or as a part of international market practices that the licensed reinsurance/composite broker can collect the premium and remit to the insurer and/or collect the claims due from the reinsurer to be passed on to the insured. In these circumstances, the money collected by the licensed insurance broker should be dealt with in the following manner:

(a) Should act as the trustee of the insurance money that he is required to handle in order to discharge his functions as a reinsurance broker and it would be deemed that a payment made to the reinsurance broker would be considered as payment made to the reinsurer;

(b) Ensure that "insurance money" is held in an "Insurance Bank Account" with one or more of the scheduled banks or with such other institutions as may be approved by the IRDA.

(c) Give written notice to, and receive written confirmation from, a bank, or other institution that he is not entitled to combine the account with any other account, or to exercise any right of set-off, charge or lien against money in that account.

(d) Ensure that all monies received from or on behalf of an insured is paid into the "Insurance Bank Account" to remain in deposit until it is transferred on to the reinsurer or to the direct insurer;

(e) Ensure that any refund of premium which may become due to a direct insurer on account of the cancellation of a policy or alteration in its terms and conditions or otherwise would be paid by the insurer directly to the direct insurer;

(f) Interest on recovery/payment received should be for the benefit of the direct insurer or reinsurer;

(g) Only remove from the "Insurance Bank Account" charges, fees or commission earned and interest received from any funds comprising the account;

(h) Ensure that no payment is made from Insurance Bank Accounts for purposes other than those specified by the IRDA regulations.

(i) Money held in the Insurance Bank Account should not be held in fixed deposits/inverted elsewhere by the insurance broker.

(j) Take immediate steps to restore the required position if at any time he becomes aware of any deficiency in the required "segregated amount".

Professional Indemnity Insurance Every insurance broker should take out and maintain at all times a professional indemnity insurance cover throughout the validity of the period of the licence granted to him by the IRDA. However, in appropriate cases, it may allow a newly licensed insurance broker to produce such a guarantee within 12 months from the date of issue of the original licence. The insurance cover must indemnify an insurance broker against:

(a) Any error or omission or negligence on his part or on the part of his employee and directors;

(b) Any loss of money or other property for which the broker is legally liable in consequence of any financial or fraudulent act or omission;

(c) Any loss of documents and costs and expenses incurred in replacing or restoring such documents;

(d) Dishonest or fraudulent acts or omissions by brokers' employees or former employees.

The indemnity cover should **(a)** be on a yearly basis for the entire period of licence; **(b)** not contain any terms to the effect that payments of claims depend upon the insurance broker having first met the liability; **(c)** indemnify in respect of all claims made during the period of the insurance regardless of the time at which the event giving rise to the claim may have occurred. However, an indemnity insurance cover not fully conforming to the above requirements would be permitted by the IRDA in special cases for reasons to be recorded by it in writing.

The limit of indemnity for any one claim and in the aggregate for the year in the case of insurance brokers would be as follows: three times remuneration received at the end of every financial year subject to a minimum of ₹50 lakh for direct broker, ₹2 crore for reinsurance broker and ₹5 crore for a composite broker.

The uninsured excess in respect of each claim should not exceed 5 per cent of the capital employed by the broker in business.

The insurance policy should be obtained from any registered insurer in India who has agreed to:

(a) Provide the insurance broker with an annual certificate containing the name and address, including the licence number of the insurance broker, the policy number, the limit of indemnity, the excess and the name of the insurer as evidence that the cover meets the requirements of the IRDA.

(b) Send a duplicate certificate to the IRDA at the time the certificate is issued to the insurance broker; and

(c) Inform the insurer immediately of any case of voidance, non-renewal or cancellation of cover midterm.

Every insurance broker should:

(a) Inform immediately the IRDA, should any cover be cancelled or voided or if any policy is not renewed;

(b) Inform immediately the insurer in writing of any claim made by or against it;

(c) Advice immediately the insurer of all circumstances or occurrences that may give rise to a claim under the policy; and

(d) Advise the IRDA as soon as an insurer has notified that it intends to decline indemnity in respect of 2 claim under the policy.

Maintenance of Books of Accounts/Records Every insurance broker should prepare on accrual basis for very financial year (April 1 – March 31) a **(i)** balance sheet/statement of affairs at the end of each accounting year, **(ii)** profit/loss account for the period, **(iii)** statement of cash/fund flow, and **(iv)** additional statements on insurance broking business required by the IRDA. A copy of the audited financial statements along with the auditor's report/observations and suitable explanation on such observations should be submitted to the IRDA before September 30 every year. Within 90 days from the auditor's report, the insurance brokers should take steps to rectify the deficiencies and inform the IRDA. All maintained books of accounts/statements/documents should be available on all working days to the authorised officers of the IRDA for inspection and should be retained for at least 10 years. The documents required for cases pending with the courts should be maintained till the final disposal of the case.

A certificate confirming the compliance of various regulations should be part of the auditor's report. The details of the statutory auditors engaged by the broker along with the audited accounts should also be submitted to the IRDA.

Submission of Half-yearly Results Every insurance broker should, before October 31, and April 30 each year, furnish to the IRDA a half-yearly unaudited financial statements containing details of performance, financial position along with the following certificate(s) to the effect that **(i)** he is maintaining required capital/networth/deposit, maintaining a separate insurance bank account and incomes are used only for specific purposes and is not engaged in any other business, **(ii)** a preferential indemnity policy is in force, and **(iii)** confirming the receipt of his remuneration.

Claims Consultancy Limited claims consultancy by broker is permitted by the IRDA: **(i)** for claims which do not emanate from a policy, upto ₹1 crore, **(ii)** a written mandate from the client to the represent him with the concerned insurer, **(iii)** a mutually-agreed fee may be charged for such services but it cannot be expressed as a percentage of the claim, **(iv)** their code of conduct will apply in all dealings.

Disclosures An insurance broker should disclose to the IRDA on its own any material change which has a bearing on its license within 30 days of the change. He should disclose to the IRDA as and when required within 30 days of the requisition the following information: **(i)** responsibilities with regard to the placement of insurance contract, **(ii)** any change in information/particulars previously furnished which have a bearing on the grant of license, **(iii)** names of clients whose portfolio they manage/have managed, and **(iv)** any other specified requirement/information. In any case, he should have to take the prior approval of the IRDA for the following: change of/in **(i)** principal officer, **(ii)** director(s)/partner(s), **(iii)** name of the company, **(iv)** place of corporate/registered office, and **(v)** principal place of business.

He should furnish the following information as and when there is a change/addition to the information furnished previously: **(i)** opening/closing of the branch offices, **(ii)** list of broker qualified persons, **(iii)** in respect of a claim under the professional indemnity policy, and **(iv)** acquiring of immovable property.

The IRDA may from time to time require the insurance broker to furnish information/data/documents in the specified manner. Failure to comply will lead to action.

A broker should also furnish the following: **(i)** audit arrangements, **(ii)** information about registered/branch offices, **(iii)** standing arrangements with other brokers/service providers, **(iv)** spread of business during the year, **(v)** bank accounts, **(vi)** professional indemnity insurance in force **(vii)** claims data, **(viii)** reinsurance balances outstanding, **(ix)** security screening proceedings for reinsurance broking, **(x)** Board of Directors/partners/management, **(xi)** financial data of brokers, **(xii)** business particulars of brokers, **(xiii)** organisation structures and **(xiv)** reinsurance business details.

Inspection The IRDA has the right to appoint its officers as an inspecting authority to inspect the premises of the insurance broker to ascertain and see how the business is carried on and also to inspect the books of accounts, records and documents to: **(i)** ensure that they are being maintained in the prescribed manner, **(ii)** ensure that the provisions of the Insurance Act, rules, regulations are being complied with, **(iii)** investigate the complaints from any insured/insurer/insurance broker/any other person on any matter having a bearing on his activities and **(iv)** investigate his affairs **suo motu** in the interest of the proper development of the insurance business or in policy-holders' interests.

The IRDA may also appoint a Chartered Accountant or an Actuary or any qualified and experienced individual in the insurance field to investigate the books of accounts or the affairs of the insurance broker.

The inspecting authority/investigator should have full access to the premises of the insurance broker and be extended all facilities for examining books/records/ documents to examine his records statements of any principal officer/employee and have power to seize/make copies of documents/records. Such persons would be duty bound to give all assistance in connection with the inspection which the broker may reasonably be expected to give. The expenses and costs of the investigation would be recovered from the concerned broker.

Suspension of Licence with Notice The licence of an insurance broker may be cancelled or suspended after due notice and after giving him a reasonable opportunity of being heard if he:

(a) Violates the provisions of the Insurance Act, IRDA Act, or rules or regulations, made thereunder;

(b) Fails to **(i)** furnish any information relating to his activities as an insurance broker as required by the IRDA, **(ii)** comply with any IRDA directions;
(c) Furnishes wrong or false information, or conceals or fails to disclose material facts in the application submitted for obtaining a licence;
(d) Does not submit periodical returns as required by the IRDA;
(e) Does not cooperate with any inspection or enquiry conducted by the IRDA;
(f) Fails to resolve the complaints of the policy-holders or fails to give a satisfactory reply to the IRDA in this behalf;
(g) indulges in rebates or inducements in cash or kind to a client or any of the client's directors or other employees or any person acting as an introducer;
(h) Is found guilty if misconduct or his conduct is not in accordance with the code of conduct;
(i) Fails to maintain the capital requirements;
(j) Fails to pay the fees or the reimbursement of expenses under these regulations;
(k) Violates the conditions of licence;
(1) Does not carry out his obligations as specified in the regulations;
(m) If the principal officer does not acquire practical training and pass the examination within the stipulated period.
(n) The IRDA feels that the establishment of an insurance broker is only to divert funds within a group of companies or their associates.

Cancellation or Suspension of Licence without Notice The licence of an insurance broker may be cancelled or suspended without notice, if he:
(a) Violates any one or more of the requirements under the code of conduct;
(b) Is found guilty of fraud, or is convicted of a criminal offence;
(c) Commits such defaults, which require immediate action in the opinion of the IRDA, provided that it has communicated the reasons for the cancellation in writing;
(d) Has not commenced the business within six months of being granted a licence.

Insurance Surveyors and Loss Assessors

The IRDA regulations relating to licensing, professional requirements and code of conduct of insurance surveyors and loss assessors are briefly discussed below.

Licensing Procedure ***Individual Surveyors and Loss Assessors*** Every person who is a student member of the Indian Institute of Insurance Surveyors and Loss Assessors (IIISLA) and intending to act as surveyor and loss assessor in respect of general insurance business should obtain a licence from the IRDA. While granting licence, the IRDA would take into account all matters relating to his duties/responsibilities/functions and satisfy itself that the applicant is a fit and proper person for licence. In particular, it would satisfy that the applicant satisfies all the applicable requirements of Section 64-UM and Section 42-D of the Insurance Act (**discussed earlier**) and Rule 56-A of the Insurance Rules and fulfils the eligibility criteria (**discussed later**), pays the fee of ₹1,000 for all membership levels, encloses the required documents, makes the applicable disclosures and would furnish such additional information as may be required by the IRDA from time to time.

On being satisfied about the applicant's eligibility, the IRDA would grant licence mentioning the level of membership granted by the IIISLA, particular class/department or subject of general insurance business, that is, fire, marine cargo, marine hull, engineering, motor, miscellaneous crop insurance and loss of profit allotted based on their technical/professional/insurance and other qualifications. The licence would be valid for 5 years.

Eligibility Criteria **(a)** ***Qualifications*****: (i)** Under Section 64-UM/42-d of the Insurance Act, **(ii)** Additional technical qualifications under Rule 56-A of the Insurance Rule, **(iii)** Post-Graduate Diploma in General Insurance from IIRM, **(iv)** B.Sc. (Agricultural Sciences), **(v)** Additional as specified by the IRDA from time to time, **(vi)** A student member of the **IIISLA**.

(b) ***Training*****: (i)** 12-month specified training (**discussed later in this Section**) and **(ii)** other specified by the IRDA from time to time;

(c) ***Examination*****:** Passing of relevant paper(s) of surveyors examination conducted by the Insurance Institute of India/any other authorised by the IRDA. The allotment of department/area of work to act as surveyor and loss assessor would be specified by the IRDA from time to time. A surveyor/loss assessor would be subject to level of membership in the **IIISLA** (**discussed later in this Section**).

Registration of License An application can the rejected if, **(i)** it does not conform the application fails to comply with, the provisions of the Insurance Act/IRDA regulations, or **(ii)** the IRDA is of the opinion that the grant of license is not in the interest of policyholders.

Corporate Surveyors and Loss Assessors Corporate surveyor means a company/firm/limited liability partnership licensed to act as surveyor and loss assessor. The IRDA would satisfy itself that the application is complete in all respects, al the applicable requirements of Sections 64-UM/42-D and Rule 56-A and the eligibility criteria applicable to individual surveyors/loss assessors *mutatis mutandis* are satisfied.

At least two directors/partners should be members of the **IIISLA** and licensed to act as surveyors/loss assessors. The department/level of membership of the director/partner under his individual license would be applicable to the company/firm and he can undertake job/issue reports only in his capacity as a director/partner of the applicant-company/firm. Employee-licensed surveyors would undertake jobs only of the concerned organisation and only in these departments and level of membership allotted to the individual license.

A director/partner of a corporate surveyor is barred from directorship/partnership in another corporate surveyor. To reflect the main object, the name of the company/firm should include .... "**Insurance Surveyors and Loss Assessors**".

The aggregate holding of equity share held by a foreign company (not exceeding 49 per cent) should be disclosed while applying for license. It should be ensured that a promoter-subscriber of the applicant has only one license.

The license fee, documents to be enclosed, declarations to be submitted applicable to individual surveyors would apply *mutatis mutandis* to corporate surveyors.

Removal of License Application should reach the IRDA 30 days before the expiry of the validity period along with a fee of ₹100 only. To avoid undue hardship, the IRDA may accept application within six months of expiry on payment of penalty of ₹752. The licence of a surveyor can be renewed for 5 years if the IRDA is satisfied that the applicant has complied with all the specified requirements.

The IRDA may refuse to grant/renew licence or suspend/cancel a licence if he/it: **(i)** makes a statement which is false in material particulars with regard to eligibility for licence or **(ii)** suffers from any of the disqualifications under Sections 42(4), and 64-UM (1)(D) of the Insurance Act.

Constitution and Functions of Surveyors and Loss Assessors Committee The IRDA would constitute a Committee to be called "Surveyors and Loss Assessors Committee" ("Committee"), for assisting it on the matters and affairs relating to insurance surveyors and loss assessors consisting of the following persons: **(i)** an Officer of the IRDA; **(ii)** two representatives of the surveyors and loss assessors; **(iii)** a representative of insurer each from public and private sector, and **(iv)** a representative of the policyholders. The Committee would be for a period of three years and presided over by the officer of the IRDA.

Functions of the Committees The Committee would perform the following functions:

(i) Recommending the syllabus for examination and practical training requirements for persons to qualify as surveyors and loss assessors.

(ii) Recommending to the IRDA for its consideration to recognise foreign qualifications and training for the purposes of grant of licence to act as surveyors and loss assessors;

(iii) Improving and developing the status and standard of the profession of surveyors and loss assessors;

(iv) Coordinating with educational or other institutions, having as their objects, wholly or partly, similar to those of the profession of surveyors and loss assessors, in such manner as may be conducive for the attainment of common objectives;

(v) Looking into the matters of professional misconduct, indiscipline, non-adherence to code of conduct by surveyors and loss assessors; and dealing with complaints of insured/insurer in respect of survey work done by them;

(vi) Discharging any other function, which may be entrusted by the IRDA, from time to time.

Appointment of Surveyors and Loss Assessors To act as a surveyor/loss assessor, a person/firm/company must obtain a license from the IRDA. An insurer/insured can appoint him to assess loss in respect of general insurance business above ₹20,000 within 72 hours from the time the occurrence of loss is known to the insured. Notice of the appointment in writing to be sent to the insurer/insured would form part of the claim settlement process. A surveyor/loss assessor would assess losses only of departments specified in the license. In case of dispute/dissatisfaction in the assessment of loss by surveyor appointed by the insurer, the insured would be entitled to appoint on payment of fee an appropriate assessor. Any dispute between them about the quantum of assessed loss may be referred to arbitration.

> **Surveyor/loss assessor** investigates, manages, quantifies, validates and deals with 'losses arising from any contingency and report thereon.

Duties and Responsibilities of a Surveyor and Loss Assessor A **surveyor and loss assessor** should, for a major part of the working time, investigate, manage, quantify, validate and deal with losses (whether insured or not) arising from any contingency, and report thereon, and carry out the work with competence, objectivity and professional integrity by strictly adhering to the code of conduct expected of him. The following would, inter alia, be the duties and responsibilities of a surveyor and loss assessor:

(i) Declaring whether he has any interest in the subject-matter in question or whether it pertains to any of his relatives, business partners or through material shareholding;

(ii) Maintaining confidentiality and neutrality without jeopardising the liability of the insurer and claim of the insured;

(iii) Conducting inspection and reinspection of the property in question suffering a loss;

(iv) Examining, inquiring, investigating, verifying and checking upon the causes and the circumstances of the loss in question including extent of loss, nature of ownership and insurable interest;

(v) Conducting spot and final surveys, as and when necessary, and comment upon franchise, excess/ under insurance and any other related matter;

(vi) Estimating, measuring and determining the quantum and description of the subject under loss;

(vii) Advising the insurer and the insured about loss minimisation, loss control, security and safety measures, wherever appropriate, to avoid further losses;
(viii) Commenting on the admissibility of the loss as also observance of warranty conditions under the policy contract;
(ix) Surveying and assessing the loss on behalf of insurer or insured;
(x) Assessing liability under the contract of insurance;
(xi) Pointing out discrepancy, if any, in the policy wordings;
(xii) Satisfying queries of the insured/insurer and of persons connected thereto in respect of the claim/loss;
(xiii) Recommending applicability of depreciation and the percentage and quantum of description;
(xiv) Giving reasons for repudiation of claim, in case the claim is not covered by policy terms and conditions;
(xv) Taking expert opinion, wherever required; and
(xvi) Commenting on salvage and its disposal wherever necessary.

A surveyor or loss assessor should submit his report to the insurer as expeditiously as possible, but not later than 30 days of his appointment with a copy of the report to the insured. The period can be extended to six months with the consent of the insured and the insurer in exceptional cases due to its special and complicated nature. Within 15 days of the receipt of the report, the insurer may require the surveyor under intimation to insured to furnish an additional report on any incomplete issues within three weeks of the date of communication from the insurer in this regard.

Categorisation of Surveyors A surveyor/loss assessor would be categorised on the basis of level of membership by the **IIISLA**. The three levels of membership are: **(i)** Licentiate, **(ii)** Associate and **(iii)** Fellow. Each will carry on work accordingly. The **IILSLA** would grant appropriate membership to eligible person(s) within 15 days from the date of receipt of application for membership based on the under-mentioned criteria.

Licentiate Member Is any person holding a valid license and fulfils the IRDA stipulations relating to training, examination, seminars and workshops conducted by the **IIISLA**. In addition to the practical training (**discussed later in this Section**), every member should undergo training for 100 hours and five seminars/workshops.

Associate Member Is a licentiate member holding valid license continuously for at least 5 years and undergoes training for 50 hours and attends at least 8 seminars/workshops.

Fellow Member Is a associate member holding valid license continuously for not less than 8 years and undergoes 25 hours training and at least 10 seminars/workshops.

Code of Conduct Every surveyor and loss assessor should:
(1) Behave ethically and with integrity in the professional pursuits. Integrity implies not merely honesty but fair dealings and truthfulness;
(2) Strive for objectivity in professional and business judgement;
(3) Act impartially, when acting on instructions from an insurer, in relation to a policyholder's under a policy issued by that insurer;
(4) Conduct himself with courtesy and consideration to all people with whom he comes into contact during the course of his work;
(5) Not accept or perform surveys works in areas for which he does not hold a licence;
(6) Not accept or perform work which he is not competent to undertake, unless he obtains some advice and assistance, as would enable him to carry out the work competently;

(7) Carry out his professional work with due diligence, care and skill and with proper regard to technical and professional standards expected of him;
(8) Keep himself updated with all developments relevant to his professional practice;
(9) At all times maintain proper record for work done by him and comply with all relevant laws;
(10) Assist and encourage his colleagues to obtain professional qualifications, and, in this behalf, provide free articleship and/or practical training for a period of twelve months;
(11) Maintain a register of survey work, containing the relevant information, such as details of insured/insurer/policy number/date of allocation of survey work/date of submission of survey report, amount of claims assessed, fee details and should keep important records of the survey reports, photographs and other important documents for a period of 3 years and furnish the same and such other specified returns, as and when called by the IRDA or by any investigating authority or the insurer. However, in case of litigation, the records should be maintained till the conclusion of the litigation.
(12) Disclose to all parties concerned his appointment, where the acceptance or continuance of such an engagement may materially prejudice, or could be seen to material affect the interests of any interested party. As soon as a conflict of interest is foreseen, every surveyor and loss assessor should notify all interested parties immediately and seek instructions for his continuance;
(13) Not disclose any information, pertaining to a client or employer or policy-holder acquired in the course of his professional work, to any third party, except, where the consent has been obtained from the interested party, or where there is a legal right to duty enjoined upon him to disclose;
(14) Neither use nor appear to use, any confidential information acquired or received by him in the course of his professional work, to his personal advantage or for the advantage of a third party;
(15) Comply with all the provisions of the Insurance/IRDA Act(s)/rules and regulations and orders/directions/guidelines issued by the IRDA;
(16) Undertake survey jobs in a company/firm only as an employee/director/partner;
(17) Neither act as a consultant of the insured nor involve in any settlement of loss particularly those being assessed by him; and
(18) Comply with the provisions of AOA/regulations and code of ethics from the **IIISLA**.

Training Applicants A student member of the **IIISLA** seeking license to act as a surveyor/loss assessor should enrol with the IRDA and undergo a practical training for at least 12 months with a licensed surveyor/loss assessor, who should be associate/fellow member of the **IIISLA**. The requirement of training would not be applicable to student-members having over 15 years of experience in areas relating to risk management/settlement of claims in relevant field in general insurance. The license to him would be in that particular area only. A practical training of not less than six months would be acquired for a licensed surveyor seeking a license for acting as a surveyor in another category. During the period of training, he should comply with the code of conduct/ethics prescribed by the **IIISLA** and duly approved by the IRDA including the following: **(i)** Behave ethically and with integrity implying not merely honesty but fair dealings and truthfulness, **(ii)** Not accept/perform/undertake any survey work and issue any report without holding a valid license, **(iii)** Maintain at all times duly certified proper record of training details, **(iv)** Disclose all information relating to any proceedings initiated/investigation pending/carried out against him by any agency, **(v)** File within 15 days any changes in information already submitted, and **(vi)** Any other information specified by the **IIISLA**.

The trainee should maintain a certified quarterly record of training and attach the certificate to the application seeking license from the **IIISLA**. The IRDA may also prescribe the passing by an applicant of an examination conducted by **IIISLA** or by an IRDA-authorised institution on the successful completion of the training.

Miscellaneous The other requirements of IRDA regulations are discussed below.

Register of Licensed Insurance Surveyors and Loss Assessors The **IIISLA** would maintain a register of all licensed insurance surveyors and loss assessors containing the following particulars: **(i)** full name, date of birth, domicile, residential and professional address; **(ii)** the date on which name is entered in the Register; **(iii)** licence number and period of validity; **(iv)** professional and other qualifications; **(v)** areas of survey work licensed to be undertaken; **(vi)** level of membership in the **IIISLA** of the surveyor and loss assessor; and **(vii)** any other particulars as may be prescribed by the IRDA from time to time. However, in the case of corporate surveyors, the particulars to be entered in the register, would be with reference to every director or partner. The IRDA may publish the appropriate relevant particulars in the register at intervals and in a manner deemed fit.

Submission of Returns Every licensed surveyor and loss assessor should: **(a)** furnish such of the document, statement, account, return on report, as and when required by the IRDA, and comply with such directions, as may be issued by the IRDA in this behalf, from time to time; and **(b)** submit an annual statement in the prescribed form. Every insurer should submit to the IRDA the following: **(i)** quarterly report on misconduct of licensed surveyors including any action taken on the employee surveyors **(ii)** a copy of the annual policy on the methodology followed for appointment/utilisation of surveyors and allotment of survey jobs to them, and **(iii)** any changes in the annual policy within 15 days of the change with reasons.

Inspection The IRDA, may appoint one or more persons as inspecting authority to undertake inspection of survey work, books, records and documents, or to investigate any bona fide complaint received against a surveyor and loss assessor. A surveyor should provide the information demanded by the inspection authority and extend all possible cooperation to facilitate the conduct of its work. After consideration of the inspection report, the IRDA would communicate the findings to the surveyor and loss assessor, and give him a reasonable opportunity of being heard before any action is taken by it on the findings of the inspection report.

Action in Default ***Suspension of License*** The IRDA would suspend for a specified period license of an individual/corporate surveyor/loss assessor if he/it: **(i)** Fails to discharge duties/responsibilities in a satisfactory/professional manner, **(ii)** Violates code of conduct, **(iii)** Makes a statement which is false in material particulars regarding eligibility for obtaining/renewal of license or in any size of the activities transacted or connected matters or has after the issue/renewal of license acquired a disqualification under Section 42(4) of the Insurance Act, **(iv)** Has contravened any provision of the Insurance/IRDA Act/Rules/regulations/directions, **(v)** Has been negligent in the discharge of obligations, and **(vi)** Has been sentenced to punishment by a court. A license may also be suspended if the IRDA is of the opinion that its continuation would be prejudicial to the policyholders interest. For an act committed by a director/partner, the license of the corporate surveyor may also be suspended.

Cancellation of License The license of a surveyor/loss assessor may be cancelled by the IRDA if found **(a)** suffering from a disqualification under Section 42(d) read with Section 42(4) of the Insurance Act, **(b)** knowingly contravening any provision of Insurance/IRDA Act/Rules/regulations/directions/instructions. The IRDA may also cancel a license if in its opinion its continuation would be prejudicial to the policyholders interest. Similarly, license may be cancelled if representation is not made to the IRDA within 45 days of the order of suspension of license.

Micro-Insurance

A **micro-insurance** product includes life as well as general micro-insurance products. A life/general insurance may offer life as well general micro-insurance products in terms of the IRDA's Micro-Insurance Regulations, 2005. **General micro-insurance product** means a health insurance contract/any contract covering the belongings, such as a hut, live stock, tools, instruments/any personal accident contract, of a personal or group (i.e., at least 20 persons), as per the terms specified below:

General micro-insurance product means health insurance contract/any contract covering belongings/any personal accident contract of a person/group.

Type of cover (1)	*Minimum amount of cover* (2)	*Maximum amount of cover* (3)	*Minimum term of cover* (4)	*Maximum term of cover* (5)	*Minimum age at entry* (6)	*Maximum age at entry* (7)
1. Dwelling and contents or livestock or tool or implements or other assets/crop insurance against all perils	₹5,000 per asset/cover	₹30,000 per asset/cover	1 year	1 year	NA	NA
2. Health insurance contract (individual)	₹5,000	₹30,000	1 year	1 year	Insurer's discretion	
3. Health insurance contract (family**) [Option to avail limit for individual/ float of family]	₹10,000	₹30,000	1 year	1 year	Insurer's discretion	
4. Personal accident (per life/earning member of family)	₹10,000	₹50,000	1 year	1 year	5 years	70 years

**means a unit comprising of husband, wife, dependent parents and a maximum of 3 children.

Life micro-insurance product means any term insurance contract, with/without return of premium/any endowment insurance contract/health insurance contract with/without an accident benefit rider, either on individual or group basis, as per the terms stated below. The group insurance contracts may be renewable on an yearly basis.

Life micro-insurance product means any term insurance contract with/without return of premium, any endowment/health insurance contract with/without accident benefit rider either on personal or group basis.

Type of cover (1)	*Minimum amount of cover* (2)	*Maximum amount of cover* (3)	*Minimum term of cover* (4)	*Maximum term of cover* (5)	*Minimum age at entry* (6)	*Maximum age at entry* (7)
1. Term insurance with/without return of premium	₹5,000	₹50,000	5 years	15 years	18 years	60 years
2. Endowment insurance	₹5,000	₹30,000	5	15	18	60
3. Health insurance (individuals)	₹50,000	₹30,000	1	7	Insurer's discretion	

(*Contd.*)

(*Contd.*)

4. Health insurance (family)	₹10,000	₹30,000	1	7	Insurer's discretion	
5. Accident benefit as rider	₹10,000	₹50,000	5	15	18	60

The main elements of IRDA's regulations, namely: tie-ups, distribution, appointment and code of conduct are discussed in this Section.

Tie-up The insurer should tie-up with a general insurer for the purpose and subject to the provisions of Section 64-VB of the Insurance Act (discussed in an earlier Section), collect the attributable premium from the prospect (proposer) and make it over to the general insurer. He would forward any claim in regard to the general micro-insurance product to the general insurer and offer all assistance for its expeditious disposal. A general insurer can similarly tie-up with a life insurer to offer life micro-insurance products.

Distribution of Micro-insurance Products In addition to the individual/corporate insurance agents and insurance brokers, insurers may distribute micro-insurance products through micro-insurance agents who would not distribute any other insurance products.

A **micro-insurance agent** means **(i)** a Non-Government Organisation (NGO), **(ii)** a Self-Help Group (SHG) and **(3)** a Micro-Finance Institution (MFI). The **NGO/SHG** means a non-profit organisations registered as a society/an informal group, consisting of 10-20 persons, which has been working for at least 3 years with marginalised groups, with proven track record, clearly stated terms and objectives/transparency and accountability as outlined in its memorandum/rules/bylaws/ regulations and which demonstrates involvement of committed people. An **MFI** means any institution/entity/association registered as a society/cooperative society including all non-profit organisations registered with non-profit objective under the appropriate laws including companies for, inter-alia, sanctioning loans/finance to members.

> **MIA**
> means a **(i)** NGO **(ii)** SHG and **(iii)** MFI.

> **MFI**
> is any entity registered with non-profit objective for sanctioning loans/finance to members.

Appointment A micro-insurance agent (MIA) can work for only one life insurer and one general insurer. The insurer would enter into a deed of agreement duly approved by its head office, with the MIA, clearly specifying the terms and conditions of the appointment, including their mutual duties and responsibilities. The deed should specifically authorise, the MIA to perform the following additional functions: **(i)** Collection of proposal forms/self-declaration forms from the proposer, of his being in good health and remittance of premium; **(ii)** Distribution of policy documents; **(iii)** Maintenance of a register of all the insured and their dependents, together with details of name/sex/age/address/nominees/ thumb impression/signature of the policy holders; **(iv)** Assistance in settlement of claims; **(v)** Ensuring nominations to be made by the insured; and **(vi)** Any policy administrative service. The agreement can be terminated by either party by giving a three months notice. But in case of termination on account of misconduct/indiscipline/ fraud by the MIA, no notice would be necessary. The MIA, with the prior approval of the insurer, can employ specified persons to discharge his functions. Corporate agents/insurance brokers procuring micro-insurance business would, however, be governed by the respective IRDA regulations applicable to them (discussed earlier).

Code of Conduct The MIAs and the specified persons employed by him should abide by the code of conduct prescribed by the IRDA's Licensing of Insurance Agents and the Insurance

Advertisement and Disclosure Regulations (discussed in earlier Sections). The insurer would have to ensure compliance with these by the MIA. Any violation of the code would result in the termination of his appointment, in addition to penal consequences for breach.

Every insurer would be subject to the 'file and use' procedure with respect to the filing of micro-insurance products with the IRDA, which should prominently carry the caption 'Micro-Insurance Product' (MIP).

The insurance contracts with individual micro-insurance policyholders should be in a simple and easily understandable vernacular language. A detailed write-up about the policy details in the vernacular language should be issued if it is not possible to issue the policy contracts in the vernacular language. The insurer should issue insurance contracts to the group micro-insurance policyholders, in an unalterable form, along with a schedule showing the details of individuals covered under the group and also issue a separate certificate to each individual evidencing proof of insurance, containing details of validity of period of cover, nominee, and addresses of the underwriting/servicing office. He should not authorise any MIA/any outsider to underwrite any insurance proposal for granting insurance cover. He should impart a minimum of 25 hours of training at its expense and through its designated officer(s) in the local vernacular language, to all the MIAs/their specified person in the areas of insurance selling, policyholder servicing and claims administration.

The remuneration of an MIA, including the commission payable by an insurer, would be subject to the following limits: **(a)** For life business, single premium policies–10 per cent and for non-single premium policies–20 per cent of the premium for all the years, **(b)** For non-life business 15 per cent of the premium. For group insurance products, the insurer may decide the commission subject to the overall limit.

The issuer must ensure that all transactions relating to the micro-insurance business are in accordance with the provisions of the Insurance Act/IRDA Act/rules and regulations and furnish the required information to the IRDA.

All micro-insurance policies may be reckoned for fulfillment of social obligations by an insurer and a policy issued in a rural area may be reckoned for both–rural and social obligations, pursuant to the provisions of the Insurance Act/regulations.

Complaints/grievances against MIAs should be handled by the insurer with speed and promptitude and a quarterly report should be sent to the IRDA regarding the handling of such complaints/grievances. The IRDA may cause an inspection of the office/records of any MIA at any time, if deemed necessary.

CORPORATE GOVERNANCE GUIDELINES FOR INSURANCE COMPANIES

These are available on the accompanying website. The address is **http://www.mhhe.com/khanfs9e.**

Issuance of Capital by Life Insurance Companies Regulation

The main elements of these regulations are: **(i)** prior written approval of IRDA, **(ii)** criteria for consideration of approval, and **(iii)** conditions for approval.

Prior Approval Prior specific written approval of the IRDA would be necessary for insurance companies before approaching the SEBI for **(i)** public issue of capital and **(ii)** divestment of equity by promoter(s) through a public offer for sale under the SEBI ICDR regulations (**discussed in Chapter 14**). However, insurance companies can issue/allot only fully paid-up shares.

An applicant-insurance company can raise share capital only on completion of 10 years/ period prescribed by Government from the date of commencement of business. The approval would be valid for one year. The IRDA's approval should not be deemed to, or serve as a, validation of the representations by the issuer and this fact should be disclosed in the offer document. It may not accord approval if, in its opinion, **(i)** the applicant-issuer is not compliant with the regulatory framework, **(ii)** it may be detrimental to the policyholders interests and **(iii)** it may not be in the interest of insurance business in India.

Criteria for Consideration of Approval The IRDA would generally consider the applicant-company's overall financial position/regulatory record/proposal for issue/offer of capital/ capital structure post-issue/offer of capital and the purposes to which the capital raised would be applied. In particular, the IRDA would, *inter-alia*, consider the following parameters: **(i)** period for which in life insurance business, **(ii)** history of compliances with the regulatory requirements, **(iii)** maintenance of the prescribed regulatory margin at the end of the preceding six quarters, **(iv)** compliance with the disclosure requirements and corporate governance guidelines, **(v)** record of policyholders protection, and **(vi)** the embedded value. The embedded value report should be prepared in the manner prescribed by the Actuarial Practice Standard issued by the Institute of Actuaries in India by an independent actuarial expert and peer review by another independent actuary. The value should be twice the paid-up equity capital including share premium.

Conditions for Approval While approving the proposal, the IRDA may prescribed the following condition: **(a)** extent to which the promoters should dilute their respective shareholdings, **(b)** maximum subscription which could be allotted to foreign investors, **(c)** minimum lock-in period for promoters (without prejudice to the SEBI ICDR regulations) and **(d)** disclosures in the offer document/prospectus in addition to those prescribed by the SEBI.

The IRDA would process/grant approved as expeditiously as possible and the issuer-applicant should ensure prompt response to queries/requests for information from the IRDA for processing the application.

Health Insurance Regulations 2016

The main elements of these regulations, namely, **(i)** registration/scope, **(ii)** health insurance products, **(iii)** general provisions, **(iv)** administration and submission of returns are discussed below.

Registration and Scope of Health Insurance Business Health insurance products may be offered only by entities with a valid registration to carry on life/general/health insurance business under the IRDA Registration of Indian Insurance Companies Regulations 2016 (**discussed earlier in this Chapter**). Life insurers may offer long term individual health insurance products for term of 5 years or more, but the premium should remain unchanged for at least every block of three years. The may not offer indemnity based individual/group products. No single premium health insurance product should be offered under the unit-linked platform. General and health insurers may offer individual health products with a minimum tenure of one year and a maximum tenure of three years, provided that the premium remains unchanged for the tenure. Group health policies may be offered for a term of one year except credit linked products where the term can be extended upto the loan period not exceeding five years. Group personal accident policies may be offered by general and health insurers with term less than one year also to provide coverage to specific events. Other insurance products offering travel cover and individual personal accident cover may also be offered for a period less than one year. Overseas/domestic travel insurance policies may only be offered by general/health insurers as a standalone product/as an add-on cover to a health/personal accident policy.

Provisions Relating to Health Insurance Products pertain to **(i)** filing procedure, **(ii)** review of products, **(iii)** group insurance, **(iv)** underwriting, **(v)** proposal form and **(vi)** pricing.

Product Filing Procedure for Health Insurance Products The insurance products of a life/general/ health insurer under health insurance business should be marketed/offered if filed as per the product filing guidelines and duly disposed of by the IRDA. The health insurance products of life insurers would also be subject to the provisions specifically provided for health products in the IRDA **(1)** Linked-Insurance **(2)** Non-linked Insurance Product Regulations **(discussed in another Section of this Chapter)**.

Review of Health Insurance Products All particulars of any health insurance product should, after introduction, revision or modification be reviewed by the appointed actuary at least once a year. If the product is found to be financially unviable, or is deficient, it may be revised appropriately.

Group Insurance A group health insurance policy should not be issued by an insurer where the group is formed with the main purpose of availing itself of insurance. There should be a IRDA-specified clearly evident relationship between the members of the group and the group policyholder. The group should have minimum size of 7, to be eligible for issuance of a group insurance policy. The insurers should follow the IRDA-specified guidelines on group insurance.

Underwriting All insurers should evolve a health insurance underwriting policy approved by the Board of the company. They should also put in place measures for periodical review of the underwriting policy in tune with the changes affecting the medical field and health insurance business. The underwriting policy should also cover the approach and aspects relating to offering health insurance coverage not only to standard lives but also to sub-standard lives. It should have in place various objectives underwriting parameters to differentiate the various classes of risks being accepted in accordance with the respective risk categorisation. Any proposal for health insurance may be accepted/modified/denied wholly based on the Board-approved underwriting policy. General and health insurers may devise and disclose upfront in the prospectus/policy document mechanism/incentives to reward policyholders for early entry, continued renewals, favourable claims experience, preventive and wellness habits.

Proposal Form The insurers should devise a proposal form to be submitted by a proposer seeking a health insurance policy capturing all the information necessary to underwrite a proposal. Information collected from the proposal form during the course of solicitation/issuance of an insurance policy should not be parted with to any third party, except with the statutory authorities or for underwriting the policy of the same individual or claim settlement. All the applicable provisions of the law/other regulations/guidelines specified by the IRDA while designing the proposal forms.

Principles of Pricing of Health Insurance Products Offered Insurers should ensure that the premium for a health insurance policy is based on **(i)** age for individual/group policies, **(ii)** other applicable relevant risk factors. For cover under family floater, the impact of the multiple incidence of rates of all family members should be considered. The premiums filed should ordinarily be not changed for three years after a product has been cleared. The premium rates may be revised depending on the experience. However, the revised rates should not be changed for at least one year from the date of the revision.

The policy premium rate should be unchanged for all **(i)** group products for the term of the policy,**(ii)** individuals and family floater products, other than travel insurance products, for at least one year in case of one-year renewable policies and 1 – 3 years in the case of the rest, **(iii)** in case of individual health products, every block of three years. Changes in rates will be applicable from the date of approval by the IRDA and applied only prospectively for new policies and from the date of renewal for the existing policies. All IRDA-specified guidelines should be complied with while pricing the products.

General Provisions Relating to Health Insurance pertains to designing, entry/exit age, renewal, free look period, cost of pre-insurance health-check-up, cumulative bonuses, migration of policy, Ayush coverage, wellness/preventive aspects, optional coverage, special provisions for senior citizens, multiple policies and loading on renewal.

Designing of Health Insurance Policies The health insurance products may be designed to offer various covers for **(i)** specific age/gender groups, **(ii)** different age groups, **(iii)** treatment in all hospitals throughout the country, **(iv)** treatment in specific hospitals/geographies only. These specifications should be disclosed clearly upfront in the product prospectus, documents and during sale process. In order to facilitate offering of innovative covers by insurers, **Pilot products** may be designed and filed for approval of the of the IRDA. They can be offered only by general and health insurers for policy tenure of one year. Every pilot product may be offered up to 5 years after which it needs to get converted into a regular product or withdrawn subject to the insured being given an option to migrate to another product subject to portability conditions. The insurers should not compel the insured to migrate to other health insurance products. In case of migration from a withdrawn product, they should offer an alternative available product. They should ensure adequate dissemination of product information on all their health insurance products on their websites, including a description of the product, copies of the prospectus, proposal form, policy document wordings and premium rates inclusive and excusive of service tax. **Pilot product** means a close-ended product with a one-year policy term which can be offered upto 5 years with a view to giving scope to innovation for covering risk that have not been offered hitherto or stand excluded in the extant products.

> **Pilot product** means a close-ended product with a one-year policy term which can be offered upto 5 years with a view to giving scope to innovation for covering risk that have not been offered hitherto or stand excluded in the extant products.

Entry and Exit Age All health insurance policies should ordinarily provide for an entry age of at least upto 65 years. Except travel insurance/personal accident and pilot products, once a proposal is accepted and a periodically renewable without break policy is issued, further renewal should not be denied on grounds of the age of the insured.

Renewal of Health Policies Unless withdrawn, a health insurance policy should ordinarily be renewable except on grounds of fraud/moral hazard/misrepresentations/non-cooperation by the insured. An insurer should not deny the renewal of a health insurance policy on the ground that the insured had made a claim(s) in the preceding policy years, except for benefit based policies where the policy terminates following payment of the benefit covered under the policy like critical illness policy. He should provide for a mechanism to condone a delay in renewal upto

30 days from the date of renewal without deeming such condonation as a break in policy. The promotion material and the policy document should explicitly state the conditions under which a policy terminates, such as on the payment of the benefit in case of critical illness benefits policies.

Free Look Period All new individual health insurance policies, except those with tenure of less than a year, should have a free look period. It would be applicable at the inception of the policy and the insured will be allowed at least 15 days from the date of receipt of the policy to review its terms and conditions and to return it if not applicable. If the insured has not made any claim during the free look period, the insured would be entitled to **(a)** a refund of the premium paid less expenses incurred by the insurer on medical examination of the insured persons and the stamp duty charges or; **(b)** where the risk has already commenced and the option of return of the policy is exercised by the policyholder, a deduction towards the proportionate risk premium for period on cover or; **(c)** where only a part of the insurance coverage has commenced, proportionate premium commensurate with the insurance coverage; **(d)** in respect of unit-linked policy, in addition to the above deductions, the insurer would also be entitled to repurchase the unit at the price as on the date of the return of the policy.

Manner of Treating Cost of Pre-insurance Health Check-up The cost of any pre-insurance medical examination should generally form part of the expenses allowed in arriving at the premium. However, in case of products with term upto one year, not less than 50 per cent of the cost should be borne by the insurer once the proposal is accepted, except in travel insurance policies. The insurers should maintain a list of medical examiners/institutions where pre-insurance medical examination may be conducted whose reports will be accepted by them. The details of fee payable should be made available to the prospective policyholder at the time of pre-insurance medical examination on demand.

Cumulative Bonus The cumulative bonuses offered under policies should be stated explicitly in the prospectus and the policy document. If a claim is made in any particular year, the cumulative bonus accrued may be reduced at the same rate at which it has accrued.

Migration of Health Insurance Insurers offering health covers specific to age groups such as maternity covers, children under family floater policies, students and so on should offer an option to migrate to a suitable alternative available health insurance policy at the end of the specific exit age or at the time of withdrawal of the policy at the option exercised by them by allowing suitable credits for all the previous policy years, provided the policy has been maintained without a break. All health insurance policies should allow the portability of any policy. **Portability** means the right accorded to an individual insurance policyholder (including family cover) to transfer the credit gained from pre-existing conditions and time-bound exclusions from one insurer/plan to another.

AYUSH Coverage The insurers may endeavour to provide coverage for one or more systems covered under `AYUSH treatment' provided the treatment has been undergone in a Government hospital or in any institute recognised by Government and/or accredited by Quality Council of India or National Accreditation Board on Health. **Ayush treatment** refers to medical/hospitalisation treatment given under Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homeopathy systems.

> **Ayush treatment** refers to medical/hospitalisation treatment given under Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homeopathy systems.

Wellness and Preventive Aspects While wellness and preventive elements as part of product design is encouraged, no policy of insurance should promote or offer the products and services of third parties who are not network providers in terms of TPA-Health Services Regulations 2016 **(discussed in another Section of this Chapter)**. Insurers should not offer discounts to the policyholders, on the products of the third parties either as part of policy contract or otherwise. However, they may endeavour promoting wellness amongst policyholders by offering the following health specific services offered by network providers: **(1)** outpatient consultations/treatments, **(2)** pharmaceuticals, **(3)** health check-ups including discounts on all the above at specific network providers. They may also endeavour to put in place procedures for offering discounts on premiums on renewals based on the fitness and wellness criteria stipulated and disclosed. The costs towards these services should be factored into the pricing of the underlying health insurance product.

Optional Coverage for Certain Items The list of generally excluded items that may be optionally covered by the insurers may be specified by the IRDA **(a)** in respect of hospitalisation indemnity policies that exclude certain standard items. Insurers should ensure that these are mentioned in the product filing, **(b)** product-wise specific list of excluded items should be disclosed in the website of insurers and a reference should be made in the prospectus and policy wordings of the respective products about them and the availability of the details on the website along with the address of website, **(c)** insurers should supply the policyholders on demand a copy of the excluded list of the concerned product if it is not incorporated in the policy document. They may offer cover for these items and mention it clearly in the policy.

Special Provision for Senior Citizens The premium charged for health insurance products offered by insurers to **senior citizens** (i.e. any person of atleast 60 years of age on the date of commencement/renewal of policy) should be fair, justified, transparent and duly disclosed upfront. They should be informed in writing of any underwriting loading charges as filed and approved over and above the premium and specific consent of the policyholder for such loadings should be obtained before issuance of a policy. All insurers and TPAs should establish a separate channel to address the health insurance-related claims as grievances of senior citizens.

Multiple Policies In case of multiple policies which provide fixed benefits, on the occurrence of the insured event in accordance with the terms and conditions of the policies, each insurer should make the claim payments independent of payments received under other similar policies. If two or more policies are taken by an insured during a period from one or more insurers to indemnify treatment costs, the policyholder should have the right to require a settlement of his/her claim in terms of any of his/her policies: **(1)** in all such cases, the insurer would be obliged to settle the claim within the limits, and according to the terms, of the chosen policy, **(2)** claims under other policy(ies) may be made after exhaustion of the sum insured in the earlier chosen policy(ies), **(3)** if the amount claimed exceeds the sum insured under a single policy after considering the deductibles or co-pay, the policyholder would have the right to choose insurers from whom he/she wants to claim the balance amount, **(4)** where an insured has policies from more than one insurer to cover the same risk on indemnity basis, he should only be indemnified the hospitalisation costs in accordance with the terms and conditions of the chosen policy.

Loadings of Renewals For individual products, the loadings on renewal should be in terms of increase or decrease in premium offered for the entire portfolio and not be based on an individual policy claim experience. The discounts and loadings offered should be **(1)** not at the discretion of the insurer, **(2)** based on an objective criteria, **(3)** disclosed upfront in the prospectus and policy document along with the objective criteria. No insurer should resort to fresh underwriting by calling for medical examination, fresh proposal form and so on, at renewal stage where there is no change in the sum insured offered. Where, however, there is an improvement in the risk profile, the insurer may endeavour to recognise that for removal of loadings at the point of renewal.

Administration of Health Insurance Policies Every insurer should ensure the following: **(i)** protection of policyholders interest, **(ii)** settlement/rejection of claims, **(iii)** minimum disclosure, **(iv)** other disclosures, **(v)** administration, **(vi)** health service agreements, **(vii)** payment to network providers, **(viii)** engagement of TPAs, **(ix)** change of TPAs and **(x)** data and related issues.

Protection of Policyholders' Interest Every insurer should be provided with a IRDA-specified customer information sheet. He should establish necessary systems, procedures, offices and infrastructure to enable efficient issuance of pre-authorisations on a 24-hour basis and for prompt settlement of claims and grievances.

Settlement/Rejection of Claim by Insurer An insurer should settle/reject a claim, within 30 days of the receipt of the last **necessary** document. Except in cases where a fraud is suspected, ordinarily no document not listed in the policy terms and conditions would be deemed **necessary**. The insurer should ensure that all the documents required for claims processing are called for at one time and that they are not called for in a piece-meal manner. The information that the insurer has captured in the proposal form, the terms and conditions offered under the policy, the medical history as revealed by earlier claims and the prior claims experience should all be maintained by him as an electronic record and not be called for again from the policyholder/insured at the time of subsequent claim settlements. The insurer may stipulate a period within which all necessary claim documents should be furnished by them to make a claim. However, claims filed even beyond such period should be considered if there are valid reasons for any delay. Every insurance claim should be disposed of in accordance with the terms and conditions of the policy contract and the extant regulations governing their settlement. No claim should be closed in the books of the insurers.

Minimum Disclosures in Policy Document In addition to the requirements stipulated in IRDA Protection of Policyholders' Interest Regulation **(discussed earlier in this Chapter)**, the policy document should contain: **(i)** list of disclosures required as per health insurance regulations, **(ii)** procedures for claims submission, time lines and possible course of action, if times lines for claim submission are not adhered to along with all the claims documents required for claim processing, **(iii)** sub-limits applicable on any of the covers offered in the health insurance product and their impact on other covers provided in the product should be clearly spelt out, **(iv)** penal interest provision should invariably be incorporated in the policy document, **(v)** the TPAs details along with the complete address and contact number should be attached to the policy document. It should also be mentioned that the updated list of the TPAs will be available on the website of the insurers.

Other Disclosures Every insurer should disclose product-wise/location or geography-wise particulars of the TPAs that are engaged for rendering health services in their respective website. The product-wise **cashless services** offered should be clearly explained in their respective website. In case of pilot products, in addition to all extant disclosures norms applicable to insurance advertisements, all the sales and publicity material pertaining to them should disclose the following: **(1)** the product offered is a pilot product and that it is a close-ended one, **(2)** it may be discontinued form the specified date or may be continued as a regular product, **(3)** in the event of its discontinuation, the insured would be provided the option of migration, **(4)** the product should carry a tag line of **Pilot Project**. The insurer should keep the insured informed of the list of network providers and display the same on their website. It should be displayed geography-wise and updated as and when there is any change in the network providers.

Administration of Health Policies Subject to the terms of a policy, the insurers should extend to all policyholders a **cashless facility** for treatment at specific establishments or the reimbursement of the costs of medical and health treatments or services availed at any medical establishment. **Cashless service/facility** means a facility extended by the insurer/TPA whereby the payments for the costs of treatment undergone by the insured are directly made to the network provider by the insurer to the extent pre-authorisation is approved. It should be offered only at establishments which have entered into an agreement with the insurer to extend such services. Such establishments will be termed as network providers. Reimbursement should be allowed at any medical establishment. All such establishment must be licensed or registered as may be required by any local/state/national law. The administration of all **health plus life-combi products** (i.e. products which offer the combination of life insurance cover and health insurance cover) should be in accordance with the specified provisions. Except in emergencies a cashless facility may require a pre-authorisation to be issued by the insurer or an appointed TPA to the network provider where the treatment is to be undergone. To avail the benefit of cashless facility, insurers should issue an identification card to the insured within 15 days from the date of issuance of a policy, either through a TPA or directly. Where there is no mention of the expiry date on the card, the insurer may provide a permanent card which is valid as long as the policy is renewed with the company. The identification card should at the minimum, carry details of the policyholder and the logo of the insurer. The insurers should endeavour to issue smart cards with features such as cards with quick response code, magnetic reader to enable the TPAs and network providers offer health service seamlessly. Where a policyholder has been issued a pre-authorisation for the conduct of a given procedure in a given hospital or if he is already undergoing such treatment at a hospital, and the hospital is proposed to be removed from the list of network provider before the final settlement of the claim, insurers should provide the benefits of cashless facility to the policyholders as if the hospital continues to be on the network provider list. An insurance company may enter into an arrangement with other insurance companies for sharing of network providers, transfer of claim and transactional data arising in areas beyond their service.

> **Cashless service/facility** means a facility extended by the insurer/TPA whereby the payments for the costs of treatment undergone by the insured are directly made to the network provider by the insurer to the extent pre-authorisation is approved.

> **Combi products** mean products which offer the combination of life insurance cover and health insurance cover.

Health Services Agreement Insurance companies may offer policies providing cashless services to the policyholders provided they are offered through network providers who have been enlisted to provide medical services under a direct written agreement with the insurer where there is a direct arrangement or by a tripartite agreement amongst health services provider, the TPA and the insurer where it is through a TPA. Where an insurer wishes to utilise the services of TPA, it should ensure that the written agreement is entered into for defined services with a TPA holding a valid CoR in accordance with the IRDA TPA Regulation, 2016 **(discussed in another Section of this Chapter)**. The agreements which should be entered into between/amongst insurers, network providers or TPAs should, *inter-alia*, cover: **(i)** the tariff applicable with respect to various kinds of healthcare services being provided by the network provider, **(ii)** a clause empowering the insurer to cancel/modify the agreement in case of any fraud, misrepresentation, inadequacy of service or other non-compliance or default on the part of TPA or network provider, **(iii)** a standard clause providing for continuance of services by a network provider to the insurance company if the TPA is changed or the agreement with TPA is terminated, **(iv)** a clause providing for opting out of network provider from a given TPA or disempanelment of a network provider by a TPA subject to IRDA-specified guidelines for reasons of inadequacy of service rendered by the TPA to the network provider, **(v)** a clause specifically fixing the onus on the insurer to deny or repudiate a claim, **(vi)** a clause enabling insurer to inspect the premises of the network provider at any time without prior intimation.

Insurers and TPAs should comply with the IRDA-specified standard clauses to be incorporated in all such agreements. The insurance company should endeavour to enter into agreements with adequate number of both public and private sector network providers across the geographical spread. The copy of the agreement should be maintained by him for a period of at least five years from the date of the expiry/termination of the agreement. The IRDA may specify certain standards, benchmarks and protocols for network provider from time to time. The insurers and TPAs should ensure that only those providers who meet with such standards, benchmarks and protocols are enrolled into the network.

Payments to Network Providers and Settlement of Claims of Policyholders The insurer should make direct payments to the network provider and to the policyholders by integrating their banking system platform with network provider or the policyholder. If a claimant opts for payment through a cheque or demand draft, the insurer should not deny such request.

Engagement of Services of TPAs by Insurers in Relation to Health Insurance Policy Every insurer should provide detailed product-wise guidelines to TPAs for handling of claims, that is, claim admission and assessments. They should articulate the payments/benefits allowed/disallowed under various products that are being serviced by the TPAs. They should also prescribe the capacity requirements, internal control procedures to be put in place by the TPA under the agreement for rendering the services under each product. Moreover, detailed product specific claim guidelines should be issued to the TPAs. They should ensure that the TPAs are not carrying out the following activities as part of the agreement: **(i)** claim rejections/repudiations with respect to the health insurance policies; **(ii)** payments to the policyholders, claimants or the network providers; **(iii)** any services directly to the policyholder/insured/any other person unless it is in accordance with the terms and conditions of the agreement entered into with the insurer and complies with the IRDA regulations. The insurers and/or TPAs, should endeavour to collect documents for processing claims for disposal electronically. Claims that are being settled should be done through e-payments by them. Where claims are directly handled by the insurers, the specified provisions should be complied in the correspondence to the policyholder with respect to settlement of the claims. The insurer would be responsible for proper and prompt service to the policyholders at all times. Where a claim is denied/repudiated, the communication should be made only by the insurer by specifically stating the reasons for the denial or repudiation, while necessarily referring to the corresponding policy conditions. He should also furnish the grievance redressal procedures available with the insurance company and with the insurance ombudsman along with the detailed address of the respective offices. More than one TPA may be engaged by an insurance company.

Change of TPAs Where there is a change in TPA, insurers should communicate to the policyholders 30 days before giving effect to the change. The contact details like helpline numbers, addresses, etc. of the new TPA should be immediately made available to all the policyholders. The insurer should take over all the data in respect of the policies serviced by the earlier TPA within thirty days from the cessation of his services and make sure that the same is transferred seamlessly to the newly assigned TPA. No inconvenience/hardship should be caused to the policyholders as a result of the change. The following aspects should receive special attention: status of cases where **(a)** pre-authorisation has already been issued by the existing TPA, **(b)** claim documents have been submitted to the existing TPA for processing, **(c)** claims where processing has been completed by the TPA and payment is pending with the insurer.

Data and Related Issues The TPA and the insurer should establish a seamless electronic flow of data transfer for all the claims. The respective claim settlement files should be handed over to the insurer within 15 days. The IRDA may require insurers, TPAs and network providers, to comply with specified data related matters that may be issued separately.

Systems to be in Place to Mitigate Frauds Insurers and TPAs should put in place systems and procedures to identify monitor and mitigate frauds and also follow the IRDA guidelines.

Submission of Returns All insurance companies carrying on health insurance business should furnish the specified returns to the IRDA.

INSURANCE PRODUCTS/SERVICES

This section is devoted to a discussion of insurance products/services with reference to **(i)** its fundamental principles, **(ii)** life insurance products including group/life insurance, **(iii)** general insurance products, namely, fire insurance, marine insurance, motor insurance, health insurance and liability insurance. **The main elements are depicted in Exhibit 6.4.**

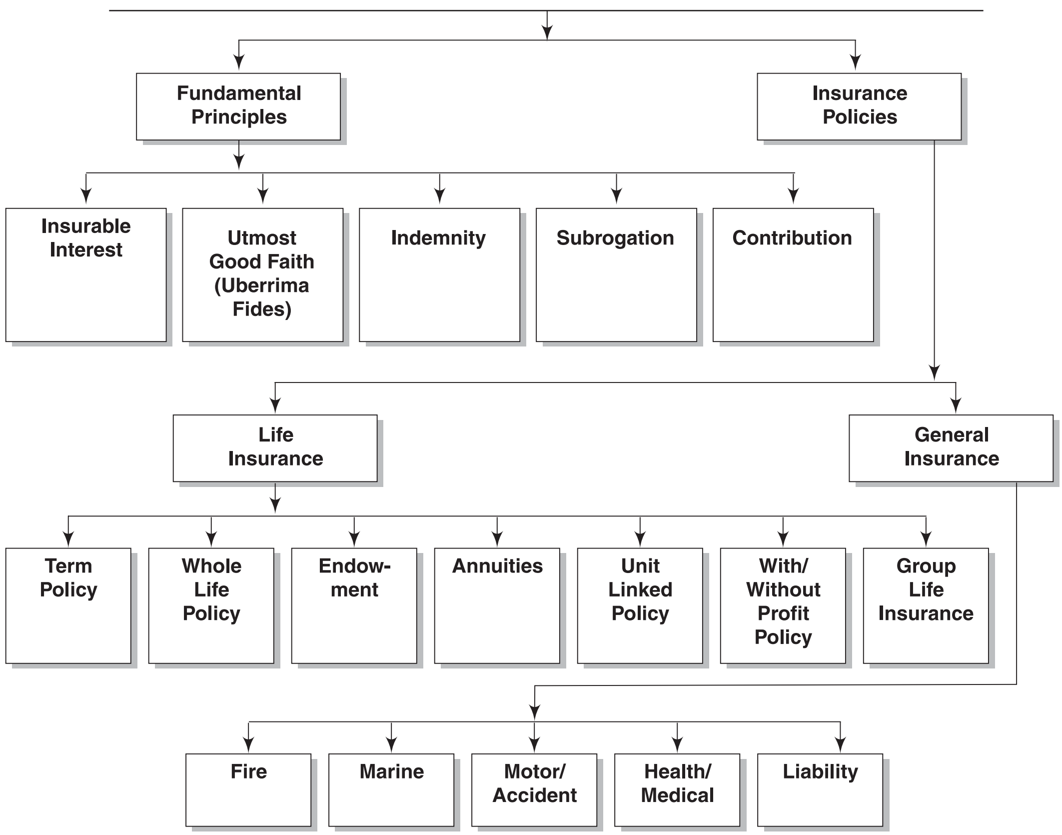
Fundamental Principles

> **Insurance** is a means of protection of economic value of assets.

Insurance is a mechanism through which assets are insured against the risk of being destroyed/lost/ made non-functional due to any accidental occurrences so that the owners of the assets can cope with the economic consequences of such an event. It is, thus, a means of protection of economic value of assets. Insurance is also a method of spreading over a large number of persons a possible financial loss too serious to be conveniently borne by an individual. The occurrences which can cause any damage to the asset are known as **perils**. The damage that these perils may cause to the asset is the risk that the asset is exposed to. Insurance reduces the impact of risk on the owner and those who depend on the asset. However, insurance does not protect the asset or prevent its loss but it can only compensate economic/financial losses.

As a specialised type of commercial contract, insurance is characterised by some fundamental principles: **(i)** Insurable interest, **(ii)** Utmost good faith (*Uberrima Fides*), **(iii)** Indemnity, **(iv)** Subrogation, and **(v)** Contribution.

Exhibit 6.4 Insurance Products/Services



Principle of Insurable Interest **Insurable interest** means that a person entering into a contract of insurance would stand to lose financially on the occurrence of the event insured against. With reference to life insurance, a person who gets the benefit of an insurance contract must have an insurable interest in the life of the insured. In a valid contract of insurance, the insurable interest must exist at the time of entering into/application for an insurance contract. The existence of insurable interest in a life insurance contract is presumed in the following cases: **(a)** own life, **(b)** husband/wife in each other's life, **(c)** creditor in the life of a debtor to the extent of debt/loan, **(d)** partners in the life of other partners to the extent of their interest in the firm, **(e)** an employer in the lives of a key employees and **(f)** a parent in the life of a child and so on. Examples of insurable interest in non-life insurance are: **(i)** ownership of property, **(ii)** car owner in third party on an accident, **(iii)** an employer in the health of his employees, **(iv)** a bank in the loyalty/integrity of cashiers/tellers and so on. An insured person can transfer (assign) his rights/liabilities to another person (assignee) who has acquired insurable interest in the property in-

> **Insurable interest** means that the person entering into a contract of insurance would stand to lose financially on the occurrence of the event insured against.

sured. The assignee would acquire all the benefits of insurance. While marine cargo policies are usually freely assignable, insurance policies can also be assigned with the consent of the concerned insurer.

Principle of Utmost Good Faith (*Uberrima Fides*) The **principle of utmost good faith** implies full and accurate disclosure of facts material to the risk to the insurer without being asked. A material fact is a fact which would influence/affect the judgement of a prudent insurer in deciding whether or not to accept a risk for insurance and on what terms. Breach of this principle would make the insurance contract null and void. The breach of utmost good faith may arise from **(i)** misrepresentation (i.e. an untrue statement of a material fact) or **(ii)** non-disclosure (i.e. failure to disclose/suppression of a known fact). The facts which should be disclosed are, *inter-alia*, **(1)** facts which show greater risk than normally expected (e.g. dangerous hobby like bungee-jumping), **(2)** external factors enhancing risk like occupation (e.g. fighter pilot), **(3)** losses/claims on previous policies, **(4)** decline/postponement of a previous proposed, and **(5)** full facts (e.g. age, medical history, smoking/drinking habits).

> **Utmost good faith** implies full and accurate disclosure of facts material to the risk to the insurer without being asked.

Principle of Indemnity Insurance contracts basically indemnify the insured in the sense that he is not allowed to make profit from them. The **indemnity principle** implies that the financial position of the insured must be restored to the level he enjoyed before suffering the loss.

> **Indemnity** implies that the financial position of the insured must be restored to the level he enjoyed before suffering the loss.

Principle of Subrogation As an extension of the core principle of indemnity, **subrogation** means the automatic transfer of rights/remedies of the insured to the insurer upon the insured having received the benefits of insurance such as salvaged/recovered value of a wrecked car, a stolen property in case of theft and burglary. The recovered/salvage property goes towards reducing the insurer's loss. However, subrogation comes into effect only on the payment of a claim.

> **Subrogation** means the automatic transfer of rights/remedies of the insured to the insurer having received the benefits of insurance.

Principle of Contribution The **principle of contribution** applies if the insured has taken several insurance policies for the same risk from several insurers. Each insurer in such a case pays only that portion of the risk as is represented by the proportion of the sum assured by him to the overall sum assured by the different insurers. For example, under a fire insurance policy, if the insured has three policies of ₹10,00,000, ₹20,00,000 and ₹30,00,000 each, the respective insurers will suffer 1/6th, 1/3rd and 1/2 of the loss respectively.

Life Insurance Services/Products

Life insurance products are based on core risk coverage needs of individuals as well as their long-term investment concerns. These are mainly divided into four groups, namely, **(1)** Term insurance **(2)** Whole-life insurance, **(3)** Endowment, and **(4)** Annuities. While the first two are focussed on risk coverage, the latter two focus on investments. Different companies design products around these main themes with variations in benefits and target specific customer segments. Unit-linked insurance policies are also available now. Insurance policies could be with profits or without profits. In addition to the individual insurance products, there are group insurance products.

Term Insurance Policy **Term insurance** policy provides pure risk cover without any element of saving for a specified period only and may be described as temporary insurance. The sum assured is payable only if the insured dies during the specified/selected period. In case the insured does not die during the tenure of insurance, nothing is payable. The term insurance plans could be of different types. Under **Level Term Insurance**, the premium and benefit is uniform throughout the term of the policy. In the event of death any time during the term, the same sum assured is payable. Where the term is for more than a year, the renewal premium is the same each year. The plan is suited to a case where a lump sum amount is needed at a certain point of time.

Term insurance provides pure risk cover/payment of sum assured only if the insured dies during the specified period.

Under a **Decreasing Term Insurance** plan, the premium is constant throughout the term, but the benefit decreases over the years. The amount payable on death depends on the timing of the death even though the premium being paid is constant. The plan is suited to cases where the need for funds decreases over time, for example, repayment of a mortgage loan.

The premium as well as the benefit amount increases periodically, as agreed, under the **Increasing Term Insurance**. The benefits, which could increase by a fixed percentage or in line with an agreed index, would be insulated against erosion in value due to inflation.

Though term insurance is for a fixed period, a **Renewable Term Insurance** provides for renewal of the policy without submitting fresh evidence of health. However, reflecting the increased age of the insured, the new premium would be higher.

Finally, **Convertible Term Insurance** includes a conversion privilege in terms of which the insured has a right to convert the policy into a permanent (endowment) plan without fresh evidence of health. The premium would be the standard rate for such a plan and the actual age of the assured on the date of conversion of policy. Such a plan would be useful to people who can afford low premium initially but can pay higher premium later on in life.

Term Insurance with Return of Premium As a variation of the pure term insurance plans discussed above, under this plan all the premiums collected are refunded if the insured survives the term. In other words, the interest earned on the premium is utilised to keep the policy in force as well as to grant a free term cover for a few years beyond completion of the term even though the premiums collected are refunded.

Whole Life Insurance Policy **Whole life insurance policy** guarantees a death benefit cover throughout the life. The assured sum is paid whenever death of the assured occurs. Premiums have to be paid throughout the life of the assured or for a shorter period.

Whole life policy guarantees a death benefit cover throughout the life of the insured.

Endowment Insurance Policy **Pure endowment insurance** is a plan in which the benefit is payable to the insured only on survival after the specified term. Endowment policies which combine the features of pure endowment and term assurance pay the assured sum either on the death of the assured

Endowment policy is a plan in which claims may arise either by death or by maturity.

or after a fixed term. In other words, claims under an endowment policy may arise either by death or by maturity.

Annuities Annuities start where life insurance ends. They stop on death of a person whereas life insurance starts after the death of the assured. **Annuity** is a form of pension in which an insurance company makes a series of periodic payments to a person (annuitant)/ his(her) dependents over a number of years (term) in return for a payment either in lump sum or in instalments. Annuities are of two types: **(i)** immediate annuity and **(ii)** deferred annuity. **Immediate annuity** is purchased with a single premium (purchase price) and begins at once or on the expiry of the designated period. If the person purchasing the annuity dies during the term, his legal heirs/nominees are entitled to the remaining instalments of the annuity. Under **deferred annuity plan**, the annuity payments commence at some specified time/age of the annuitant. Such type of annuity can be funded either by a single payment or a series of regular payments. The payment starts after the deferment period (i.e. lapse of a selected period).

> **Annuity** involves a series of periodic payments to the annuitant or dependents.

Unit-Link Insurance Policies (ULIP) **A ULIP** is an insurance policy in which the benefits depend on the performance of the investment portfolio. Each premium paid by the insured is split into two parts. While one part is used to provide insurance cover, the balance is invested in mutual fund units. The ULIP, thus, combines the benefit of insurance protection and investment in a managed fund.

> **ULIP** combines the benefits of insurance protection and investment in managed fund.

With Profit and Without Profit Policies A life insurance policy that has additional amounts added to the assured sum or paid separately as cash bonus as a result of surplus/profit made on the investment of the fund by the insurance company is called a 'with profits policy'. Policies that are not entitled to bonus are 'without profit policies'.

Group Life Insurance Products The **Group insurance** is a plan of insurance which covers a similar/homogeneous group of individuals under a single policy (i.e. master policy). In contrast to individual insurance, group insurance contracts are entered into by the insurance company with an employer, a labour union or a voluntary association. The individuals covered in the group insurance scheme are not parties to the contract. The amount as well as the terms of the insurance are negotiated by the group policyholders only. For groups of reasonable size and a fairly uniform risk, the insurance is concerned not with assessing the risks of the individuals in the group but with assessing the broad risk characteristics of the group as a whole. This translates into reduced insurance/under-writing and lower administration cost to the insurer. Hence, the premium rate is lower on group policies as compared to similar individual policies. It is paid by the employer/trustee/group/association on behalf of the individuals they represent. The amount of insurance cover is decided upon for the group as a whole. This may be either uniform for all members or a graded amount for different categories based on salaries and so on.

> **Group insurance** covers a similar/ homogeneous group of individuals under a single policy.

Some of the group insurance schemes available in India now are: **(i)** Employees Deposit Linked Insurance Scheme (EDLI) under the *Employees Provident Fund Act*, **(ii)** Group insurance scheme of LIC in lieu of EDLI, **(iii)** Group gratuity scheme under the *Payment of Gratuity Act*, **(iv)** Group Superannuation Scheme, **(v)** Group Savings Linked Insurance Scheme, **(vi)** Voluntary

Retirement Scheme, **(vii)** Group Leave Encashment Scheme, **(viii)** Group Annuity Scheme, and **(ix)** Group Credit Term Scheme to cover the risk of mortality of borrowers under a mortgage programme or lending operation of a bank/finance company.

General Insurance

General/non-life insurance contract covered here are the following categories: **(1)** Fire insurance, **(2)** Marine insurance, **(3)** Accident/motor insurance, **(4)** Health insurance, and **(5)** Liability insurance.

Fire Insurance Fire insurance is designed to provide for financial loss to property due to fire and other related hazards. Examples of property that can be covered under fire insurance policy are: **(1)** Buildings and their contents such as machinery/equipment/accessories and goods, raw materials, semi-finished goods, finished goods, packing material and so on stored in factories/godowns; **(2)** Electrical installations of a building; **(3)** Goods in the open; **(4)** Dwellings and their contents; **(5)** Furniture/ fixtures/fittings; and **(6)** Pipelines located inside/outside buildings/dwellings/compounds.

> **Fire insurance** provides for financial loss to property due to fire and related hazards.

Fire Hazards Fire hazards covered under a typical/standard fire insurance policy could be of 12 different types listed below:

- **Fire** usually excludes destruction/damage caused to property by **(i)** its fomentation, natural heating/spontaneous combustion (which can be covered at an extra premium; **(ii)** its underlying any heating/drying process, and **(iii)** burning of any property insured by order of any public authority.
- **Explosion/Implosion** would exclude destruction/damage caused to boilers/economisers/ other vessels in which steam is generated/machinery or apparatus subject to centrifugal force by its own explosion/implosion. However, such explosions to boilers can be covered by boiler explosion policy under engineering insurance.
- **Aircraft damage** Destruction/damage caused by an aircraft/other aerial or spatial devices and articles dropped by them excluding those caused by pressure waves.
- Lightening
- **Riots, strikes, malicious and terrorism damage** Direct visible physical loss/destruction/damage by external violent means caused to property but excluding those caused by **(a)** total/partial cessation of work, stoppage, retardation/slowdown or interruption/cessation of any process/operation or omission of any kind, **(b)** permanent/temporary dispossession of any building/plant/factory/unit/machinery resulting from unlawful occupation by any person or prevention of access to the same, **(c)** permanent/temporary dispossession resulting from confiscation/commandeering/requisition, or destruction by order of government/any lawfully constituted authority, and **(d)** burglary, house breaking theft, larceny or any attempt by any person taking part in such activities.
- **Impact damage** Impact by any rail/road vehicle or animal by direct contact but not belonging to/owned by **(a)** the insured/any other occupier of the premises or **(b)** their employees while acting in the course of their employment.
- Storm, cyclone, typhoons, tempest, hurricane, tornado, flood and inundation.

- **Subsidence and landslide including road slides** Destruction/damage caused by subsidence of part of the site on which the property stands or landslide/road slide excluding: **(a)** normal cracking, settlement/breeding/bedding down of new structures, **(b)** settlement/movement of made-up ground, **(c)** coastal or river erosion, **(d)** defective design/workmanship or use of defective materials, and **(e)** demolition/construction, structural alternatives or repair of any property or groundswork or excavations.
- Missile testing operations
- Bursting and/overflowing of water tanks, apparatus and pipes.
- Leakage from automatic sprinkler installations excluding destruction/damage caused by **(a)** repair/alternation to the buildings/premises, **(b)** repairs/removals/extension of the sprinkler installations, and **(c)** defects in construction known to the insured.
- Bush fire excluding fire caused by forest fires.

General Conditions Fire insurance policies carry the general conditions specified below:

1. The policy would become void in the event of non-disclosure of material facts, misrepresentation, mis-description by the insured. This is to make sure that the principle of utmost good faith is complied with.
2. All insurance under such policies would automatically cease if the building or structure covered by the policy falls, or is displaced in full or in part, unless the insurer is given a notice within seven days of the event of such a fall or displacement. On receiving such notice, the insurer may agree to continue the insurance subject to revised rates, terms and conditions as may be decided by it and confirmed in writing. Such exclusion would not apply if the fall or displacement is caused by the hazard that is insured under the policy.
3. Under any of the following circumstances the insurance ceases to exist as regards the property insured if, before the occurrence of any loss or damage, the insured does not obtain the sanction of, or an endorsement of the insurer: **(a)** If the trade or manufacture carried out in the property is altered, of if the nature of the occupation of the property, or other circumstances affecting the building insured or containing the insured property are changed in a way that the risk of loss or damage is increased, **(b)** If the building insured or containing the insured property becomes unoccupied and remains so continuously for 30 days or more, **(c)** If the interest in the property passes from insured to some one else, except by succession, will or such similar operation of law, and **(d)** all of the above changes in the risk and nature of the hazard have to be notified to the insurer prior to the occurrence of any loss or damage. However, in the event of the death of the insured his legal heirs automatically become the insured.
4. If there is a marine policy covering the property and the loss, the fire policy would pay only the excess over the amount payable under the marine policy. This is a necessary condition because the marine policy also covers risk of fire, for example, if goods stored in the hold of the ship are destroyed by fire on the ship, the marine policy would pay for the loss. If there is any balance loss that the marine policy could not pay, the same would be covered by the fire policy.
5. Cancellation of the policy is possible by either party. If the cancellation is issued by the insured, the premium is retained by the insurance company on a short period basis. The insurance company can also cancel the policy by giving 15 days notice to the insured in which case the premium would be refunded on a *pro-rata* basis, depending on the remaining period of coverage.

6. The duties of the insured on the happening of the loss are: **(a)** notice of loss/damage should be given to the insurer immediately, **(b)** Within 15 days or further time as allowed by the insurer, submit a claim statement giving item-wise detail of amount of loss not including profit of any kind, **(c)** particulars of other insurances applicable to the loss/damage to be submitted, **(d)** non-compliance of these conditions could make the claim untenable, **(e)** the insurer is not liable for any loss after the expiry of 12 months from the date of loss unless the claim is the subject of pending action, arbitration or litigation, and **(f)** if the liability is disclaimed by the insurer and the insured has not filed a suit in court for recovery, within 12 months of the date of the disclaim, the claim is deemed to have been abandoned by the insured. It is not recoverable thereafter.
7. Rights of insurers in respect of the occurrence of loss or damage are: **(a)** enter and take possession of the building or premises where the loss has occurred, **(b)** take possession of the insured property that was in the building during the loss/damage, **(c)** remove, sort, arrange or salvage the insured property, **(d)** sell, dispose off the damaged property as they deem fit, for account of whom it may concern, **(e)** the insurer can exercise the above rights until the claim is closed or withdrawn by the insured in writing. Further, the insured would not incur any liability whatsoever on account of this action for payment of the claim, which would depend upon the terms and conditions of the policy, **(f)** if the insured or any person on his behalf does not co-operate or hinders the process in any way, all benefits under the policy could be forfeited, and **(g)** the insured does not have the right to abandon the damaged property whether the insurer takes possession of it or not.
8. If the claim is fraudulent or any false evidence is produced by the insured to avail of a benefit under the policy, the insured losses all the benefits under the policy. Similarly, if the loss or damage is caused wilfully by the insured or with his connivance, all the benefits under the policy would be forfeited.
9. The insurer has the right to replace or re-instate the property that is lost/damaged instead of paying for the loss or damage. This condition is invoked usually when the insured is claiming a disproportionately large quantum of loss than what the insurer is willing to admit.
10. An insured is expected to insure his property to the fullest extent of its value. In the event of the claim, if it is found that he has not covered the property to its full value, he has to bear a portion of the loss. The loss borne by the insured would be calculated in the same proportion as the insured amount bears to the actual value of the property. As an example: Value of property, ₹5,00,000 – Sum assured, ₹3,00,000 = Loss, ₹1,00,000. The amount payable = ₹3,00,000/₹5,00,000 × 1,00,000 = ₹60,000.
11. In the event of one or more policies covering the same property for the same hazard, all policies would contribute towards the claim in the same proportion as they bear individually to the sum assured.
12. If the loss/damage is caused by a third party, the insured is required to help and assist the insurer to enable it to recover the loss from the third party responsible for the loss/damage. The insured's right to recover against a third party are subrogated to the insurer, and this transfer of rights takes places even before the insurer pays for the loss/damage.
13. Any discipline regarding the amount of claim payable would be referred to arbitration as per the provisions of the *Arbitration and Conciliation Act.*

14. Upon the settlement of any loss under the fire policy, *pro rata* premium for the un-expired period from the date of the loss to the expiry of the policy for the amount equivalent to the loss is payable by the insured to the insurer. The amount of premium payable under this policy is deducted from the net claim payable under the policy. However, the sum assured stands reduced by the amount of loss in case the insured immediately on occurrence of the loss exercises his option not to re-instate the sum assured as above.

15. All notices under this policy are required to be given in writing.

Special Policies Fire insurance policies have certain unique policy issues such as risk of consequential damage, replacement/reinstatement values policies, multi-location/floater policy and industrial all risk policy.

> **Consequential loss policies** cover the loss of profit due to damage to property by fire.

Consequential Loss/Damage Policies A typical fire insurance policy designed to cover the risk of damage/loss due to fire to property does not cover consequential losses in terms of trading loss/loss due to interruption of business. The consequential loss/damage policies attempt to cover the loss of profit due to damage to property.

The basis of loss of profit is related to the revenue/total income of business. If this is stopped/ reduced, the profits are affected. The loss of profit is, therefore, determined with reference to reduction of revenue/turnover. **Turnover** is defined in such policies as the money paid to the insured for goods sold and delivered and for services rendered in the course of business at the premises. Turnover usually consists of **(1)** variable charges which vary in direct proportion to the volume of business transaction and **(2)** standing charges which are fixed in nature and cannot be reduced in direct proportion to any reduction of business. The turnover minus variable and standing charges is net profit. The difference between turnover and variable charges is gross profit. Any loss of turnover would affect gross profit.

> **Replacement value policy** is a policy in which it is possible to recover the cost of replacing the damaged property by new property of the same kind.

Replacement/Reisntatement Value Policy Such a fire policy specifies that in the event of loss due to fire, the insurer would pay an amount required for re-instatement/replacement of the property insured. Such a policy, however, does not cover stocks/goods. In this policy, it is possible to recover not just the depreciated value of the property lost but also the cost of replacing the damaged property by new property of the same kind.

> **Floater policy** covers stocks lying at different locations.

Floater/Multi-location Policy Under this policy, stocks lying at different locations (i.e. warehouses, godowns, factories) are covered under one sum insured.

Industrial All-Risk Policy This type of policy is a package cover for the following perils: **(1)** fire, **(2)** burglary, **(3)** machine breakdown, boiler explosion and material damage to electronic equipment, **(4)** business interruption as an optional cover. Under insurance of upto 15 per cent is permitted and discounts are available in tariff rates.

> **Hull insurance** provides insurance of the carrier of the goods.

> **Cargo insurance** provides cover for losses that could occur to goods in transit.

Marine Insurance Marine insurance has two broad components: **(1)** hull insurance and **(2)** cargo insurance. **Hull insurance** is concerned with the insurance of the carrier of the good and is purchased by the owner of the vehicles. **Cargo insurance** provides cover for losses/damages that could occur to goods in transit on sea, rail, road and air. It can cover **(i)** shipment of inland ships, steamers, boats and crafts, **(ii)** coastal shipment by steamers, sailing vessels, mechanised boat and so on, **(iii)** export/import shipments by ocean-going vessels of all types and **(iv)** consignments shipped by rail, road, air and articles sent by post/couriers.

Marine Insurance Act (MIA) The legal framework for carrying out marine insurance is provided by MIA, 1963. The MIA deals with the details of the contents of the marine insurance policy. Though the policy form contains all the details of the policy, the claims attached to it specify the risks covered/exchanged and other terms and conditions of insurance. These are broadly **Institute Clauses** for seafaring vessels (drafted by the Institute of London Underwriters) and **Inland Road/Rail Clauses** for surface transport (drafted by the Tariff Advisory Committee).

Institute Cargo Clauses (ICC) The important risks covered by the ICC are as follows.

1. **ICCC (C)** **(a)** fire, **(b)** vessel/craft being stranded/grounded/sunk/capsized, **(c)** overturning/ derailment of land conveyance, **(d)** collision/contact of vessel/craft/conveyance with any external object other than water, **(e)** discharge of cargo at port of distress and **(f)** jettison.
2. **ICC (B)** In addition to risk covered under **ICC (C)** above: **(a)** earthquake, volcanic eruption/ lighting, **(b)** washing over-board, **(c)** entry of sea/lake/river water into vessel/craft/hold/conveyance/container/liftvan/place of storage, **(d)** total loss of any package lost overboard or dropped while loading/ unloading. On payment of extra premium, the following "**extraneous risks**" can also be added, namely, **(1)** theft, pilferage and/or non-delivery, **(2)** fresh water/rain water damage, **(3)** hook and/or oil damage, **(4)** damage by mud, acid and other substances, **(5)** heating and sweating, **(6)** breakage, **(7)** leakage, **(8)** country damage and **(9)** bursting/tearing of bags.
3. **ICC (A)** Unlike ICC (C) and **(B)**, the risks covered are not specified under ICC (A). These clauses provide cover for all risks of damage/loss to the subject matter insured caused incidentally.
4. **ICC (Air) Excluding Sending by Post** The risks of loss under this clause are the same as those under ICC (A) above.
5. **Inland Transit (Rail/Road) Clause 'C'** This clause covers risks of loss/damage caused by **(a)** fire and **(b)** lighting.
6. **Inland Transit (Rail/Road) Clause 'B'** This clause covers risk of loss/damage by **(a)** fire, **(b)** lighting, **(c)** breakages of bridges, **(d)** collision with/by the carrying vehicle, **(e)** overturning of the carrying vehicle, and **(f)** derailment/other such accidents to the carrying wagon vehicle.
7. **Inland Transit (Rail/Road Clause 'A'** All risks of loss/damage to the insured goods are covered.

Motor/Accident Insurance Motor insurance is statutorily mandated. *The Motor Vehicles Act* requires compulsory insurance to take care of those who may get injured in an accident. The insurance of damage to the vehicle is not mandatory. The liabilities that are to be covered are:

- Any liability arising in respect of death/bodily injury to any person including the owner of the vehicle/his authorised person in the carriage;
- Any liability incurred in respect of damage to any property of a third party,
- Liability incurred in respect of death/bodily injury of any passenger of a public service vehicle,

- Liability arising under *Workmen's Compensation Act* in respect of injury/death of **(a)** a paid driver, **(b)** conductor/ticket examiner and **(c)** workers carried in a goods vehicle,
- Liability for bodily injury/death of passenger carried for reward/hire by reason of contract of employment,
- The policy should carry '**no fault' liability** limited to a specified sum (₹50,000 in case of death; ₹25,000 in case of permanent disability; and ₹6,000 in case of damage to property). The injured party/insured does not have to prove any fault in order to claim this amount under the policy.

Types of Vehicles For the purpose of insurance, motor vehicles are classified into three categories: **(a)** private cars, **(b)** motor cycles/scooters, and **(c)** commercial vehicles further classified into **(1)** goods carrying vehicles, **(2)** passenger carrying vehicles (i.e. auto rickshaw, taxis, buses), **(3)** miscellaneous (i.e. hearses, ambulances, cinema/recording vans, mobile utilities).

> **Third party liability policy** indemnifies the insured against all labilities caused by injury to any person.

Types of Policies Two types of motor insurance policies are available for all types of vehicles: **(i)** Third party liability policy/act liability policy, and **(ii)** comprehensive/own damage losses and act liability policy. Under the **third party/act liability policy,** the insurer indemnifies the insured against all sums which he may become legally liable to any person, including occupants of the insured vehicle, provided they are not carried for hire/reward **(i)** by reason of death or bodily injury caused to such third parties or **(ii)** by damage to property of third parties caused by/arising out use of the vehicle. While liability for damage to property in limited to ₹6,000, liability for death/bodily injury is unlimited. **The comprehensive/own damage losses and act liability** policy covers an entire range of risks, namely, **(1)** fire, explosion, self-ignition/lightning, **(2)** burglary/house-break/theft, earthquake, **(3)** flood/typhoon/hurricane/storm/tempest/inundation/cyclone/hailstorm/frost, **(4)** terrorist activity, **(5)** malicious act, **(6)** riot and strike, **(7)** landslide/rockslide, **(8)** accidental external means, and **(9)** transit by road/inland waterways/lift/elevator/air. However, there are some exclusions to such a policy such as mechanical breakdown/failures/breakages, wear and tear, depreciation, consequential loss, loss when vehicle is driven under intoxication, damage to tyres unless the vehicle is damaged the same time, and overloading/strain of commercial vehicles and so on.

Health/Medical Insurance Health insurance covers mainly two types of benefits: **(i)** reimbursement of medical expenses related to specific diseases and **(ii)** hospitalisation. It is of recent origin in India. Some of the policies available now are: Individual Mediclaim Policy, Group Mediclaim Policy, Bhavishya Arogya Policy, Jan Arogya Bima Policy, Cancer Insurance, and Overseas Medical Cover. Both cashless and cash-reimbursements are used for claims settlement. The third party administrators (TPAs) are tying up with insurers to offer their services under health and medical insurance plans.

> **Individual mediclaim policy** covers the hospitalisation and domiciliary hospitalisation expenses.

Individual Mediclaim Policy This policy covers the hospitalisation and domiciliary hospitalisation expenses for diseases suffered during the policy period. It also covers hospitalisation for injuries caused during an accident. The policy usually covers the following expenses: **(1)** Boarding expenses in a hospital or nursing home - as per the description provided in the policy, **(2)** Surgical fees, anesthetist fees, medical practitioner and consultant's fees, specialist fees, **(3)** Nursing expenses, and **(4)** Anesthesia, blood, oxygen, operation theatre charges, surgical appliances, medicines and drugs, diagnostic reports, dialysis, chemotherapy, prosthetic limbs and so on.

The total liability covered under such a policy does not exceed the total sum assured under the policy, for each such disease as is mentioned in the schedule by the insurer at the time of buying the policy.

Reimbursement is not commonly used as a claim settlement system in Mediclaim, and permitted only when the treatment is taken at a hospital or that meets the criteria prescribed in the policy.

To recover claims under this policy, the claimant should be hospitalised for a minimum period of 24 hours. Also, expenses incurred for a period up to 30 days prior to hospitalisation and 60 days after hospitalisation could be considered as part of the claim. For certain treatments such as chemotherapy, eye surgery, dental surgery, kidney-stone removal, dialysis and so on, the 24 hours limit could be waived if the insured is discharged prior to 24 hours by the doctor.

Domiciliary Hospitalisation This is a medical treatment where the patient cannot be moved to a hospital or nursing home due to the condition or lack of facility/accommodation, and the treatment is carried out by professional doctors at home. The benefit covers all the normal hospitalisation expenses except the pre- and post hospistalisation treatment expenses. Also, it does not cover expenses incurred for asthma, bronchitis, chronic nephritis, diarrhoea, diabetes, epilepsy, hypertension, influenza, psychiatric disorders, pyrexia, tonsillitis, laryngitis and phyaryngitis, arthiritis, gout and rheumatism. The policy covers all treatment period exceeding three days and relapse within 45 days.

Exclusions No claim is payable under this policy for the following:

1. All diseases that were pre-existing at the time of taking out the policy.
2. Any disease contracted by the insured within 30 days of taking out the policy. This would not apply if in the opinion of the medical practitioners, the insured could not have known of pre-existing disease at the time of taking the policy. This condition would also not apply if the insured has been covered by any medical insurance policy without a break for the previous 12 months.
3. During first year of operation of the policy, the expenses on treatment of diseases such as Cataract, Hysterectomy, Hernia, Fistula, Hydrocele, Sinusitis, Piles, and so on.
4. Circumcision, unless necessary for the treatment of a disease not excluded in the policy.
5. Vaccination or inoculation of any kind.
6. Cosmetic surgery or aesthetic treatment other than that which is necessitated due to accident or part of any illness.
7. Cost of spectacles, contact lenses, hearing aids.
8. Dental treatment or dental surgery of any kind unless requiring hospitalisation.
9. Convalescence, general debility, run down condition or rest-cure, congenital external disease or defects, sterility, venereal diseases, self injury or use of intoxicating drugs.
10. Various conditions commonly referred to as AIDS.
11. Expenses on vitamins and tonics unless forming part of a treatment
12. Treatment arising from childbirth.
13. Voluntary medical termination of pregnancy.
14. Naturopathy treatment.

Conditions Applicable to the Mediclaim Policy are:

1. Mediclaim is available to persons between five and 80 years of age. Children below five years can be covered only if one of the parents is covered concurrently.
2. A 10 per cent discount is available if the entire family avails of the cover at the same time. Family includes spouse, dependent children and dependent parents.
3. The sum assured is increased by five per cent for each of claim free insurance, subject to a maximum accumulation for 10 years.
4. The insured is permitted on health check up for every four years of coverage, the cost of which should not exceed one per cent of the sum assured.
5. The cover could be extended to Nepal and Bhutan as well.
6. In claim processing, the first intimation of claim must be given to the insurance company with the relevant details within seven days of the date of hospitalisation.
7. Final claim should be filed within 30 days of completion of treatment.
8. The sum assured is available from ₹15,000 to ₹5,00,000. Of this, domiciliary limit is fixed at 20 per cent of the sum assured.
9. The premium qualifies for a tax benefit under section 80-D of the *Income-tax Act.*

Bhavishya Arogya Policy This is a deferred mediclaim policy that can be taken at any age between 25 and 55 years of age. The retirement age can be selected by the insured at the time of taking the policy and can be between 55 and 60 years of age. The amount of total benefit can be a maximum of ₹50,000 during the lifetime of the insured commencing from the date of retirement, and cannot exceed ₹20,000 per illness or injury. The coverage under the policy is similar to that of the regular mediclaim policy with the following points of difference:

1. The policy does not cover pre and post hospitalisation expenses.
2. The exclusions applied to mediclaim in respect of the following items do not apply to this policy: **(a)** 30 day waiting period, **(b)** pre-existing conditions, **(c)** circumcision, pregnancy etc, and **(d)** first year exclusions.
3. The policy only comes into affect on retirement, and cannot be advanced on the insured choosing to retire earlier than originally selected.
4. The policy allows for a suitable refund of premium in case of premature death of the insured. In case of voluntary withdrawals, a refund of upto 75 per cent of the refund payable on death is permitted.
5. The insured can increase the amount of cover anytime until four years prior to the retirement age in additional multiples of ₹10,000 each.
6. No previous medical examination is necessary for this policy.
7. Assignment is possible in this policy as against the regular mediclaim.

Jan Arogya Bima Policy This policy is devised to address the smaller covers and people with limited means of paying the premium. This policy works like a usual mediclaim policy but differs on a few value added extras such as: **(i)** It does not offer any cumulative bonuses, **(ii)** It does not offer any medical check up benefits. The sum assured is limited to ₹5,000 and the premium is very low as compared to the regular policy.

Cancer Insurance There are two cancer policies offered in India: one is a Group Policy issued by the Indian Cancer Society (ICS) and the other is a Group Policy offered to members of the Cancer Patients' Aid Association (CPAA). In both cases, the insured have to be valid members of the Society/Association to qualify for the policy. The cover is limited to ₹50,000 in the case of the ICS policy and can go upto ₹2,00,000 in case of the CPAA policy. Both policies require cancer check- up prior to taking out the policy and cover only allopathic mode of treatment including costs of diagnosis, biopsy, surgery, chemotherapy, radio therapy, hospitalisation and rehabilitation.

Group Mediclaim Policy The group mediclaim policy is available to any corporate, association, institution and group of people provided they form the minimum number of persons to be covered under the policy. The policyholder in the case of this type of insurance is the group itself and the premiums are payable by the group. The individual members of the group may enter and exit the policy upon their becoming or ceasing to be member of group. The benefits covered under the group policy are the same as in individual policy except for the following differences:

1. Cumulative bonus and health check up expenses are not payable to members of the group in case of group policies.
2. Group discount in premium is available according to scale depending upon the total number of insured persons covered under the group policy at the inception of the policy.
3. Renewal premium is subject to bonus in case of low claim ratio - typically up to 5 per cent bonus in case of claims not exceeding 60 per cent and up to 40 per cent bonus in case of claims ratio not exceeding 25 per cent. Similarly, extra loading is also applied if the claims ratio is adverse. Up to 200 per cent loading may be applied if the claims ratio goes beyond 175 per cent.
4. Maternity benefit extension is available at extra premium of 10 per cent of the total basic premium. This benefit has to be included in the cover at the time of inception of the policy and special conditions apply to the claim made under this benefit: **(a)** Benefit is available only in respect of expenses incurred in hospital/nursing home as in-patient, **(b)** A waiting period of nine months is applicable for payment of any claim. The waiting period can be relaxed only in case of delivery, miscarriage, abortion-by-accident or medical emergency, **(c)** Claim is payable only in respect of first two children, **(d)** Expenses incurred for voluntary termination of pregnancy in the first 12 weeks is not admissible, and **(e)** Pre-natal and post-natal expenses are not covered.

The insured is required to give a complete list of people covered under the policy and keep it updated from time to time. No change in sum assured is permitted under this policy. It can be graded, however, for different levels of cover for different people in the group.

No refund of premium is permitted in this policy in respect of a person leaving the group if he has claimed any settlement under the policy.

Overseas Medical Cover This policy is devised for payment of medical expenses for illness suffered or accidental injuries sustained by Indians when travelling abroad on work or for a holiday. Originally introduced in 1984, the policy was modified in 1991 as Employment and Study Policy; and a fully revised Videsh Yatra Mitra Policy was introduced in 1998. This final version of the policy covers several aspects of foreign travel that go beyond the ordinary such as loss of passport, personal accident and so on.

Eligibility of Cover:

(1) Indian residents can avail of the cover for taking trips abroad for either business or holiday purpose.

(2) Accompanying spouse and children of the person who is going abroad will be treated as going for holiday travel.
(3) Foreign nationals who work in India and earn remuneration in Indian rupees covering their official trips abroad.
(4) The cover is available to adults upto 70 years of age (beyond 70 years are admissible at extra premium); for children the cover is available for all ages above six months (children between six months and five years of age are covered with the exclusion of certain paediatric diseases).

Covered Expenses:
(1) The policy covers expenses incurred for the treatment within 90 days of the manifestation of the injury or disease.
(2) Expenses for physician's services, hospitalisation, medical services and medical transportation.
(3) Up to US$ 225 per occurrence for dental services for immediate relief only. However, dental care necessary as a result of an accident would be subject to the limit of the cover.
(4) Expenses for medical evacuation, including transportation and medical care *en route* to a hospital in India or the nearest suitable place, for a person ordinary resident in India, as advised by an medical advisor.
(5) Expenses for physician ordered evacuation, transportation and necessary medical care *en route* when the insured is critically injured and no suitable local medical assistance is available.
(6) If an assured person dies outside India, the expenses for air transport of the remains for repatriation to India or up to an equivalent amount for a local burial or cremation in the country where the death occurred.

No claim is admissible in the following cases, under this policy:
(1) This policy does not cover pregnancy and resulting child birth, abortion, miscarriage, etc.
(2) Cosmetic surgery necessary as a result of an accident.
(3) Routine physical examination where there is no indication of impairment to normal health.
(4) Expenses for treatment that could have been reasonably delayed until the insured person's return to India.
(5) In the event the insured is unable to present himself for medical examination when called by an insurer, the limit of expenses is a maximum of US$ 10,000.

> **Liability insurance** covers **(1)** employee liabilities, **(2)** employee state insurance liability, **(3)** non-industrial risks, **(4)** professional liabilities, and **(5)** product liabilities.

Liability Insurance The Public Liability *Insurance Act, 1991* defines the scope of liability insurance in India. Conventionally, **liability insurance** concerned itself with the work place and issues arising out of working conditions/death/accident at work/unforeseen incidents while in employment. However, recently third party liability in damages for suits filed against manufacturers by their customers as well as similar liability of professionals towards the users of these services has become a matter of insurable interest. The shareholders activism is also causing directors/officers of corporate to cover themselves against negligence of duties. The extent of insurance available to cover the risk of public utility is discussed below.

Types of Liabilities Insurance is available across several types of liabilities. These are also known as **indemnity policies**:

(1) Employee liabilities: Chief among these are those related to working conditions, and are covered under the Workmen's Compensation Insurance policies. Liability in this area chiefly covers the industrial risks.

(2) Employees state insurance liability: is defined in relation to injury to any employee while at work. It defines the limits of such liability on the part of the employers.

(3) Non-industrial risks: These relate to non-industrial but mainly commercial enterprises such as cinemas, restaurants, offices, shopping complexes, schools, exhibitions and fairs, shops and so on.

(4) Professional liabilities: These relate to liability that could arise from the practice of a particular profession. Medical practitioners, engineers, architects, chartered accountants, directors of companies, lawyers and solicitors and so on are covered under this group.

(5) Product liabilities: These are liabilities that could arise from the sale of products to customers and resulting damage to any customer due to a fault in the product. Edible products, equipment and machinery, clocks and watches, air-conditioner units, chemical products, motor vehicle tyres, fireworks and explosives, elevators and escalators and so on are covered under such policies.

Industrial Risks As per the public liability policy covering the industrial risks, there exists a no-fault liability, that is, irrespective of any negligence, wrongdoing or default on the part of any employer or owner in the event of death or injury to any person or damage to property out of an accident handling hazardous material. This is known as **compulsory liability**. The claimant is not required to prove that death, injury or damage occurred due to any neglect. The amount of relief payable under such a policy is as under: **(1)** Fatal accident: ₹25,000 per person; **(2)** Permanent total disability: ₹25,000 per person; **(3)** Permanent partial disability: Amount of relief on the basis of percentage of disablement as certified by a doctor; **(4)** Temporary partial disability: A fixed monthly relief not exceeding ₹1,000 per month; **(5)** Actual medical expenses: Up to a maximum of ₹12,500; and **(6)** Actual damage to property: Up to ₹6,000.

This is a compulsory liability and has to be insured for an amount not less than the paid-up capital of an undertaking handling hazardous substances. If not a company, paid-up capital would mean the market value of all its assets and stocks on the date of the insurance contract.

Non-Industrial Risks There are nine different categories under which the non-industrial establishments are classified for the purpose of indemnity insurance:

(1) Hotels, motels, restaurants, club-houses, boarding and lodging houses, flight kitchens, and other establishments in the hospitality businesses.

(2) Cinema halls, auditoriums, theatres, public halls, *pandals*, open air theatres and other concert venues.

(3) Residential premises owned and used for private purposes.

(4) Offices, administrative premises, medical premises, airports, research institutes and laboratories.

(5) Schools, educational institutions, public libraries.

(6) Exhibitions, fairs, fetes, melas, stadia and public grounds.

(7) Permanent amusement parks.

(8) Depots, warehouses, godowns, shops, tank farms and other similar non-industrial risks.

(9) Film studios—indoor and outdoor, circus, zoological parks.

Limits of Indemnity Limits of indemnity are:

(1) Minimum as described in the compulsory liability policy.

(2) The insured has to select limits of indemnity based on Any One Accident (AOA) and Any One Year (AOY) basis, in a ratio of 1:1, 1:2, 1:3 or 1:4 basis. For example, for AOA, the limit may be ₹10 lakhs, with AOY going up to 10 lakhs, 20 lakhs, 30 lakhs or 40 lakhs.

(3) The insured has to bear a compulsory excess of 0.5 per cent in case of industrial risks (subject to minimum excess of ₹2,000 and maximum of ₹3,00,000) and 0.25 per cent in case of non-industrial risks (minimum, ₹1,000 and maximum ₹1,00,000).

(4) Usually, the indemnity is restricted to only that which arises out of accidents during the period of insurance and first claimed, in writing, during the period of insurance.

(5) The policy can cover the insured only against legal liabilities and other than that, which is covered under the *Public Liability Insurance Act*.

(6) Indemnity is also provided only for accidents occurring in India and those covered in Indian law, and in respect of accidents caused only to third parties.

(7) The important exclusions of the policy are: **(a)** Product liability, **(b)** Pollution liability, **(c)** Transportation of hazardous goods liability, and **(d)** Injuries to employees—covered under ESIC/workmen compensation.

Premium Rates Premium rates for indemnity insurances is based on the following factors: **(1)** Risk group, **(2)** Limits of indemnity AOA, **(3)** The ratio of AOA or AOY, and **(4)** Turnover of the insured. Risk categories are divided into four broad groups:

Group I: Biscuit factories, coir factories, glass and ceramic factories and silk factories and so on.

Group II: Breweries, cigarette factories, shoe factories, sugar factories and so on.

Group III: Distilleries, man-made yarn factories, fibre manufacturers, paper and cardboard mills and so on.

Group IV: Celluloid goods manufacturing, fertilizer factories, match factories, synthetic rubber factories and so on.

The rates are the lowest on Group I risks and move up along the scale rising towards the Group IV risks.

Turnover Turnover is defined for most risk groups for the purpose of the indemnity policies:

(i) For manufacturing units, it is the entire gross sales turnover, including all levies of taxes of the manufacturing unit and the taxes for handling hazardous goods, if any.

(ii) For godowns and warehouses, the turnover would mean the total annual rental receipts of the premises, building or storehouse.

(iii) For transport operators the term ‘turnover’ would mean the total annual freight receipts.

(iv) For all other types of business, the turnover would mean the total annual gross receipts.

While the rate for insurance ranges between 0.70 rupees per mille to 0.80 rupees per mille, the turnover loading is added to such a rate as follows:

(i) For turnover upto ₹1 crore, 0.12 per mille subject to a minimum of ₹1,200.

(ii) For turnover between ₹1 crore to ₹5 crore, a sum of ₹100 plus 0.084 per mille on ₹4 crore.

(iii) For turnover between ₹5 crore to ₹10 crore, ₹4,560 plus 0.072 per mille on ₹5 crore.

Over and above the premium rate, an amount equivalent to the premium is payable by the insured towards an Environment Relief Fund of the Government. This fund pays relief when it exceeds the amount payable under this policy.

Product Liability The demand for product liability insurance has arisen because of a wide array of products that are now sold and consumed in the modern society could cause death, bodily harm or injury to the consumers, if defective. Besides, the containers/packaging of such goods could also cause injury. Examples of such products are: electrical appliances, LPG cooking gas, household cleaning agents that include strong acids and chemicals, ready to eat packaged foods such as chocolates, dairy products, medicines, aerated bottled water, household pesticides, syringes and so on. An increasing consciousness of consumer rights and protection of these rights has given way to formation of consumer courts, and indeed the *Consumer Act*. The basic structure of the product liability policy is similar to the earlier described policies. However, it does not cover following claims:

1. Costs incurred in repair, reconditioning, modification or replacement of any part of the product that is defective.
2. Claims arising from any product guarantee.
3. Claims arising from failure of goods and services to fulfil the purpose for which they were intended.
4. Claims arising out of recall of any product or any part of it.
5. Products exported from India, unless covered in a separate policy for that purpose.

Classification of Products For the purpose of product liability there are eight groups:

1. Carpets, clocks and watches
2. Alcoholic beverages, fans and kitchenware
3. Bread, biscuits and cakes, milk products and soft drinks
4. Agricultural equipment and farm machinery, motor vehicles, forklift trucks and toys
5. Air conditioning nits and ducts, chemical products, cosmetics, pharmaceutical products
6. Cast iron products, motor vehicle tyres and tubes, wire products
7. Explosives and fireworks, ladders, scaffoldings etc.
8. Lifts and escalators—these are usually covered in a separate policy and cover death/bodily injury as also damage to property.

In calculating the premium for product liability, the factors taken into consideration are the class of risk, turnover of the company, limits of indemnity chosen by the product seller and ratio of limits between AOA and AOY. A compulsory excess of 0.5 per cent of AOA is required in case of exports, except in case of US and Canada where the excess is a minimum of one per cent or ₹4,000.

Professional Indemnities **Professional indemnities** are designed to provide insurance cover to professionals against any legal liabilities to pay damages arising out of negligence in their professional conduct. The professions covered under this policy are: **(1)** Doctors and medical practitioners, **(2)** Medical establishments, **(3)** Engineers, architects and interior decorators, **(4)** Chartered accountants, financial consultants, management consultants, and **(5)** Lawyers, solicitors, advocates and counsels. These policies generally

Professional indemnities are designed to provide insurance cover to professionals against legal liabilities to pay damages arising out of negligence in their professional conduct.

provide cover with a limit of indemnity on any one year for any one claim. Compulsory and voluntary excess also applies except in the case of medical practitioners and establishments. The rates of premium charged vary, though based on the mille rates on the AOY basis. For doctors separate rates are charged for consultants, surgeons, plastic surgeons, anesthetists and general practitioners. For medical establishments, additional premium per capita is charged for every in and out patient. The policy structure is similar to other indemnity policies with many common clauses, exclusions and conditions. However, in the case of medical professionals exclusions apply in the case of AIDS and cosmetic surgery.

Director's Liability A special type of professional indemnity is covered by the **directors' and officers' liability policy**. This is a highly specialised policy introduced recently in India. Directors and certain officers of a company hold positions of trust and responsibility in a company; they become liable to pay damages to shareholders, creditors, customers and lenders of the company for wrongful acts committed by the company or by them while in supervision of the company. The policy is designed to provide insurance protection against liability arising from such damages.

> **Director's liability policy** is designed to provide insurance protection against liability arising from damages for wrongful acts committed by a company/its directors.

Workmen's Compensation Insurance This policy basically covers the employers against liability arising from compensations given to workmen as a result of death or disability arising in and out of, and during the course of employment. There are two types of covers in this policy:

Table A Cover: This provides indemnity against legal liability under the *Workmen's Compensation Act, Fatal Accidents Act and Common Law.* This is usually issued only for those employees that are covered under the *Workmen's Compensation Act.*

Table B Cover: This provides indemnity against legal liability under the *Fatal Accident Act* and Common Law only. This may be issued in respect of only such employees that are not covered under the *Workmen's Compensation Act.*

The policy usually does not specify the sum assured because the amount of compensation provided in the Act(s) could be awarded by a Court and may not be easy to predict.

The tariff for such insurance is grouped with various trades depending on hazards involved in the nature of the employment. Usually the rate charged is a mile rate of the total earnings of all the employees covered under a policy. Since on many occasions the total earning of the employees may not be exactly predictable, a deposit premium is charged and adjusted on the expiry of the policy based on the actual earnings of the employees for that policy period.

Such policies can be extended to include, at an extra premium, certain diseases mentioned in the Act, medical expense reimbursement and liability towards contract workmen.

Employee State Insurance Liability The objective of Employee State Insurance is to provide certain benefits to the employee in case of sickness, maternity, and employment injury and to make provisions for certain other matters in relation thereof. A statutory corporation called the Employee State Insurance Corporation has been set up separately to monitor the abidance of the ESI rules by all employers. The scheme is applicable to all industrial employees as described in the Act and the Act operates in certain industrial areas notified by the Government. The employers, employees and the Government, create a fund under the scheme from contributions and the following expenses are met through this fund:

1. Sickness benefit, maternity benefit, disablement benefit, dependence (on death) benefit and medical benefit.
2. Establishment and maintenance of ESI hospitals and dispensaries for the benefit of the insured persons and their families.
3. Administration of the scheme.

Wherever the *ESI Act* applies, the *Workmen's Compensation Act* ceases to apply automatically. Hence, there is no need for a WC Insurance Policy if there already exist an ESI policy.

RECAPITULATION

- Until 1999, the insurance organisation in India was comprised of two state-owned monolithic institutions: LIC and GIC and its four subsidiaries. With the entry of private players, the organisation has undergone a notable transformation. The elements of the present framework are the (i) Insurance Act, (ii) IRDA Act and (iii) Regulations framed by the IRDA.
- The Insurance Act provides the broad framework for the insurance sector in the country. Some of the important aspects of the framework contained in the Act are: eligibility, registration, accounts and balance sheet, actuarial report and abstract; investment of assets; insurance business in rural/social sector; investigation; power to issue directions; registration of principal/chief/special agent(s); issue of license to intermediary/insurance penalties; power to call for information; power of Government to make rules; powers of IRDA to make regulations.
- Any class of insurance business can be carried out only by a public company, a cooperative society, an insurance cooperative society, or a body corporate other than a private company. After the enactment of the IRDA Act, only Indian insurance companies are eligible to carry out any class of insurance business (i.e., life/general/fire/marine and miscellaneous), Indian companies are defined as those in which the aggregate holding of equity by a foreign company does not exceed 26 per cent of the paid-up equity capital.
- To carry on their business, insurance companies should be registered with the IRDA. It would register an applicant on being satisfied that its financial condition and the general character of its management are sound, the volume of its business, capital structure and earnings prospects would be adequate, the interest of the public would be served, and it has complied with all the other requirements. The minimum paid up capital of an insurance company should be ₹100 crore (for life/general business) and ₹250 crore (for reinsurance business). The registration would be renewed annually. Promoters cannot hold more than 26 per cent of the paid-up capital of an insurance company. Every insurer should also keep a specified deposit with the RBI which would be deemed to be a part of its assets.
- The assets of insurers should be invested in the following manner: 25 per cent in Government securities (including deposits with the RBI); at least 25 per cent in Government/other approved securities; and the balance in approved and other investments. Upto 15 per cent of the controlled fund of the insurers can be invested in other investments. Upto 25 per cent of the assets of general insurance companies can be invested in other investments. No funds of policyholders can be invested outside India.
- The IRDA may conduct an investigation in to the affairs of an insurer. It may issue directions in public interest/to prevent the affairs of an insurer being conducted in a manner detrimental to the interest of its policyholders or generally to secure the proper management of any insurer,

which would be binding on the insurer. The CEO of an insurer may be removed from office on similar grounds.

- Penalties can be imposed for the following offences under the Insurance Act: **(a)** default in compliance with/act in contravention of the act, **(b)** carrying on business in contravention of requirement of registration and deposits, **(c)** false statements in documents, **(d)** wrongly obtaining/withholding property, **(e)** offences by companies, and **(f)** failure to comply with the rural/social sector obligations.
- The Government may make rules to carry out the purposes of the Act and the IRDA may make regulations to carry out its provisions.
- The duty of the IRDA is to regulate, promote and ensure the orderly growth of the insurance and reinsurance business. Its powers and functions include: Issue/renewal/ cancellation/ suspension of registration of insurance companies; protection of policyholder's interests; specifying the requisite qualifications/practical training for intermediaries/agents; specifying the code of conduct for surveyors/loss assessors; promoting efficiency in the conduct of insurance business; promoting/regulating professional organisations; calling for information, undertaking inspection, conducting inquiries/investigations of insurers/intermediaries/other organisations; regulating investments of funds/maintenance of margin of solvency and so on. The IRDA would be bound by the directions of the Government on questions of policy.
- The powers of the Government in relation to the undermentioned activities/operations of insurance companies have been delegated to the IRDA: **(i)** investment of assets, **(ii)** maintenance of assets, **(iii)** limit on expenditure, **(iv)** provision regarding directors, **(v)** acquisition of surrender values by policyholders and so on.
- To carry out its powers/functions, the IRDA has issued a number of regulations as ground rules for the conduct of insurance business. The major regulations covered here relate to the following: Rural/social sector obligations; Insurance advertisements/disclosures; Licensing of insurance agents; General insurance - reinsurance; Appointment of an actuary; Registration of Indian insurance companies; Investment norms; Preparation of financial statements and auditor's report; Third party administrators - health services; Protection of policyholders interest's; Licensing of corporate/composite corporate agents; Distribution of surpluses; Life insurance - reinsurance; Insurance brokers; Insurance surveyors and loss assessors; Micro-insurance; and Corporate governance guidelines for insurance companies.
- All new life insurers have to undertake the following obligation pertaining to the rural sector: of the total policies written in that year the percent share of the rural sector is as follows: first year–7 per cent; second year–9 per cent; third year–12 per cent; fourth year–14 per cent; fifth year–16 per cent; and sixth year–18 per cent. The obligations for general insurers are: in the first two years the share should be 2 and 3 per cent and it should be 5 per cent thereafter. All categories of insurers are obliged to issue 5, 7, 10, 15, 20 and 25 thousand lives in the first six years respectively. The norms would be reviewed by the IRDA every five years.
- An insurance advertisement means/includes any communication directly or indirectly related to an insurance policy and intended to result in an eventful sale/solicitation of a policy from the public. It includes all forms of printed/published materials or any material using the print and/or electronic medium for public communication.
- Insurance intermediaries include brokers, consultants, surveyors and loss assessors.
- Every insurer/intermediary/agent should **(1)** have a compliance officer to oversee advertisements, **(2)** establish and maintain a system of control over the content/form/ method of dissemination of all advertisements, **(3)** maintain a register to include a specimen of every advertisement for 3 years,

(4) file a copy of each advertisement with the IRDA as soon as it is issued first and **(5)** file a certificate of compliance with the IRDA regulations and the advertisement code prescribed by the ASCI. The register would be open to inspection/review by the IRDA for content/context/ prominence/ position of the required disclosures /omission of the required information and so on.

- Any change in an advertisement would be considered a new advertisement. All advertisements by insurance agents must have prior written approval from the insurer, which must ensure that they comply with the IRDA regulations and are not deceptive/misleading. The identity of all advertisers should be stated.
- In case of a complaint, the IRDA can take action and issue directions to the advertisers. Failure to comply would entail necessary action, including levy of penalty.
- An Insurance/composite insurance agent means an individual appointed for soliciting/procuring insurance business including business relating to continuance/renewal/revival of insurance policies. A composite insurance agent is appointed by two/more insurers and he can act as an agent for one life/general/health insurance and one mono-live insurer. The application seeking appointment as an insurance agent should be made to the designated official appointed by the insurer to make the appointments. The main elements of the IRDA regulations relate to: (i) appointment of insurance agents, (ii) insurance agency examination, (iii) code of conduct, (iv) right to inspect, (v) suspension/cancellation of appointment, and (vi) general conditions of appointment.
- A life insurer cannot transact business without an appointed actuary, who should be a fellow member of the Acturial Society, of India. He should have access to all the information/ documents of the insurer, for a proper/effective performance of his duties/functions. The duties and obligations of an appointed actuary include: **(1)** advice to the insurer in the area of product design and pricing, insurance contract wording, investment and reinsurance, **(2)** ensure solvency of the insurer, **(3)** comply with the IRDA's directions, **(4)** certify the acturial report and abstract/other returns, and so on.
- The appointed actuary should enjoy absolute privilege to any written/oral statement, so as to perform his functions.
- An Indian insurance company is a company owned and controlled by resident Indian citizens/ Indian companies owned/controlled by the resident Indian citizens.
- Indian promoter means (i) a company which is not a subsidiary, (ii) banks(s) excluding foreign banks, (iii) core investment company, (iv) public financial institution, (v) LLP, and (vi) other person/entity allowed by the IRDA. Foreign investors mean all eligible non-resident entities/ persons resident outside India investing in and Indian insurance company through FDI/FPI windows.
- The main elements of the IRDA regulations relating to their registration are: (i) procedure for registration, (ii) application for registration, (iii) annual fee, and (iv) action in case of default.
- The investment norms for insurance companies relate to regulation of investment and exposures.
- The controlled fund of a life insurer should be invested as follows: In Government/approved securities at least–50 per cent; approved investments,–35 per cent; and infrastructure investments-

15 per cent. In the case of a general insurer, investment in other investments can be upto 25 per cent.

- The share of Government/approved securities in the investment of assets of a pension and general annuity business should be 40 per cent and the balance (60 per cent) should be in approved and other investments. Not more than 25 per cent of the fund should be invested in an unapproved category in case of unit linked life insurance business.
- The assets of a reinsurance business should be invested in the same pattern as of a general insurance business.
- The different categories of investments should conform to the exposure norms specified below: **(a)** limit for investee company: not exceeding the lower of 10% of capital, free reserves, debentures/bonds of the investee company or 10% of the assets of the general insurer/controlled fund of the life insurer; **(b)** limit for the group: the same as in **(a)**; limit for the industry sector to which the investee company belongs: not exceeding 10% in the total investment exposure to the industrial sector as a whole.
- All insurance companies can deal in financial derivatives. Margin/unamortised premium paid by an insurer to the extent they are reflected as an asset position in the balance sheet as per the IRDA guidelines, would be treated as approved investments, only to the extent that the derivative position constitutes a hedge for the underlying investment/portfolios which itself is treated as approved investments.
- The TPAs provide health services for a fee/remuneration specified in an agreement with an insurance company. It prescribes the terms/conditions of health services which may be rendered to and/or received by parties to the agreement. A TPA registered with the IRDA should have a minimum capital of ₹1 crore, at least one of the directors should be a doctor registered with the MCI and not more than 26 per cent of its shares should be held by a foreign company.
- A TPA should act in the best possible professional manner and would be duty-bound to follow the prescribed code of conduct. He should maintain records of all transactions carried on behalf of the insurance company and follow strictly, the professional confidentiality between the concerned parties. To look into the proper and efficient performance of any TPA, the IRDA may constitute committees consisting of members representing the TPAs, insurers, IRDA and so on. All contracts of TPAs with the insurance companies would be open for inspection by the IRDA.
- The main elements of the regulations aimed at the protection of the policyholders, interest are: point of sale, proposal for insurance, redressal of grievances, matters included in policy, claims procedures and policyholders' servicing.
- A prospectus of an insurance product should clearly state the scope of benefits, the extent of insurance cover, explain the warranties/exceptions/conditions of the insurance cover and whether the product is participating or non-participating. The insurer should provide all material information in respect of a proposed cover to the prospect, to enable him to decide on the best cover that would his interest.
- A proposal for insurance cover must be in a written document. The insurer should encourage the prospect to avail of the nomination facility. The proposal should be processed with speed and efficiency and the decision communicated within 15 days.
- Every insurer should have in place a proper procedure and an effective mechanism to address complaints and grievances of policyholders efficiently and with speed.
- The insurance policies should clearly state the matters specified by the IRDA.
- The life insurance policy should state the primary documents normally required to be submitted by a claimant in support of a claim. The claim should be processed without delay and paid

within 30 days, failing which interest rate of 2 per cent above the bank rate would have to be paid.

- A life insurer should respond within 10 days of the receipt of any communication from its policyholders in all matters such as change of address, nomination, assignment, current status of policy, loan on security, duplicate policy, endowment and so on.
- A corporate agent means a company/LLP/cooperative society/bank/corresponding bank/RRB/NGO/MFI/other person recognised by the IRDA for soliciting, procuring and servicing of life/general/health insurance business. A composite corporate agent solicits/services all the three or a combination of insurance business. The main elements after IRDA regulations are: **(i)** registration, **(ii)** requirement of indemnity insurance policy, **(iii)** Board approved policy for open architecture, **(iv)** conflict of interest, **(v)** servicing of policyholder, **(vi)** sale of insurance by telemarketing mode, **(vi)** code of conduct, **(vii)** inspection, **(viii)** suspension/cancellation of registration, **(ix)** change in ownership/shareholding, and **(x)** maintenance of records/books/accounts.
- The Insurance broker arranges, for a commission, insurance contracts with insurance/reinsurance companies on behalf of his clients. There are three categories of insurance brokers: direct, reinsurance and composite. While a direct broker functions in general/life insurance business, a reinsurance broker arranges reinsurance for direct insurers. A composite broker performs the functions of both the direct broker and the reinsurance broker. The framework of their operations includes the following: license, remuneration, ceiling on business from a single client, code of conduct, segregation of insurance money, professional indemnity insurance, books, disclosures, inspection, and cancellation/suspension of registration.
- An insurance broker should obtain a licence from the IRDA. The IRDA takes into account the following: **(i)** he does not suffer from any disqualification, **(ii)** he the has necessary infrastructure, **(iii)** he has two qualified persons in employment, **(iv)** fulfillment of capital and deposit requirements; **(v)** the principal officer possesses the minimum laid down qualification, has received the prescribed training, passed the required examination and has not violated the code of conduct.
- The main elements of the code of conduct of an insurance broker relate to: **(1)** standards of professional conduct and discharge of functions in the policyholder's interest; **(2)** matters relating to client relationships, **(3)** matters relating to sales practices, **(4)** matters relating to furnishing of information, **(5)** conduct in relation to insurance contract, **(6)** conduct in relation to renewal of policies, **(7)** conduct in relation to claim by clients, **(8)** receipt of complaints, **(9)** documentation, **(10)** advertising, **(11)** receipt of remuneration; **(12)** training and so on.
- Every insurance broker should have a professional indemnity insurance throughout the validity of the licence.
- The IRDA can conduct an inspection of insurance brokers. Their licenses can be suspended/cancelled by the IRDA, with/without notice.
- The main elements of the operations of surveyors and loss assessors are licensing procedure, constitution and functions of surveyors and loss assessors, categorisation, code of conduct, practical training, register, submission of returns and inspection.
- Both individual and corporate surveyors and loss assessors should have a licence from the IRDA. The IRDA has constituted a Surveyors and Loss Assessors Committee to assist it on matters relevant to surveyors and loss assessors. The functions of the Committee would be recommending the

(i) syllabi for examination and practical training for surveyors and loss assessors, **(ii)** considerations while recognising foreign qualifications and training to grant licence; **(iii)** improving/ developing their status; **(iv)** coordination with educational/other institutions; **(v)** looking into matters of professional misconduct, indiscipline, non-adherence to code of conduct and so on.

- The duties and responsibilities of surveyor loss assessors are: to investigate, manage, quantify, validate and deal with losses arising from any contingency and report thereon and to carry out the work with competence, objectivity and professional integrity by strictly adhering to the code of conduct. They should submit their report as expeditiously as possible, but not beyond 30 days.
- Based on their professional qualification, training experience and so on, surveyors and loss assessors are categorised into A, B and C categories. They are eligible to carry on their work as per the categorisation specified in the licence.
- Every surveyor/loss assessor should abide by the prescribed code of conduct. He should undergo practical training for at least 12 months with Category A or B surveyor/loss assessor. He may also be required by the IRDA to pass an examination on the successful completion of training. The IRDA should maintain a register of all licensed surveyors and loss assessors. It can inspect, survey the work/books/records/ documents or investigate any bona fide complaint against a surveyor/loss assessor and take the necessary action.
- Micro-insurance products are both general and life insurance products. A general micro-insurance product (GMIP) means a health insurance contract/any contract covering belongings, such as, hut, livestock, tools, instruments/any personal accident contract a on personal/group basis. Life micro-insurance product (LMIP) means any term insurance contract with/without return of premium/any endowment insurance contract/health insurance contract with/without an accident benefit rider, either on individual or group basis.
- In addition to the insurance agents/brokers, MIPs can also be distributed by MIAs, namely, SHFs, NGOs and MFIs.
- Corporate governance is a system of financial and other controls in a corporate entity and broadly defines the relationship between the Board of Directors, senior management and shareholders. The corporate governance framework should clearly define the roles/responsibilities/ accountability within an organisation with in-built checks and balances. The main elements of the IRDA corporate governance guidelines for insurance companies are: **(i)** objectives, **(ii)** governance structure, **(iii)** Board of Directors, **(iv)** control functions, **(v)** senior management, **(vi)** disclosure requirements, **(vii)** outsourcing, **(viii)** relationship with stakeholders, **(ix)** interaction with supervisor, and **(x)** whistle blower policy.
- The objective is to ensure that the structure/responsibilities/functions of the Board of Directors/senior management of the company fully recognise the expectations of all stakeholders as well as those of the regulator. The structure should **(i)** take steps to adopt sound/prudent principles/practices in the governance of the company, and **(ii)** have the ability to quickly address issues of non-compliance/weak oversight and controls.
- The Board of Directors should ensure ongoing compliance with the statutory requirements relating to **(i)** 5-year lock-in for promoters, **(ii)** FDI ceiling of 26 per cent, **(iii)** prior approval of IRDA for registration/transfer of shares, **(iv)** conflict/potential conflict of interest of shareholders, policyholders, management, auditors/actuaries/directors/senior managers and so on.
- The elements of governance structure relate to varying structure and group/conglomerates.
- The insurance companies should familiarise with corporate governance structure/requirements appropriate to listed companies as outlined in Clause 49 of the listing agreement. Whatever

structure of the Board of Directors is taken, the broader elements of good corporate governance should be present. The companies associated with a group/or financial/non-financial conglomerate should also maintain consistency in policies/practices to reinforce controls across the group.

- The elements relating to the Board of Directors are composition, role and responsibilities, fit and proper criteria and conduct of meetings.
- The Board should comprise competent/qualified directors. Its size/composition should ensure that they collectively provide knowledge, skills, experience and commitment along with independence. There should be a significant number of independent directors, ranging between one-third and half and in no case less than two.
- The Board should concentrate on the direction/control/governance and particularly articulate/commit to a corporate philosophy/governance that will shape the level of risk adoption, standard of business conduct and ethical behaviour of the company. Delegation would not absolve the directors from responsibilities. The interest of policyholders should receive special attention. There should be concurrent arrangements to review policies.
- The directors have to meet the **fit and proper** criteria in terms of integrity in personal behaviour and business conduct, soundness of judgement and financial soundness. They should not have been convicted/come under adverse notice of law involving moral turpitude. A nomination committee of the Board should handle appointments/reappointments of directors.
- The annual report of the company should disclose the number of meetings of the Board, details of their composition, numbers of meetings attended and remuneration to independent directors.
- The main elements of the control function are policy framework and delegation of functions.
- Given the risk associated with operations and its impact on business, the Board of the company should have a policy framework in terms of **(i)** robust/efficient mechanism for identification/assessment/control/mitigation/ monitoring of risk, **(ii)** appropriate **(a)** processes for compliance with policy/laws/regulations, **(b)** internal controls, **(iii)** internal audit function and **(iv)** independence of control function.
- With a view to providing adequate time for discharge of the significant responsibilities, the Board can delegate the overall monitoring responsibilities to various committees in terms of their constitution, objectives, responsibilities, frequency of meetings/quorum requirements. Typically, the committee that assists the Board are: **(a) mandatory**, namely, audit, investment, risk management, ALM committees, policyholders protection committee, and other **(b) non-mandatory** committees, such as remuneration/ethics committees.
- The elements relating to the senor management are CEO and other functionaries, appointed actuaries and external audit.
- The Board should carry out a due diligence to establish that the CEO is fit and proper. It should have succession planning for the senior functionaries through a process of identification/nurturing of individuals for taking over senior management positions.
- The Board should ensure that the requirements pertaining to the appointment/qualifications/powers/duties/obligations of the appointed actuaries are scrupulously complied with.
- The guidelines/directions relating to the external auditors include their qualifications and experience/rotation period of appointment and so on. The external/statutory auditors should have access to the audit committee/Board.

- The disclosure requirements include the following: **(i)** quantitative/qualitative information on the financial/operating ratios, **(ii)** solvency margins, **(iii)** policy lapse ratio, **(iv)** financial performance, **(v)** risk management structure, **(vi)** details of claims, **(vii)** all pecuniary relationships/ transactions of the non-executive directors and so on.
- Insurers can outsource only functions permitted by the IRDA. All such arrangements should have the approval of the Board and should be reported to the IRDA.
- The stakeholders in an insurer are its shareholders, employees, policyholders, superiors and others, including creditors, service providers, rating agencies, equity analysts and so on. Their concerns must be duly addressed by the companies.
- The insurers should put in place a whistle blowing policy in terms of mechanism for employees to raise concerns internally about possible irregularities, governance weaknesses, financial reporting issues/other such matters. The appointed actuary and the statutory/internal auditors should also **whistle blow** to enable the IRDA to take prompt action to protect the policyholders' interest.
- The main elements of issue of capital by life insurance companies regulations are: **(i)** prior written approval of IRDA, **(ii)** criteria for consideration of approval, and **(iii)** conditions for approval.
- Prior specific written approval of the IRDA would be necessary for insurance companies before approaching the SEBI for **(i)** public issue of capital and **(ii)** divestment of equity by promoter(s) through a public offer for sale under the SEBI ICDR regulations. However, insurance companies can issue/allot only fully paid-up shares.
- In particular, the IRDA would, *inter-alia*, consider the following parameters: **(i)** period for which in life insurance business, **(ii)** history of compliances with the regulatory requirements, **(iii)** maintenance of the prescribed regulatory margin at the end of the preceding six quarters, **(iv)** compliance with the disclosure requirements and corporate governance guidelines, **(v)** record of policyholders protection, and **(vi)** the embedded value.
- While approving the proposal, the IRDA may prescribed the following condition: **(a)** extent to which the promoters should dilute their respective shareholdings, **(b)** maximum subscription which could be allotted to foreign investors, **(c)** minimum lock-in period for promoters (without prejudice to the SEBI ICDR regulations) and **(d)** disclosures in the offer document/prospectus in addition to those prescribed by the SEBI.
- Health insurance products may be offered only by entities with a valid registration to carry on life/general/health insurance business. The main elements of the IRDA health insurance regulations are: **(i)** registration/scope,**(ii)** products, **(iii)** general provisions, and **(iv)** administration and submission of returns.
- The health insurance products offered by the insurers are long-term products by life insurers, short-term (1-3 years) by health and general insurers, group health/personal accident policies, overseas/domestic travel insurance policies and so on.
- The provisions relating to health insurance products pertain to filing procedure, review of products, group insurance, underwriting, proposal form and pricing.
- The general provisions relating to health insurance pertain to designing of policies, entry/exit age renewal, free lock period, cost of pre-insurance health check-up, cumulative bonuses, migration of policy, Ayush coverage wellness/ preventive aspects, optional coverage, special provisions for senior citizens, multiple policies and loading on renewal.

- The administration of health insurance policies cover protection of policyholders interest, settlement/rejection of claims, minimum disclosures, other disclosures, administration, health service agreements, payment to network providers, engagement of TPAs, change of TPAs and data/related issues.
- As a special type of contract, the fundamental principle of insurance are insurable interest, utmost good faith, indemnity, subrogation and contribution. Insurable interest means that the person entering into the insurance contract would suffer financial loss on the occurrence of the event insured against. Utmost good faith implies full and accurate disclosure of all facts material to the risk to the insurance company. Indemnity implies the restoration of the financial position of the insured to the level he enjoyed before suffering the loss. Subrogation means the automatic transfer of rights/remedies of the insured to the insurer after receiving the benefits of insurance. There are two types of insurance policies: life and general.
- Life insurance products are based on core risk coverage needs as well as long-term investment concerns. They cover both individuals and groups. The main individual products are: term insurance, whole-life insurance, endowment policies and annuities.
- Term insurance policy provides only risk cover for a specified period only. The different types of term insurance plans are level term insurance, decreasing term insurance, increasing term insurance, renewable term insurance, convertible term insurance and term insurance with return of premium.
- Whole life insurance guarantees death benefit cover throughout the life of the assured and the policy amount is paid whenever his death occurs.
- Claims under endowment policy arise either by the death of the assured or by maturity (i.e. after a fixed period).
- Annuities are a form of insurance in which the insurer makes a series of payments to the annuitant/his dependent over a number of years in return for a payment in lump sum or in instalments. Annuities are of two types: immediate and deferred.
- The unit-linked insurance policies combine insurance protection and investment in a managed fund.
- Insurance policies that are entitled to bonus are with profit policies and policies that are not entitled to bonus are without profit policies.
- Group insurance is a plan insurance which covers a similar/homogenous group of individuals under a single policy, for example, employees.
- General insurance contracts include the following: (i) fire, (ii) marine, (iii) accident/motor, (iv) health, and (v) liability.
- Fire insurance is designated to provide for financial loss to property due to fire and other related hazards. Special type of insurance policies have unique coverage such as risk of consequential damage, replacement/reinstatement value, multilcoation/floater and industrial all risk.
- Marine insurance comprises of hull insurance and cargo insurance. Hull insurance covers insurance of the carrier of goods. Cargo insurance provide cover for losses/damages that could occur to goods in transit on sea, rail, road and air.
- Motor/accident insurance is statutorily mandated to take care of those who may get injured in an accident. Two types of such policies are available: (i) third party liability policy and (ii) comprehensive policy.

- Health/medical insurance covers mainly two types of benefits (i) re-imbursement of medical expenses related to specific diseases and (ii) hospitalisation. Some of the available policies are: Individual/Group Mediclaim Policy, Bhavishya Arogya Policy, Jan Arogya Bima and overseas medical cover.
- Liability insurance/indemnity policies cover several types of liabilities such as employee liabilities, employee state insurance liability, non-industrial risks, professional liabilities and product liabilities.

REVIEW QUESTIONS

6.1 Discuss the framework of regulation contained in the Insurance Act with reference to
- Eligibility
- Regulations
- Investment of assets
- Penalties

6.2 Write notes on
- Licensing of insurance agents
- Registration of surveyors and loss assessors
- Re-insurance

6.3 Discuss the main features of the *IRDA Act*.

6.4 Discuss briefly the rural/social sector obligations of insurance companies in India.

6.5 Explain briefly the advertisement and disclosure requirements of insurers.

6.6 Outline the main requirements for getting a license to work are an insurance agent.

6.7 Critically examine the 2016 framework of registration of Indian insurance companies.

6.8 What are the investment norms applicable to insurance companies in India?

6.9 Write a note on TPAs.

6.10 What are the main elements of the provision for the protection of policyholders, interests in life and general insurance.

6.11 Explain briefly the 2016 licensing procedure for corporate/composite corporate agents.

6.12 What is the IRDA framework for insurance brokers?

6.13 Write briefly about loss assessors and surveyors.

6.14 Outline the framework for micro-insurance in India.

6.15 Discuss the main elements of the issue of capital by life insurance companies regulations.

6.16 What are the main features of health insurance regulations 2016?

6.17 Explain the following principles of an insurance contract:
- Insurable interest
- Utmost good faith
- Indemnity
- Subrogation
- Contribution

6.18 Discuss the four main types of life insurance policies.

6.19 What is group life insurance? What are the different types of group life insurance policies that are commonly available in India?

6.20 **(a)** Enumerate the different types of perils covered under a fire insurance policy
(b) Discuss briefly the special fire insurance policies sold in India.

6.21 **(a)** What are the different types of marine insurance policies?
(b) What are the main clauses of export/import marine policies?
(c) What are the main clauses of an inland transit policy?

6.22 Write brief notes on
- Liabilities covered under motor insurance
- Types of motor insurance policies

6.23 **(a)** Describe the key features of a Mediclaim policy.
(b) Explain briefly Bhavishya Arogya Bima and Jan Arogya Bima policies

6.24 **(a)** What type of third party liabilities are covered by liability insurance?
(b) List the industrial and non-industrial risks covered by a liability insurance policy.
(c) Define turnover and state the premium rates in vogue for different turnover levels.
(d) Explain **(1)** product indemnity and **(2)** professional indemnity.

CHAPTER 7

Venture Capital Financing

Learning Objectives

- Explain the six elements—features, selection of investment, investment nurturing/aftercare, valuation of portfolio, structural aspects, exit—of venture capital financing.
- Discuss the (i) SEBI Alternative Investment Fund Regulations and (ii) SEBI Foreign Venture Capital Investors Regulations as the framework for venture capital financing in India.
- Understand the SEBI regulations relating to angel funds.

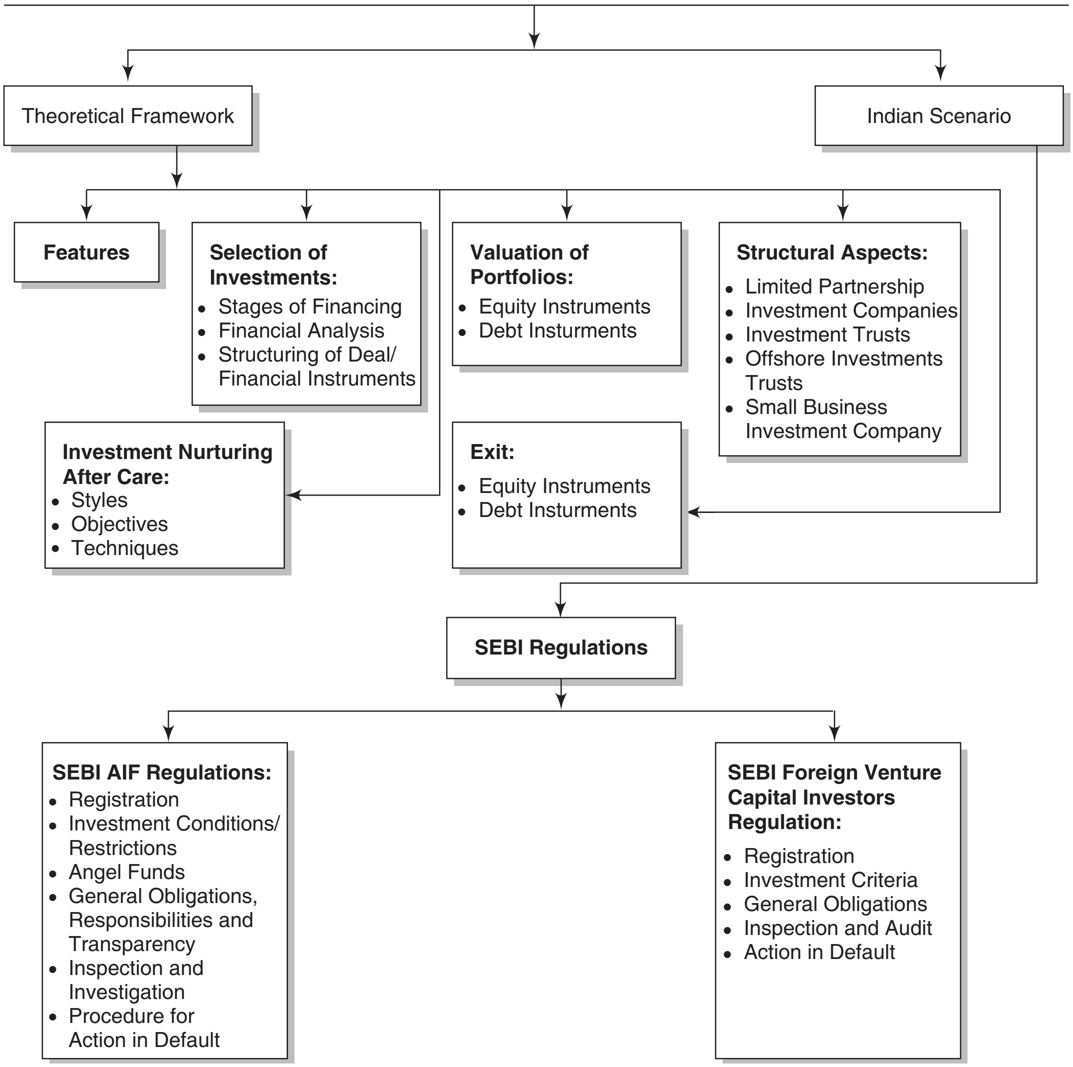
INTRODUCTION

Venture capital institutions, which emerged the world over to fill gaps in the conventional financial mechanism, focused on new entrepreneurs, commercialisation of new technologies and support to small and medium enterprises in the manufacturing and the service sectors. Over the years, the concept of venture capital has undergone significant changes. The *modus operandi* has shifted from technology-oriented manufacturing organisations to being very close to "private equity class" for unlisted new companies in all sectors of the economy, irrespective of the nature of their projects. They also maintain a close rapport and a '**hands-on**' approach in nurturing investments during their association with the assisted/investee companies as active partners rather than as passive investors.

Although the development of the venture capital started in the USA in the mid-fifties, venture capital institutions are of fairly recent origin in India. Before their emergence, the development finance institutions partially played the role of venture capitalists by providing assistance for direct equity participation to ventures in the pre-public issue stage and by selectively supporting new technologies. The initial steps for the institutionalisation of venture capital in India were taken by the Government in November, 1988, when guidelines were issued for setting up of venture capital funds/companies (VCFs/VCCs) for investing in unlisted companies and to avail of a concessional facility of capital gains tax.

The various facets of venture capital institutions/financing discussed in this chapter **are portrayed in Exhibit 7.1.** The theoretical aspects of such organisations are examined in Section 1. Section 2 presents a comprehensive profile of the VCFs in India. The main points are summarised in the last Section.

Exhibit 7.1 Venture Capital Financing



THEORETICAL FRAMEWORK[1]

Venture capital financing is emerging as a new institutional mechanism post-1990 in the country. As a new technique of financing to inject long-term capital into the small and medium sectors, it has made notable contribution to growth in the developed countries, particularly in the USA and the UK. The nascent venture capital industry in India can profitably draw upon their experiences. The theoretical aspects of the venture capital institutions, based largely on these experiences, are briefly described in this section. The aspects covered below include features, selection of investments, investment monitoring/nurturing, portfolio valuation, structure and legal framework and existing form of investments.

Features

Venture capital has, somehow, come to acquire various connotations. It is defined as an equity/equity-related investment in a growth-oriented small/medium business to enable investees to accomplish corporate objectives, in return for minority shareholding in the business or the irrevocable right to acquire it.

Venture capital is a way in which investors support entrepreneurial talent with finance and business skills to exploit market opportunities and, thus, to obtain long-term capital gains. It is the provision of risk-bearing capital, usually in the form of participation in equity, to companies with high-growth potential.

In addition, it provides some value addition in the form of management advice and contribution to over-all strategy. The relatively high risks are compensated by the possibility of high return, usually through substantial capital gains in the medium term.[2]

According to a very widely-accepted definition, venture capital is described as a separate asset class, often labelled as private equity. Private equity investment sits at the furthest end of the risk-reward spectrum from government bonds and can broadly describe equity investment in private companies not quoted on the stock market.[3]

Based on the above description of venture capital, then, some of its distinguishing features as against other capital investments are:

- Venture capital is basically equity finance in relatively new companies when it is too early to go to the capital market to raise funds. However, such investment is not exclusively equity investment. It can also be made in the form of loan finance/convertible debt to ensure a running yield on the portfolio of venture capitalists. Nonetheless, the basic objective of venture capital financing is to earn capital gain on equity investment at the time of exist and debt financing is only supplementary.
- It is a long-term investment in growth-oriented small/medium firms. The acquisition of outstanding shares from other shareholders cannot be considered venture capital investment. It is new, long-term capital that is injected to enable the business to grow rapidly.
- There is a substantial degree of active involvement of the venture capital institutions with the promoters of the venture capital undertakings. It means such finance also provides business skills to the investee firms which is termed as '**hands-on**' approach/management. However, venture capitalists do not seek/acquire a majority/controlling interest in the investees, though under special circumstances and for a limited period, they might have a controlling interest. But the objective is to provide business/managerial skill only and not interfere in management.
- Venture capital financing involves high risk-return spectrum. Some of the ventures yield very high returns to more than compensate for heavy losses on others which also may have had potential of profitable returns. The returns in such financing are essentially through capital gains at the time of exits from disinvestments in the capital market.
- Venture capital is not technology finance though technology finance may form a sub-set of venture capital financing. The concept of venture capital embraces much more than financing new, high technology-oriented companies. It essentially involves the financing of small and medium-sized firms through early stages of their development until they are established and are able to raise finance from the conventional, industrial finance market. The scope of venture capital activity is fairly wide.

In brief, a **venture capital institution** is a financial intermediary between investors looking for high potential returns and entrepreneurs who need institutional capital as they are yet not ready/able to go to the public.[4]

Venture capital institution (fund) is a financial intermediary between investors looking for high potential returns and entrepreneurs who need institutional capital as they are yet not ready to go to the public.

Selection of Investment

The first step in the venture capital financing decision is the selection of investment. The starting point of the evaluation process by the venture capital institution (VCI) is the business plan of the venture capital undertaking (promoter). The appraisal is akin to the feasibility studies of the development finance institutions for grant of term loans and other financial assistance.

In addition to the project history, if any, track record of the entrepreneur, market potential study and projections of future turnover, profitability and so on, it also covers a review of the likely threats from technological obsolescence/competing technologies and preliminary views on preferred exits.

The selection of the investment proposal includes, *inter alia*, stages of financing, methods to evaluate deals and the financial instruments to structure a deal.

Stages of Financing The selection of investment by a VCI is closely related to the stages and type of investment. From analytical angle, the different stages of investments are recognised and vary as regards the time-scale, risk perceptions and other related characteristics of the investment decision process of the VCIs. The stages of financing, as differentiated in the venture capital industry, broadly fall into two categories: **(a)** early stage, and **(b)** later stage.

Early Stage Financing This stage includes **(i)** seed capital/pre-start-up, **(ii)** start-up and **(iii)** second-round financing.

Seed Capital This stage is essentially an '*applied research*' phase where the concepts and ideas of the promoters constitute the basis of a pre-commercialisation research project usually expected to end in a prototype which may or may not lead to a business launch. This phase gradually moves towards the development phase leading to a prototype product testing and then to commercialisation. The evaluation of the project by the VCIs has to ensure that the technology skills of the entrepreneur matches with market opportunities.

The main risk at this stage is marketing related. The commercial acumen of the promoter to take advantage of the market opportunity, awareness of competition, the timing of launching the product and so on, are important elements of the appraisal. The risk perception of investment at this stage is extremely high. However, very few VCIs invest in this pre-commercialisation/seed stage of product development.

Start-Up This is the stage when commercial manufacturing has to commence. Venture capital financing here is provided for product development and initial marketing. The essence of this stage is that the product/service is being commercialised for the first time in association with the VCIs. It includes several types of new projects such as (i) greenfield based on a relatively new or high technology, (ii) new business in which the entrepreneur has good knowledge and working experience, (iii) new projects by established companies and (iv) a new company promoted by an existing company with limited finance to commercialise new technology.

Start-up is a stage when product/service is commercialised for the first time in association with a venture capital institution.

At this stage, some indication of the potential market for the new product/service is available. Partly because of the equity dilution syndrome[5], in the sense of resistance from the promoters to the dilution of control of the business, and partly due to the unviability of the small amount of equity investment, the involvement of VCIs in start-up projects is generally and relatively low. The risk perception is very high.

Second Round Financing This represents the stage at which the product has already been launched in the market but the business has not, yet, become profitable enough for public offering to attract new investors. The promoter has invested his own funds but further infusion of funds by the VCIs is necessary. The time-scale for the investment is shorter than in the case of start-ups. The VCIs provide larger funds at this stage than at other early-stage financing. This financing is partly in the form of debt to also provide some income to them.

Later Stage Financing This stage of venture capital financing involves established businesses which require additional financial support but cannot take recourse to public issues of capital. It includes mezzanine/development capital, bridge/expansion, buyouts and turnarounds.

Mezzanine/Development Capital This is financing of established businesses which have overcome the extremely high-risk early stage, have recorded profits for a few years but are yet to reach a stage when they can go public and raise money from the capital market/conventional sources.

> **Mezzanine/development capital**
> is financing of established businesses which require additional financial support but cannot take resource to public issue.

Among the uses of such types of venture capital financing are purchase of new equipment/plant, expansion of marketing and distribution facilities, re-finance of existing debt, penetration into new regions, induction of new management and so on. The development finance stage has a time-frame of one to three years and falls in the medium risk category. It constitutes a significant part of the activities of many VCIs.

Bridge/Expansion This finance by VCIs involves low risk perception and a time-frame of one to three years. Venture capital undertakings use such finance to expand business by way of growth of their own productive asset or by the acquisition of other firms/assets of other firms. In a way, it represents the last round of financing before a planned exit.

> **Buyout**
> implies transfer of management control.

Buyouts These refer to the transfer of management control. They fall into two categories: **(a)** management buyouts (MBOs) and management buyins (MBIs).

> **Management buyouts**
> are provisions of funds to enable existing management to acquire an existing product line.

Management Buyouts In MBOs, VCIs provide funds to enable the current operating management/investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.

> **Management buyins**
> are funds provided to enable an outside group buy an ongoing company.

Management Buyins MBIs are funds provided to enable an outside group [of manager(s)] to buy an ongoing company. They usually bring three elements together: a management team, a target company and an investor (VCI). MBIs are less popular than MBOs. An MBI is inherently more risky because the management comes from outside and finds it difficult to assess the actual potential of the target company. Generally, MBIs are able to target only the weaker/underperforming companies.

Buyouts involve a time-frame from investment to public offering of one to three years with low risk perception.

Turnarounds These are a sub-set of buyouts and involve buying the control of a sick company. Two kinds of inputs are required in a turnaround–namely, money and management. The VCIs have to identify good management and operations leadership. Such form of venture capital financing involves medium to high risk and a time-frame of three to five years. It is gaining widespread acceptance and increasingly becoming the focus of attention of VCIs.

> **Turnarounds** involve buying the control of a sick company.

To conclude, venture capital firms finance both early and later stage investments to maintain a trade-off between risk and profitability. In early stage investment, particularly start-ups in high-technology industries, the technology is often untried at a commercial level of operation, market is undeveloped and potential competition is unknown as the product itself is new. Apart from the evaluation of the technology and the likely market, the most important factor to be considered by VCIs is the capability of the promoter/entrepreneur to implement the project with a reasonable chance of success.

In later stage investments, the technology has already been tried out commercially, the products have been introduced in the market and the business/entrepreneur has a track record which is closely examined by the VCIs.[7]

Financial Analysis[8] Venture capital investments are generally **idea-based** and **growth-based** in contrast to the conventional investments which are **asset-based**. While the latter type are generally valued on the basis of tangible assets/future earnings streams, the former have to be in the nature of things valued differently in order to decide the required venture capital percentage ownership of the VCIs in venture capital undertaking. Some of the valuation methods which illustrate the approach that VCIs can adopt are: **(i)** conventional venture capitalist valuation method, **(ii)** the first Chicago method and **(iii)** the revenue multiplier method.

> **Conventional method** is a method of valuation of venture capital undertakings which takes into account only the starting time of investment and the exit time.

Conventional Venture Capitalist Valuation Method This method of valuation of venture capital undertakings (VCUs)/investee companies (ICs) takes into account only two points of time in the life of the venture capital investment, namely, the starting time of investment and the exit time when the investments would be liquidated through sale to public/third party and so on. The sequence of steps in the valuation of the VCUs and the determination of the percentage share ownership of the VCIs in the ICs are:

(i) To compute the annual revenue at the time of liquidation of the investments, the present annual revenue in the beginning is compounded by an expected annual growth rate for the holding period, say, seven years;

(ii) Compute the expected earnings level, that is equal to future earnings level multiplied by after tax margin percentage at the time of liquidation;

(iii) Compute the future market valuation of the VCU, that is equal to earnings levels multiplied by expected P/E ratio on the date of liquidation;

(iv) Obtain the present value of the ICs, using a suitable discount factor; and

(v) If the present value of the VCU is ₹50 lakh and the entrepreneur wants ₹20 lakh as the venture capital from the VCIs, the minimum percentage of ownership required is two-fifths (40 per cent).

The weakness of this method is that it ignores the **stream** of earnings (losses) during the entire period and over-emphasises the one exit date.

The first chicago method considers the entire earnings stream of the venture capital undertaking.

The First Chicago Method This method is an improvement over the conventional method of valuation to the extent it gives allowance to the **nature** of the **path** between the starting point and the exit point/date and considers the entire earnings stream. The steps involved in the valuation process are:

(i) Three alternative scenarios, are perceived/considered, namely, '**success**', '**sideways survival**' and '**failure**'. Each one of these is assigned a probability rating;

(ii) Using a discount rate, the discounted present value of the VCU is computed. The discount rate is substantially higher to reflect risk dimension.

(iii) The discounted present value is multiplied by the respective probabilities. The expected present value of the VCU is equal to the total of these in the three alternative scenarios.

(iv) Assuming expected present value of the VCU at ₹5 crore and the fund requirement from the VCIs as ₹2.5 crore, the minimum ownership required is 50 per cent (half).

Revenue Multiplier Method A revenue multiplier is a factor that can be used to estimate the value of a VCU. By multiplying that factor the annual revenue of the company is estimated by VCIs. Symbolically,

$$M_t = \frac{V}{R} = \frac{(1+r)^n\,(a)\,(p)}{(1+d)^n}$$

Where,

V = present value of the VCU
R = annual revenue level
r = expected annual rate of growth of revenue
n = expected number of years from the starting date to the exit date (holding period)
a = expected after-tax profit margin percentage at the time of exit
P = expected price/earnings (P/E) ratio at exit time
d = appropriate discount rate for a venture investment at this stage, risk and other relevant factors

This method can be used in the case of early stage/start-up venture capital investments when earnings, based on after-tax profits, may be low/negative in early years but there may be revenue/sales income. However, the technique requires a wealth of data which may not be available in a country like India at this stage of the growth of VCFs. Where it is difficult to estimate the revenue multiplier, the Chicago method would give better results than the conventional valuation method.

Structuring the Deal/Financial Instruments The structuring of the deal refers to the financial instruments through which venture capital investment is made. The availability of a wide variety of financial instruments provides considerable flexibility in structuring a venture capital deal. From the point of view of nature, the financial instruments a VCI can choose from, can be broadly divided into equity and debt instruments.

Equity Instruments **(1)** Ordinary equity shares; **(2)** Non-voting equity shares which are entitled to a higher dividend but carry no voting rights; **(3)** Deferred ordinary shares on which the ordinary share rights are deferred for a specified period/until the happening of a certain event such as listing of shares on the stock exchange or the sale of the company; **(4)** Preferred ordinary shares. In addition to the voting rights, such shares also carry rights to a modest fixed dividend; **(5)** Equity warrants entitle investors in debentures/bonds to acquire ordinary shares at a future date; **(6)** Preference shares; **(7)** Cumulative convertible preference shares which are converted into equity shares after a specified time; **(8)** Participating preference shares which, in addition to the preference dividend, are entitled to an extra dividend after the payment of dividend to the equity shareholders; **(9)** Cumulative convertible participatory preferred ordinary shares combine the benefit of preferred dividend and cumulative as well as participative features and **(10)** Convertible cumulative redeemable preference shares have two elements, namely, convertibility into equity at specified point of time and redeemability on the expiry of a certain period. The redeemable part carries a fixed coupon rate by way of preference dividend. Of the types of equity-linked financial instruments, the equity warrants, non-voting equity shares and cumulative convertible participating preferred ordinary shares can be used to structure a flexible venture capital deal.

Debt Instruments To ensure that the entrepreneur retains managerial control and the VCI receives a running yield during the early years when the equity portion is unlikely to yield any return, debt instruments are also used by VCIs. They include, in addition to conventional loans, income notes, non-convertible debentures, partly convertible debentures, fully convertible debentures, zero interest bonds, secured premium notes and deep discount bonds.

Conditional loan is a quasi-equity instrument without any predetermined repayment schedule or interest rate; the charge is a royalty on sales.

Conditional Loan This is a form of loan finance without any pre-determined repayment schedule or interest rate. The suppliers of such loans recover a specified percentage of sales towards the recovery of the principal as well as revenue in a pre-determined ratio, usually 50:50. The *charges on sales* is known as **royalty**. The investor stands to gain/lose depending on whether the actual sales are higher/lower than the projected sales. Conditional loan, in a sense, is *quasi-equity* instrument.

Conventional Loans These are modified to the requirements of venture capital financing. They carries lower interest initially which increases after commercial production commences. A small royalty is additionally charged to cover the interest foregone during the initial years. Although the repayment of the principal is based on a pre-stipulated schedule, VCIs usually do not insist upon mortgage/other security.

Income notes are instruments which carry a uniform low rate of interest plus a royalty on sales.

Income Notes These fall between the conventional and the conditional loans and carry a uniform low rate of interest plus a royalty on sales. The principal is repaid according to a stipulated schedule.

Non-convertible Debentures (NCDs) These carry a fixed/variable rate of interest, are redeemable at par/premium, are secured, and can be cumulative/non-cumulative.

Partly Convertible Debentures (PCDs) These have two components: **(i)** a convertible portion and **(ii)** a non-convertible portion. The convertible portion is converted into equity shares at par/premium. The non-convertible portion earns interest till redemption generally at par. Such instruments are best suited to second round venture capital financing.

Zero Interest/Coupon Bonds/Debentures These can be either convertible or non-convertible with zero/no interest rate. The non-convertible bonds are sold at a discount from their maturity value while the convertible ones are converted into equity shares at a stipulated price and time. They offer considerable flexibility and are an appropriate instrument for later stage venture capital financing.

Secured Premium Notes These are secured, redeemable at premium in lumpsum/instalments, have zero interest and carry a warrant against which equity shares can be acquired. This instrument is also useful for later stage financing.

Deep Discount Bonds These are issued at a large discount to their maturity value. As a long-term instrument, these are not suited to venture capital investment.

Investment Nurturing/Aftercare

Unlike the conventional financial institutions, which normally keep aloof from the management and operations of the assisted concerns, VCIs have an active, intimate and constant ongoing involvement during the entire life of the investment in VCUs. The enduring relationship between the VCIs and VCUs and the active role by the former in the management of the latter is termed as **investment nurturing/after care**. The main elements of after care are: **(i)** after the stage of investment decision, provision of continuing guidance and support to optimise the benefits of investment to both–VCIs and VCUs, **(ii)** building of joint relationship to tackle operational and other problems of business and **(iii)** protection of the investment/interest of the VCIs. Investment nurturing differs from the investment monitoring by the conventional financial institutions which collect and use specific information about the operations of the assisted project, whereas the former is wider in coverage to include the provision of guidance and skills for the management of the venture. The after care stage of venture capital financing relates, *inter alia*, to different styles of nurturing, its objectives and techniques.

Styles The styles of nurturing refers to the extent of participation by VCIs in the affairs of VCUs. The style depends upon a variety of factors such as the specialisation of the VCI, stage of investment, financing plan, the stage of the development of the venture capital industry itself and so on. It broadly falls into three categories: **(i)** hands-on, **(ii)** hands-off and **(iii)** hand-holding.

Hands-on Nurturing It refers to continuous and constant involvement in the operations of the investee company which is institutionalised in the form of representation on the board of directors. With wider exposure and experience, VCIs can provide useful guidance on aspects of long-term business planning, technology development, financial planning, marketing strategy and so on. The hands-on care style is useful/essential in early stage financing, i.e., seed capital and start-up investments. This type of care is provided either by the in-house expertise or by a core group of external advisors/experts in specific areas if the former is not available in all types of projects.

> **Head-on nurturing** is a continuous and constant involvement in the operations of the venture capital company by the venture capital institution which is institutionalised in the form of representation on the Board of Directors.

Hands-off Nurturing VCIs play a relatively passive role in the hands-off style. Although they usually reserve the right, they rarely have nominee directors on the board of the VCUs. Normally, they do not actively participate in formulating strategies/policy matters in spite of the right to do so. This type of nurturing style is appropriate in case of syndicated/joint/consortium venture financing in which some financiers may follow the hands-on approach while others may follow the hands-off approach. The hands-off style may also be appropriate after the initial plan of the venture is over and the business is running smoothly.

> **Hand-off nurturing** is the passive role played by the venture capital fund in formulating strategies/policy matters.

Hands-holding Nurturing This is mid-way between hands-on and hands-off styles. It is, essentially, a reactive approach. Like the hands-on style, the VCI has the right to have a nominee on the board of directors of the VCU, but actively participates in the decision-making process only on being approached by the latter. If the VCU experiences any difficulty, the VCI provides either in-house assistance or assistance from outside experts.

Objectives of Aftercare[9] The objectives of nurturing by VCIs, *inter alia*, are:

(i) To ensure the proper utilisation of assistance provided. Any deviation from the programme/appraisal should be within the prior approval of the VCI;
(ii) To ensure the implementation of the project/venture within the time and costs envisaged;
(iii) In case of time and cost overruns beyond the control of the VCU, to assist in finding additional/supplementary finance;
(iv) To provide strategic inputs in technology production, finance, marketing, personnel and so on;
(v) To anticipate likely problems and advise preventive/remedial actions;
(vi) To ensure that the venture does not default in any statutory/other obligations;
(vii) To evaluate the performance of the project and suggest measures for improvement, if required;
(viii) To use the feedback received during the course of nurturing the investment for studying the problems and finding suitable solutions; and
(ix) To utilise the experience gained for a better appraisal of new ventures.

Techniques VCIs follow systematic techniques to achieve the foregoing objective. Some of the important techniques are briefly discussed below.

Personal Discussions One technique for obtaining information from a VCU is personal/informal discussion with the entrepreneur(s). Though the information, thus, collected does not have any formal sanctity, it provides the most comprehensive and effective insight into the working of the venture. This technique is especially useful when the venture is facing operational problems.

Plant Visits These refer to the collection of information from on the spot visit of the plant site. In the case of ventures at the implementation stage, the purpose of plant visit is to review the progress of the project, to see that adequate and well-qualified personnel have been appointed for its implementation, to ensure that the requisite sanctions are obtained for funds from other sources, if necessary, and to check if the venture has initiated action for obtaining working capital from banks. For projects which are complete and on which production has started, the plant visit technique examines, *inter alia*, the following aspects:

- The staffing pattern of the production, marketing, finance and personnel departments;
- Operational performance of the project;
- Marketing aspects with special reference to product acceptance, market penetration, distribution, pricing, product awareness, advertising, competition and so on;
- Management of accounts with special reference to overdues of receivables;
- Proper costing of products and efficient control of inventory;
- Position regarding statutory liabilities; and
- Labour relations.

Feedback Through Nominee Directors The nominee directors not only protect the interest of the VCIs, but they are also expected to effectively contribute to the management and provide requisite guidance. They should also ensure that the business is run on a sound basis. Moreover, they should be able to anticipate problems and suggest solutions. The nominee directors should, therefore, have a good exposure to industry, have adequate knowledge about technological development, changes in Government policies, financial management, laws, regulations and so on.

Periodic Reports VCIs should receive periodic reports about the operations of projects. These should be properly analysed. The projected and actual performance should be compared and analysed and follow-up action initiated.

Commissioned Studies If VCUs are not performing well/experiencing difficulties which cannot be solved by VCIs themselves, special studies may be commissioned to identify problems and offer solutions so that preventive action may be taken.

Valuation of Portfolio[10]

The venture capital portfolio has to be valued from time to time to monitor and evaluate the performance of the venture capital investment, that is, whether there has been an appreciation in the value of the investment or otherwise. The portfolio valuation approaches/techniques depend on the type of investments, namely, equity and debt instruments. These, in turn, depend on the stage of investment: seed, start-up, early and later stages of the venture.

Equity Investments The valuation methods for equity instruments of VCUs are: **(i)** cost method, and **(ii)** market value-based methods.

Cost Method According to this method, the value of equity holding is computed/recorded at the historical cost of acquisition until it is disposed of. Although simple, objective, and easy to understand, it does not indicate a fair value of investment, does not reflect management performance and may result in two values for equity acquired at two different points in time. It does not provide a satisfactory basis of valuation of venture capital investments.

Market Value-based Methods Such methods can be divided into: **(i)** quoted market value, **(ii)** fair market value and **(iii)** others. They are conceptually superior to the cost method.

Quoted Market Value Method This is based on market quotations of securities. It is, therefore, relevant only to organisations listed on stock exchanges. Moreover, market values may not be available for infrequently traded shares. In addition, if the holdings of VCIs are substantially large, the realisable value on the market may be considerably lower than the quoted valued. In the foregoing situations, the market value may not reflect the real/true valuation. Therefore, an appropriate discount should be applied to the quoted price while valuing the portfolio. This approach is better than the cost-based approach for evaluation of a venture portfolio.

Fair Market Value Method This considers the fair price as the basis of portfolio valuation and is used where the quoted market value does not reflect the correct value of the venture capital investment. The fair value refers to the price that would be agreed upon in an open and unrestricted market between fully informed, knowledgeable and willing parties at an arm's length without constraint. It is, thus, a subjective value.

> **Fair value**
> is the price to be agreed upon in an open and unrestricted market between parties and equationally expressed as a representative lavel of earnings multiplied by an appropriate capitalisation rate.

This approach to valuation of venture capital investments is based on the assumption that *assets are worth what they can earn*. In operational terms, a representative rate level of earnings is selected and capitalised by an appropriate multiplicity/capitalisation rate which provides a reasonable return on the basis of the estimated future earnings and degree of risk.

Stages of Investments As pointed out earlier, the methods of portfolio valuation of shares depend on the stage of venture capital investments. From the viewpoint of stages of investments, the equity investments fall into three broad categories:

Unquoted Venture Investments Unquoted venture investments are defined as investments in immature companies, namely, seed, start-up and early stage, until the companies stabilise and grow. They should generally be valued at cost as their market value is not available. They may, however, have to be written up (valued at higher than cost) or written down in (assigned a lower value than cost) exceptional circumstances/cases.

The unquoted venture investments can be written up in cases where a third party with arm's length relationship with the VCU values it at a significantly higher value which may be taken to represent the value of the investment. They can also be valued at a price higher than the cost when the operating results are significantly higher than those projected originally. The investment should be valued using an appropriate P/E ratio and suitably adjusted/discounted to account for the unquoted nature of investments as well as the relatively short profit-earning record of the venture. However, care should be taken while upvaluing investment that the venture has started generating a reasonable turnover and independent third party transactions have taken place.

Investments should be written down if the venture is facing long-term problems, requires additional finance or the operating results are substantially below the original projections or a third party with an arm's length relationship values it at less than the original cost. However, undervaluation should be revalued as early as justified.

Unquoted Development Investments Unquoted development investments are investments in mature companies with a profit record and where an exit can be reasonably foreseen. They also do not have a market value. The basis of valuation should be somewhat similar to unquoted venture investments, based on a suitable P/E ratio applied to earnings of the venture, suitability discounted to take care of the limited marketability of the unquoted nature of the investment. The discount would depend upon the subjective judgement of the valuer but should generally vary between 20 and 25 per cent depending on various factors. The percentage of discounts would depend on the proximity to the exit point: *a lower discount when prospects of an exit are foreseen early and a higher discount if it is likely to be delayed.*

Quoted Investments Quoted investments in companies which have achieved a possible exit by floatation of issues. They are valued at market quotations. In case of restrictions/limitations on the sale of shares, a suitable discount should be applied to the market value of the shares. The rate of discount would depend on the size and depth of the market, the period of applicability of restrictions, the holdings of VCIs relative to public holdings, restrictions in any buy-back agreement with promoters and statutory restrictions.

Debt Instruments VCIs provide, in addition to equity capital, debt finance. From the point of view of their valuation as a part of the overall portfolio (fund), they are divided into **(i)** convertible, **(ii)** non-convertible and **(iii)** leveraged.

Convertible Debt Debt instruments are generally valued at cost. But convertible debts are converted into equity at a specified price and time. They should, therefore, be valued in the case of VCIs on the same basis as equity investments. There are two appropriate methods for valuing them, that is, market value method and fair value method.

Market Value Method This is appropriate for quoted convertible debt investments on the basis of the same principles as are applicable to quoted investments. A modified/refined version of this approach is the use of the moving average/weighted average of the market values of the investments at the end of a pre-determined number of periods as the basis of valuation of convertibles. The merit of this modification is that it retains the benefit of market value method and, at the same time, the effects of temporary fluctuations are minimised as the average value represents the long-term value of investment. The market value method, however, underestimates the net realisable value in a growing VCU.

Fair Value Method This is appropriate, as in the case of unquoted equity investments, for unquoted convertible debt investments. As pointed out earlier, the valuation according to this method is based on the price agreed upon in an open and unrestricted market. This is a subjective method as the valuation is significantly influenced by judgement and experience.

Non-convertible Debt This debt supplied by VCIs can be of two types: fixed interest bearing such as bonds/debentures and mortgages and non-interest bearing such as zero interest bonds and secured premium notes.

Fixed Interest Non-convertible Debt This should be valued by relating the nominal yield of the investment to an appropriate current yield which depends upon a number of factors such as interest yield on the date of valuation, maturity date of the issue, safety of the principal, debt-service coverage, stability and growth of the earnings of the venture and so on.

Non-interest Non-convertible Debt A factor of critical importance in this case is the solvency of the venture. If it is doubtful, an appropriate discount rate may be used to the value computed according to the method used for valuating fixed interest non-convertible debt.

Highly Leveraged Investments These should, generally, be valued at cost.

Structural Aspects[11]

The structuring of VCIs is important from the viewpoint of the profitability of such organisations and their contributors and participants. While deciding upon a structure, the objectives generally sought are:

- Limited liability of investors;
- Simple operation of funds;
- Tax transparency of the fund in the sense that double taxation is avoided;
- Tax exemption of the **carried interest** defined as the extra incentive/profit to the managers over and above the share attributed to their capital contribution and the management fee;
- Maximum tax benefits to investors.

The alternative forms in which VCIs can be structured are: **(i)** limited partnership, **(ii)** investment company, **(iii)** investment trust, **(iv)** offshore funds and **(v)** small business investment company.

Limited partnership consists of two types of partners **(i)** limited liability and **(ii)** unlimited liability.

Limited Partnership Normally, the partnership form of organisation/structure has unlimited liability of partners. Limited partnership has evolved to cater to the needs of venture capital industry in the USA as the most favoured method of their structuring but is, relatively, less popular in the UK. Limited partnership consists of two types of partners: general and limited. The general partner, whose liability is unlimited, invites other investors to become limited partners in the partnership with limited liability and invest but do not participate in the actual operations of the business.

The general partners can be individuals, a corporate body or a partnership. In other words, a venture capital organisation can be structured as a limited partnership and one more partnership acting as the general partner can be formed. As an alternative to the second partnership, the general partners as individuals may set up a service corporation to discharge the functions of the general partner on payment of fee. The main functions of the general partners/service corporations are: **(i)** business identification and development, **(ii)** investment appraisal and investigation of potential investment, **(iii)** negotiation and closing of deals, **(iv)** investment monitoring, advice and assistance to VCUs; **(v)** arrangement for sale of shares at the exit time and **(vi)** other fund management functions.

Mode of Compensation The general partner/service corporation as a fund manager is compensated in two ways: **(1)** annual management fee, **(2)** carried interest.

Annual Management Fee This covers the normal operating expenses such as salary and allowances of employees, administrative expenses and all expenses related to the selection of investments as well as disinvestments but excludes legal expenses and professional fee related to investment portfolio which are reimbursed separately. It is generally two to three per cent of the net asset value (NAV) or the capital of the fund, the latter being the more preferred basis.

Carried interest is the gain received by the general partner in a limited partnership.

Carried Interest The most popular approach is that the general partner contributes one per cent and the limited partners contribute 99 per cent of the capital of the fund. The general partner normally receives one-fifth of the net gains as carried interest while the remaining four-fifths is distributed among the limited partners.

Evaluation The benefit of limited partnership, as a form of structuring of VCIs, is its tax treatment. The profit of limited partnership is taxed only at the level of the partners. It is completely tax free if the partner is a tax free entity such as pension funds. The second advantage is operational in the sense that the fund managers are entitled to an incentive in the form of carried interest. However, a major drawback is the unlimited liability of the general partner. Moreover, he is liable to tax on gains on sale of investments, whether distributed or not. Nevertheless, on balance, the advantages outweigh the disadvantages and limited partnership emerges as a satisfactory form of venture capital organisation.

Investment Company This is organised as a limited company. Although it is the simplest structure for a VCI, a serious drawback is the double taxation of income. Both the investment company and its shareholders are liable to tax on their respective incomes.

Investment Trust This is a company and is, generally, not liable to tax on chargeable gains/dividends but most of the other income of the trust is taxable. The entitlement to tax concessions is subject to certain stipulations such as income should be derived wholly/mainly from investment in shares/securities, holding in any single company other than another investment trust should not exceed 15 per cent of the value of the investment, the shares are listed, it distributes at least 85 per cent of the income from shares/securities and so on.

Offshore Investment Company This is incorporated in a country other than the country in which the offshore company makes an investment. Its tax liability depends on the tax laws applicable to the resident status of the company.

Offshore Unit Trust This resembles an offshore investment company in organisation but enjoys tax concessions and has a very flexible structure.

Small Business Investment Company This provides an impetus to banks to participate in ventures in the form of equity and long term debt. It can, however, invest only in small concerns. It is prohibited from investing more than 20 per cent of its capital and reserves nor is it allowed to acquire controlling interest in a single company. The loans must be for more than five years. It has a very flexible structure of equity investments.

Exit

The last stage in venture capital financing is the exit to realise the investment so as to make a profit/minimise losses. In fact, the potential exit in terms of the realisation horizon (exit timing) has to be planned at the time of the initial investment itself. The precise timing of exit depends on several factors such as nature of the venture, the extent and type of financial stake, the state of actual and potential competition, market conditions, the style of functioning as well as perception of VCIs and so on. For example, early stage financing typically takes a long-term view of eventual realisation/exit from five to seven years. In case of later stage financing, the realisation horizon could be shorter in the range of three to five years.

The important aspect of the exit stage of venture capital financing is the decision regarding the disinvestments/realisation alternatives which are related to the type of investment, namely, equity/quasi-equity and debt instruments.

Disinvestments of Equity/Quasi-Equity Investments There are five disinvestment channels for realisation of such investments: **(i)** going public, **(ii)** sale of shares to entrepreneurs/employees, **(iii)** trade sales/sale to another company, **(iv)** selling to a new investor and **(v)** liquidation/receivership. The first four alternative routes are voluntary while the last one is involuntary.

Going Public/Initial Public Offering/Flotation The most common channel of disinvestment by a VCI is through public issue of capital of the VCU, including its own holdings. The merits of public issues are liquidity of investments through listing on stock exchanges, higher price of securities compared to private placement, better image and credibility with public, managers, customers, financial institution and so on. However, companies going public are subject to reporting requirements, stock exchange regulations and disclosure requirements; the cost of issue is higher; the accountability to shareholders' increases and so on.[12] On the whole, public issue method is the most popular exit route for VCIs.

Related to the public issues method is the OTCEI route. A VCI can exit by way of a boughtout deal to a member of the OTCEI who would offer the shares thus acquired to the public at a future date.

Sale of Shares to Entrepreneurs/Employees/Earnout The shares/stakes of VCIs may be sold to the entrepreneurs/companies themselves who are allowed to buy their own equity. Alternatively, the entrepreneurs can acquire the shares from VCIs through employees by forming an **employees stock ownership trust**. The sources of the trust to acquire the shareholding of the VCIs are contribution by the employees/company and borrowing from financial institutions and banks.

> **Earnout**
> is the sale of shares/stake of venture capital institution to entepreneurs/investee companies themselves.

A related alternative is **exit by puts and calls** when VCIs may have entered into a formal exit agreement at a price based on a pre-determined formula with the entrepreneurs. The **put option** is the right to sell while the **call option** is the right of the entrepreneurs to buy. This is a fairly popular exit route. The important put-and-call formulae are:

Book Value Method This is used in mature companies that have achieved a healthy track record, that is they have achieved a reasonable degree of stability in operations.

P/E Ratio This is the most common method for exercising the put and call option. The price is equal to the earnings per share multiplied by the P/E ratio.

Percentage of Sales Method This is a modified P/E ratio. On the basis of the pre-tax earnings/profit before tax as a percentage of sales for the industry, the hypothetical/notional profit before tax for the investee company is determined as also the earnings per share. The value of the shares is obtained by multiplying the notional earnings per share with the industry P/E ratio. This method is suitable in the early stages when profits are lower but the sales have reached a reasonable level.

Multiple of Cash Flow Method In this, cash flow is used in place of the earnings or sales. The cash flow is multiplied by the industry multiplier to arrive at the value of the company/shares.

Independent Valuation This is valuation by outside experts on the basis of either earnings potential method/price-earnings ratio method or the liquidation method. On the assumption of liquidation a VCU, the net value is computed on the basis of the net/realisable value of all the assets less the liabilities.

Agreed Price This is the price between the VCIs and the entrepreneur agree on at the time of making the investment itself.

Trade sale implies the sale of the entire investee company to another company/ third party.

Trade Sales The entire company is sold to another company/third party. Highly popular method, at times the trade sales may be through a management buyin or buyout. The most appropriate method for such a sale would vary from one case to another, keeping in view taxation and other considerations. The alternative modalities for trade sales are:

(i) Cash sales of equity ownership of both the parties which would attract heavy tax burden.
(ii) Against issue of notes secured by the assets of the buyer company and receive cash in pre-determined instalments in order to ensure proper tax planning.
(iii) In consideration for the shares of the buying company with no tax liability.

Takeout is the sale of the equity stake of a venture capital institution to a new investor including another venture capital fund.

Sales to a New Investor/Takeout The equity stake of VCIs can be sold to a new investor who may be a corporate body or even another venture capital organisation. The corporate investor may acquire the stake to develop a business relationship due to considerations of synergy of operations. The purchase of the equity holdings of a VCI by another VCI may be related to the nature of the business objectives of the original VCI. For instance, he may have financed an early stage venture and may like to exit after its operations have stabilised. For second round financing, he may sell his equity to another VCI which is willing to provide financing to the venture.

Liquidation This is an involuntary exit forced on the VCI as a result of a totally failed investment. The VCIs can use this exit method when the venture is not performing well and has reached a stage beyond recovery due to stiff competition, technology failure/obsolescence of technology, poor management and so on.

Exit of Debt Instruments Exit in case of debt component of venture capital financing, in contrast with equity/quasi-equity component, has to normally follow the pre-determined route. In case of a normal loan, the exit is possible only at the end of the period of loan. If the loan agreement permits, whole or part can be converted into equity prior to that. For conditional loans, exit, earlier than projected at the time of initial investment, is possible on the basis of lumpsum repayment consistent with the expectations of the VCI of the likely return on the loan.

INDIAN VENTURE CAPITAL SCENARIO

The venture capital industry in India is of relatively recent origin. Before its emergence, the development finance institutions (DFIs) had been partially playing the role of venture capitalists by providing assistance for direct equity participation to ventures in the pre-public issue stage and by selectively supporting new technologies. The need for venture capital in the country was felt around 1985 when a lot of investors burnt their fingers by investing in fledging enterprises with unproven projects which were not yet commercialised after the setback in the stock markets and the amendment in the Securities Contracts Regulation Act barring companies having an equity capital of less than ₹3 crore from being listed on stock exchanges. Against the background of these two developments, the creation of a venture capital fund on an experimental basis was announced in the document on Long-Term Fiscal Policy presented in Parliament by the Ministry of Finance in December, 1985. The concept was operationalised only in the fiscal budget for 1987-88 when a cess of up to 5 per cent was introduced on all technology import payments to create a pool of funds. Until recently, a part of the pool of funds was being drawn by the Industrial Development Bank of India (IDBI) for providing financial assistance under its venture capital fund scheme.

Although the DFIs started coming with venture capital schemes as early as 1986 to provide finance to technology-based entrepreneurs for their research and development efforts at innovative products/processes, the real thrust was provided by the Finance Minister in the budget speech for 1988-89 announcing the formulation of a scheme under which venture capital funds (VCFs)/venture capital companies (VCCs) would be enabled to invest in fledgling enterprises and be eligible for concessional treatment of capital gains to non-corporate entities. This was followed by the issuance of comprehensive guidelines on November 25, 1988 by the Controller of Capital Issues (CCIs) for setting up of VCFs/Cs for investing in unlisted companies and to avail of concessional facility of capital gains tax. These guidelines construed venture capital rather narrowly as a vehicle for equity-oriented finance for technological upgradation and commercialisation of technology promoted by relatively new entrepreneurs. Yet, they institutionalised the venture capital concept which received official recognition through them. Consequent upon the empowerment of the Securities and Exchanges Board of India (SEBI) in April 1995 to regulate VCFs/Cs, the guidelines issued by the CCI became dysfunctional and were repealed on July 25, 1995.

In recognition of the growing importance of venture capital as one of the sources of finance for the Indian industry, particularly for the smaller, unlisted companies, the Government of India announced a policy governing the establishment of domestic VCFs/Cs. Till 1995, they were paying a 20 per cent tax on capital gains from investments. During the budget speech for 1995-96, the Finance Minister announced exemption from tax on income by way of dividends and long-term capital gains from equity investment made by approved VCFs/Cs in unlisted companies in the manufacturing sector, including software units but excluding other service industries. However, the income in the hands of their shareholders was to be fully taxable. The VCFs were brought, from the viewpoint of tax, at par with the mutual funds. To operationalise these, the Central Board of Direct Taxes (CBDT) notified a scheme on July 18, 1995. Moreover, with a view to augment the availability of venture capital, the Government of India issued guidelines on September 20, 1995, for overseas venture capital investment in India. The SEBI Venture Capital Fund Regulations were issued in 1996. During his budget speech for 1996-97, the Finance Minister announced that VCCs would exercise voting rights in the assisted concerns. Recognising the acute need for higher investment in venture capital activities, SEBI appointed the Chandrasekhar Committee to identify the impediments in the growth of venture capital industry in the country and suggest suitable measures for its rapid growth. The recommendations of the panel had been accepted in principle and those concerning SEBI had been implemented.

Other recommendations relating to Government/RBI/CBDT had been pursued by SEBI. The venture capital funds were regulated by the **(i)** SEBI Venture Capital Funds Regulation, 2000 and **(ii)** SEBI Foreign Venture Capital Investors Regulation Act, 2000. The SEBI Alternative Investment Fund Regulations, 2012 has replaced the SEBI VCF Regulations. The salient features of the regulatory framework in terms of these two SEBI regulations are discussed in this Section.

AIF means any fund established/incorporated in India in the form of a trust/company/limited liability partnership/body corporate which is **(i)** a privately pooled investment vehicle and collects funds from Indian/foreign investors for investing in accordance with a defined investment policy for the benefit of its investors, and **(ii)** not covered under the mutual fund/other regulations of the SEBI to regulate fund management activities.

SEBI Alternative Investment Funds Regulation, 2012

Alternative Investment Fund (AIF) means any fund established/incorporated in India in the form of a trust/company/limited liability partnership/body corporate which is **(i)** a privately pooled investment vehicle and collects funds from Indian/foreign investors for investing in accordance with a defined investment policy for the benefit of its investors, and **(ii)** not covered under the mutual fund/other regulations of the SEBI to regulate fund management activities. However, it excludes: **(i)** family trusts set up for the benefit of relatives, **(ii)** ESOP (employees stock option plans) trusts, **(iii)** employee welfare/gratuity trusts, **(iv)** holding companies, **(v)** other special purpose vehicles (SPVs) including securitisation trusts, **(vi)** funds managed by a securitisation/reconstruction company, and **(vii)** any such pool of funds directly regulated by another regulator in India. The main elements of the SEBI regulation relating to AIFs, namely, **(a)** registration, **(b)** investment conditions/restrictions, **(c)** general obligations and responsibilities and transparency, **(d)** inspection, and **(e)** procedure for action in case of default are discussed in this Section.

Registration of Alternative Investment Funds (AIFs) To set-up an **AIF**, an entity/person has to obtain a certificate of registration from the SEBI. However, the funds registered as venture capital fund under SEBI Venture Capital Funds Regulations, would continue to be regulated by the respective regulations till the existing fund or scheme managed by the fund is wound up and such funds would not launch any new scheme. Moreover, the existing fund or scheme would not increase the targeted corpus of the fund or scheme. The venture capital funds may seek re-registration as AIFs subject to approval of two-thirds of their investors by value of their investment. The AIFs can seek registration in one of the three categories: **(i)** I, **(ii)** II, **(iii)** III.

Venture capital fund means an alternative investment fund which invests primarily in unlisted securities of start-ups, emerging/early-stage venture capital undertakings mainly involved in new products/services, technology/intellectual property right based activities/a new business model.

"**Category I AIF**" which invests in start-up or early stage ventures/social ventures/small and medium enterprises (SMEs)/infrastructure/other sectors or areas which the Government/regulators consider as socially/economically desirable and would include venture capital funds, SME funds, social venture funds, infrastructure funds and such other specified alternative investment funds. The **AIFs** which are generally perceived to have positive spillover effects on economy and for which the SEBI/Government of India/other regulators in India might consider providing incentives/concessions would be included and such funds which are formed as trusts/companies would be construed as "venture capital company/fund" as specified under the Income Tax Act. **Venture capital fund** means an alternative investment fund which invests primarily in unlisted securities of start-ups, emerging/early-stage venture capital undertakings mainly involved in new products/

new services, technology/intellectual property right based activities/a new business model. **Venture capital undertaking** means a domestic company which is **(i)** not listed on a recognised stock exchange in India at the time of making investment; and **(ii)** engaged in the business for providing services, production/manufacture of article/things and does not include the following activities/sectors: **(1)** non-banking financial companies; **(2)** gold financing; **(3)** activities not permitted under industrial policy of Government of India; and **(4)** any other activity which may be specified by the SEBI in consultation with the Government of India from time to time. **SME fund** means an alternative investment fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed/proposed to be listed on a SME exchange/SME segment of an exchange.

Venture capital undertaking means a domestic company which is (i) not listed on a recognised stock exchange in India at the time of making investment; and (ii) engaged in the business for providing services, production/ manufacture of article/ things.

SME fund means an alternative investment fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed/proposed to be listed on a SME exchange/SME segment of an exchange.

Social venture means a trust/society/company/venture capital undertaking/limited liability partnership formed with the purpose of promoting social welfare/solving social problems/providing social benefits and includes: **(i)** public charitable trusts registered with the charity commissioner; **(ii)** societies registered for charitable purposes/promotion of science, literature/fine arts; **(iii)** company registered under Section 25 of the Companies Act; **(iv)** micro finance institutions. **Social venture fund** means an alternative investment fund which invests primarily in securities/units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns. **Infrastructure funds** invest primarily in unlisted securities/partnership interest/listed debt/securitised debt instruments of investee companies/SPVs engaged in or formed for the purpose of, operating/developing/holding infrastructure.

Social venture fund means an alternative investment fund which invests primarily in securities/units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns.

Social venture means a trust/society/company/venture capital undertaking/ limited liability partnership formed with the purpose of promoting social welfare/solving social problems/providing social benefits.

Infrastructure funds invest primarily in unlisted securities/partnership interest/listed debt/securitised debt instruments of investee companies/SPVs engaged in. or formed for the purpose of, operating/developing/holding infrastructure.

"Category II AIF" which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-today operational requirements. Funds such as private equity funds/debt funds for which no specific incentives or concessions are given by the Government or any other regulator would be included. **Private equity fund** means an **AIF** which invests primarily in equity/equity linked instruments (i.e. instruments convertible into equity/preference shares, share warrants, compulsorily/optionally convertible debentures) or partnership interests

Private equity fund means an **AIF** which invests primarily in equity/equity linked instruments (i.e. instruments convertible into equity/preference shares, share warrants, compulsorily/optionally convertible debentures) or partnership interests of investee companies (i.e. companies/SPVs/ limited partnership/ body corporate in which an AIF makes an investment) according to the stated objectives of the fund.

of investee companies (i.e. companies/SPVs/limited partnership/body corporate in which an AIF makes an investment) according to the stated objectives of the fund. **Debt fund** is an AIF which invests primarily in debt/debt securities of listed/unlisted investee companies according to its stated objectives.

Debt fund is an AIF which invests primarily in debt/debt securities of listed/unlisted investee companies according to its stated objectives.

"Category III AIF" which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Funds such as hedge funds or funds which trade with a view to make short-term returns or such other funds which are open-ended and for which no specific incentives or concessions are given by the Government or any other regulator would be included. **Hedge funds** employ diverse/complex trading strategies and invest in securities having diverse risks or complex products including listed/unlisted derivatives.

Hedge funds employ diverse/complex trading strategies and invest in securities having diverse risks or complex products including listed/unlisted derivatives.

An application for grant of certificate should be made for any of these categories of ₹1,00,000. The certificate of registration would be valid till the alternative investment fund is wound up. The SEBI may, in the interest of the investors, issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as an alternative investment fund. It may, in order to protect the interests of investors, also appoint any person to take charge of records, documents, securities on specified terms and conditions of such an appointment.

Eligibility Criteria The eligibility criteria for registration as AIF are:

(a) The memorandum of association/trust/partnership deed respectively in case of company/trust/limited liability partnership permits it to carry on the activity of an AIF;

(b) The applicant is prohibited by its memorandum and articles of association/trust/partnership deed from making an invitation to the public to subscribe to its securities;

(c) The instrument of trust in case of a trust-applicant is in the form of a deed and has been duly registered under the provisions of the Registration Act;

(d) The partnership in case of partnership-applicant is duly incorporated and the partnership deed has been duly filed with the Registrar under the provisions of the Limited Liability Partnership Act;

(e) A body corporate-applicant is set up/established under the laws of the central or state legislature and is permitted to carry on the activities of an AIF;

(f) The applicant, sponsor and manager are fit and proper persons based on the criteria specified in **SEBI Intermediaries Regulations**;[@@]

(g) The key investment team of the manager of the AIF has adequate experience, with at least one key personnel having not less than five years experience in advising/managing pools of capital or in fund/asset/wealth/portfolio management or in the business of buying, selling and dealing of securities/other financial assets and has relevant professional qualification;

(h) The manager/sponsor has the necessary infrastructure and manpower to effectively discharge its activities;

(i) The applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style/strategy and proposed tenure of the fund/scheme;

[@@]An account available in Khan, M.Y., *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 4

(j) Whether the applicant or any entity established by the sponsor/manager has earlier been refused registration by the SEBI.

Furnishing of Information The SEBI may require the applicant to furnish any such further information/clarification regarding the sponsor/manager or nature of the fund/fund management activities or any such matter connected thereto to consider the application for grant of a certificate or after registration. If required, the applicant/sponsor/manager would appear before the SEBI for personal representation.

Procedure for Grant of Certificate The SEBI may grant certificate under any specific category of alternative investment fund, if it is satisfied that the applicant fulfills the specified requirements. It would, on receipt of the registration fee (₹5,00,000) grant a certificate of registration. The registration may be granted with such conditions as may be deemed appropriate by the SEBI.

Conditions of Certificate The certificate would, *inter-alia*, be subject to the following conditions. The AIF would **(a)** abide by the provisions of the SEBI Act/regulations; **(b)** not carry on any other activity other than the permitted activities; **(c)** forthwith inform the SEBI in writing, if any information or particulars previously submitted are found to be false or misleading in any material particular or if there is any material change in the information already submitted. Prior approval of the SEBI would be necessary to change category of registration.

Investment Conditions and Restrictions The investment conditions/restrictions relate to: **(i)** investment strategy, **(ii)** investment in AIF, **(iii)** placement memorandum, **(iv)** schemes, **(v)** tenure, **(vi)** listing, **(vii)** general investment conditions, **(viii)** conditions for category I AIF, **(ix)** conditions for category II AIF, **(x)** conditions for category III AIFs and **(xi)** other AIF.

Investment Strategy The AIF should state investment strategy, investment purpose and its investment methodology in its placement memorandum to the investors. Any material alteration to the fund strategy can be made with the consent of atleast two-thirds of unit holders by value of their investment.

Investment in AIF Investment in all categories of AIFs would be subject to the following conditions:

(a) The AIF may raise funds from any Indian, foreign or non-resident Indian investor by way of issue of **units** (i.e. a beneficial interest of the investors in the AIF/a scheme of the AIF including shares/partnership interests);

(b) Each scheme of the AIF would have **corpus** (i.e. total amount of funds committed by the investor in the AIF by way of a written contract/any such document as on a particular date) of atleast twenty crore rupees;

(c) The AIF would not accept an investment of value less than one crore rupees from an investor. In case of investors who are employees or directors of the AIF/manager, the minimum value of investment should be twenty five lakh rupees;

(d) The manager/sponsor would have a continuing interest in the AIF of not less than the lower of 2.5 per cent of the corpus or five crore rupees in the form of investment in the AIF and such interest should not be through the waiver of management fees. For Category III AIF, the continuing interest should be not less than 5 per cent of the corpus or ten crore rupees, whichever is lower;

Units
are beneficial interest of the investors in the AIF/a scheme of the AIF including shares/partnership interests.

Corpus
is total amount of funds committed by the investor in the AIF by way of a written contract/any such document as on a particular date.

(e) The manager/its sponsor should disclose their investment in the AIF to investors;
(f) No scheme of the AIF would have more than one thousand investors. The provisions of the Companies Act would be applicable if the AIF is formed as a company,
(g) The fund would not solicit/collect funds except by way of private placement.

Placement Memorandum Funds would be raised by the AIFs through private placement by issue of information/placement memorandum containing all material information about the AIF and the manager, background of key investment team of the manager, targeted investors, fees and all other expenses proposed to be charged, tenure of the AIF/scheme, conditions/limits on redemption, investment strategy, risk management tools and parameters employed, key service providers, conflict of interest and procedures to identify and address them, disciplinary history, the terms and conditions on which the manager offers investment services, its affiliations with other intermediaries, manner of winding up of the AIF/scheme and such other information as may be necessary for the investor to take an informed decision on whether to invest in the AIF.

Schemes The placement memorandum should be filed with the SEBI atleast thirty days prior to launch of scheme along with the specified fees of ₹100,000. Payment of fees would not be required in case of launch of first scheme by the AIF. The SEBI may communicate its comments, if any, to the applicant who should incorporate them in placement memorandum prior to launch of scheme.

Tenure Category I and Category II AIF would be close-ended and the tenure of fund/scheme would be determined at the time of application subject to a minimum tenure of three years. Category III AIF may be open-ended or close-ended. Extension of the tenure of the close-ended AIF may be permitted up to two years subject to approval of two-thirds of the unit holders by value of their investment. In the absence of consent of unit holders, the AIF should fully liquidate within one year following expiration of the fund tenure/extended tenure.

Listing Units of close-ended AIF may be listed on stock exchange only after final close of the fund/scheme subject to a minimum tradable lot of one crore rupees and permitted.

General Investment Conditions Investments by all categories of AIFs would be subject to the following conditions:
(a) They may invest in securities of companies incorporated outside India subject to such conditions/guidelines that may be stipulated/issued by the RBI/SEBI;
(b) Co-investment in an **investee company** (i.e. company/special/purpose vehicle/limited liability partnership/body corporate/real estate/infrastructure investment trust) by a manager/sponsor would not be on terms more favourable than those offered to the AIF;
(c) Category I and II AIFs should invest not more than 25 per cent and Category III 10 per cent of the investible funds in one investee company; (i.e. a company/SPV/limited liability partnership/body corporate/real estate/infrastructure investment trust)
(d) The AIFs should not invest in **associates** (i.e. a company/limited liability partnership/body corporate in which a director/trustee/partner/sponsor/manager of the AIF or director/partner of the manager/sponsor holds individually/collectively more than 15 per cent of its paid-up equity share capital/partnership interest) except with the approval of 75 per cent of investors by value of their investment;

> **Associates** is a company/limited liability partnership/body corporate in which a director/trustee/partner/sponsor/manager of the AIF or director/partner of the manager/sponsor holds individually/collectively more than 15 per cent of its paid-up equity share capital/partnership interest.

(e) The un-invested portion of the investible funds may be invested in liquid mutual funds/bank deposits/other liquid assets of higher quality such as T-bills, CBLOs, CPs, CDs, till deployment of funds as per the investment objective;

(f) The AIFs may act as nominated investor as specified in SEBI Issue of Capital and Disclosure Requirements Regulations. **(discussed in Chapter 11).** The SEBI may specify additional requirements/criteria for AIF/for a specific category.

(g) Investments by category I/II AIFs in the shares of entities listed on institutional trading platform would be deemed to be investment in unlisted securities.

Conditions for Category I AIF *(a)* The following investment conditions would apply to all Category I AIFs:

They should invest in investee companies/venture capital undertaking/special purpose vehicles/limited liability partnerships/units of other AIFs. They may invest in units of Category I AIFs of same sub-category subject to the condition that they would not invest in units of other fund of funds. The investment conditions applicable to the venture capital funds (**discussed later**) would not be applicable to investments by them. Such investment funds cannot borrow funds directly/indirectly/engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than 10 per cent of the corpus.

(b) Venture Capital Funds The following additional investment conditions would apply to venture capital funds:

(1) At least two-thirds of the investible fund should be invested in unlisted equity shares/equity linked instruments of a venture capital undertaking/in companies listed/proposed to be listed on a SME exchange or SME segment of an exchange;

(2) Not more than one-third of the investible fund should be invested in: **(i)** subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; **(ii)** debt/debt instrument of a venture capital undertaking in which the fund has already made an investment by way of equity or contribution towards partnership interest; **(iii)** preferential allotment, including through qualified institutional placement, of equity shares or equity-linked instruments of a listed company subject to lock-in period of one year; **(iv)** the equity shares/equity-linked instruments of a **financially weak company**, (i.e. a company, which has at the end of the previous financial year accumulated losses, resulting in erosion of more than 50 per cent but less than 100 per cent of its net worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed, **(v)** special purpose vehicles which are created by the fund for the purpose of facilitating/promoting investment in accordance with these regulations. The above investment conditions/restrictions should be achieved by the fund by the end of its life cycle.

> **Financially weak company**
> is a company, which has at the end of the previous financial year accumulated losses, resulting in erosion of more than 50 per cent but less than 100 per cent of its net worth as at the beginning of the previous financial year.

(3) Such funds may enter into an agreement with a merchant banker to **(i)** subscribe to the unsubscribed portion of the issue **(ii)** receive/deliver securities in the process of market making under SEBI Issue of Capital and Disclosure Requirements Regulations.

(4) They would be exempt from **SEBI Prohibition of Insider Trading Regulations**,[@@] in respect of investment in companies listed on SME exchange or SME segment of an exchange pursuant to due their diligence subject to the following conditions: **(i)** the fund would disclose within two working days of such acquisition/dealing to the stock exchanges where the investee company is listed; **(ii)** such investment would be locked -in for a period of one year from the date of investment.

(c) SME Funds The following additional conditions would apply to SME funds: Atleast 75 per cent of the corpus should be invested in unlisted securities/partnership interest of venture capital undertakings/investee companies which are SMEs or in companies listed/proposed to be listed on SME exchange/SME segment of an exchange. The conditions stipulated in **(b) (3)** and **(b) (4)** above in relation to venture capital fund would be applicable to the SME funds also.

(d) Social Venture Funds The following additional conditions would apply to social venture funds: **(1)** Atleast 75 per cent of their investible funds would be invested in unlisted securities/partnership interest of social ventures. **(2)** They may **(i)** accept grants, provided that utilisation of such grants would be restricted to investment specified in **(1)** above and the amount should not be less than ₹25 lakh; no profit/loss would accrue to the provider of the grant and **(ii)** give grants to social ventures, provided that appropriate disclosure is made in the placement memorandum; **(iii)** accept **muted returns** for their investors, that is, they may accept returns on their investments which may be lower than the prevailing returns for similar investments.

(e) Infrastructure Funds The following additional conditions would apply to infrastructure funds: Atleast 75 per cent of the corpus should be invested in unlisted securities/units or partnership interest of venture capital undertaking/investee companies/special purpose vehicles, which are engaged in, or formed for the purpose of, operating, developing or holding infrastructure projects. They may also invest in listed securitised debt instruments/debt securities of investee companies/special purpose vehicles, which are engaged in, or formed for the purpose of, operating, developing or holding infrastructure projects.

Conditions for Category II AIFs The applicable investment conditions are as follows. They should invest primarily in unlisted investee companies/units of other AIFs specified in the placement memorandum. They may also invest in units of Category I/II AIFs but not in units of other fund of funds. The restrictions on borrowing funds/leveraging applicable to Category I funds would also apply to them. However, they may borrow for meeting temporary funding requirements for not more than **(i)** 30 days, **(ii)** four occasions in a year, and **(iii)** 10 per cent of the investible funds. They may engage in hedging, subject to SEBI guidelines, The conditions stipulated in **(b) (3)** and **(b) (4)** in relation to venture capital funds would also be applicable to such funds.

Conditions for Category III Alternative Investment Funds The applicable investment conditions are. They may invest in **(i)** securities of listed/unlisted investee companies/derivatives/ complex/structured products, **(ii)** units of Category I/II AIFs. But they cannot invest in units of other fund of funds. They may engage in leverage or borrow subject to consent from the investors in the fund and subject to a SEBI-specified maximum limit. They should disclose information regarding the overall level of leverage employed, the level of leverage arising from borrowing of **(i)** cash, **(ii)** position held in derivatives/in any complex product and the **(iii)** main source of leverage in their fund to the investors and to the SEBI periodically. They would

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[@@]An account available in chapter 10.

be regulated through issuance of SEBI-specified directions regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest.

Other AIFs The SEBI may lay down framework for AIFs other than the Category I, II and III funds.

Angel Funds An **angel fund** means a sub-category of VCF under Category I-AIF that raises funds from angel investors and invests according to the specified stipulations. An **angel investor** means any person who proposes to invest in an angel fund and satisfies one of the following conditions: **(a)** an individual investor who has **(1)** tangible assets of at least ₹2 crore excluding value of his principal residence and **(2) (i)** early stage investment experience (i.e. prior experience in investing in start-up/emerging/early-stage ventures), **(ii)** serial entrepreneur (i.e. a person who has promoted/co-promoted more than one start-up venture), **(iii)** is a senior management professional with at least 10 years of experience; **(b)** a body corporate with a net worth of atleast ₹10 crore; **(c)** an AIF registered under SEBI regulations as VCF. The main elements of the SEBI regulations relating to angel funds are: **(1)** inapplicability of the SEBI AIF regulations, **(2)** registration, **(3)** investments in angel funds, **(4)** schemes, **(5)** investments by angel funds, **(6)** obligations of their sponsors and managers, and **(7)** prohibition of listing.

Angel investor
means **(a)** an individual investor who has **(1)** tangible assets of atleast ₹2 crores, **(2)(i)** early stage investment experience, **(ii)** serial investor, **(iii)** as a senior management professional, **(b)** a body corporate with a minimum networth of ₹10 crore, **(c)** a SEBI-registered AIF.

Inapplicability All the provisions of the SEBI AIF regulations would apply to the angel funds, their sponsors/managers/investors except relating to the following:

- investment condition applicable to all categories of AIFs. But the sponsors/managers of angel investors should disclose their investments in AIFs to the investors of the AIF;
- launching of schemes;
- listing;
- general investment conditions pertaining to investment in companies incorporated outside India/in associates and ceiling on investment in one investee company;
- investment by one category I AIF in another AIF of the same category and investment conditions applicable to the VCFs.

Registration An angel investor would be registered with the SEBI on the pattern of an AIF **(discussed earlier)**. A SEBI-registered AIF which has not made any investments may convert into an angel fund.

Investment An angel fund should **(i)** only raise funds by issue of units to angel investors **(ii)** have a corpus of at least ₹10 crore, **(iii)** accept upto a maximum of three years on investment of not less than ₹25 lakh from an angel investor, and **(iv)** raise funds through private placement by issue of information/placement memorandum.

Schemes The angel fund may launch schemes subject to filing with the SEBI a scheme memorandum containing all material information about investments proposed in the scheme at least 10 days prior to launching it. The payment of schemes fee would not apply to such schemes. No scheme should have more than 49 angel investors.

Investment by Angel Investors Angel funds should invest only in VCUs which **(a)** have been incorporated during the preceding years, **(b)** have turnover of less than ₹25 crore, **(c)** are not promoted/sponsored by/related to an **industrial** group (i.e. group of body corporates with the same promoter/promoter group(s), a parent company/its subsidiaries, a group of body corporates in which same person/group of persons exercise control and group of body corporates comprised of associates/subsidiaries holding companies) whose group turnover (i.e. combined total revenue of the industrial group) exceeds ₹300 crore, and **(d)** are not **companies with family connections** with any angel investor who is investing in the company. A company with a family connection means **(a)** if the angel investor is an individual/any company **(i)** promoted by him/relative, **(ii)** where he/relative is a director/has control/shares/voting rights entitling them 15 per cent or more of the shares/voting rights; **(b)** if the angel investor is a company, any company which is **(i)** a subsidiary/holding/part of the same group/under same management of the investor, **(iii)** where the body corporate/directors/partners have control/shares/voting rights investing them to 15 per cent or more of the shares/voting rights in the company.

Investments by an angel fund in any VCU should be not less than ₹50 lakhs and not more than ₹5 crore and locked-in for 3 years. Angel fund should not invest in associates and not more than 25 per cent of their total investments under all schemes should be in one VCU.

Obligations of Sponsors/Managers of Angel Funds The sponsor should ensure that angel investors satisfy the specified conditions pertaining to them. The sponsor/manager should have a continuing interest in the angel fund of the lower of at least 2.5 per cent of the corpus and ₹50 lakh. The interest should not be through waiver of management fee. The manager should obtain an understanding from every angel investor in terms of prior confirmation of his approval for such investment.

Prohibition of Listing Units of angel funds should not be listed on any recognised stock exchange.

General Obligations and Responsibilities and Transparency Included in general obligations/responsibility and transparency of the AIFs are: **(i)** general obligations, **(ii)** conflict of interest, **(iii)** transparency, **(iv)** valuation, **(v)** obligation of manager, **(vi)** dispute resolution, **(vii)** power to call for information, **(viii)** maintenance of records, **(ix)** submission of reports to the SEBI, and **(x)** winding-up.

General Obligations The AIFs should review the policies and procedures, and their implementation, on a regular basis, or as a result of business developments to ensure their continued appropriateness. Their sponsor/manager should appoint a SEBI-registered custodian for safekeeping of securities if the corpus of the AIF is more than five hundred crore rupees. However, the sponsor/manager of a Category III AIF should appoint custodian irrespective of the size of corpus. The should inform the SEBI in case of any change in the sponsor/manager/designated partners/any other material change from the information provided by them at the time of application for registration. In case of change in **control** (i.e. change in control in terms of SEBI Substantial Acquisition of Shares/Takeovers[@@] if its shares are listed and change in the controlling interest/legal form in other cases) of the AIF, sponsor/manager, prior approval from the SEBI should be taken by the AIF. Their books of accounts should be audited annually by a qualified auditor.

Conflict of Interest The sponsor/manager of the AIF should act in a fiduciary capacity towards its investors and disclose to them all conflicts of interests as and when they arise or seem likely to

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[@@]An account available in Chapter 12.

arise. The manager should establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business. They should abide by SEBI-specified high level principles on avoidance of conflicts of interest with associated persons.

Transparency All the AIFs should ensure transparency and periodical disclosure of information to investors on the following: **(a)** financial, risk management, operational/portfolio, and transactional information regarding fund investments; **(b)** any fees **(i)** ascribed to the manager /sponsor **(ii)** charged to the AIF/any investee company by an associate of the manager/sponsor; **(c)** any inquiries/ legal actions by legal/regulatory bodies in any jurisdiction, as and when occurred; **(d)** any material liability arising during the AIF's tenure as and when occurred; **(e)** any breach of a provision of the placement memorandum/agreement made with the investor or any other fund documents as and when occurred; **(f)** change in control of the sponsor/manager/investee company; **(g)** provide at least on an annual basis, within 180 days from the year-end, reports to investors including the following information, **(1)** financial information of investee companies, **(2)** material risks and how they are managed which may include: **(i)** concentration risk at fund level, **(ii)** foreign exchange risk at fund level, **(iii)** leverage risk at fund and investee company levels, **(iv)** realisation risk (i.e. change in exit environment) at fund and investee company levels, **(v)** strategy risk (i.e. change in or divergence from business strategy) at investee company level, **(vi)** reputation risk at investee company level, **(vii)** extra-financial risks, including environmental, social and corporate governance risks, at fund and investee company level. Category III fund should, however, provide quarterly reports to investors within 60 days of the end of the quarter, **(h)** any significant change in the key investment team; **(i)** When required by the SEBI, information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).

Valuation The AIF should provide to its investors, a description of its **(i)** valuation procedure and **(ii)** the methodology for valuing assets. The Category I and II funds should undertake valuation of their investments, atleast once in every six months, by an independent valuer. Such period may be enhanced to one year on approval of atleast 75 per cent of the investors by value of their investment. Category III funds should ensure that calculation of the net asset value (NAV) is independent from the fund management function of the AIF and disclosed to the investors at intervals not longer than a quarter for close-ended funds and a month for open-ended funds.

Obligation of Manager The manager would be obliged to: **(a)** address all investor complaints; **(b)** provide to the SEBI any information sought; **(c)** maintain all specified records; **(d)** take all steps to address conflict of interest; and **(e)** ensure transparency and disclosure.

Dispute Resolution By itself or through the manager/sponsor, the AIF should lay down procedures for resolution of disputes between the investors, AIF, manager/sponsor through arbitration or any such mechanism as mutually decided between the investors and the AIF.

Power to Call for information The SEBI may at any time call for any information from an AIF, its manager/sponsor/trustee/investor with respect to any matter relating to its activity as an AIF or for the assessment of systemic risk or prevention of fraud. The information should be furnished within the specified time.

Maintenance of Records The manager/sponsor of the AIF should maintain for a period of five years after the winding up of the fund the following records describing: **(a)** the assets under the scheme/fund; **(b)** valuation policies and practices; **(c)** investment strategies; **(d)** particulars of investors and their contribution; and **(e)** rationale for investments made.

Submission of Reports to the SEBI The SEBI may at any time call upon the AIF to file such reports, as it may desire, with respect to the activities carried on by the AIF.

Winding-up An AIF set up as a trust would be wound up: **(a)** when its tenure or all schemes launched by it, as mentioned in the placement memorandum, is over; **(b)** if it is the opinion of the trustees/trustee company, that it be wound-up in the interests of investors in the units; **(c)** if 75 per cent of the investors by value of their investment pass a resolution at a meeting of unitholders that it be wound up; and **(d)** if the SEBI so directs in the interests of investors.

An AIF set up as a limited liability partnership should be wound up in accordance with the provisions of The Limited Liability Partnership Act: in terms of stipulations **(a), (c)** and **(d)** applicable to the winding up of trust-AIFs.

An AIF set up as a company should be wound up in accordance with the provisions of the Companies Act. An AIF set up as a body corporate should be wound up in accordance with the provisions of the statute under which it is constituted.

The trustees/trustee company/Board of Directors/designated partners of the AIF should intimate to the SEBI and investors of the circumstances leading to its winding up. On and from the date of intimation, no further investments should be made on behalf of the AIF. Within one year from the date of intimation, the assets should be liquidated, and the proceeds accruing to investors distributed to them after satisfying all liabilities. Upon winding up, the certificate of registration should be surrendered to the SEBI.

Inspection The SEBI may, *suo motu,* or upon receipt of information/complaint, appoint person(s) as inspecting authority to undertake inspection of the books of account, records and documents relating to an AIF for any of the following reasons: to **(a)** ensure that the books of account, records and documents are being maintained by the in the specified manner; **(b)** inspect complaints received from investors, clients or any other person, on any matter having a bearing on its activities; **(c)** ascertain whether the provisions of the SEBI Act/regulations are being complied with; **(d)** inspect *suo motu* its affairs in the interest of the securities market/ investors. Before ordering an inspection, the SEBI should give not less than ten days notice to the AIF. However, where the SEBI is satisfied that in the interest of the investors no such notice should be given, it may by an order in writing direct that the inspection of the affairs of the AIF be taken up without such notice.

Obligations During the course of an inspection, the concerned AIF would be duty bound to discharge its obligations specified below. It would be the duty of every officer of the AIF and any other associated person who is in possession of relevant information pertaining to its conduct and affairs of including manager to produce such books, accounts and other documents in his custody or control and furnish him with such statements and information as the inspecting authority may require for the purposes of the inspection. It would also be their duty to give to the inspecting authority all such assistance and extend all such co-operation as may be required in connection with the inspection and furnish such information as sought in connection with the inspection. The inspecting authority would, have the power to examine on oath and record the statement of any employees/directors/person responsible for, or connected with, their activities of or any other associated person having relevant information pertaining to the fund. The inspecting authority would also have power to obtain authenticated copies of documents, books, accounts from any person having control over or custody of them. The inspecting authority would, as soon as possible, on completion of the inspection, submit an inspection report to the SEBI and if directed submit an interim report.

The SEBI may after consideration of the inspection report and giving reasonable opportunity of hearing to the AIF or its trustees/directors/manager issue such direction as it deems fit in the interest of securities market/investors including directions in the nature of: **(a)** requiring not to launch new schemes or raise money from investors for a particular period; **(b)** prohibiting the person concerned from disposing of any of the properties of the fund or scheme acquired in violation of these regulations; **(c)** requiring the person connected to dispose of the assets of the fund/scheme in a manner as may be specified in the directions; **(d)** requiring the person concerned to refund any money or the assets to the concerned investors along with the requisite interest or otherwise, collected under the scheme; and **(e)** prohibiting the person concerned from operating in the capital market or from accessing the capital market for a specified period.

Procedure for Action in Case of Default An AIF which: **(a)** contravenes any of the provisions of the SEBI Act/regulations, **(b)** fails to furnish any information relating to its activity, **(c)** furnishes information which is false or misleading in any material particular, **(d)** does not submit periodic returns or reports as required, **(e)** does not co-operate in any enquiry, inspection or investigation conducted, **(f)** fails to resolve the complaints of investors/give a satisfactory reply in this behalf, would be dealt with in the manner provided under the **SEBI Intermediaries Regulations**.[@@] The SEBI may also to issue directions or measures under the SEBI Act or under any other law for the time being in force.

SEBI Foreign Venture Capital Investors (FVCIs) Regulations, 2000

A foreign venture capital investor (FVCI) is an investor incorporated and established outside India and proposes to make investment in accordance with these regulations. The main elements of FVCIs are described below. **A list of FVCIs registered with the SEBI is given in Appendix 7-D on the website. The address is http://www.mhhe.com/khanfs9e**.

Registration A FVCI should be registered with SEBI to carry on business in India. To seek registration with SEBI, an applicant should apply in the prescribed form along with an application fee of US$ 2,500. The eligibility criteria for registration of an applicant include the following conditions: **(i)** its track record, professional competence, financial soundness, experience, general reputation of fairness and integrity; **(ii)** the RBI's approval for investing in India; **(iii)** it is an investment company/trust/partnership, pension/mutual/endowment fund, charitable institution or any other entity incorporated outside India; **(iv)** it is an asset/investment management company, investment manager or any other investment vehicle incorporated outside India; **(v)** it is authorised to invest in Venture Capital Funds (VCFs)/Alternative Investment Fund/carry on activity as a FVCI; **(vi)** it is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of its promoters' track record where it is neither a regulated entity nor an income tax payer; **(vii)** it has not been refused a certificate by SEBI and **(viii)** it is a fit and proper person. The provisions of the **SEBI Intermediaries Regulation, 2008** would apply to determine if the applicants are fit and proper persons. The applicant may be required by SEBI to furnish such further information as it may consider necessary.

[@@]An account available in Khan, M.Y., *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 4.

A VCF means a fund established in the form of a trust/company including a body corporate and registered under the SEBI VCF Regulations which **(i)** has dedicated pool of capital, **(ii)** raised in the manner specified under the regulations and **(iii)** invests in accordance with the regulations.

On being satisfied that the applicant is eligible and on receipt of the registration fee of US$ 10,000, SEBI would grant it a certificate of registration subject, *inter alia*, on the conditions that it would **(a)** abide by the *SEBI Act* and FVCIs regulation, **(b)** appoint a domestic custodian (i.e. a person registered under SEBI Custodian of Securities Regulations, 1996) for custody of securities **(c)** enter into an arrangement with a designated bank (i.e. any bank in India permitted by the RBI to act as a banker to the FVCI) for operating a special non-resident rupee/foreign currency account, and **(d)** forthwith inform SEBI, in writing, if any information/particulars previously submitted to it are found to be false/misleading in any material particular or if there is any change in any information already submitted.

Investment Criteria The investments by FVCIs should conform to the norms prescribed by SEBI. First, they should disclose their investment strategy to SEBI. They can invest their total funds committed in one VCF/AIF. At least 66.67 per cent of the investible fund (i.e. the funds committed for investment in India net of expenditure for administration/management of the fund) should be invested in unlisted equity shares or equity linked instruments of venture capital undertakings (VCUs). A **venture capital undertaking** means a domestic company which is **(i)** not listed in India, **(ii)** engaged in the business of providing services/production/manufacture of article/ things excluding the following activities/sectors: (1) NBFCs other than the RBI-registered CICs in the infrastructure sector, AFCs and IFCs, (2) gold financing, (3) activities not permitted under Government industrial policy, and (4) any other activity specified by the SEBI in consultation with the Government. Further, not more than 33.33 per cent of the investible funds may be invested by way: **(a)** subscription to the IPO (initial public offer) of VCUs whose shares are proposed to be listed, **(b)** debt/debt instruments of a VCU/investee company in which the FVCI has already made an investment by way of equity, **(c)** preferential allotment of equity shares of a listed company subject to lock-in period of one year, **(d)** it should disclose the duration of the life cycle of the fund, and **(e)** special purpose vehicles (SPVs) created to facilitate/promote investment according to share regulations.

Equity-linked instruments include instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily/optionally convertible into equity. A VCU means a domestic company **(i)** whose shares are not listed on a recognised stock exchange in India, **(ii)** which is engaged in the business of providing services, production/manufacture of articles/things but excludes such activities/sectors which are specified in the negative list by the SEBI with approval of Government, namely, **(a)** non-banking financial services excluding the NBFCs registered with and categorised as asset finance companies by the RBI, **(b)** gold financing excluding companies engaged in gold financing for jewellery, **(c)** activities not permitted under the industrial policy of the Government of India, and **(d)** any other activity specified by the SEBI from time to time.

General Obligations and Responsibilities The FVCIs have to maintain, for a period of eight years, books of accounts/records/documents which would give a true and fair picture of their affairs and intimate to SEBI the place where they are being maintained. They may be called upon at any time by SEBI to furnish within a specified time any information with respect to any matter relating to their activities. Moreover, they/a global custodian acting on their behalf should enter into an agreement with the domestic custodian to act as a custodian of securities for them. They have also to ensure that the domestic custodian takes steps for **(i)** monitoring of their investments in India, **(ii)** furnishing of periodic reports to, and such information as may be called for by SEBI. A branch of a bank approved by the RBI should be appointed by the FVCIs the as designated bank for opening of foreign currency denominated accounts/special non-resident rupee account.

Inspection and Investigation The SEBI has the right to, *suo moto*, or upon receipt of information/complaint, order an inspection/investigation in respect of conduct and affairs of any FVCI by an officer to **(i)** ensure that the books/accounts/documents are being maintained in the specified manner, **(ii)** inspect/investigate into complaints from investors/clients/any other person on any matter having a bearing on its activities, **(iii)** ascertain whether the provisions of the SEBI Act and FVCIs regulations are being complied with and **(iv)** inspect/investigate, *suo moto*, into its affairs in the interest of the securities market/investors. The FVCI/any other associated person, including asset management company/fund manager, in possession of information relevant to its conduct/affairs must **(1)** produce to the investigating/inspecting officer such books/accounts/other documents in his custody/control and furnish him such statements and information as he may acquire and **(2)** give to him all assistance and extend all cooperation, and furnish all information sought by him.

He would also have the power **(1)** to examine on oath and record the statement of any person responsible for or connected with the activities of the FVCI and **(2)** to get authenticated copies of documents/books/accounts of the FVCI from any person having control/custody over them. On the basis of the inspection/investigation report, SEBI has the right to require the FVCI to take such measures or issue such directions as it deems fit in the interest of the capital market and investors, including directions in the nature of **(a)** requiring the disposal of the securities or investment in a specified manner, **(b)** requiring not to further invest for a particular period and **(c)** prohibiting operation in the capital market in India for a specified period.

Procedure for Action in Case of Default In addition to the issue of appropriate directions specified above, SEBI can also suspend/cancel registration of the FVCI on the basis of the investigation report in terms of the **Intermediaries Regulation, 2008**.

Suspension of Registration The registration of a FVCI can be suspended by SEBI if it **(1)** contravenes any of the provisions of the SEBI Act or SEBI FVCI Regulations, **(2)** fails to furnish any information relating to its activities as required by SEBI, **(3)** furnish to it information which is false/misleading in any material particular, **(4)** does not submit periodic returns/reports as required by it and **(5)** does not cooperate in any enquiry/inspection conducted by it.

Cancellation of Registration The SEBI may cancel the registration of a FVCI when he **(1)** is guilty of fraud/has been convicted of an offence involving moral turpitude, **(2)** has been guilty of repeated defaults of the nature resulting in suspension of registration; **(3)** does not meet the eligibility criteria laid down in SEBI FVCIs Regulations and **(4)** contravenes any of the provisions of *SEBI Act*/these regulations.

The order of suspension/cancellation of registration may be published by SEBI in two newspapers. Action may also be initiated by SEBI for suspension/cancellation of registration of an intermediary who fails to exercise due diligence in the performance of its functions/comply with its obligations under these regulations. Any person aggrieved by an order of SEBI may prefer an appeal to Securities Appellate Tribunal (SAT).

Recapitulation

- Venture capital, as a fund-based financial service, has emerged the world over to fill gaps in the conventional financial mechanism, focusing on new entrepreneurs, commercialisation of new technologies and support to small/medium enterprises in the manufacturing and the service sectors. Over the years, the concept of venture capital has undergone significant changes. The nascent venture capital industry in India can profitably draw upon the experiences of the developed countries.
- The characteristics features of venture capital differentiate it from other capital investments. It is basically equity finance in relation to new listed companies and debt financing is only supplementary to ensure running yield on the portfolio of the venture capitalists/capital institution (VCIs). It is long-term investment in growth-oriented small/medium firms. There is a substantial degree of active involvement of VCIs with the promoters of venture capital undertakings (VCUs) to provide, through a hands-on approach, managerial skills without interfering in the management. The venture capital financing involves high risk-return spectrum. It is not technology finance, though technology finance may form a sub-set of such financing. Its scope is much wider.
- The first step in venture capital financing is the selection of the investment. It includes stages of financing, methods to evaluate deals and the financial instruments to structure a deal. The stages of financing as differentiated in venture capital industry are early stage and later stage. Included in early stage are seed capital/pre-start-up, start-up and second-round financing. The later stage of venture capital financing covers mezzanine/development capital, bridge/expansion, buyouts and turnarounds. The venture investments are generally **idea-based and growth-based**. Of the three methods of financial analysis/evaluation which VCIs can adopt, namely, conventional venture capital valuation method, the first Chicago method and the revenue multiplier method, the first Chicago method gives better results. The structuring of venture capital deals is a mix of the available financial instruments: equity and debt. The equity instruments include ordinary, non-voting, deferred ordinary, preference, warrants, cumulative convertible preference, participating preference and so on. The main types of debt instruments are conventional loan, conditional loan, income notes, NCDs, PCDs, zero interest bonds, secured premium notes and deep discount bonds.
- The after-care stage of venture capital financing relates to different styles of nurturing, its objectives and techniques. The style of nurturing which refers to the extent of participation by VCIs in the affairs of the venture, falls into three broad categories: hands on, hands off and hands holding. Some of the important techniques to achieve the objectives are personal discussion; plant visits, nominee directors, periodic reports and commissioned studies.
- The valuation of the venture capital portfolio to monitor and evaluate the performance of the equity investment is done by using cost method or market value-based methods consisting of quoted market value method and fair market value method. The methods of valuing debt instruments vary with the nature of such instruments.
- The alternative forms in which VCIs can be structured are: limited partnership, company, trust and small business investment company.
- The last stage in venture capital financing is the exit to realise the investment so as to maximise profit/minimise loss. The alternative routes for disinvestments of equity/quasi-equity instruments are market flotation, arnout, trade sales, takeout and liquidation.
- The venture capital industry in India is of relatively recent origin. Before its emergence, the DFIs had partially been playing the role of venture capitalists by providing assistance for direct equity participation to ventures in the pre-public stage and by selectively supporting new technologies.

The concept of venture capital was institutionalised/operationalised in November 1988 when the CCI issued guidelines for setting up of VCFs for investing in unlisted companies and to avail of a concessional facility of capital gains tax. These guidelines, however, construed venture capital rather narrowly as a vehicle for equity-oriented finance for technological upgradation and commercialisation of technology promoted by relatively new entrepreneurs. These were repealed on July 25, 1995. Recognising the growing importance of venture capital, the Government announced a policy for governing the establishment of domestic VCFs. They were exempted from tax on income by way of dividends and long-term capital gains from equity investment in the specified manner and in conformity with stipulations in unlisted companies in the manufacturing sector, including software units, but excluding other service industries. To augment the availability of venture capital, guidelines were issued in September, 1995 for overseas venture capital investments in the country. After empowerment to register and regulate VCFs, SEBI issued VCF Regulations, 1996. They have now been replaced by the Alternative Investment Fund Regulations.

- **Alternative investment fund (AIF)** means any fund established/incorporated in India in the form of a trust/company/limited liability partnership/body corporate which is **(i)** a privately pooled investment vehicle and collects funds from Indian/foreign investors for investing in accordance with a defined investment policy for the benefit of its investors, and **(ii)** not covered under the mutual fund/other regulations of the SEBI to regulate fund management activities. The main elements of the SEBI regulation relating to AIFs, namely, **(a)** registration, **(b)** investment conditions/restrictions, **(c)** general obligations and responsibilities and transparency, **(d)** inspection, and **(e)** procedure for action in case of default are discussed in this Section.
- To set an **AIF**, an entity/person has to obtain a certificate of registration from the SEBI. The existing venture capital funds may seek re-registration as AIFs subject to approval of two-thirds of their investors by value of their investment. The AIFs can seek registration in one of the three categories: **(i)** I, **(ii)** II, **(iii)** III.
- **"Category I AIF"** which invests in start-up or early stage ventures/social ventures/small and medium enterprises (SMEs)/infrastructure/other sectors or areas which the Government/regulators consider as socially/economically desirable and would include venture capital funds, SME funds, social venture funds, infrastructure funds and such other specified alternative investment funds. The **AIFs** which are generally perceived to have positive spillover effects on economy and for which the SEBI/Government of India/other regulators in India might consider providing incentives/concessions would be included and such funds which are formed as trusts/companies would be construed as "venture capital company"/fund" as specified under the Income Tax Act. **Venture capital fund** means an alternative investment fund which invests primarily in unlisted securities of start-ups, emerging/early-stage venture capital undertakings mainly involved in new products/new services, technology/intellectual property right based activities/a new business model. **Venture capital undertaking** means a domestic company which is **(i)** not listed on a recognised stock exchange in India at the time of making investment; and **(ii)** engaged in the business for providing services, production/manufacture of article/things and does not include the following activities/sectors: **(1)** non-banking financial companies; **(2)** gold financing; **(3)** activities not permitted under industrial policy of Government of India; and **(4)** any other activity which may be specified by the SEBI in consultation with the Government of India from time to time. **SME fund** means an alternative investment fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed/proposed to be listed on a SME exchange/SME segment of an exchange. **Social venture** means a trust/society/company/venture capital undertaking/limited liability partnership formed with the purpose of promoting social welfare/solving social problems/providing social

benefits and includes: **(i)** public charitable trusts registered with the charity commissioner; **(ii)** societies registered for charitable purposes/promotion of science, literature/fine arts; **(iii)** company registered under Section 25 of the Companies Act; **(iv)** micro finance institutions. **Social venture fund** means an alternative investment fund which invests primarily in securities/units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns. **Infrastructure funds** invest primarily in unlisted securities/partnership or interest/listed debt/securitised debt instruments of investee companies/SPVs engaged in. or formed for the purpose of, operating/developing/holding infrastructure.

- **"Category II AIF"** which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-today operational requirements. Funds such as private equity funds/debt funds for which no specific incentives or concessions are given by the Government or any other regulator would be included. **Private equity fund** means an **AIF** which invests primarily in equity/equity linked instruments (i.e. instruments convertible into equity/preference shares, share warrants, compulsorily/optionally convertible debentures) or partnership interests of investee companies (i.e. companies/SPVs/limited partnership/body corporate in which an AIF makes an investment) according to the stated objectives of the fund. **Debt fund** is an AIF which invests primarily in debt/debt securities of listed/unlisted investee companies according to its stated objectives.
- **"Category III AIF"** which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Funds such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open-ended and for which no specific incentives or concessions are given by the Government or any other regulator would be included. **Hedge funds** employ diverse/complex trading strategies and invest in securities having diverse risks or complex products including listed/unlisted derivatives.
- The eligibility criteria for registration as AIF are: **(a)** The memorandum of association/trust/partnership deed respectively in case of company/trust/limited liability partnership permits it to carry on the activity of an AIF; **(b)** The applicant is prohibited by its memorandum and articles of association/trust/partnership deed from making an invitation to the public to subscribe to its securities; **(c)** The instrument of trust in case of a trust-applicant is in the form of a deed and has been duly registered under the provisions of the Registration Act; **(d)** The partnership in case of partnership-applicant is duly incorporated and the partnership deed has been duly filed with the Registrar under the provisions of the Limited Liability Partnership Act; **(e)** A body corporate-applicant is set up/established under the laws of the central or state legislature and is permitted to carry on the activities of an AIF; **(f)** The applicant, sponsor and manager are fit and proper persons based on the criteria specified in SEBI Intermediaries Regulations; **(g)** The key investment team of the manager of the AIF has adequate experience, with at least one key personnel having not less than five years experience in advising/managing pools of capital or in fund/asset/wealth/portfolio management or in the business of buying, selling and dealing of securities/other financial assets and has relevant professional qualification; **(h)** The manager/sponsor has the necessary infrastructure and manpower to effectively discharge its activities; **(i)** The applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style/strategy and proposed tenure of the fund/scheme; **(j)** Whether the applicant or any entity established by the sponsor/manager has earlier been refused registration by the SEBI.
- The investment conditions/restrictions relate to: **(i)** investment strategy, **(ii)** investment in AIF, **(iii)** placement memorandum, **(iv)** schemes, **(v)** tenure, **(vi)** listing, **(vii)** general investment

conditions, **(viii)** conditions for category I AIF, **(ix)** conditions for category II AIF, **(x)** conditions for category III AIFs and **(xi)** other AIF.

- Investment in all categories of AIFs would be subject to the following conditions:- **(a)** The AIF may raise funds from any Indian, foreign or non-resident Indian investor by way of issue of **units** (i.e. a beneficial interest of the investors in the AIF/a scheme of the AIF including shares/partnership interests); **(b)** Each scheme of the AIF would have **corpus** (i.e. total amount of funds committed by the investor in the AIF by way of a written contract/any such document as on a particular date) of atleast twenty crore rupees; **(c)** The AIF would not accept an investment of value less than one crore rupees from an investor. In case of investors who are employees or directors of the AIF/manager, the minimum value of investment should be twenty five lakh rupees. **(d)** The manager/sponsor would have a continuing interest in the AIF of not less than the lower of 2.5 per cent of the corpus or five crore rupees in the form of investment in the AIF and such interest should not be through the waiver of management fees. For Category III AIF, the continuing interest should be not less than 5 per cent of the corpus or ten crore rupees, whichever is lower. **(e)** The manager/its sponsor should disclose their investment in the AIF to investors; **(f)** No scheme of the AIF would have more than one thousand investors; **(g)** The fund would not solicit/collect funds except by way of private placement.
- Category I and Category II AIF would be close-ended fund/scheme. Category III AIF may be open-ended or close-ended.
- Units of close-ended AIF may be listed on stock exchange only after final close of the fund/scheme subject to a minimum tradable lot of one crore rupees and permitted.
- Investments by all categories of AIFs would be subject to the following conditions: **(a)** They may invest in securities of companies incorporated outside India subject to such conditions/guidelines that may be stipulated/issued by the RBI/SEBI; **(b)** Co-investment in an investee company by a manager/sponsor would not be on terms more favourable than those offered to the AIF; **(c)** Category I and II AIFs should invest not more than 25 per cent and Category III 10 per cent of the corpus in one investee company; (**d)** The AIFs should not invest in **associates** (i.e. a company/limited liability partnership/body corporate in which a director/trustee/partner/ sponsor/manager of the AIF or director/partner of the manager/sponsor holds individually/collectively more than 15 per cent of its paid-up equity share capital/partnership interest) except with the approval of 75 per cent of investors by value of their investment; **(e)** The un-invested portion of the corpus may be invested in liquid mutual funds/bank deposits/other liquid assets of higher quality such as T-bills, CBLOs, CPs, CDs, till deployment of funds as per the investment objective; **(f)** The AIFs may act as nominated investor as specified in SEBI Issue of Capital and Disclosure Requirements Regulations. **(discussed in Chapter 14).** The SEBI may specify additional requirements/criteria for AIF/for a specific category.
- The following investment conditions would apply to all Category I AIFs: **(a)** They should invest in investee companies/venture capital undertaking/special purpose vehicles/limited liability partnerships/units of other AIFs. They may invest in units of Category I AIFs of same sub-category subject to the condition that they would not invest in units of other fund of funds. The investment conditions applicable to the venture capital funds (**discussed later**) would not be applicable to investments by them. Such investment funds cannot borrow funds directly/indirectly/engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than 10 per cent of the corpus. **(b) Venture Capital Funds** The following additional investment conditions would apply to venture capital funds: **(1)** At least two-thirds of the corpus should be invested in unlisted equity shares/equity linked instruments of a venture capital undertaking/in companies listed/proposed to be listed on a SME exchange or SME segment of an exchange; **(2)** Not

more than one-third of the corpus should be invested in: **(i)** subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; **(ii)** debt/debt instrument of a venture capital undertaking in which the fund has already made an investment by way of equity or contribution towards partnership interest; **(iii)** preferential allotment, including through qualified institutional placement, of equity shares or equity-linked instruments of a listed company subject to lock-in period of one year; **(iv)** the equity shares/equity-linked instruments of a **financially weak company**, (i.e. a company, which has at the end of the previous financial year accumulated losses, resulting in erosion of more than 50 per cent but less than 100 per cent of its net worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed, **(v)** special purpose vehicles which are created by the fund for the purpose of facilitating/promoting investment in accordance with these regulations. The above investment conditions/restrictions should be achieved by the fund by the end of its life cycle. **(3)** Such funds may enter into an agreement with a merchant banker to **(i)** subscribe to the unsubscribed portion of the issue **(ii)** receive/deliver securities in the process of market making under SEBI Issue of Capital and Disclosure Requirements Regulations. **(4)** They would be exempt from SEBI Prohibition of Insider Trading Regulations, in respect of investment in companies listed on SME exchange or SME segment of an exchange pursuant to due their diligence subject to the following conditions: **(i)** the fund would disclose within two working days of such acquisition/dealing to the stock exchanges where the investee company is listed; **(ii)** such investment would be locked -in for a period of one year from the date of investment. **(c) SME Funds** The following additional conditions would apply to SME funds: **(1)** Atleast 75 per cent of the corpus should be invested in unlisted securities/partnership interest of venture capital undertakings/investee companies which are SMEs or in companies listed/proposed to be listed on SME exchange/SME segment of an exchange. The conditions stipulated in **(b) (3)** and **(b) (4)** above in relation to venture capital fund would be applicable to the SME funds also. **(d) Social Venture Funds** The following additional conditions would apply to social venture funds: **(1)** Atleast 75 per cent of their corpus would be invested in unlisted securities/partnership interest of social ventures. **(2)** They may **(i)** accept grants, provided that utilisation of such grants would be restricted investment specified in **(1)** above; **(ii)** give grants to social ventures, provided that appropriate disclosure is made in the placement memorandum; **(iii)** accept muted returns for their investors, that is, they may accept returns on their investments which may be lower than the prevailing returns for similar investments. **(e) Infrastructure Funds** The following additional conditions would apply to infrastructure funds: Atleast 75 per cent of the corpus should be invested in unlisted securities/units or partnership interest of venture capital undertaking/investee companies/special purpose vehicles, which are engaged in, or formed for the purpose of, operating, developing or holding infrastructure projects. They may also invest in listed securitised debt instruments/debt securities of investee companies/special purpose vehicles, which are engaged in, or formed for the purpose of, operating, developing or holding infrastructure projects.

- The applicable investment conditions are as follows. They should invest primarily in unlisted investee companies/units of other AIFs specified in the placement memorandum. They may also invest in units of Category I/II AIFs but not in units of other fund of funds. The restrictions on borrowing funds/leveraging applicable to Category I funds would also apply to them. They may engage in hedging, subject to SEBI guidelines, The conditions stipulated in **(b) (3)** and **(b) (4)** in relation to venture capital funds would also be applicable to such funds.
- The applicable investment conditions are: They may invest in **(i)** securities of listed/unlisted investee companies/derivatives/complex/structured products, **(ii)** units of Category I/II AIFs. But they cannot invest in units of other fund of funds. They may engage in leverage or borrow

subject to consent from the investors in the fund and subject to a SEBI-specified maximum limit. They should disclose information regarding the overall level of leverage employed, the level of leverage arising from borrowing of **(i)** cash, **(ii)** position held in derivatives/in any complex product and the **(iii)** main source of leverage in their fund to the investors and to the SEBI periodically. They would be regulated through issuance of SEBI-specified directions regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest.

- The SEBI may lay down framework for AIFs other than the Category I, II and III funds.
- **Valuation** The AIF should provide to its investors, a description of its **(i)** valuation procedure and **(ii)** the methodology for valuing assets. The Category I and II funds should undertake valuation of their investments, atleast once in every six months, by an independent valuer. Such period may be enhanced to one year on approval of atleast 75 per cent of the investors by value of their investment. Category III funds should ensure that calculation of the net asset value (NAV) is independent from the fund management function of the AIF and disclosed to the investors at intervals not longer than a quarter for close-ended funds and a month for open-ended funds.
- Angel funds raises funds from angel investors to invest in specified investments. An angel investor means **(a)** an individual who has/is tangible assets of atleast ₹2 crore; early stage investment experience/serial entrepreneur/senior management professional with 10 years experience, **(b)** a body corporate with net worth of ₹10 crore and **(c)** a SEBI registered AIF.

  Angel funds should invest only in VCUs which **(a)** have a turnover of less than ₹25 crore, **(b)** are not promoted/sponsored by/related to an industrial group, **(c)** are not companies with family connections with any angel investor who is investing in the company. Their investment in any VCU should be between ₹50 lakh and ₹5 crores and locked in for 3 years. They should not invest in associates and total investment in one VCU should not exceed 25 per cent of the total.
- An AIF which: **(a)** contravenes any of the provisions of the SEBI Act/regulations, **(b)** fails to furnish any information relating to its activity, **(c)** furnishes information which is false or misleading in any material particular, **(d)** does not submit periodic returns or reports as required, **(e)** does not co-operate in any enquiry, inspection or investigation conducted, **(f)** fails to resolve the complaints of investors/give a satisfactory reply in this behalf, would be dealt with in the manner provided under the SEBI Intermediaries Regulations. The SEBI may also to issue directions or measures under the SEBI Act or under any other law for the time being in force.

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REVIEW QUESTIONS

7.1 Describe briefly the distinguishing features of venture capital financing as against other capital investments.

7.2 Discuss the process of selecting an investment in venture capital financing.

7.3 What are the main areas of focus of the aftercare stage of venture capital financing.

7.4 Write a brief note on valuation techniques for a venture capital portfolio.

7.5 What are the alternative forms in which venture capital institutions can be structured?

7.6 What are the important channels for exit of investments in venture capital financing?

7.7 Explain briefly the salient features of the scheme of regulation of alternative investment funds by the SEBI.

7.8 Discuss the main elements of the SEBI regulation relating to angel funds.

7.9 Discuss the main features of the SEBI FVCI regulations.

CHAPTER 8

Banking Products and Services

Learning Objectives

- Understand the role/functions of the RBI as the nerve centre of the financial/monetary system and the main regulator of the banking system.
- Explain the main deposit products presently available in Indian banks and outline the operations of deposit accounts.
- Discuss the main loan products in Indian banks and instruments used by customers in banking transactions.
- Understand the various modes of creating charge on secured advances.
- Examine the retail banking products presently available in India and list the channels of service delivery/distribution.
- Analyse the features of the money market products in India.

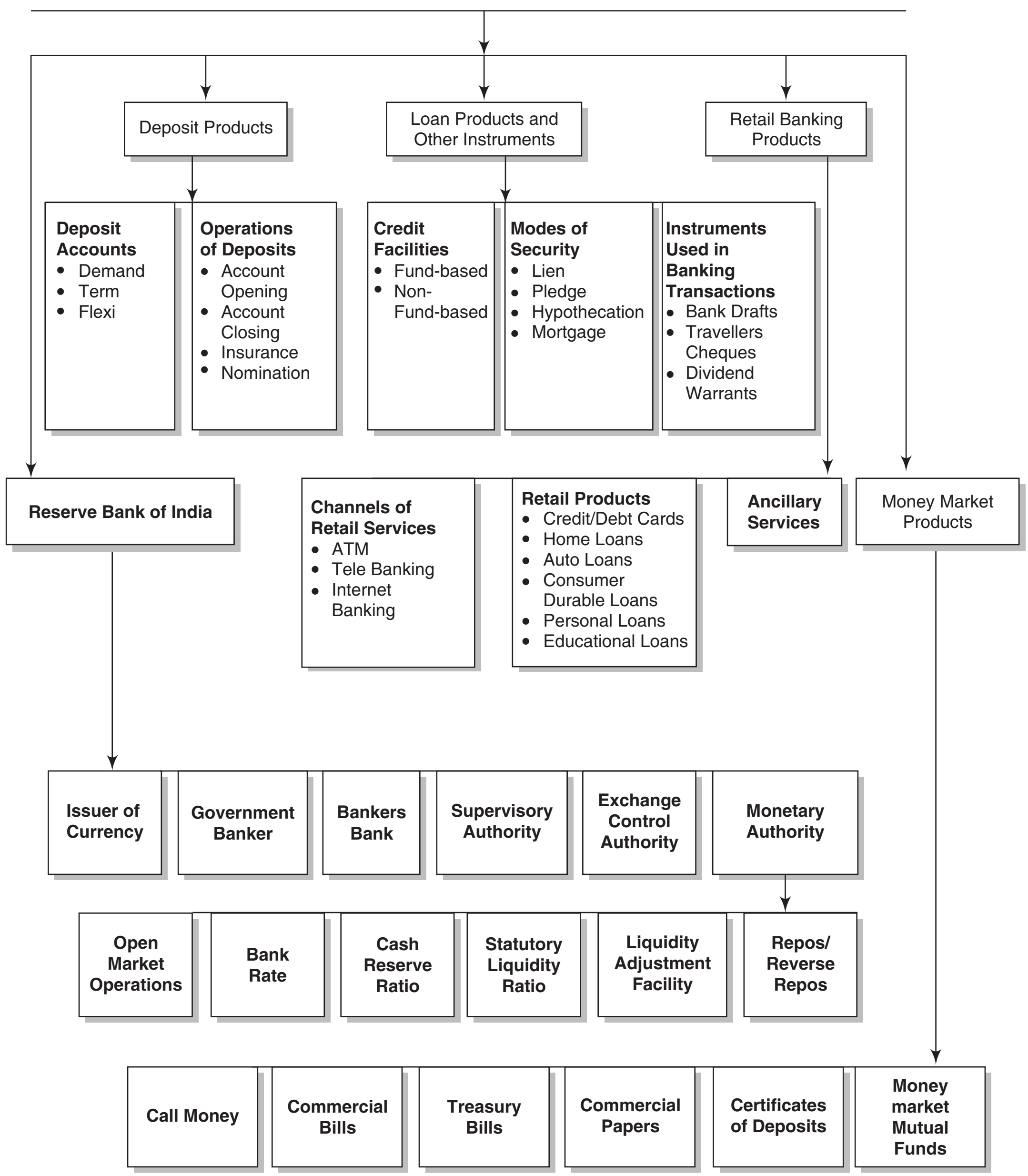
INTRODUCTION

The essence of banking is the **acceptance** of deposits from the public with the facility of withdrawal of money by cheques. Banks accept deposits from the public and advance them as loans/investments to those who need them. A unique feature of banks is "**credit creation**", that is, creation of additional money for lending/investing. The central bank (RBI) is the nerve centre of the financial/monetary system and the main regulator of the banking systems. **The main elements of banking products/services are depicted in Exhibit 8.1**. While Section 1 dwells on the functions of the RBI, the major products/services, namely, deposits, loans/advances, retail and money market are covered in Sections 2–5. **Foreign exchange/currency (Forex) products are outside the scope of this book**. The main points are summarised in the last section.

RESERVE BANK OF INDIA (RBI)

The RBI, as the central bank of the country, is the nerve centre of the financial and monetary system and the main regulator of the banking system. As the apex institution, it has been guiding, monitoring, regulating, controlling and promoting the banking as well as the financial system. This section briefly describes the main functions performed by the RBI.

Exhibit 8.1 Banking Products and Services



The roles that the RBI plays in the Indian banking system relate to **(i)** Note issuing authority **(ii)** Government banker **(iii)** Bankers' bank **(iv)** Supervising authority **(v)** Exchange control authority and **(vi)** Regulator of money and credit.

Note Issuing Authority/Issuer of Currency

The RBI has, since its inception, the sole right/authority/monopoly to issue currency notes other than one rupee notes/coins and coins of smaller denominations. In fact, the issue of currency notes is one of its basic functions. Although one rupee notes/coins and coins of smaller denominations are issued by the Central Government, they are put into circulation only through the RBI. The currency notes issued by the RBI are legal tender everywhere in India, without any limit. Currency management involves efforts to achieve self-sufficiency in the production of currency notes/coins with a judicious denomination mix, improvement in the efficiency of distribution networks and withdrawal and destruction of notes, technology upgradation and enhancement in the security features of currency notes. The responsibility of the RBI is not only to put currency into/withdraw it from circulation, but also to exchange notes/coins of one denomination for those of other denominations as demanded by the public.

The RBI can issue notes against the security of coins/bullion, foreign securities, rupee coins, Government of India securities and such bills of exchange/promissory notes as are eligible for purchase by it. The currency notes have a cent per cent backing/cover in these approved assets.

Government Banker

The RBI is the banker to the Central and the State Governments. It provides in this capacity, to the Government(s), all banking services such as acceptance of deposits, withdrawal of funds by cheques, making payments as well as receiving /collecting payments on their behalf, transfer of funds, management of public debt and so on. It receives Government deposits free of interest and it is not entitled to any remuneration for the conduct of the ordinary banking business of the Government(s). The RBI also provides safe custody facilities; manages special funds such as the Consolidated Sinking Fund, Calamity Relief Fund; issues and manages Relief Bonds; and administers schemes for disbursal of the pension of Government employees and so on.

The issue, management and administration of the public debt of the Government(s) is a major function of the RBI for which it charges a commission. The objective of the debt management policy is to raise resources from the market at the minimum cost, while containing the refinance risk and maintaining consistency with the monetary policy objectives. To bridge temporary mismatches in the cashflows (i.e., temporary gaps between receipts and payments), the RBI provides Ways and Means Advances (WAMAs). The maximum maturity period of these advances is three months. In addition to WAMAs, the State Governments make heavy use of overdrafts from the RBI, in excess of the credit limits (WAMAs) granted by the RBI. Overdrafts are, in a way, unauthorised WAMAs drawn by the State Governments, on the RBI. In fact, the management of these overdrafts is one of the major responsibilities of the RBI these days.

Bankers' Bank

As a bankers' bank, the RBI has a very special relationship with banks and the major part of its business is with these banks. It controls the volume of their reserves (SLRs and CRRs) and determines their deposits credit-creation ability. The banks hold all/part of their reserves with the RBI and in times of need, they borrow from it. The RBI is, in effect, the banker/lender of the last resort to the banking system. It is the ultimate source of money and credit in India.

Supervising Authority/Regulator and Supervisor

As a regulator and supervisor, RBI provides broad parameters within which the banking system functions. It regulates and supervises the banking system in India according to the provisions of the RBI Act and the Banking Regulation Act. The non-banking financial companies (NBFCs) are regulated by the RBI under the provisions of Chapter III-B of the RBI Act. To promote a sound/adequate and effective banking system, the RBI is vested with wide-ranging powers to supervise and control banks. These, *inter-alia*, include: **(i)** to issue licenses for the establishment of new banks/bank branches **(ii)** to prescribe minimum requirements relating to paid-up capital, reserves, transfer to reserve fund, cash reserves and other liquid assets **(iii)** to inspect the working of banks in respect of their organisational set-up, branch expansion, deposit mobilisation, investment and credit portfolio management, credit appraisal, region-wise performances, profit planning, manpower planning and training and so on **(iv)** to conduct *ad hoc* investigations from time to time, into complaints, irregularities and frauds in respect of banks **(v)** to control methods of operations of banks so that they do not fritter away funds in improper investments and injudicious advances **(vi)** to control appointment/reappointment/ termination of appointment of chairmen/chief executive officers of private sector banks and **(vii)** to approve/force amalgamations/reconstruction/liquidation of banks.

Exchange Control (EC) Authority

As the exchange control authority, the function of the RBI is to develop and regulate the foreign exchange market. Its role is to facilitate external trade and payment and provide for orderly development and maintenance of foreign exchange market within the framework of the Foreign Exchange Management Act (FEMA). The RBI is the custodian of the country's foreign exchange reserves. It is vested with the responsibility of managing the investment and utilisation of the reserves in the most advantageous manner. Its role, as the stabiliser of the foreign exchange market, has become all the more important with the introduction of the floating exchange rate system and convertibility of the rupee on trade and current accounts. The RBI has the authority to enter into foreign exchange transactions, both on its own account as well as on behalf of the Government. It deals in foreign exchange with the public through authorised dealers (ADs). It supervises, monitors and controls the foreign exchange market with a view to creating an active market with wide participation by the ADs and the exporters/importers so that the various currencies are actively traded, facilitating customers to obtain fine quotations, with rate variations being kept to the minimum. The objective of the RBI in respect of the foreign exchange forward market is to make it a useful tool for covering all exchange risks of the importers/exporters. Its regulations aim at ensuring that the forward market facilities are need-based and are not used for speculative purposes.

Regulator of Money and Credit/Monetary Authority

The RBI, as the central bank of the country, formulates and conducts the monetary policy. Monetary policy refers to the use of the techniques of monetary control to achieve the broad objectives of **(a)** maintaining price stability and **(b)** ensuring adequate flow of credit to productive sectors so as to assist growth. A country's monetary policy creates conditions for growth by influencing the cost and availability of money and credit. It uses instruments directed towards regulating the money supply and the cost and availability of credit in the economy. The important techniques/tools/instruments of monetary control that are adopted by the RBI include: Open Market Operations (OMOs), Bank Rate, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Liquidity Adjustment Facility (LAF), and Repo Rates.

Open Market Operations (OMOs) The OMOs refer to the sale and purchase of securities of the Central and State Governments and Treasury-bills (T-bills). The multiple objectives of OMOs, *inter-alia*, are: **(i)** To control the amount of and changes in bank credit and money supply through controlling the reserve base of banks **(ii)** To make the bank rate policy more effective **(iii)** To maintain stability in the Government securities/T-bills market **(iv)** To support the Government's borrowing programme and **(v)** To smoothen the seasonal flow of funds in the bank credit market. Through the OMOs, the RBI can affect the reserve position of banks, yields on Government securities/T-bills and the volume and cost of credit.

> **Open market operations**
> refer to the sale and purchase of Government securities and T-bills.

However, inspite of the wide powers to the RBI, the OMOs is not a widely-used technique of monetary control in India. There is no restriction on the quantity/maturity of the Government securities which the RBI can buy/sell/hold. The OMOs are conducted only in Central Government securities of all maturities. The Government securities directly bought by the RBI at the time of issue of loans are excluded from the OMOs. The RBI is continuously in the market, selling Government securities on tap and buying them mostly in 'switching operations'; it does not ordinarily purchase them against cash. Switching operations involve the sale of long-term Government securities in exchange for short-term securities. In addition, the OMOs have been mostly used for debt management which has undermined their effectiveness as a tool of monetary policy. Nevertheless, the OMOs have indirectly helped in the regulation of the supply of bank credit in two ways: first, when they are conducted for switching operations, they lengthen the maturity structure of the Government securities which, in turn, has a favourable impact on the monetary policy; second, the net sales (sales minus purchase) of the Government securities has increased over the years which has helped in regulating the flow of bank credit to the private sector.

Bank Rate The **bank rate** (B/R) is the standard rate at which the RBI buys/rediscounts bills of exchange/other eligible commercial paper(s). It is also the rate that the RBI charges on advances on specified collaterals to banks. An increase/decrease in the B/R would decrease/increase the volume of credit. An increase in the B/R would result in an increase in the lending rate of banks and *vice versa*. Thus, the B/R technique regulates the cost/availability of finance and, to that extent, the volume of funds available to banks and financial institutions. The B/R has emerged as a signalling rate to reflect the stance of the monetary policy. The interest rates on different types of accommodation from the RBI, including refinance, are now linked to the B/R. Banks use the signal of a B/R change to price their loans. The announcement impact of a B/R change has been reflected in the primary lending rates of banks.

> **Bank rate**
> is the **(i)** standard rate at which the RBI buys/discounts bills of exchange/eligible commercial papers, **(ii)** rate it charges on advances on specified collaterals to banks.

> **Cash reserve ratio**
> refers to the cash which banks have to maintain with the RBI as a percentage of their demand and time liabilities.

Cash Reserve Ratio The CRR refers to the cash which banks have to maintain with the RBI, as a percentage of their demand and time liabilities. The objective is to ensure the safety and liquidity of bank deposits. The RBI is empowered to impose penal interest on banks in respect of their shortfall in the prescribed

CRR. The penal interest is a specified percentage above the B/R. Moreover, the RBI can disallow fresh access to its refinance facility to defaulting banks and charge additional interest over and above the basic refinance rate on any accommodation availed of, and which is equal to the shortfall in the CRR. In addition, default in CRR results in a graduated penalty by way of loss of interest on the defaulting bank's cash balances. The RBI pays interest equal to the B/R on all eligible cash balances. The CRR, as an instrument of monetary policy, has been very actively used by the RBI recently in the downward direction. It is at its lowest level now.

Statutory Liquidity Ratio (SLR) While the CRR enables the RBI to impose primary reserve requirements, the SLR enables it to impose secondary and supplementary reserve requirements on the banking system. The objectives of the SLR are three-fold: **(i)** To restrict the expansion of bank credit, **(ii)** To augment a bank's investment in Government securities and **(iii)** To ensure solvency of banks. The SLR is the ratio of cash in hand (excluding CRR), balances in current account with banks and RBI, gold and unencumbered approved securities (i.e., Central and State Government securities, securities of local bodies and Government guaranteed securities) to the total demand and time liabilities of the banks. The SLR defaults result in restrictions on the access of refinance from the RBI and in higher costs of refinance. An increase in the SLR does not, however, restrain total expenditure in the economy; it would restrict only the private sector expenditure, but it would also help increase the Government/public sector expenditure. A decrease in the SLR would have the opposite effect. In a sense, therefore, SLR is not a technique of monetary control; it only distributes bank reserves in favour of the Government/public sector.

> **Statutory liquidity ratio** is the ratio of cash balances in current account with banks and the RBI, gold and unencumbered approved securities (i.e., Government and Government guaranteed securities).

Liquidity Adjustment Facility (LAF) The LAF has emerged as one of the most important instruments of monetary policy in recent years. The RBI, as the lender of the last resort, was providing various general and sector-specific refinance facilities to the banks. In keeping with the recent policy objective of shifting from direct to indirect techniques of monetary control, it became necessary to do away with all sector-specific and discretionary refinance facilities and to move towards a general refinance facility.

The LAF operates through repo auctions, that is, the sale of Government securities from the RBI portfolio for absorption of liquidity, and reserve repo auctions, that is, buying of Government securities for injection of liquidity on a daily basis, thereby creating a corridor for the call money rates and other short-term interest rates. The funds under LAF are expected to be used by banks for their day-to-day mismatches in liquidity. The maturity of repos is from one day to fourteen days. All scheduled banks are eligible to participate in the repo and reverse repo auctions. The minimum bid size for LAF is ₹5 crore and in multiples of ₹5 crore thereafter. All transferable Government of India dated securities/T-bills (except 14-day T-bills) can be traded in the repo and reverse repo markets. Call rate is a prime representative indicator of the availability of liquidity in the economy. The Discretionary Liquidity (DL) and call rate impact each other. The DL is the sum of the RBI balance sheet flows that arise out of its money market operations. It represents a change in the total liquidity in the system which occurs due to monetary policy action. It comprises policy-induced flows from the RBI to banks. It is the sum of the following: **(i)** net repos and OMOs of the RBI and **(ii)** RBI credit to banks.

While interest rates in the repo market usually emerge out of bids (i.e., auctions are conducted on a 'uniform price' basis), the RBI occasionally conducts fixed interest rate (multiple price) auctions to send signals to the market. The LAF technique is based on the view that the RBI balance sheet can be partitioned into autonomous and discretionary components. The Autonomous Liquidity (AL) and DL bear an inverse relationship with the changes in the inter-bank call money rate. The AL is comprised of the RBI balance sheet flows that stem from regular central banking functions, such as currency authority and banker to Government and banks. It essentially comprises liquidity that flows to banks without any monetary policy action. It represents the autonomous outflows from the RBI, netted for liabilities to sectors other than banks in the banking system. The AL is the sum of RBI's net incremental claims on the following: **(i)** the Government, adjusted for OMOs and repo operations **(ii)** banks (other than credit to schedule banks) **(iii)** commercial sector and **(iv)** foreign assets net of liabilities (other than schedule bank deposits with RBI). In other words, the AL comprises the incremental accommodation in the Ways and Means Advances (WMAs), net primary subscription to T-bills, dated securities and non-marketable securities; and rupee coins netted for the Government deposits with the RBI. The RBI's primary market subscriptions are included in the AL. In brief, AL is highly influenced by currency and is essentially a sum of flows determined by macroeconomic conditions (other than RBI's intervention in the money market).

The RBI can target call rate by modulating changes in AL and DL. The primary usefulness of LAF lies in its impact on short-term interest rates. During the regime of 'net liquidity ratio' and the 'slab rate system', it was the cost of liquidity which was controlled. The net liquidity (NL) is the sum of AL and DL. It is simply a change in bank reserves. The technique of CRR was used to control the quantum of liquidity. Now, the technique of LAF which operates primarily through buying and selling of repos to modulate discretionary liquidity, controls the quantum as well as the cost of liquidity.

Under LAF, the RBI, periodically, daily if necessary, sets/resets its repos and reverse repo rate; it uses 3-day or 4-day repos to siphon of liquidity from the market. The repos are used for absorbing liquidity at a given rate (floor), and for infusing liquidity through reverse repos, at a given rate (ceiling). Liquidity is also made available to banks and PDs in the form of refinance at the B/R. There, thus, now exists an interest rate corridor in the inter-bank call money market with the repo rate acting as a floor rate, the B/R acting as a ceiling rate, and call rate acting as a middle rate. The repo rate is a three to four day rate, while the call rate is an overnight rate. It has been observed that usually, the call rate is higher than the repo rate. The B/R and repo rate are now emerging as the key indicators of movements in the interest rates in the money and credit markets. It has been found that call money rate and other money market rates respond to both high and low repo rates.

Merits of LAF The LAF is a new short-term liquidity management technique. It is a flexible instrument in the hands of the RBI to modulate, even out, adjust or manage short-term market liquidity fluctuations on a daily basis and to help create stable or orderly conditions in the overnight/call money market. It is meant to help monetary authorities to transmit short-term interest rate signals to other money markets, financial markets, and the long-end of the yield curve. The repo operations also provide liquidity and breadth to the underlying treasury securities markets. They help the banking system also by providing it with an outlet for short-term liquidity, and thereby to optimise the return on short-term surplus funds. **The LAF operations combined with OMOs and B/R changes, have become the major technique (operating procedure) of the monetary policy in India.**

Repos/Reverse Repos A **repo/reverse repo**/ready forward/repurchase (buy-back) is a transaction in which two parties agree to sell and repurchase the same security. The seller sells specified securities, with an agreement to repurchase the same at a mutually decided future date and price. Likewise, the buyer purchases the securities, with an agreement to resell the same to the seller on an agreed date and at a predetermined price. The same transaction is repo from the viewpoint of the seller of the securities and reverse **repo** from the viewpoint of the buyer of the securities. Whether a transaction is **repo** or **reverse repo** would depend on the counterparty (seller/buyer) which initiates it. Repo is also referred to as a ready forward transaction as it is a means of funding by selling a security held on a spot basis and repurchasing the same on a forward basis.

> **Repos/Reverse repos** is a collateralised short-term borrowing and lending through sale/repurchase operations in debt instruments/the same security. The same transaction is a repo for the seller and reverse repo for the buyer of the securities.

> **Repo rate** the annual interest rate for the funds transferred by the lender to the buyer.

Repo is a collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. It is a temporary sale of debt, involving full transfer of ownership of the securities, that is, the assignment of voting and financial rights. The difference between the price at which the securities are bought and sold is the lender's profit/interest earned for lending money. The transaction combines elements of both a securities purchase/sale operation, as also a money market borrowing/lending operation. The terms of the contract is in terms of a **repo rate**, representing the money market borrowing/lending rate. **Repo rate** is the annual interest rate for the funds transferred by the lender to the buyer. It is generally lower than the B/R.

Repos/reverse repos are used to **(i)** meet a shortfall in the cash position **(ii)** increase returns on funds held **(iii)** borrow securities to meet regulatory (SLR) requirements **(iv)** by the RBI adjust liquidity in the financial system under the LAF.

The counterparty risks in repos are minimum. As market-based instruments, repos can be used as an indirect instrument of monetary control, for absorbing/injecting short-term liquidity. They help maintain an equilibrium between demand for, and supply of, short-term funds. The repos market serves as an equilibrium between the money market and the securities market and provides liquidity and depth to both. Monetary authorities can transmit policy signals through repos to the money market which has a significant influence on the Government securities market and foreign exchange market.

Repos are usually entered into with a maturity of 1-14 days. The collateral security in the form of SGL is transferred from the seller (borrower) to the buyer (lender). Generally, repo transactions take place in market lots of ₹5 crore. Repo transactions have very low credit risk due to the SGL mechanism and the existence of a collateral in the form of the underlying security. The interest rate risk is also minimal because the period of lending is very short. Similarly, the liquidity risk is very little because the lender has surplus funds. Moreover, settlement risk is small as all transactions are settled through the Public Debt Office and the SGL System of the RBI. Thus, repo transactions are very safe.

There are two legs involved in a repo transaction. In the first leg, the borrower sells the security to the lender and the transaction is generally concluded at the market value of the security to avoid the credit risk of the counterparty. In the second leg, the interest paid for borrowing, that is, the repo rate, is adjusted with the interest earned on the securities during the holding period, to arrive at the reversal price.

Types of Repos Two types of repos are currently in operation in India: Inter-bank repos and RBI repos.

Inter-Bank Repos Such repos are now permitted only under regulated conditions. They are permitted for restricted, eligible participants and instruments. All Central Government dated securities, State Government securities and T-bills of all maturities are eligible for repo. Banks can undertake repo deals if they are routed through their SGL accounts maintained by the RBI. Repos are allowed to develop a secondary market in PSU bonds, FIs bonds, corporate bonds and private debt securities if they are held in demat form and the deals are done through recognised stock exchange(s). There are no restrictions regarding a minimum period for inter-bank repo deals. Non-bank participants (i.e., FIs and other specified parties) are allowed to participate only in the reverse repo, that is, they can only lend money to other eligible participants. The non-bank entities holding SGL accounts with the RBI can enter into reverse repo transactions with banks/ PDs, in all Government securities. With the phasing out of the non-bank entities from the call/ notice money market and the setting up of the Clearing Corporation, the inter-bank repo market has emerge as a significant component of the money market. The mutual funds are the major providers of funds, while the foreign/private sector banks and the PDs are the major borrowers in the repo market.

RBI Repos The RBI undertakes repo/reverse repo operations with banks and PDs as part of its OMOs, to absorb/inject liquidity. With the introduction of the LAF, the RBI has been injecting liquidity into the system through repos on a daily basis. The repo auctions are conducted on all working days except Saturdays and are restricted to banks and PDs. This is in addition to the liquidity support given by the RBI to the PDs through refinance/reverse repo facility at a fixed price. Auctions under LAF were earlier conducted on a uniform price basis, that is, there was a single repo rate for all successful bidders. Multiple price auction was introduced subsequently. The weighted average cut-off yield in case of a multiple price auction is released to the public. This, along with the cut-off price, provides a band for call money to operate.

The RBI conducts repo auctions to provide banks with an outlet for managing short-term liquidity, even out short-term liquidity fluctuations in the money market, and optimise returns on short-term surplus liquid funds. The RBI has switched over from discriminatory price auction repos to the daily fixed rate repos auction system. Fixed rate repos signal money market rates, bring about orderly conditions in the forex market and impart stability to short-term interest rates by setting a floor for call money rates. The RBI participates actively in the call money market with LAF repos operations conducted throughout the year to modulate the surplus liquidity in the market. It also conducts reverse repo operations under the LAF to prevent sudden spurts in the call rates. Both repos and reverse repo operations play an effective role in imparting stability to the market.

The repo rate has become akin to a signalling rate, together with the B/R. The repo rate serves the purpose of a floor and the B/R, that of a cap for the money market to operate within an interest rate corridor. The repo rate, along with the B/R and CRR, has emerged as an important tool of liquidity and monetary management.

To sum up, the RBI's regulation of money and credit now comprises **(i)** the reactivation of OMOs and introduction of repos **(ii)** the introduction of LAF and its emergence as one of the significant operating instruments **(iii)** the reactivation of B/R and the use of repo rates **(iv)** the continuation of the use of the CRR. The B/R changes, combined with changes in the CRR and the LAF repo rates have emerged as active and important tools of liquidity and monetary management. The LAF has developed as an effective tool for absorbing/injecting liquidity on a day to day basis in a flexible manner and for providing a corridor for the call money and other money markets.

DEPOSIT PRODUCTS

The major source of bank funds is deposits. Deposits are, in a sense, products/services offered by banks across all segments of their customer base, that is, individuals/ professionals/self-employed persons/corporates and so on. The focus of banks is on creating products/services to cater to the needs of the target customers while being profitable for them. The approach to deposit-product is based on the specific liquidity position of the bank(s) and the time horizon to meet various obligation, from time to time. This section discusses **(i)** the various types of deposits/accounts and **(ii)** some of operational aspects of deposit accounts.

Types of Deposits/Accounts

Deposits of banks are classified into three categories: **(i)** Demand deposits **(ii)** Term/fixed deposits and **(iii)** Hybrid/flexi deposits. The demand and time deposits of banks constitute their demand and time liabilities that they report on every Friday to the RBI.

Demand deposits are repayable to the depositors on demand.

Demand Deposits Demand deposits are repayable to the depositors on demand. There are two types of such deposits: **(i)** current and **(ii)** savings deposits.

Current Deposits/Accounts The features of current accounts/deposits are as follows. First, there are no restrictions on the number and amount of withdrawals/deposits. Withdrawals are permitted by cheques in favour of self as well as other parties. The payees can endorse the cheques in favour of third parties. Secondly, current deposits are non-interest bearing and banks are not allowed to pay interest/brokerage to the depositors. In case of accounts which do not maintain sufficient balances, the banks charge incidental expenses from the depositors in the form of a uniform ledger folio charge per portfolio. Thirdly, overdraft of different durations (i.e. short period or on regular basis) are permitted in current accounts. The regular overdraft facility is extended as per prior arrangement between the bank and the accountholder(s). A mutually agreed upon interest in levied by the bank on the overdraft portion of drawings. Moreover, third party cheques/bills collection and purchase facilities may also be granted to the accountholders as per mutually agreed arrangements and charges. Finally, periodical statements of accounts for record and reconciliation are provided by the banks to the accountholders. They show all the debit/credit transactions and balances date-wise as recorded in the ledger account of the bank(s).

The primary object of current account/deposit is not to solicit savings of the depositors. It is meant for the convenience of the depositors who are relieved of handling cash/payments. Such accounts suit the requirements of large customers whose banking transactions are numerous on every banking day.

Saving Deposits Saving bank accounts collect savings from depositors who save a part of their current income to meet their future needs as well as earn income from them. As a product, savings deposits encourage savings habits among the depositors. Such accounts can be opened by all types of entities.

The savings bank deposits are of two types: **(i)** with cheque book facility to withdraw cash/ make payments, **(ii)** with non-cheque book facility where account holders can have withdrawal facility only at the drawee bank branch through a withdrawal form. Third party payments are not possible in this case. The operational features of savings accounts are the following:

Withdrawals are permitted on demand on presentation of cheque/withdrawal form (letter). However, cash withdrawals beyond a specified amount per transaction/ day require prior notice.

Consistent with the objective of such accounts to encourage savings, banks normally impose restrictions on withdrawals within a given period, the minimum balance to be maintained and so on. The number of withdrawals in a year is limited to 100. Violation would involve levy of a fee/service charge.

The interest on saving deposits are regulated by the RBI. The interest is computed on the daily balance in the savings deposit. No overdraft is permitted and savings accounts cannot have a debit balance. Banks provide a pass book to the depositors containing date-wise debit/credit transactions and credit balances in the ledger account maintained by them.

Term Deposits Such deposits are repayable on maturity as agreed between the depositor(s) and the bank(s). They comprise of **(i)** fixed deposits, and **(ii)** recurring deposits.

> **Term deposits** are repayable on maturity as agreed between the depositor(s) and the bank(s).

Fixed Deposits Such deposits are ones that are with banks for a fixed period specified at the time of making the deposit. They are repayable on the fixed maturity date along with the principal and accrued interest. However, the option to receive the interest on regular basis may be embedded in the deposit at the discretion of the depositor. No other operation can be performed by the depositors against the deposits. On maturity, the deposit can be renewed for another term at the prevailing rate of interest.

A deposit receipt is issued by the bank containing depositor's name, principal amount, date of deposit, maturity period, interest rate and so on. The deposit receipt is, however, not transferable like a cheque.

Fixed deposits can be prepaid, at the discretion of the bank, to accommodate depositors request. However, interest would be paid for the period actually elapsed at a rate one per cent below the rate applicable to the period elapsed. Loans/overdrafts against the security of fixed deposits may be sanctioned by banks at rates of interest 1 – 2 per cent higher than the interest on the deposit.

The minimum period of fixed deposits is 7 days. The maximum term/band of term maturities/ rate of interest for each band are determined by banks.

The rate of interest on fixed deposits cannot be altered under any circumstances during the deposit period. Banks are free to fix their own interest rates on deposits of various maturities. In general, banks pay higher interest on fixed deposits *vis-à-vis* savings deposits to compensate the depositors for foregoing liquidity for longer period. Moreover, the administrative cost of maintenance of these accounts is very small compared to savings deposits. Banks can also freely deploy such funds to earn return. However, the maturity-wise interest rates are uniform except in two cases: **(i)** in case of high value deposits, that is, in excess of ₹15 lakh and wholesale deposits of ₹100 lakh and above and **(ii)** deposits of senior citizens in the range of 0.25 and 0.50 per cent.

Recurring/Cumulative Deposits As a variant of the savings deposit, such deposits inculcate regular and compulsory savings habit amongst depositors to meet specific future needs such as higher education/marriage of children/ purchase of vehicles and so on. The depositors deposit a predetermined amount at a pre-determined frequency, generally monthly/ quarterly, for a pre-specified period ranging between 12 and 120 months.

> **Recurring deposits** are deposits of a pre-determined amount at a pre-determined frequency (monthly/quarterly) for a pre-specified period (12-120 months).

As in the case of fixed deposits, the interest is pre-fixed but a little lower than or almost equal to the fixed deposit rate for the same maturity period. The total deposit amount together with the accrued interest is repaid on the date of maturity. For instance, assuming 8 per cent interest compounded quarterly, a monthly deposit of ₹100 for two years would have a maturity value of ₹2,626 (i.e. ₹2,400 deposit and ₹226 cumulative interest). Depositors are eligible to borrow/ take advance against the deposit. In case of closure of a recurring deposit (i.e. pre-payment) (before maturity), the interest payable by the bank would be lower than the contracted rate and some penalty could also be charged. For instance, no interest would be paid if the deposits are made for less than three months; interest at 1.5 per cent is payable for deposits made upto six months; upto 4 per cent below the rate applicable to a recurring deposit of the period for which the deposit has actually run in case of deposits are held for over an year.

Hybrid/Flexi Deposits These deposits are a combination of demand and fixed deposits. Example of such deposits are the Quantum Deposit Scheme (ICICI Bank) and Multi Option Deposit Scheme (of the SBI). The depositor opens a savings account. Once the quantum of deposits crosses the pre-agreed level, the surplus is automatically transferred (i.e. **sweep transfer**) to the pre-determined term deposit of a pre-determined maturity, usually one year. In the event of a shortfall in the savings account/component, cheques issued by the depositors are paid by automatically transferring back from the term/fixed component (**reverse sweep**) to the savings component.

> **Flexi deposits** are a combination of demand and fixed deposits.

The rate of interest on the term deposit is higher than on the savings deposit. However, in case of reverse sweep, the interest would be lower than the original rate since the term deposit is broken.

The term deposits are recorded only in the books of the bank(s) and no term deposit receipts are issued. However, they would be reflected in the depositors pass book for the savings deposit.

Operational Aspects of Deposits

The aspects of operations of deposits discussed below are: **(i)** account opening/closing, **(ii)** deposit insurance and **(iii)** nomination.

Opening of New Accounts In general, deposit accounts can be opened by person(s) who are major (18 years of age) and of sound mind. Accounts for the benefit of minors can be opened and operated by parents/guardian in the single name of the child or in their joint names payable to either or survivor. While opening deposit accounts, banks have to comply with the RBI-prescribed **Know Your Customer (KYC)** procedure. The focus of **KYC** is on establishing the identity and residential address of the depositor-customer by the specified documentary evidences. A person who wants to open a deposit account has to:

> **Know your customer** is the procedure to establish the identity and residential address of the depositor(s) by specified documentary evidence.

- Fill up and sign the prescribed account opening application form. The depositor is recognised mainly by the signature on cheques/vouchers which are compared with the specimen signature to verify the genuineness of the signature.
- Furnish **(i)** an introductory reference from an existing customer of the bank who has to sign on the application form **(ii)** acceptable proof of his identity/ residential address such as passport, driving license, ration card, voters ID card, PAN card, telephone/electricity bill and so on **(iii)** a photograph and, **(iv)** a minimum initial deposit.

An agent having a power of attorney can operate an account on behalf of a customer/client. Under a mandate, an authorised agent can operate an account temporarily for a specified period.

In case of illiterate persons, their **(i)** thumb impression in lieu of signature are obtained and verified by two persons who know the bank as well as the depositors, **(ii)** photographs are affixed to the ledger accounts and also to the savings deposit pass book for identification. They do not enjoy cheque facility.

The special requirements to be fulfilled for opening and conducting a deposit account by a Hindu Undivided Family (HUF) are: **(i)** the account should be opened in the name of the **Karta**/HUF **(ii)** a declaration signed by the **Karta**/all coparceners affirming the composition of the HUF, its **Karta** and all other coparceners **(iii)** only the **Karta**/authorised coparceners can operate the deposit account, and **(iv)** on death of a coparcener, his share would be handed over to his family.

Banks have to ensure the following while opening of an account of a partnership firm: **(i)** the account is signed for/on behalf of the firm by all the authorised partners and not in an individual name **(ii)** a copy of the partnership deed executed by all the partners should be submitted to the bank **(iii)** a partnership letter signed by all the partners is obtained to ensure their several and joint liabilities. Any cheque payable to the firm cannot be endorsed by a partner in his name and credited to his personal account. A guarantee given to the bank should be signed by all the partners.

The special requirements to open an account in the name of a company are: **(i)** the application form should be signed by the authorised director(s) **(ii)** submission of certified copies of the Memorandum and Articles of Association to guard against ***ultra vires*** acts **(iii)** certificate of commencement of business and list of directors and **(iv)** certified copy of the Board resolution regarding the opening/conduct of account.

The NRIs can open the following two types of accounts: **(i) Foreign Currency Non-Resident (FCNR) Accounts** in any foreign currency as a term deposit upto 3 years renewal, paying interest linked to the international rates of interest of the respective currencies **(ii) Non-Resident External (NRE) Accounts** in the form of savings/current/fixed deposit/recurring deposits. All remittances are converted into rupees. Interest rates are fixed by the RBI.

Closing of a Deposit Account On direction in writing from the depositor, the banker is duty bound to close an account. If an account remains unoperated for a very long period and the customer cannot be traced after reasonable effort, the balance is usually transferred by the bank to an Unclaimed Deposit Account and the account is closed. A bank can also close an account if a customer is found to be **undesirable** customer who is guilty of conducting his account in an unsatisfactory manner, for example, use of forged cheques/issue of cheques without sufficient funds/failure to repay loans, overdraft and so on.

The operation of an account must be stopped by the bank on receipt of a notice of **(i)** death **(ii)** insanity of the depositor(s). Similarly, insolvency/liquidation of a depositor would also result in stoppage of operation of an account.

On receipt of a **Garnishee Order** from a court, the bank would be duty bound to suspend payment from the account. Likewise, on receipt of a notice of assignment of the credit balance in the account of a depositor to a third party, the bank must pay the amount accordingly.

Insurance of Bank Deposits The Deposit Insurance and Credit Guarantee Corporation of India (DICGCI) provides insurance cover to every depositor to the extent of rupees one lakh. The DICGCI reimburses the depositors in case the insured bank fails/is amalgamated with another bank and defaults in paying fully the balances due to the depositors in cash/by crediting in the books of the concerned bank. The bank(s) has/have to pay the DICGCI an insurance premium of 5 paise per annum for every hundred rupees of its total assessable deposits.

Nomination Facility of nomination is available to depositors in banks in all types of deposits to facilitate expeditious settlement of claims in the accounts of deceased depositors and minimise the hardship to the family members on the death of the depositor(s). the nominee(s) would be paid the amount of deposit on the death of the depositor(s). There can be only one nominee in a joint deposit. Only individuals are eligible to be nominees. The nominee(s) can also exercise the right to get premature encashment of fixed deposits. In case the nominee is a minor, another person appointed by the depositor(s) can receive the amount during the minority of the nominee(s). A nomination may be varied/cancelled by the depositor(s). On making payment to the nominee(s), the bank(s) would be fully discharged from liability in respect of the deposit(s).

LOAN PRODUCTS AND OTHER INSTRUMENTS

The major use of bank funds are loans and advances. The loan products of banks are their assets which are used to finance bank customers. In banking transactions, certain other instruments are also used frequently by customers. This section discusses: **(i)** credit facilities (loans/advances) given by banks to customers and **(ii)** modes of security/creating charge on secured advances/loans by banks and **(iii)** instruments used by customers in banking transactions.

Credit Facilities

The credit facilities extended by banks to customers/borrowers are: **(i)** fund-based and **(ii)** non-fund based.

> **Fund based credit facilities** provide funds to borrowers for working capital and capital expenditure.

Fund-based Credit Facilities Such credit facilities provide funds to borrowers for **(i)** working capital and **(ii)** capital expenditure/project finance including deferred payment guarantee.

Working Capital Finance These facilities are granted for a short period, generally upto one year, and are renewed/rolled over from year to year depending upon the fresh assessment of the requirements of the borrower(s). They are provided by way of **(i)** cash credit, **(ii)** overdraft, **(iii)** demand loan and bills purchased/discounted.

> **Cash credit** is running account for drawing of funds with three features: credit limit, drawing power, and actual drawls.

Cash Credit It is a unique credit facility offered by banks in India. It is a running account for drawing of funds with three features, namely, **(i)** credit limit/line of credit **(ii)** drawing power and **(iii)** actual drawls. The borrower can draw funds within the specified **credit limit** sanctioned by the bank against the security of inventory (stock) and receivables (book debts) which are pledged/hypothecated by the borrowers. The borrower(s) submits monthly statements of the charged assets and the bank permits him to draw cash/cheques within the **drawing** power, that is, the value of the pledged assets less the stipulated margin, that the cash credit account can sustain. The bank undertakes continuous verification of the actual inventory/receivables of the borrower. The borrower has to pay interest on actual **withdrawals**/daily debit balances in the account. The borrower deposits the sale proceeds in the cash credit account.

Overdraft Overdraft is drawing from a current account in excess of credit balance. Banks sanction an overdraft limit for a specified purpose/period. Overdraft can be both secured and unsecured. Drawings can be made upto a sanctioned limit and interest is charged on the daily debit balance in the account.

> **Overdraft**
> is drawing from a current account in excess of credit balance.

Demand Loan A demand loan is a one-time facility subject to periodic/lumpsum/principal repayment along with the monthly/quarterly interest payment. The loan is a fixed amount advanced to the borrower initially for a specific purpose, generally upto one year. No subsequent withdrawals are allowed.

> **Demand loan**
> is a one-time facility subject to periodic/lumpsum/principal repayment and interest payment.

Bills Purchased/Discounted A bill of exchange (B/E) is drawn by a seller (drawer) on the purchaser of goods (drawee) directing the drawee to pay the specified amount as per the terms of credit. A bill can be **(i)** demand bill payable on demand **(ii)** usance bill payable on the expiry of credit period, normally upto three months.

> **Bill of exchange**
> is an order by a seller/drawer on the purchaser of goods (drawee) to pay the specified amount as per the terms of credit.

The procedure for bills purchases/discount is as follows. The seller (drawer) submits the bills along with the transportation (i.e. rail/lorry/air/bill of lading) receipts and document of title to goods to his bank who sends the documents to the drawee for presentment for payment (demand bill)/acceptance (usance bill). The sellers' bank purchases the demand bills and discounts the usance bills by crediting the drawer's account with the bill amount less the interest/discount. In case of non-payment of bills on the due date, the drawer would have to pay the bill amount together with additional interest. The bank ensures that the bills purchased/discounted are genuine and represent specific transaction of sale of goods between the seller and the purchaser.

Term Loans/Project Finance **Term loans** are given by banks for capital expenditure, that is, acquisition of fixed assets for setting up a new unit or modernisation/expansion/diversification of an existing one. They have some special features *vis-à-vis* working capital loans. A detailed project appraisal in terms of the **(i)** technical/commercial/managerial viability and **(ii)** financial viability/debt servicing capacity is carried out by the bank before sanctioning the loan. The loan is secured by mortgage of either the specific fixed assets financed or the entire block of fixed assets of the borrower. The loan is repaid by the borrower from its cash accruals in equated monthly/quarterly instalments over the loan tenure. In addition to the mortgage of assets coupled with the promoters guarantee, banks introduce some positive/negative covenants/conditions in terms of minimum working capital, restrictions on dividends, restraint on further borrowings and so on in the loan agreement to ensure financial discipline by the borrower(s).

> **Term loans**
> are loans given by banks for capital expenditure.

Non-Fund Credit Facility Such facilities do not involve outlay of funds and are fee-based. They are a sort of a commitment to honour certain promises and are known as off-balance (liability) items. However, outlay of funds is contingent upon the devolvement of the commitments (contingent liability). Included in such facilities are: **(i)** letters of credit and **(ii)** bank guarantees.

Letter of Credit (L/C) A **letter of credit** is an arrangement whereby a bank (issuer), at the request of a customer (opener of L/C), undertakes to pay the named beneficiary (seller) by a specified date, against the presentment of the specified document(s), the value of the goods/services. An L/C

> **Letter of credit**
> is an arrangement whereby a bank undertakes to pay the named beneficiary the value of goods/services.

involves three parties: **(i)** issuing bank **(ii)** opener (buyer) and **(iii)** beneficiary (seller). The seller supplies goods to the buyer and tenders the consignment documents to the issuing bank against its undertaking in the L/C, who makes payment of the bills and recovers the payment from the buyer.

An L/C may be issued on a **D/P** (deliverable on payment) or **DA** (deliverable against acceptance) basis as regards the delivery of the documents of title to goods to the buyer to enable him to take delivery of the goods. It may be inland for domestic trade or cross border for overseas trade. The bank charges commission on issuance of L/C and interest for negotiating documents under the L/C.

Guarantees Banks issue guarantees on behalf of obligors as a security for due fulfillment of a contract by them in favour of beneficiaries. The guarantee is limited in terms of amount and time framework for its enforcement by the beneficiary. Guarantees may be of different kinds such as financial, performance, deferred payment depending on the nature of the contract between the applicant(s) and the beneficiary(ies). The issuing bank charges commission on the basis of the amount and validity period of the guarantee.

Modes of Security on Secured Advances by Banks

Secured advances by banks are advances which provide security to a bank by means of a charge/right created in the assets of the borrower in favour of the bank. The capacity of the borrower to repay the loan out of his earnings would reflect the risk exposure of the bank. In case of default of the borrower, the interest of the bank would be safeguarded by the availability of security in the form of rights/charge in the assets of the borrower. The various modes of creating a charge in assets are:**(i)** lien **(ii)** pledge **(iii)** hypothecation and **(iv)** mortgage.

> **Lien**
> is the right of a bank to retain assets of the borrowers and sell them under the specified circumstances.

Lien A **lien** empowers a bank to retain all the securities/assets of the customers in respect of the balance due from him. Although the ownership in securities vests in the customers, the bank gets the right to sell them under the specified circumstances. Under **negative lien**, the bank does not have the right to retain any asset/is not entitled to realise dues from such assets but the borrower submits a declaration to the bank to the effect that the specified assets are free from any charge/encumbrance and no charge would be created against them and/or they would not be disposed of without the permission of the bank.

> **Pledge**
> is the delivery of movable goods from the borrower to the bank to secure a debt entitling the bank to sell them if the loan is not repaid within the stipulated time.

Pledge A **pledge** is a delivery of goods from one person (pledger) to another (pledgee) to secure a debt. In a contract of pledge, the borrower is the pledger while the bank is the pledgee. The goods pledged are only movable goods. The ownership in pledged goods continues to remain with the pledger but their possession is given to the pledgee. The pledgee-bank gets the right to sell the goods if the pledger fails to repay the loan within the stipulated time. Alternatively, it may file a suit against the pledger to recover the debt while retaining the pledged goods as security. Upon repayment of the debt covered by the pledge, the banker has to return the goods to the pledger. During possession of the goods, the bank must take adequate and reasonable care of the goods as if they belong to him.

Hypothecation **Hypothecation** refers to a charge on movable goods/commodities/ receivables and so on in which possession and ownership of the securities/assets charged to the banks remains with the borrower(s). He has also the right to sell/use them. Through a hypothecation deed, the borrower undertakes to give possession of the goods when directed by the bank. The borrower has to submit stock statement of goods/book debts hypothecated to the bank on a regular basis. The bank has the right to inspect the goods under hypothecation at any time to ensure, *inter-alia*, that they are not hypothecated to another bank. A hypothecation charge in case of a company must be registered with the Registrar of Companies (ROCs) within 30 days from the date of its creation failing which the bank would lose its priority in the charge in case of multiple financing by two/ more banks.

Hypothecation refers to a charge on movable goods in which the borrower undertakes to give their possession to the bank when directed.

Mortgage **Mortgage** is the transfer of interest in a specific immovable property for the purpose of securing the payment of money advanced/to be advanced by way of loan/an existing or future debts/the performance of an agreement which may give rise to a pecuniary liability. In other words, mortgage is a charge on an immovable property to cover a loan/advance (mortgage money). Ownership and possession of the property remains with the borrower (mortgagor) but some of the interest in the property is transferred to the bank/transferee (mortgagee) through a mortgage deed. A mortgage can be created for present as well as future debt(s). If the mortgager is a company, the mortgage charge must be registered with the ROCs within 30 days from the date of its creation. Mortgages are of five types: **(i)** simple mortgage **(ii)** mortgage by conditional sale **(iii)** usufructuary mortgage **(iv)** English/ legal mortgage and **(v)** equitable mortgage/mortgage by deposit of title deeds.

Mortagage is a charge on an immovable property to cover a loan.

Simple mortgage is a charge in which the mortgagor binds himself personally to pay the mortgage money.

Mortgage by conditional sale is a mortgage in which the mortgage can sell the property on certain conditions.

Usufructuary mortgage is a mortgage in which the mortgagee gets possession of the property together with the right to receive the rent etc from the property.

Legal mortgage is a mortgage in which ownership in the property is transferred to the mortgagee.

Simple Mortgage In a **simple mortgage**, a mortgage deed is executed but the mortgaged property remains in the possession of the mortgagor who binds himself personally to pay the mortgage money. In the event of failure to pay the mortgage money, the bank (mortgagee) has the right to sell the property through the intervention of a court of law and apply the sale proceeds to liquidate the loan.

Mortgage by Conditional Sale **Mortgage by conditional sale** is a mortgage in which the mortgagee ostensibly sells the mortgaged property on certain conditions. The mortgagor does not have any personal liability and the sale procedure through the court intervention can be cumbersome. On default, the sale of the property becomes absolute. On repayment of debt, the sales becomes void and the bank retransfers the property to the mortgagor.

Usufructuary Mortgage Such a mortgage is a mortgage in which the mortgagee gets possession of the property until repayment of debt. He also gets the right to receive rent/profits accruing from the property and to appropriate them in lieu of interest/repayment of mortgage money. The mortgagor has no personal responsibility.

English/Legal Mortgage The mortgagee binds himself personally to repay the mortgage money. The mortgagor and the mortgagee execute the mortgage deed. While the property remains with the mortgagor, its ownership is transferred in the name of the mortgagee subject to its re-transfer back to the mortgagor on loan repayment. The mortgagee can sell the property on non-payment of debt, under English mortgage, but court intervention would be required in case of sale under legal mortgage. Legal mortgages **(i)** require registration with the Registrar of Assurances within four months from the date of execution and **(ii)** attract **ad valorem** stamp duty. In case of a company, the mortgage deed must be registered with the ROCs within 30 days of its execution. On repayment of the mortgaged money, the mortgagee has to execute a separate document to retransfer the property to the mortgagor.

Equitable Mortgage An **equitable mortgage** involves delivery of documents to a creditor of title to immovable property to create a charge on the property. Only the original title deeds are delivered to the mortgagee and no other documents are executed by the mortgagor. The original deeds remain strictly in the custody of the bank until full liquidation of the loan. On deposit of the title deed, the bank (mortgagee) prepares a memorandum of oral assent indicating the date on which the title deeds were deposited and maintains a register of attendance where the oral assent is written and the mortgagor's signature of having attended the bank on that particular date is taken. The mortgaged property is not transferred to the mortgagee. Court intervention would be required to dispose of the property in the event of default. In case of a company mortgage, the equitable charge must be registered with the ROCs within 30 days of its creation.

> **Equitable mortgage** involves delivery of the original title deeds to immovable property to the mortgagee to create a charge on the property.

Instruments Used in Banking Transactions

The instruments issued by banks for use by customers in banking transactions are: **(i)** bankers/demand draft, **(ii)** travellers cheques and **(iii)** dividend/interest warrants.

> **Bank draft** is a payment order issued by a branch of a bank upon another branch.

Bankers/Demand Draft Such a draft is a payment order issued by a branch of a bank upon another branch, directing the drawee branch to pay on demand a specified sum of money to the specified person.

> **Travellers cheques** are a pay order drawn by a bank on itself.

Travellers Cheques **Travellers cheques** are a safe substitute for cash to travellers and mitigate the risk of loss in transit. They are in the form of a pay order drawn by the bank/issuer on itself, payable to the payee/order of the payee. The name of the payee is left blank at the time of issue and filled up by the holder/bearer while encashing the cheque.

Dividends/Interest Warrants Used for dividend/interest payment, they are like cheques drawn on a bank, the specified amount being payable to the named person(s). They are issued in a printed form, crossed to prevent misuse and have a validity of three months.

RETAIL BANKING PRODUCTS

> **Retail banking** is a part of a bank that offers products/services to individual customers.

Retail banking is a part of a bank that offers products/services primarily to individual customers/professionals/self-employed individuals/small businesses and so on. It focuses on creating products/services that meet the needs of target customers and are profitable to the bank as well. The approach is on a mass production basis where all risks/operations are based on/geared to cater to a larger number of customers. This contrasts sharply with corporate (wholesale) banking where focus is on large-sized customer accounts rather than large number of customers. This section discusses **(i)** channels of retail banking services delivery and **(ii)** some important retail banking products and **(iii)** ancillary services of banks.

Channels of Retail Banking Services

Consumer behaviour is changing rapidly due to the developments of technology and the use of banking services is characterised by individuality, mobility, independence of time and place and flexibility. The channels discussed below are: automated teller machine (ATM) card, tele banking, and internet banking.

Automated Teller Machine (ATM) Card A significant channel of banking services delivery is presently *via* the ATM upon insertion of a plastic card and its unique Personal Identification Number (PIN). The ATM card is plastic card with a magnetic strip with the individuals' account number. When the card is inserted in the ATM, the sensing equipment identifies the account holder and asks for the **PIN**. The account holder identifies himself by pressing the relevant number buttons on the ATM. The ATM then verifies the account number on the ATM card along with the secret code number stored in the ATM. When they match, the ATM props up a menu screen which allows the user to transact almost all types of banking transactions.

A typical transaction would be cash withdrawal. The bank(s) generally restrict the maximum amount and the frequency of withdrawal of cash. The amount is immediately debited to the concerned account through accounting entries pre-programmed on the ATM. Similarly, cash/cheques can be deposited through ATM for credit to an account. The ATM dispenses an envelop which should be filled up with cheque/cash. The account number to be credited is registered on the envelop and stored. Later on, the bank staff collects the envelop to credit the account. Account balance enquiries, fixed deposits, debits/credits to the account and so on can also be queried on the ATM. A full-fledged ATM can perform the following functions: **(i)** Cash dispensing **(ii)** Generating statement of accounts **(iii)** Account balance enquiry **(iv)** Request for cheque book **(v)** Deposit of cash/cheques **(vi)** Issue of gift/travellers cheques and **(vii)** Utility payments like telephone/electricity bills and so on.

The advantages of ATM as a service delivery channels, over personal teller are: **(i)** Round-the-clock accessibility, with no need for employee interface **(ii)** Convenient locations of ATMs **(iii)** Automatic/instantaneous accounting of transactions and **(iv)** Cost effectiveness and so on.

Telebanking Customers can access their accounts for information/transaction through tele/phone banking. A telephone PIN (T-PIN), similar to the ATM PIN is provided to each customer. He can call the exclusive telebanking number and identify himself to the automated voice in terms of his account number and T-PIN. Cash withdrawals/deposits are not available through telebanking services. But many banks offer a cash delivery/collection service to certain customers.

Internet Banking An emerging channel of service delivery to a banking customer is the internet. The access to account information/transaction is offered through the world-wide network of computers on the internet. Every bank has special firewalls and its own security measures to protect the accounts from non-authentic use from unauthorised users. Each account holder is provided a PIN similar to the ATM/Telebanking PIN. The access to the account is allowed upon a matching of the account details and PIN entered on the computer system. A higher level of security may be reached by an electronic finger-printer taken before and after every transaction. Then both versions are compared. In case of any difference, the transaction is aborted. Account querying/ transactions are possible on the internet banking platform. The accounting is instantaneous and fund transfers can be affected immediately. However, cash transactions are not possible.

The merits of internet banking, as distribution channel, are: **(i)** Complex products may be offered on equivalent quality with lower costs to more potential customers, **(ii)** There may be contracts from any place at any time of day/night. Thus, banks may enlarge their market area without building new offices/field services.

Retail Banking Products

The retail banking products discussed below are: **(i)** credit cards/other types of cards **(ii)** home loans **(iii)** auto loans **(iv)** consumer durable loans **(v)** personal/unsecured loans and **(vi)** educational loans.

Credit Cards A **credit card** is a plastic card that allows its holder to buy goods/services on credit from approved sales outlets and to pay it at fixed intervals through the card issuing agency (bank). It guarantees payment against a sale voucher signed by the credit card holder. Each credit card bears a specimen signature of its holder and is embossed by the issuing bank with the holder's name/ number. When goods/services are purchased/supplied, the holder gives his card to the supplier. He places the card in a special imprinter machine which records the name/number of the holder on sales voucher. The particulars of the transitions are also added on the voucher. The holder signs the voucher. The supplier then sends the voucher to the issuing bank which pays the amount claimed less a service charge (normally 3–7 per cent). At the end of the month, the bank sends a fully itemised statement to its cardholder who must remit his payment/cheque either for the total amount or the minimum balance. There is no interest charge if the full payment is made by the due date. The interest on payment of the minimum balance is quite high (36–42 per cent). Some banks make a specific annual charge to their cardholders. Credit cards may also be used for obtaining cash from the branches of the issuing bank.

> **Credit card** is a plastic card that allows its holder to buy goods/services on credit from approved sales outlets and to pay at fixed intervals through the bank.

Other Types of Cards Included in other types of cards are: debit cards, cash cards, cheque cards, charged card, and smart card.

Debit Card Debit cards allow for direct withdrawal of funds from a customer's bank account. It is a special plastic card connected with electro-magnetic identification that one can use to pay for purchases directly from his bank account. The cardholders accounts are immediately debited against purchases/services through the computer network. This system is intended to replace the cheque system of payment. However, debit cards can be issued to only customers who maintain adequate balance in their accounts.

> **Debit card** allows for direct withdrawal of funds from a customer's bank account.

Cash Cards Also known as ATM cards, such cards are used for withdrawing cash/currency notes from the ATM.

Cheque Cards They are issued by a bank to a customer to be shown when he writes a cheque promising that the bank would put out the money written on the cheque. The cardholder is given by the bank a card and a cheque book. He has to use the cheques for paying for purchases and the supplier is assured of guaranteed payment. The customer has to keep sufficient balance in his account or he can draw upon an overdraft facility upto a specified limit.

Charged Cards They are cards with which one can buy goods/services from various establishments. The full amount owed must be paid on demand. No credit facility is available in charged cards. The periodic bill amount is paid off by the bank by charging to the customers account.

Smart Cards A smart card enables the cardholders to perform several banking functions, apart from credit purchases from approved sales outlets, for example, cash withdrawals from ATMs, verification of entries in accounts, seek information pertaining to accounts and so on. It can also perform calculations and maintain records.

Home Loans The salient features of bank home loans are: **(i)** types **(ii)** eligibility norms/terms **(iii)** pre and post-approval/disbursal stage documentation **(iv)** repayment period **(v)** collaterals **(vi)** interest calculations **(vii)** fee/charges and **(viii)** tax concessions.

Types A variety of home loans from banks are available: **(i)** Home Purchase Loan: is a basic home loan for the purchase of a new house **(ii)** Home Improvement Loan: is given for repairs/renovation in an existing house already purchased by the borrower **(iii)** Construction Loan: is a loan for construction of a house **(iv)** Home Extension Loan: is a loan for expansion/extension of an existing house such as adding a room/floor and so on **(v)** Home Conversion Loan: allows the borrower to transfer an existing loan to the new home loan which includes the extra amount required and does away the need to pre-pay the existing loan **(vi)** Land Purchase Loan: is provided to purchase land for construction of a house/investment purpose **(vii)** Bridge Loan: is given to persons who are looking to sell their existing home and purchase another one. It helps finance the purchase of a new home until the existing one is sold **(viii)** Balance Transfer Loan: allows the borrower to repay an existing loan and avail of another loan at lower rate of interest **(ix)** Refinance Loan: is given to repay debts taken from friends/relatives and so on for purchase of a home and **(x)** Stamp Duty Loan: is sanctioned to pay the stamp duty on the purchase of a home.

Eligibility The primary eligibility term is the repaying capacity of the borrower. It is determined by the banks based on factors such as income, age, qualifications, number of dependents, spouse's income, assets/liabilities, stability and continuity of occupation, savings history and so on.

Pre/Post-Approval/Disbursal (Stage) Documentation The pre-approval documents along with the application form required by a bank are: **(i)** Proof of income, that is, **(a)** salary/TDS certificate/slip in case of salaried employees and **(b)** track record of business and copy of the audited financial statements of the last two years in case of self-employed borrowers **(ii)** Last six months bank account statements **(iii)** Latest credit card statement **(iv)** Passport size photograph **(v)** Signature verification from the borrower's bank and **(vi)** Proof of residence.

The post-approval/disbursal stage documents required are: **(i)** Allotment letter, **(ii)** Photocopies of title deeds, **(iii)** Agreement to sell, **(iv)** Non-encumbrance certificate, and **(v)** Approved plans/clearance certificates along with estimates if property is self-constructed.

Repayment Period The repayment period range is generally 5–15 years. A 20-year repayment, usually at a higher rate, is also available. The repayment is usually in EMIs by way of post-dated cheques. The EMI comprises of both interest payment and principal repayment.

Collateral Securities In addition to mortgage of the house/land being purchased, banks also take collateral securities to ensure repayment of loan in the event of non-availability of the borrowers normal source of income. These could be personal guarantees, assignment of insurance policies/ shares/mutual fund units/bank deposits and so on. The first mortgage of the property normally by way of deposit of title deeds is the primary security for the loan. However, liquidation of the mortgage is usually the last resort of a bank for the repayment of the housing loan.

Interest The interest rate on home loans is usually calculated on **(i)** monthly **(ii)** yearly reducing balance. In the monthly reducing balance method (**MRBM**), the principal on which interest is paid reduces every month as the EMI is paid, while in the yearly reducing balance method (**YRBM**) it is reduced at the end of the year. The YRBM involves higher interest rate as the borrower continues to pay interest on a certain portion of the principal which has already been paid by way of EMI. The effective rate is approximately 0.70 per cent higher than in the MRBM.

Banks offer options of both fixed and adjustable/floating rate of interest. In the fixed rate option, the benefit of interest fall is not incorporated in the borrowers plan. Conversely, the borrower stands to gain in a rising interest rate scenario. The floating rate of interest reflects the trends in the interest rate scenario.

Fee/Charges The charges/fee associated with home loans are: **(i)** Processing charge is a fee payable to the bank on applying for a loan to cover the administrative expenses incurred in processing a loan application. It could be a fixed fee or a percentage of the loan amount applied for/sanctioned **(ii)** Prepayment penalties, in the range of 0.50 – 1.0 per cent of the amount repaid, are charged in the event of pre-payment of a loan **(iii)** Commitment fee is charged if a loan is not availed of within a stipulated period of the processing/sanction of the loan and **(iv)** Miscellaneous charges could include documentation/consultation charges.

Tax Treatment The repayment of principal upto ₹1,00,000 along with other investments is exempted under Section 80-C of the Income Tax Act. Interest on payments housing loan upto ₹1,50,000 is deductible under Section 24 of the Income Tax.

Auto/Car Loans The main features of auto/car loans are: **(i)** types **(ii)** eligibility **(iii)** pre/post-approval documentation **(iv)** repayment period **(v)** collateral securities **(vi)** interest rate calculation **(vii)** fees/charges and **(viii)** tax benefits.

Types The auto/car loans could be: **(i)** New Car Loan is a simple loan for purchasing a new car; **(ii)** Used Car Loan is a loan facility for purchase of second-hand cars. This involves valuation of the car by certificated valuers and **(iii)** Auto Refinance is a loan facility given on an existing car owned by the borrower if it is not hypothecated to any other financier.

Eligibility Terms The eligibility criteria for auto loans is almost uniform: age of the borrower, between 21 – 58 years; annual income, above ₹60,000. The amount sanctioned depends on the cost of the vehicle, type (standard/premium), and percentage financing offered, say, upto 90 per cent for a new car while used cars get lower financing.

Pre/Post-Approval/Disbursal Documentation The pre-approved documentation is similar to home loan requirements. The post-approval documentation includes photocopies of registration certificate (RC) book, insurance policy and road tax papers.

Repayment Period Usually, auto loans are available for 1–5 years. Longer loans upto seven years may be available in special cases, depending on the brand. The super premium cars generally have a restricted tenure of three years.

Collateral Securities Typically, no additional collateral is required. The RC book is endorsed for hypothecation to the bank which by itself is sufficient security.

Interest Rate Calculation The interest rate is usually charged on a flat rate/reducing balance basis which could be daily, monthly, quarterly or annually. The bank offers upfront a rate known as the **Rack Rate**. These are usually negotiable based on simple negotiating skills or on credit profile. Some banks offer a discount based on **relationship pricing criteria**, that is, the borrower has other relationships with the bank by way of deposits/credit cards/other loans with a good track record of repayment.

Fee/Charges Prior to the completion of transaction, the borrowers have to pay processing fee, advance EMIs/post-dated cheques, stamp/registration charges and insurance.

Tax Benefits Only self-employed persons can avail of tax benefits on depreciation/interest paid on the amount borrowed to purchase the vehicle.

Consumer Durable Loans **Consumer durable loans** cover purchases of durables such as refrigerators, washing machines, air conditioners, microwave ovens, televisions, music systems, DVD players and so on.

The eligibility terms for such loans are: **(i)** Borrowers age, 21–60 years, and **(ii)** minimum gross monthly salary of ₹4,500/annual income of self-employed individuals, ₹45,000. The amount of loan varies according to the nature of the durable purchased.

The documentation requirements of durable loans are proof of identity/residence. Post-dated cheques are collected from the borrowers as part of the documentation requirements.

The repayment period ranges between 12 and 36 months. No collateral security is required in such loans. The interest rates vary, depending on the seasonality of the product. Self-employed persons can avail of tax benefits on depreciation/interest paid if the durables are for professional purposes.

Personal/Unsecured Loans A **personal loan** is an all-purchase loan to meet the personal requirements of the borrower. Typically, the take-home salary should be over ₹8,000 and the borrowers age should be between 21–58 years. The loan eligibility is determined primarily by the borrowers capacity to repay from his current earnings. The EMI usually should not exceed 30–40 per cent of the net take-home salary of the borrower. His place of residence/workplace and employment track record are given higher priority than in secured loans. The maximum loan sanctioned is usually in the range of 11 times the net take-home salary of the borrower. The ceiling on such loans is ₹lakh.

> **Personal loan** is an all-purpose loan to meet the personal requirements of the borrowers.

The pre-approval documentation requirements are the same as in the case of home/auto loans. The banks collect post-dated cheques for the full tenure of the loan prior to disbursal.

The typical tenure of such loans is upto three years with a 6-month lock-in period. No collateral/guarantee is taken by the bank. The interest rates are usually very high. The fees/charges include **(i)** processing fee (1–3 per cent of the loan) **(ii)** foreclosure/prepayment penalty (2–3 per cent) and **(iii)** commitment fee (1 per cent) in case the sanctioned loan is not availed of within a stipulated time. If the loan amount is for a professional purpose, self-employed borrowers may avail of tax benefit on interest paid.

Educational Loans Educational loans cover a variety of courses to meet the cost of **(i)** tuition/mess/examination fee **(ii)** books/equipments/instruments required by the students. For overseas studies, the air fare is also covered.

The primary eligibility requirement is that the student should have got admission to the course for which loan is sought. The age criteria is 16–26 years. Past academic record is also considered.

The ceiling on the loan is ₹7.5 lakhs for studies in India and upto ₹15 lakh for studies abroad. Usually, no margin money is required for loans upto ₹4 lakh. For loans exceeding ₹4 lakh, a margin money of 5 per cent and 15 per cent for studies in India and overseas respectively is stipulated.

The pre-approval documentation requirements would, in addition to confirmed admission by an educational institution, include, **(i)** bank account statements for the last six months **(ii)** passport size photograph **(iii)** signature verification from the borrower's bank **(iv)** proof of residence **(v)** salary certificate/slip and TDS certificate of borrower's parents/details of business track record and the audited financial statements of the last two years of self-employed parents **(vi)** past academic track record of the student and **(vii)** airline booking details in case of overseas education.

The disbursement is made directly to the concerned educational institution to cover tuition/hostel/mess fees. Air fair is directly paid to the airlines. For purchase of books/equipments/instruments, periodical disbursements are made to the student(s).

The repayment starts six months after completion of course or commencement of a job whichever is earlier. No collateral security is required for loans upto ₹25,000. For loans of higher amount, national savings certificates/bonds/property mortgages are taken as collateral. Some banks require the applicant to take an insurance policy of a like amount at the time of disbursal of the loan.

The interest on educational loans is computed as per the RBI guidelines. The fee/charges includes processing/documentation cost/prepayment penalty and penal interest for overdue amount/period. Under Section 80-E of the Income-tax Act, a deduction is allowed in respect of interest on loan for educational purposes for a maximum period of 8 years or till interest is paid whichever is earlier.

Ancillary Services

In addition to ancillary services such as funds remittances, letter of credit and guarantees, agency services, banks provide safe custody of valuables and maintain safe deposits/lockers. Safe custody of valuables/important documents is provided by banks on a fee basis. Customers have faith in banks about the safety/security/ confidentiality of the valuables kept with them. The duly sealed safe custody boxes are kept by banks in their **strong room/vault** and a receipt is issued to the depositor.

Banks also provide safe deposit lockers at their branches. They have reliable locking arrangements. They are kept in vault of banks to provide double safety. They are operated by dual key system one of which is with the authorised bank officer and the other with the customer. Customers have to pay yearly rentals on hiring the lockers.

MONEY MARKET PRODUCTS

The money market is a market for overnight to short-term funds, and for short-term money and financial assets that are close substitutes for money. "Short-term", in the Indian context, generally means a period upto one year; "close substitute for money" denotes any financial asset that can be quickly converted into money with minimum transaction cost and without loss in value. The broad objectives/functions of the money market are to provide:

(i) An equilibrating mechanism for evening out short-term surpluses and deficiencies

(ii) A focal point of central bank (RBI) intervention for influencing liquidity in the economy and

(iii) A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost.

This section discusses the main money market products, namely: Call/notice money, Treasury-bills (T-bills), Commercial bills, Commercial papers (CPs), Certificate of deposits (CDs) and Money market mutual funds (MMMFs).

Call/Notice Money and Short-term Deposits/Term Money

> **Call money** is borrowing and lending funds overnight to meet the CRR requirements of banks.

This money market product in India deals with the (borrowed and lent) overnight/one-day (call) money and notice money for period(s) upto 14 days. It primarily serves the purpose of balancing the short-term liquidity position of banks. The call/notice money is short-term fund repayable on demand and with maturity period varying between one day to a fortnight. When money is borrowed/lent for a day, it is known as call (overnight) money. When money is borrowed/lent for more than a day and upto 14 days, it is known as notice money. Call money is required by banks to meet their CRR requirements. They borrow money from other banks to cover any shortage of cash on a **'reporting Friday'.** As per the RBI stipulations relating to the maintenance of CRR by banks, to enable banks to choose an optimum strategy of holding CRR depending upon their intra-period cash flows, banks are allowed to maintain the CRR on the basis of the last Friday of the second preceding fortnight. The daily minimum requirement is 50 per cent of the fortnightly required for the first 7 days of the reporting fortnight and 65 per cent for the remaining 7 days including the reporting Friday for smooth adjustment of liquidity and better cash management to avoid sudden increase in overnight call rates.

The call market is now a pure inter-bank market. As per the RBI prudential norms/limits relating to reliance (lending and borrowing) of banks on call market, lending of a bank, on a fortnightly average basis, should not exceed 25 per cent of its owned funds (i.e. paid-up capital plus reserves). However, a bank can lend upto 50 per cent on any day during the fortnight. The borrowing of a bank should not exceed the higher of 100 per cent of owned funds or a 2 per cent of its aggregate deposits, on any day during a fortnight, the ceiling on borrowing being 125 per cent. However, these limits are not applicable for days on which Government dated securities are issued in the market.

The interest rate paid on call loans is known as the call rate. The call rate varies from day-to-day and often from hour to hour. It is very sensitive to changes in demand for the supply of call loans. The call rates are influenced by a number of factors:

- Easy/tight liquidity conditions in the market affect the call rate. When liquidity conditions are easy, call rates move around repo rate. During tight liquidity conditions, call rates tend to rise towards the bank rate. The liquidity conditions in the market on the supply side are governed by deposit mobilisation, capital flows and reserve requirements. The demand side of the liquidity position is dependent on tax outflows, Government borrowing programmes, non-food credit take-off and seasonal fluctuations.
- Reserve requirements relating to the maintenance of CRR affect the call rate: an increase in CRR increases call rates and *vice-versa.*

- Asymmetrical nature of participants in the call market in terms of few lenders and large chronic borrowers also results in fluctuations in call rates.
- Volatile forex market conditions also affect call rates. Banks fund foreign currency positions by withdrawing from the call market leading to a hike in the call rates. The RBI intervention in order to prevent the unusual depreciation of the rupee and the temporary withdrawal of the money market support so as to first stabilise the forex market lead to flaring of call rates.

The RBI takes steps to moderate liquidity and volatility in the call market through repos and refinance operations and changes in CRR. The reverse repos are also employed to eject liquidity in the market. Moreover, the LAF modulates short-term liquidity under varied financial market conditions and imparts stability to market conditions.

Commercial Bills

> **Commercial bill** is a short-term negotiable and self-liquidating written instrument containing an unconditional order signed by the maker directing to pay a certain amount of money only to a particular person/ the bearer of the instrument.

Commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It is a written instrument containing an unconditional order signed by the maker, directing to pay a certain amount of money only to a particular person or to the bearer of the instrument. Bills of exchange are drawn by the seller (drawer) on the buyer (drawee) for the value of the goods delivered by him. Such bills are called *trade bills*. Commercial banks can be inland or foreign. Inland bills are drawn/payable in India or drawn upon any person resident in India. Foreign bills are **(i)** drawn/payable outside India, **(ii)** drawn on a party/payable in India or drawn in India/payable outside India. A related classification is export and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by overseas exporters. When trade bills are accepted by commercial banks, they are called *commercial bills*. If the seller gives some time for payment, the bill is payable at a future date (usance bill). During the currency of the bill, if the seller is in need of funds, he may approach his bank for discounting the bill (discounted bill). One of the methods used by banks for providing credit to customers is by discounting commercial bills at a negotiated discount rate. The bank receives the maturity proceeds (face value) of discounted bills from the drawee. Meanwhile, if the bank is in need of funds, it can rediscount the bills already discounted in the commercial bill discount market.

Bill rediscounting is an important segment of the money market and the bill, as a product, provides short-term liquidity to the banks in need of funds.

The development of bill finance/culture not only facilitates an efficient payment system but also ensures the liquidity of the assets/funds of the banks. However, commercial bills, as money market products, are not developed in India to the extent desirable or as compared to its counterparts in other money markets. The factors hindering the development of bill finance/culture are:

(i) Reluctance on the part of the users to move towards bill culture owning to the element of strict financial discipline
(ii) Lack of an active secondary market
(iii) Administrative problems relating to the physical scrutiny of invoices, physical presentation of bills for payment, endorsements/re-endorsement at the time of rediscounting
(iv) Absence of specialised credit information agencies

(v) System of cash credit which is more convenient and cheaper than bill financing as the procedure for discounting/rediscounting are complex and time-Consuming
(vi) Misuse of the bill market in the early 1990's by banks and finance companies
(vii) Small size of the foreign trade
(viii) Absence of specialised discounting institutions

Treasury Bills (T-bills)

T-bill
is an instrument of short-term borrowing by Government to bridge temporary gaps between receipts and expenditures.

A **T-bill** is basically an instrument of short-term borrowing by the Government of India. It is a particular kind of finance bill (i.e. a bill which does not arise from any genuine transaction in goods) or a promissory note issued by the RBI on behalf of the Government. The T-bills are used to raise short-term funds to bridge seasonal/temporary gaps between receipts (revenue and capital) and expenditure of the Government of India. The main features of T-bills are: **(i)** They are negotiable securities **(ii)** They are issued at discount and are repaid at par on maturity. The difference (discount) between the price at which they are sold and their redemption value is the effective return on T-bills **(iii)** High liquidity on account of short tenure (i.e. 91-day and 364-days) and inter-bank repos **(iv)** Absence of default risk due to Government guarantee and RBI's willingness to always purchase/ discount them, negligible capital depreciation **(v)** Assured yield **(vi)** Low transaction cost **(vii)** Eligibility for inclusion in SLR and **(viii)** Purchases/sales effected through the SGL (Subsidiary General Ledger) Account with the RBI.

The development of T-bills is at the heart of the growth of the money market. The T-bills play a vital role in the cash management of the Government. Being a risk-free instrument, their yields at various maturities serve as a benchmark and help in pricing different floating rates instruments in the market. The T-bill segment of the money market products is RBI's preferred tool for intervention to influence liquidity and short-term interest rates. Its development is a prerequisite for effective OMOs.

Types of T-bills There are two types of T-bills: **(i)** 91-Day and **(ii)** 364-Day.

91-Day T-bills The RBI issued 91-day T-bills on the basis of weekly auctions. The **auction system** was replaced by on **tap basis** since 1965 at a discount rate (bill rate) related to change in the bank rate till 1974. A scheme for the issue of 91-day T-bills was introduced in 1992-93 on the basis of auction system with a predetermined/notified amount. The cut-off yields were significantly higher than the fixed discount rate on tap bills. The major holders of auctioned 91-days T-bills are the RBI, State governments and banks. The 91-day T-bills are sold/auctioned on competitive/non-competitive bids. The state governments, state-run pension funds and eligible provident funds participate in the auction on a non-competitive basis. In a non-competitive bid, the participants are not allowed to bid and they have to put in their applications and are allotted T-bills at the weighted average price determined in competitive bidding. They are not allowed any rediscounting facility from the RBI. The non-competitive bids aim at attracting retail investors in the T-bills. The participants in the competitive bids are banks, mutual funds, financial institutions, foreign banks, corporates, FIIs and so on.

364-Day T-bills These T-bills were introduced by the Government in April 1992 to stabilise the money market. They are sold on the basis of a fortnightly auction, but the amount, however, is not specified in advance. Since the RBI does not extend rediscounting facility to such bills, they have been instrumental in reducing the net RBI credit to the Government. The 364-day T-bills became extremely popular due to their higher yield coupled with liquidity and safety and are being used as a benchmark by the financial institutions for determining the rate of interest on floating bonds/notes. They have also widened the money market and provided an innovative outlet for surplus funds. The periodicity of holding 364-day T-bills auctions was made on a monthly basis since October 1998, as against the earlier arrangement of fortnightly auctions. A multiple/discriminatory price auction is conducted where successful bidders have to pay prices (yield) they have actually bid. The investors response to these T-bills depends, *inter-alia*, on the uncertainties in the Government securities market, variations in the SLR and the yield.

The T-bills are zero coupon bonds issued by the RBI, maturing in less than a year. They are issued in the form of a promissory notes. The RBI presently issues T-bills only in two maturities, namely, 91 days and 364 days. These bonds do not bear any coupon and are, hence, issued at a discount and redeemed at par. They are issued on a yield basis and not on a price basis. The T-bills are issued by the RBI through the auction method. It declares the auction calendar at the starting of the financial year, mentioning the amount of issue, the day of the auction and the day of payment.

The 91-day T-bills are auctioned every Wednesday. The multiple price based auction technique is used. The 364-day T-bills are auctioned on second and fourth Wednesday of the month using the uniform price based auction. T-bills are quoted in yield terms.

The T-bills have a primary as well as a secondary market. In the primary market, RBI auctions T-bills. The dealers bids through the Negotiated Dealing System (NDS). In secondary market, the already issued T-bills are traded in by banks, financial institutions and mutual funds. The quotes for T-bills in the secondary market are on a yield basis. Two-way yields are quoted, indicating the buying as well as the selling yields. The bid yield is higher than the ask yield, indicating an inverse relationship with prices. The deals are either conducted directly through the Negotiated Dealing Screen or through a broker. All T-bills deals are reported through the Negotiated Dealing Screen (NDS). Bids are to be submitted on NDS by 2.30 p.m. on Wednesday. If Wednesday happens to be a holiday, bids are to be submitted on Tuesday.

Bids are submitted in terms of price per ₹100. For example, a bid for 91-day T-bills auction could be for ₹97.50. The auction committee of the RBI decides the cut-off price and results are announced on the same day. Bids above the cut-off price receive full allotment; bids at cut-off price may receive full or partial allotment and bids below the cut-off price are rejected.

Types of Auctions There are two types of auctions: **(i)** multiple price auction and **(ii)** uniform price auction.

Multiple Price Auction The RBI invites bids by price, that is, the bidders have to quote the price (per ₹100 face value) at which they desire to purchase. It then decides the cut-off price at which the issue would be exhausted. Bids above the cut-off price are allotted securities. In other words, each winning bidder pays the price it bids.

The advantage of this method is that the RBI obtains the maximum price each participant is willing to pay. It can encourage competitive bidding because each bidder is aware that he will have to pay the price it bids, not just the minimum accepted price. The disadvantage is that bidders bid more cautiously (that is, offer lower prices) in these auctions. This is so because it may happen that bidders who paid higher prices could face large capital losses if the trading in these securities starts below the marginal price at the auction. This is known as the “winner’s curse”. The winner’s curse can be a problem in those markets where price volatility is high. In order to eliminate the problem, the RBI introduced uniform price auction in case of 91-day T-bills.

Uniform Price Auction In this method, the RBI invites bids in descending order and accepts those that fully absorb the issue amount. Each winning bidder pays the same (uniform) price decided by the RBI. In other words, all winning bidders are awarded the auctioned amount at the same price.

The advantage of the uniform price auction are that they tend to minimise uncertainty and encourage broader participation. On the other hand, it may be possible that uniform price auctions could reduce the need to prepare for the auction as allotment at a uniform price reduces the incentive to bid. Moreover, there are dangers of irresponsible bidding or of collusion in a uniform price auction.

There is a fixed calendar for auction of bills. The RBI, through a press communication, two or three days prior to the auction, invites bids indicating the auction date and the amount/type of auction and so on. The T-bill auction is operationalised on the Public Debt Office Negotiated Dealing System (PDO-NDS). It is processed on-line in a straight-through-process (STP) on the system.

Commercial Papers (CPs)

Commercial paper is a short-term unsecured negotiable instrument consisting of usance promissory notes with a fixed maturity.

The CP is a short-term unsecured negotiable instrument consisting of usance promissory notes with a fixed maturity, thus, indicating the short-term obligation of an issuer. It is generally issued by companies as a means of raising short-term debt and, by a process of securitisation, intermediation of the bank is eliminated. The PDs and all-India financial institutions can also issue CPs. It is issued on a discount to face value basis but it can also be issued in interest-bearing form. The issuer promises the buyer a fixed amount at a future date but pledges no assets. His liquidity and earning power are the only guarantee. In other words, the CP is not tied to any specific self liquidating trade transaction in contrast to the commercial bills that arise out of specific trade/commercial transaction. A CP can be issued by a company directly to the investor or through bank/merchant banks (dealers). When the companies directly deal with the investors, rather than use a securities dealer as an intermediary, the CP is called a *direct paper*. Such companies/borrowers announce the current rates of CPs of various maturities. Investors can then select those maturities that closely approximate their holding period and acquire the security/paper directly from the issuer. When CPs are issued by security dealer/dealers on behalf of their corporate customers, they are called *dealer papers*. They buy at a price less the commission and sell at the highest possible level. It is generally backed by a revolving underwriting facility from banks to ensure continuous availability of funds on each roll-over of the CP. Moreover, unlike commercial bills, maturities within the range can be tailored to specific requirements.

The main elements of the present framework of the Indian CP market, prescribed by the RBI, are outlined below.

Issuers Corporates, primary dealers (PDs) and the all-India financial institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by the RBI are eligible to issue CPs. A corporate would be eligible to issue CP provided: **(a)** the tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹4 crore; **(b)** company has been sanctioned working capital limit by bank(s) or all-India FIs; and **(c)** the borrowal account of the company is classified as a standard asset by the financing bank(s)/institution(s). Working capital limit means the aggregate limits including those by way of purchase/discount of bills sanctioned by banks/FIs for meeting the working capital requirements.

Rating Requirements All eligible participants should obtain the credit rating for issuance of the CP from CRISIL Ltd/ICRA Ltd/CARE Ltd/FITCH Ltd or other credit rating agencies specified by the RBI from time to time. The minimum credit rating should be **P-2** of CRISIL or equivalent rating by other agencies. The issuers should ensure at the time of issuance of the CP that the rating obtained is current and has not fallen due for review.

Maturity A CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

Denomination A CP can be issued in denominations of ₹5 lakh or multiples thereof. The amount invested by a single investor should not be less than ₹5 lakh (face value).

Limits and the Amount of Issue of CP A CP can be issued as a "stand alone" product. The aggregate amount of a CP from an issuer should be within the limit as approved by its Board of Directors or the quantum indicated by the credit rating agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' financing including CPs.

An FI can issue a CP within the overall umbrella limit fixed by the RBI, that is, the issue of the CP together with other instruments, namely, term money borrowings, term deposits, certificates of deposit and inter-corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. The CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP should have the same maturity date. Every issue of CP, including renewal, should be treated as a fresh issue.

Issuing and Paying Agent (IPA) Only a scheduled bank can act as an IPA for issuance of the CPs.

Investment in CP The CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, NRIs and FIIs. However, investment by FIIs should be within the limits set for their investments by the SEBI.

Mode of Issuance The CP can be issued either in the form of a promissory note or in a dematerialised form through any depository approved by and registered with the SEBI. However, banks, FIs and PDs are required to make fresh investments and hold CPs only in dematerialised form. It will be issued at a discount to face value as may be determined by the issuer. No issuer should have the issue of a CP underwritten or co-accepted.

Payment of CP The initial investor should pay the discounted value of the CP by means of a crossed account payee cheque to the account of the issuer through the IPA. On maturity, when CP is held in physical form, the holder of the CP should present the instrument for payment to the issuer through the IPA. However, when CP is held in demat form, the holder of the CP will have to get it redeemed through the depository and receive payment from the IPA.

Stand-by Facility In view of the CP being a 'stand alone' product, it would not be obligatory in any manner on the part of the banks and FIs to provide stand-by facility to its issuers. They have, however, the flexibility to provide for a CP issue, credit enhancement by way of stand-by assistance/credit back-stop facility and so on, based on their commercial judgement, subject to prudential norms as applicable and with specific approval of their Board of Directors. The non-bank entities including corporates may also provide unconditional and irrevocable guarantee for credit enhancement for a CP issue provided: **(i)** the issuer fulfils the eligibility criteria prescribed for issuance of CP **(ii)** the guarantor has a credit rating at least one notch higher than the issuer given by an approved credit rating agency and **(iii)** the offer document for CP properly discloses the net worth of the guarantor company, the names of the companies to which it has issued similar guarantees, the extent of the guarantees offered by it, and the conditions under which the guarantee will be invoked.

Procedure for Issuance Every issuer must appoint an IPA for issuance of a CP. He should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, the issuing company should issue physical certificates to the investor or arrange for crediting the CP to the investor's account with a depository. The investors should be given a copy of the IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

Role and Responsibilities The role and responsibilities of the issuer, the issuing and the paying agent (IPA) and credit rating agency (CRA) are set out below:

(a) Issuer With the simplification in the procedure for CP issuance, issuers would now have more flexibility. They would, however, have to ensure that the guidelines and procedures laid down for the CP issuance are strictly adhered to.

(b) Issuing and Paying Agent (IPA) The IPA should ensure that the issuer has the minimum credit rating as stipulated by the RBI and the amount mobilised through issuance of CP is within the quantum indicated by the CRA for the specified rating or as approved by its Board of Directors, whichever is lower. It has to verify all the documents submitted by the issuer, namely, copy of the Board resolution, signatures of authorised executants (when CP in physical form) and issue a certificate that the documents are in order. It should also certify that it has a valid agreement with the issuer. The certified copies of original documents verified by the IPA should be held in its custody. Every CP issue should be reported to the RBI. The IPAs, which are NDS members, should report the details of CP issue on NDS platform within two days from the date of completion of the issue. Further, all scheduled banks, acting as an IPA, will continue to report CP issuance details as hitherto within three days from the date of completion of the issue, incorporating the specified details till NDS reporting stabilises to the satisfaction of the RBI.

(c) Credit Rating Agency (CRA) The code of conduct prescribed by the SEBI for CRAs for undertaking rating of capital market instruments would be applicable to them for rating a CP. Further, the CRA would henceforth have the discretion to determine the validity period of the rating depending upon its perception about the strength of the issuer. Accordingly, the CRA should at the time of rating, clearly indicate the date when the rating is due for review. While the CRAs can decide the validity period of credit rating, they would have to closely monitor the rating assigned to the issuers *vis-à-vis* their track record at regular intervals and make their revision in the ratings public through their publications and website.

Documentation Procedure The Fixed Income Money Market and Derivatives Association of India (FIMMDA) may prescribe, in consultation with the RBI, for operational flexibility and smooth functioning of the CP market, any standardised procedure and documentation that are to be followed by the participants, in consonance with the international best practices. The issuer/IPAs may refer to the detailed guidelines issued by the FIMMDA in this regard. Violation of these guidelines will attract penalties and may also include debarring of the entity from the CP market.

Defaults in CP Market In order to monitor defaults in redemption, banks which act as IPAs are advised to immediately report, on occurrence, full particulars of defaults in the repayment of the CPs to the RBI in the prescribed format.

The participants in the market are corporate bodies, banks, mutual funds, the UTI, LIC, GIC and so on, which have surplus funds and are on a lookout for opportunities for short-term investments. The PDs also operate both in the primary and secondary markets for CPs by quoting its bid and offering prices.

Although the CP market has become fairly popular now, a secondary market is yet to develop and when fully developed, it would impart strength and vitality to the money market. Investors, with temporary surplus, would be able to get attractive yields for their short-term funds and borrowers would be able to raise resources at market-related rates. The development of a secondary market with the active participation of the PDs will improve the liquidity of CPs.

Certificate of Deposits (CDs)

Certificate of deposits is a marketable/negotiable receipt of funds deposited in a bank for a fixed period at a specified rate of interest.

A CD is a document of title to a time deposit and can be distinguished from a conventional time deposit in respect of its free negotiability and, hence, marketability. In other words, CDs are a marketable receipt of funds deposited in a bank for a fixed period at a specified rate of interest. They are bearer documents/instruments and are readily negotiable. They are attractive both to the bankers and the investors in the sense that the former is not required to encash the deposit prematurely, while the latter can sell the CDs in the secondary market before its maturity and thereby the instrument has liquidity/ready marketability.

The CDs, as a money market product, are issued within the framework of the RBI guidelines. The main elements of these are discussed below:

- A CD is a negotiable money market instrument, issued in a demat form or as a usance promissory note for funds deposited at a bank/other eligible financial institutions (FIs) for a specified time period.
- The CDs can be issued by **(i)** commercial banks [excluding the RRBs/Local Area Banks (LABs)] and **(ii)** select all-India FIs permitted by the RBI to raise short-term resources within the umbrella limit fixed by it.
- Banks can issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by the RBI, that is, issue of CDs together with other instruments, namely, term money, term deposits, CPs and inter-corporate deposits should not exceed 100 per cent of its net owned funds as per the latest audited balance sheet.
- The minimum amount of a CD should be ₹1 lakh, that is, the minimum deposit that could be accepted from a single subscriber should not be less than ₹1 lakh and in multiples of ₹1 lakh.
- The CDs can be subscribed by individuals/corporations/ companies/ trusts/funds/associations and so on. The NRIs may also subscribe to CDs on a non-repatriable basis only. Such CDs cannot be endorsed to another NRI in the secondary market.

- The maturity period of a CD issued by a bank should be between 7 days (minimum) and one year (maximum). The FIs can issue CDs with maturity of 1-3 years.
- The CDs may be issued at a discount on face value. They can also be issued on floating rate basis provided the methodology of the compiling the floating rate is objective, transparent and market-based. The issuer is free to determine the discount/coupon rate. The interest rate on the floating rate CDs should be set periodically according to the predetermined formula that indicates the spread over a transparent benchmark.
- Banks have to maintain the appropriate SLR and CRR on the issue price of the CDs.
- There is no lock-in period for the CDs. The physical CDs can be freely transferred by endorsement and delivery. The dematted CDs can be transferred as per the procedure applicable to other demat securities.
- Loans against CDs and buy-back of CDs by the issuers before maturity are not permitted.
- The CDs should be issued only in demat form. Issuance of CDs in physical form, if any, on the insistence of the investors should be separately reported to the RBI. The issuance of CD would attract stamp duty. There would be no grace period for repayment.
- Since physical CDs are freely transferable by endorsement and delivery, they should be printed on good quality security paper and necessary precautions should be taken to guard against tampering with the document. They should be signed by two/more authorised signatories.
- The holders of the dematted CD should approach their respective Depository Participants (DPs) and give transfer/delivery instructions to transfer the demat security to the CD Redemption Account maintained by the issuer. The holder should also communicate to the issuer by a letter/fax a copy of the delivery instruction given to the DP and intimate the place at which the payment is requested to facilitate prompt payment. Upon receipt of the demat credit of CDs in the CD Redemption Account, the issuer on maturity date would arrange to pay to the holder/transferor by way of bankers cheque/high value cheque.

  The physical CDs may be presented by the last holder. Banks should make payments only by crossed cheque to guard against any defect in the chain of endorsement.
- Duplicate certificates can be issued in case of loss of physical certificates only in physical form after compliance with the following: **(i)** a notice in at least one local newspaper of loss of CD certificate **(ii)** lapse of 15 days from the date of notice and **(iii)** execution of an indemnity bond by the investor to the satisfaction of the issuer of the CD.

Initially, in 1990, CDs were highly popular instruments in the primary market, primarily due to their higher interest rates as compared to normal bank lending rates. However, there has been a relative decline in interest rates after 1991 due to the ease with which banks could access other low cost funds and were, hence, flush with funds, to the extent that the primary market in CDs became almost non-existent. In spite of the effort of the DFHI, the secondary market of this instrument could never come into being. Issues of CDs in India are limited to those periods when all the other sectors of the money market become tight. Due to the absence of a well developed secondary market for investors (mostly cash-rich corporates) it is a 'take and hold to maturity' instrument.

Money market mutual fund is a conduit through which investors can earn market related yield from investment in money market instruments.

Money Market Mutual Funds

The sophistication and versatility of the money market is reflected in the diversity of money market instruments/products to suit the varied needs of market participants. The money market instruments outlined earlier in the chapter deals with wholesale transactions involving large amount and are suitable for large corporate and institutional investors. To enable small investors to participate in the money market, a money market mutual fund (MMMF) works as a conduit through which they can earn the market related yield. In April 1991, the RBI outlined a broad framework for setting up these institutions. As a follow-up, in September 1991, a Task Force was appointed to work out the operating guidelines for the setting up of MMMFs. Following the recommendations of the Task Force, in April 1992, the RBI announced detailed guidelines in this regard. Despite the lapse of three years since the guidelines were issued, MMMFs continued to be consciously absent in the money market in India. With a view to imparting greater liquidity and depth to the money market and in order to make the scheme more flexible and attractive to banks and financial institutions, certain modifications to the existing scheme were introduced in December 1995.

In its credit policy, announced on October 29, 1999, the RBI stipulated that from the angle of consistent policy, with regard to investor protection, MMMFs would be brought under the umbrella of the SEBI regulations like other mutual funds. Once the SEBI regulatory framework for MMMFs was in place, the RBI would withdraw its guidelines. However, banks/FIs desirous of setting up MMMFs would have to take necessary clearance from the RBI before approaching the SEBI for registration. The SEBI Mutual Fund Regulations (discussed in a subsequent chapter) are since 2000 applicable to money market mutual funds also.

However, the growth in MMMFs has been less than expected. The size of the MMMF schemes floated by three sponsors is rather small. The MMMFs would hopefully grow when the Indian money market would grow in volume and acquire depth.

Recapitulation

- The RBI is the nerve-centre of the money market and the main regulator of the banking system. The functions/roles of the RBI comprise: note issuing authority (issue of currency), Government banker, bankers' bank, supervisory authority, promoter of the financial system and regulator of money and credit (monetary authority).
- One basic function of the RBI is to issue currency notes that are legal tender every where in India without any limit. Currency management by the RBI involves efforts to achieve self-sufficiency in the production of currency notes/coins, with a judicious denomination mix, improvement in the efficiency of distribution networks, withdrawal and destruction of notes, technology upgradation and enhancement in the security features of currency notes. The currency notes have 100 per cent backing of eligible assets.
- As the Government banker, apart from banking services relating to receipts/payments on behalf of the Government, the issue, management and administration of Government public debt is a major function of the RBI. The objective of its debt management policy is to raise resources at the minimum cost, while maintaining consistency with the monetary policy objectives. To bridge temporary mismatches in the cashflows, it provides WAMAs for a period upto 3 months.
- As the bankers' bank, the RBI has a special relationship with banks. It controls the volume of SLR and CRR and determines their credit-creation ability. It is, in effect, the banker of the last resort.
- As a regulator and supervisor, the RBI prescribes the broad parameters within which the banking and financial system functions. It regulates and supervises the banking system, under the provisions of the Banking Regulation Act. The NBFCs are regulated under the provisions of Chapter III-B of the RBI Act.

- The RBI develops and regulates the foreign exchange market within the framework of the FEMA.
- As the central bank of the country, the RBI formulates and conducts the monetary policy. Monetary policy refers to the use of the techniques of monetary control to achieve the broad objectives of maintaining price stability and ensuring an adequate flow of credit to productive sectors so as to assist growth. The instruments of monetary control used by the RBI are: OMOs, Bank rate, Refinance, CRR, SLR, LAF and Repo Rates.
- The OMOs involve sale and purchase of Government securities and T-bills. Through the OMOs, the RBI can affect the reserve position of banks, yields on Government securities/T-bills and volume/cost of credit. They are poised to emerge as a major tool of monetary policy in India.
- The B/R is the standard rate (i) at which the RBI buys/rediscounts bills of exchange/other eligible commercial papers and (ii) that RBI charges on advances on specified collaterals to banks. The B/R technique regulates the cost/availability of finance to banks/FIs.
- The CRR refers to the cash which banks have to maintain with the RBI as a percentage of their demand and time liabilities to ensure safety and liquidity of bank deposits. As an instrument of policy, the CRR has been used by the RBI very actively.
- The SLR enables the RBI to impose a secondary and supplementary reserve requirement. Strictly speaking, SLR is not a technique of monetary control; it only distributes bank resources in favour of the Government/public sector.
- The LAF has emerged as one of the most important instruments of monetary policy in recent years. The LAF operates through repo auctions for absorption of liquidity and reverse repo auctions for injection of liquidity on a daily basis, thereby creating a corridor for the call rates and other short-term interest rates. The funds under LAF are expected to be used by banks for their day to day mismatchces in liquidity.
- A repo/reverse repo/ready forward/repurchase (buy-back) is a transaction in which two parties agree to sell and repurchase the same security. The seller sells specified securities, with an agreement to repurchase the same at a mutually decided future date and price. Likewise, the buyer purchases the security with an agreement to resell the same to the seller, on an agreed date and at a predetermined price. The same transaction is 'repo' from the viewpoint of the seller and 'reverse repo' from the angle of the buyer. Repo is also known as ready forward as it is a means of funding by selling a security held on a spot basis and repurchasing the same on a forward basis. The terms of the contract are in terms of a repo rate, representing the money market borrowing/lending rate. It is generally lower than the B/R. Repos have a maturity of 1-14 days. They are very safe transactions.
- Two types of repos are currently in operation in India: bank repos and RBI repos.
- The inter-bank repos are permitted under regulated conditions. Banks can undertake repo deeds in all Government securities and T-bills of all maturities, through the SGL Account maintained by the RBI. Repos are also allowed to develop a secondary market in PSU bonds, FI bonds, corporate bonds and private debt securities if held in demat form and if deals are done through stock exchange(s). However, non-bank participants can deal only in reverse repos, that is, they can only lend money to the eligible participants. Such entities holding SGL accounts, can enter into reverse repos with banks, in all Government securities.
- The RBI undertakes repos/reverse repo operations with banks/PDs to absorb/inject liquidity under the LAF. It uses the daily fixed rate repo auction system. It participates actively in the call market, with LAF repos conducted throughout the year to modulate the surplus liquidity in the market. It also conducts reverse repo operations under the LAF to prevent sudden spurts

in the call rates. The repo rate has emerged as the signalling rate, together with the B/R. The repo rate serves the purpose of a floor rate and the B/R serves as a cap for the money market to operate within an interest rate corridor.

- Deposit products are the major source of bank funds. The two components of deposit products are: **(i)** various types of deposits and **(ii)** operations of deposit accounts.
- Deposits of banks are classified into: **(i)** demand, **(ii)** term/fixed and **(iii)** hybrid/flexi deposits.
- Demand deposits, repayable to depositors on demand, are of two types: **(i)** current and **(ii)** savings.
- The primary objective of current deposits is not soliciting savings but convenience of the large customers who are relieved of handling payments. There are no restrictions on withdrawals/deposits in current accounts. Withdrawals are permitted by cheques in favour of self/other parties. They are non-interest bearing. In case of accounts which do not have sufficient balances, the bank may levy service charges. Overdrafts of different durations, short term/regular, are permitted.
- As a product, savings deposits encourage saving habits among the depositors. Such deposits may be either with cheque book facility or with no cheque book facility. Withdrawals are on demand. There are restrictions on the number of withdrawals and the minimum balance to be maintained. The interest rates are regulated by the RBI. No overdraft facility is available on such deposits.
- Term/fixed deposits are repayable on pre-fixed maturity. They comprise of **(i)** fixed and **(ii)** recurring deposits.
- Fixed deposits are for a fixed period specified at the time of making the deposits. The repayment on maturity includes principal and the accrued interest. The option to receive interest on quarterly/monthly basis also is available at the discretion of the depositors. On maturity, the deposits can be renewed for another term at the prevailing rate of interest. They can be prepaid at the discretion of the bank on depositors request at a lower rate of interest. Loans against the security of fixed deposits may be availed of. The minimum period of deposit is 7 days. The interest on such deposits is higher *vis-à-vis* saving deposits.
- Recurring/cumulative deposits are a variant of savings deposit. A pre-fixed amount at a pre-fixed frequency (monthly/quarterly) for a pre-specified period (12 to 120 months) is deposited. The interest is pre-fixed and almost equal to the fixed deposit rate. Loans against the deposit are permitted. Prepayment of deposits at lower rate of interest are also permitted.
- The hybrid/flexi deposits are a fusion of demand and fixed deposits. Balance in excess of a specified level in a savings deposit is automatically transferred (sweep transfer) to the predetermined term deposit of a pre-determined maturity. In the event of a shortfall in the savings component, funds are automatically transferred back through reverse sweep.
- The operational aspects of deposits are: **(i)** opening/closing accounts, **(ii)** deposit insurance and **(iii)** nomination.
- While opening new accounts, banks have to comply with the RBI-prescribed **KYC** procedure in terms of establishing the identity and residential address of the depositor by special documentary evidence. A person who wants to open a deposit account has to **(i)** fill up and sign the prescribed application form **(ii)** furnish **(a)** introductory reference from an existing depositor of the bank **(b)** acceptable proof of his identity/residential address such as passport, licence, ration card, voters ID card, telephone/electricity bills and so on **(c)** a photograph and **(d)** a minimum initial deposit.
- Banks deposits to the extent of rupees one lakh per account are insured by the DICGCI of the RBI.

- Nomination facility is available to the depositors in all types of deposits. The nominees would be paid the outstanding amount on the death of the depositor.
- The loan products of banks are their assets. There are three aspects of loan/advance products of banks: **(i)** credit facilities given to customers **(ii)** mode of security/creation of charge on secured loan/advances and **(iii)** instruments used by customers in banking transactions.
- The credit facilities from banks are divided into: **(i)** fund-based and **(ii)** non-fund-based.
- The fund-based credit facilities provide funds for **(i)** working capital and **(ii)** term/project finance for capital expenditure.
- The working capital finance is provided by way of **(a)** cash credit **(b)** overdraft **(c)** demand loan and **(d)** bills purchased/discounted.
- Cash credit is a unique credit facility. It is a running account for drawing of funds with three elements: credit limit/line of credit drawing power and actual drawls. Interest is payable on the actual drawls. Overdraft is drawing from a current account in excess of credit balance. A **demand** loan is a one-time facility subject to periodic/lumpsum principal repayment together with monthly/quarterly interest payments. Bills purchase/ discounting is a specific-asset credit facility.
- Term/project loan involves a detailed project appraisal of the borrower. It is secured by mortgage of property. To ensure safety of funds loan agreements contain some positive/negative covenants/conditions.
- The non-fund-based credit facilities do not involve outlay of funds. They are contingent liabilities and banks would be liable only on devolvement of the commitments. The credit facilities in this category are: letter of credit and guarantees.
- Secured advances of banks have charge against assets in various modes: **(i)** lien **(ii)** pledge **(iii)** hypothecation and **(iv)** mortgage.
- Although ownership in assets/securities in **lien** vests in the borrowers, the bank gets the right to retain and sell them under certain circumstances to recover money. In a negative lien, the bank does not have such rights. But the borrower submits a declaration to the bank to the effect that the assets are free of encumbrances and no charge would be crated against them nor would they be sold without its permission.
- Pledge is delivery of movable goods from pledgor to the pledgee to secure a debt. While the ownership in the goods lies with the pledgor, their possession is given to the pledgee who can sell them in the event of default in repayment.
- Hypothecation refers to a charge on movable goods/receivables and so on in which possession/ownership/and right to sell assets remains with the borrower(s). But he undertakes through a hypothecation deed to give possession of the goods on direction of the bank. The pledgor has to submit periodical stocks statements to the pledgee to ensure that they are not hypothecated to another bank. Hypothecation charge in case of a company requires registration with the ROCs.
- Mortgage is a charge on immovable property to cover a loan (mortgage money). Although ownership/possession of the property remains with the mortgagor, but some of the interest in the property is transferred to the mortgagee through a mortgage deed. The mortgage must be registered with the ROCs. Mortgages are of five types: **(i)** simple **(ii)** mortgage by conditional sale **(iii)** usufructuary mortgage **(iv)** English/legal mortgage and **(v)** equitable mortgage.
- Though the property remains in the possession of the mortgagor in a **simple** mortgage, but he binds himself through a trust deed personally to pay the mortgage money. In the event of default, the mortgagee has the right to sell the property through court intervention.

- The mortgagor has no personal liability in **mortgage by conditional** sale. He can sell the property on certain conditions.
- Usufructuary mortgage is a mortgage in which the mortgagee gets possession of the property and the rights to receive rent/profits accruing from the property in lien of mortgage money. The mortgagor has no personal responsibility.
- In a legal/English mortgage, the property remains in the possession of the mortgagor but the ownership is transferred in the name of the mortgagee subject to its re-transfer back on loan repayment. The mortgagee can sell the property in the event of default under English mortgage, but intervention of court would be required in legal mortgage.
- Equitable mortgage involves delivery of documents of title to immovable property to create a charge on the property. The property is not transferred to the mortgagee. Court intervention would be necessary to dispose of the property in the event of default.
- The instruments issued by banks for use by customers in banking transactions are: **(i)** bankers draft **(ii)** travellers cheques and **(iii)** dividend/ interest warrants.
- Retail banking refers to banking products/services offered to primarily individual customers/ professionals/self-employed individuals and so on. The two elements of retail banking are: **(i)** channels of retail banking services delivery and **(ii)** retail banking products.
- In addition to the personal teller, the technology-driven channels of retail banking services delivery are **(i)** ATM **(ii)** telebanking and **(iii)** internet banking**.**
- A full-fledged ATM can perform the following functions: **(a)** cash dispensing **(b)** generation of statement of accounts **(c)** account balance enquiry **(d)** request for cheque book **(e)** deposit of cash/cheques **(f)** issue of travellers cheques **(g)** utility payments like telephone/electricity bills and so on. As a service delivery channel, the merits of ATM are round the clock accessibility, convenient locations, automatic accounting of transaction and cost effectiveness.
- Telebanking enables customers access their accounts for information/ transaction. But cash deposits/withdrawals are not available through such services. Some banks offer cash delivery/ collection to select customers.
- Banks can enlarge their market area through internet banking without building new offices/ field services.
- The popular retail banking products are **(i)** cards **(ii)** home loans **(iii)** auto loans **(iv)** commercial durable loans **(v)** personal/unsecured loans **(vi)** educational loans.
- The cards issued by banks are credit cards, debit cards, cash cards, cheque cards, charged cards and smart cards.
- Credit card is a plastic card that allows its holder to buy goods/services on credit from approved sales outlets and to pay at fixed intervals through the bank. The holder can either remit the full payment or the minimum balance. There is no interest charge if full payment is made within the due date (30 days). The interest on the payment of the minimum balance is very high. Credit cards may also be used for obtaining cash from the branches of the issuing banks.
- Debit cards allows for direct withdrawal of funds from a customer's bank account. **Cash/ATM** cards are used to withdraw cash from the ATM. **Cheque** cards promise that the bank would put out the money written on the cheque for paying for purchases and the supplier would be assured of guaranteed/payment. A **Smart** card enables the cardholders to perform several banking functions such as credit purchases, cash withdrawals from ATMs, verification of entries in accounts and so on. It can also perform calculations and maintain records.

- A variety of home loans are available from banks, namely: **(i)** purchase/improvement/extension/conversion home loans and **(ii)** land purchase loan/bridge loan/balance transfer loans/refinance loans/stamp duty loans. The primary eligibility criteria is the repaying capacity of the borrower based on factors such as income, age, number of dependents, savings history and so on. A number of pre and post-approval/disbursal stage documentations are required. The repayment period generally ranges between 5 and 15 years. It is usually in EMIs by way of post-dated cheques. Banks take collateral securities to ensure repayment of loan in the event of the non-availability of the borrowers normal source of income. The interest rate on home loan is usually calculated on monthly or yearly reducing balance. The effective rate is higher in the yearly reducing balance method. Banks offer both fixed and floating interest rate options. The charges/fee associated with home loans are processing fee, prepayment penalties, commitment fee and documentation charges. Both the interest payment and principal payments are tax-deductible upto specified amount.
- Auto loans could be for new/used cars and auto-refinance. The eligibility criteria includes age/income of the borrowers. The pre-approval documentation requirement is similar to the home loans. The post-approval documentation includes registration certificate (RC) book of the vehicle. Such loans are usually available for upto 5 years. No additional collateral is required. The repayments are in EMIs by way of advance cheques. The borrowers have to pay processing fee, stamp/registration charges and insurance. Only self-employed persons can avail of tax benefits on depreciation of the vehicle and interest paid.
- Consumer durable **loans** cover purchase of durable goods such as refrigerators, washing machines, microwave ovens, TVs and so on. The eligibility criteria are borrowers age, minimum gross salary/annual income of self-employed person and so on. The documentation requirements are proof of identity/residence. The repayment period ranges between 12 and 36 months. No collateral security is asked for. Interests rates vary seasonally. Only self-employed persons can avail of tax benefits on depreciation and interest payments.
- A personal loan is an all-purpose unsecured loan to meet the personal requirements of the borrower (s). The loan eligibility is determined primarily by the borrower's capacity to repay from his current savings. The EMI usually should not exceed 30-40 per cent of his net take-home salary. The loan ceiling is usually in the range of 11 times the net home-take salary. The pre-approval documentation requirements are same as in case of home/auto loans. Banks collect post-dated cheques for the full tenure of the loan prior to disbursal. The typical tenure is 36 months. No collateral is required. The interest rates are usually very high. The fee/charges including processing fee, foreclosure penalty and commitment fee.
- Education loans are given for a variety of courses to meet the cost of tuition/mess/examination fee, books/equipments/instruments and air fair for overseas studies. The primary eligibility criteria is the confirmed admission of the student to the course. The ceiling on loan is ₹7.5 lakh for studies in India and ₹15 lakh for studies abroad. The disbursement is made directly to the concerned institution/airlines. Disbursement for books and so on are made periodically to the student(s). Collaterals in the form of NSCs/bonds/property mortgages/insurance policy are required. The interest on loan is computed as per the RBI guidelines. The interest payments and principal repayments are tax-deductible. The repayment starts six months after completion of course/ commencement of job.
- Money market is a market for overnight to short-term funds (i.e., upto 1 year) and for short-term money and financial assets that are close substitutes for money, that is, financial assets that can be quickly converted into cash (money) with minimum transaction cost and without loss in value.

- These broad objectives/functions of the money market are three-fold: (i) It acts as an equilibrating mechanism for evening out short-term surpluses and deficiencies of funds (ii) It is the focal point of RBI intervention for influencing liquidity in the economy and (iii) It provides reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable cost or to temporarily deploy their excess funds for earning returns.
- The main money market products are: **(i)** Call/notice money **(ii)** T-bills **(iii)** Commercial bills **(iv)** CPs **(v)** CDs and **(vi)** MMMFs.
- The call/notice money deals with overnight/one-day (call) money and notice money for upto 14 days. Call money is required by banks to meet their CRR requirements on a reporting Friday. The call market is a pure inter-bank market now. There are also prudential limits on lending and borrowing by banks. The lending limit on a fortnightly average basis is 25 per cent of owned funds. The borrowing limits are the higher of 100 per cent of owned funds or 2 per cent of the aggregate deposits of a bank.
- The interest rate paid on call loans is known as the call rate. The call rates are affected by a number of factors such as easy/tight liquidity conditions, reserve requirements, volatile forex market conditions and so on. The RBI moderates liquidity and volatility in the call market through LAF, repo and reverse repo and changes in CRR.
- A commercial bill is a short-term negotiable and self-liquidating instrument. It is a written instrument containing an unconditional order signed by the maker (seller of goods), directing the buyer to pay a certain amount of money only to a particular person or to the bearer of the instrument. The bills can be discounted in the bill discount market.
- Bill rediscounting, as a money market product, has not become popular in India inspite of several measures, including abolition of stamp duty, taken by the RBI to develop bill finance. The main factors hindering the development of the bill finance/culture are: system of cash credit, small size of foreign trade, absence of specialised discounting institutions, lack of an active secondary market and so on.
- A T-bill is an instrument of short-term borrowing by the Government of India to bridge seasonal/temporary gaps between receipts and expenditures. It is issued by the RBI on behalf of the Government. The features of T-bills are: negotiability, issued at discount and redemption at par on maturity, high liquidity, low transaction cost, absence of default risk, eligibility for inclusion in the SLR and transaction through SGL Account. Being a risk-free instrument, the yields on T-bills at various maturities serve as a benchmark and help in pricing different floating rate instruments in the market. The T-bill market is the RBI's preferred tool for intervention, to influence short-term interest rates.
- T-bills are zero coupon bonds issued by the RBI on behalf of the Government, in the form of a promissory note. It presently issues T-bills in two maturities: 91 days and 364 days. They are issued through auction. The RBI declares the auction calendar at the starting of the financial year, mentioning the amount of issue, the day of auction and the day of payment.
- The 91 days T-bills are auctioned every Wednesday. The multiple price based auction technique is used. Under this method (also known as French Auction), all bids equal to/above the cut-off price are accepted. However, the bidder has to obtain the T-bills at the price quoted by him. The 364 days T-bills are auctioned on the second and fourth Wednesdays of the month, using the uniform price based auction (also known as Dutch Auction). Under this system, all the bids equal to/above the cut-off prices are accepted at the cut-off level. The bidder obtains the T-bills at the cut-off (uniform) price and not at the price quoted by him.
- A CP is a short-term, unsecured, negotiated instrument consisting of a usance promissory note with a fixed maturity. It is not tied to any specific self-liquidating trade transaction.

Depending on whether it is issued by the company concerned directly or through a dealer, the CP is called a *direct paper* or a *dealer paper* respectively. As a short-term instrument, a CP offers several advantages to the issuers as well as the investors, such as simplicity, flexible maturities, lower cost, higher credit standing, no restriction on end-use of funds, high liquidity, higher return and so on.

- The framework of the Indian CP market has to conform to the RBI guidelines. The main elements of the framework relate to the (i) eligible issuers in terms of minimum tangible net-worth, sanction of working capital limits by banks/FIs and classification of borrowal account as standard asset, (ii) instrument in terms of minimum rating, denomination and stand-alone character (iii) renewal of a CP (iv) eligible investors and (v) form of issue and so on.
- A CD is a negotiable money market product, issued in a demat form or as a usance promissory note for funds deposited at a bank/other eligible FIs for a specified time period. In other words, a CD is a marketable receipt of funds deposited in a bank/FII, for a fixed period, at a specified rate of interest. It is attractive both to the bank/FII and the investors as the former does not have to encash the deposit prematurely, while the latter can sell it in the secondary market before its maturity.
- The framework of the issue of CDs in India is prescribed by the RBI. The main elements of the RBI guidelines relate to eligibility of issuers, aggregate amount of issue, minimum issue size and denomination, eligible subscribers, maturity, discount/coupon rate, reserve requirements, transferability, loans/buy back and so on.
- An MMMF is a conduit through which small investors can participate in the money market to earn the market-related yield. They are, however, a marginal product in the Indian money market.

REVIEW QUESTIONS

8.1 Explain briefly the **(i)** role and **(ii)** functions of the RBI as a central bank.

8.2 Discuss the main features of **(a)** demand, **(b)** term and **(c)** hybrid deposits.

8.3 Describe the procedure relating to opening of bank accounts.

8.4 Write notes on:
- Closing of bank accounts
- Insurance of bank deposits
- Nomination facility in bank accounts

8.5 Describe briefly the various fund-based credit facilities that banks offer to customers for working capital needs.

8.6 Explain briefly the various forms of non-fund credit facilities from banks to customers.

8.7 Discuss the features of the following types of mortgages: **(i)** simple mortgage, **(ii)** mortgage by conditional sale, **(iii)** usufructuary mortgage, **(iv)** legal/English mortgage, and **(v)** equitable mortgage.

8.8 Write brief notes on:
- Lien
- Pledge
- Hypothecation

8.9 Explain briefly the features of instruments issued by banks for use by customers in banking transactions.

8.10 Describe each of the following:
- Credit cards
- Debit cards
- Cheque cards
- Charge cards
- Smart cards
- ATM cards

8.11 Explain the features of home loans extended to customers by banks.

8.12 Explain briefly the following types of loans extended by banks to customers:
- Auto loans
- Consumer durable loans
- Educational loans
- Personal/unsecured loans

8.13 Write notes on:
- ATM
- Telebanking
- Internet banking

8.14 Describe briefly the features of money market.

8.15 Write notes on the following money market products:
- Call loans
- Commercial bills
- T-bills
- CPs
- CDs
- Money market mutual funds.

CHAPTER 9

Mutual Funds: Services and Products

Learning Objectives

- Understanding the special nature of mutual fund products and the benefits to the investors of a diversified portfolio.
- Outline the procedure for registration of mutual funds and their constitution and management, and operation of trusts.
- Discuss the constitution and management of an asset management company (AMC) and custodian.
- Explain the procedure for launching mutual fund schemes.
- Examine the investment objectives and valuation policies of the mutual funds.
- Understand the main features of real estate mutual fund schemes.
- Explain the main features of infrastructure debt fund schemes.
- Outline the main types of mutual fund products available in the country.
- Understand the difference between the rupee cost averaging and value averaging.

INTRODUCTION

With the emergence of the capital market at the centre stage of the Indian financial system, from its marginal role a decade earlier, the Indian capital market also witnessed, during the same period, a significant institutional development in the form of a diversified structure of mutual funds. A mutual fund is a special type of investment institution that acts as an investment conduit. It pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. Mutual funds issue securities (known as units) to the investors (known as unit-holders) in accordance with the quantum of money invested by them. The profits (or losses) are shared by the investors in proportion to their investments. A mutual fund is set up in the form of a trust, which has **(i)** sponsor, **(ii)** trustees, **(iii)** asset management company (AMC) and, **(iv)** custodian. The trust is established by a sponsor(s) who is/are like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit-holders. The AMC manages the funds by making investments in various types of securities. The custodian holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC, they monitor the performance and compliance of the SEBI Regulations by the mutual fund. As an investment intermediary, they offer a variety of services/advantages to the relatively small investors who, on their own, cannot successfully construct and manage an investment portfolio mainly due to the small size of their funds, lack of expertise and experience and so on. These, *inter-alia*, include convenience, lower risk through diversification, expert management and reduced cost due to economies of scale.

Convenience Mutual funds convert securities into more *convenient* vehicle for the mobilisation of savings, particularly of small savers. This convenience to the savers has two dimensions. One is ***divisibility***. They adjust the denomination of the securities to suit the requirements of individual savers by offering securities of varying sizes. They divide primary securities of higher denomination into indirect securities of lower denomination so that even savings can be tapped from small pockets for ultimate investment in real assets. For examples, the minimum threshold investment in new (primary/direct) issues in India presently in rupees 5 – 7 thousands. In the case of mutual funds, the minimum investment requirement is rupees one thousand only. Borrowers too achieve *flexibility* in dealing with a financial intermediary as compared to dealing with a large number of lenders. They are able to obtain terms suiting their needs more readily.

The other convenience of mutual fund units is their ability to transform a primary security of a certain ***maturity*** into an indirect security of a different maturity. Mutual funds, in fact, manufacture liquidity. They create claims, which are more liquid than the securities they buy, and issue them to savers. The redemption facility available to unitholders of open-ended mutual funds can be cited in support of this argument. To the extent that mutual funds agree to buy their own units, investors are spared the inconvenience of stock exchange dealings. As a result, maturities on indirect securities may conform more with the desires of ultimate borrowers and lenders than those on primary securities.

Lower Risk Mutual fund investments also have the merit of exposing investors to lower risk. This is mainly because of the benefits of '**diversification**' that becomes available to even small investors. Mutual funds enable investors, through a single commitment, to diversify investments widely, thereby reducing the risk of capital depreciation and poor dividends. Since diversification is a function of the size of investible funds as well as market information and supervision facilities available to investors, relatively small investors with limited capital can obtain better diversification by purchasing units of mutual funds than what they could do by direct purchase of securities in the securities market. Thus, mutual funds extend the same facilities—of diversification and reduction in the risk—as are available to an investment portfolio of large institutional investors. In effect, a mutual fund transforms the relatively small investors in matters of diversification of investment, into large institutional investors, as they share proportionate beneficiary interest in the total portfolio.

Expert Management Mutual funds give, both large and small investors, the benefits of trained, experienced and specialised management together with continuous supervision, neither of which the investor is, as a rule, qualified to supply himself. The importance of this service provided by mutual funds should be viewed in the context of the complexities involved in the selection and supervision of securities, namely, specialised knowledge, training, ability, aptitude, time, and inclination. Large investors can set right these deficiencies by engaging experts. But small investors cannot avail of these facilities due to financial limitations. With their specialised knowledge and facilities, the professional managers of mutual funds can demonstrate a superior performance to that of the individual investors. Thus, in effect, mutual funds place the small investors in the same position in the mater of expert management as large institutional investors.

Economies of Scale Mutual funds provide economies of scale. As they are continually in the business of purchasing/selling primary securities, the economies of scale not available to a borrower or to an individual saver, are available to them. They exploit economies of scale in investing. Its one implication is that they are able to channel funds from the ultimate lenders to the ultimate borrowers at a lower cost.

It is obviously in recognition of these benefits that the official policy in India is geared to promote mutual funds as the preferred route for investment of funds for small investors, through measures such as raising the threshold/minimum limit of investment in the primary market from ₹1,000 to ₹2,000; schemes of firm and proportional allotments; the treatment of capital gains arising out of long-term holdings of units of mutual funds for one year instead of three years (as it was earlier); the reduction from 20 to 10 per cent in capital gains tax; exemption of dividend income from mutual funds in the hands of the investors, together with the total exemption of the income of the mutual funds from tax and so on. However, mutual funds whose investment in equity shares is less than 50 per cent of the funds of the scheme have to pay 12.5 per cent tax on dividend payment.

The present Chapter is devoted to a discussion on mutual fund products/services. **The framework of their regulation and operation is depicted in Exhibit 9.1.** Section 1 of the chapter outlines the broad regulatory mechanism. The SEBI mutual funds guidelines issued under the Mutual Fund Regulations are covered in **Appendix 9-B on the website. The website address is http://www.mhhe.com/khanfs9e**. The classification of mutual funds on the basis of the funds/schemes is covered in Section 2. Some concluding observations are given in the last Section.

OPERATIONS OF MUTUAL FUNDS: REGULATORY MECHANISM

The main elements of the SEBI regulatory mechanism of mutual funds are: **(i)** registration of mutual funds with the SEBI, **(ii)** constitution and management of mutual funds, and operation of trusts, **(iii)** constitution and management of asset management company and custodian, **(iv)** schemes of mutual funds, **(v)** investment objectives and valuation policies, **(vi)** real estate mutual fund schemes, **(vii)** general obligations, **(viii)** inspection and audit and **(ix)** procedure for action in case of default.

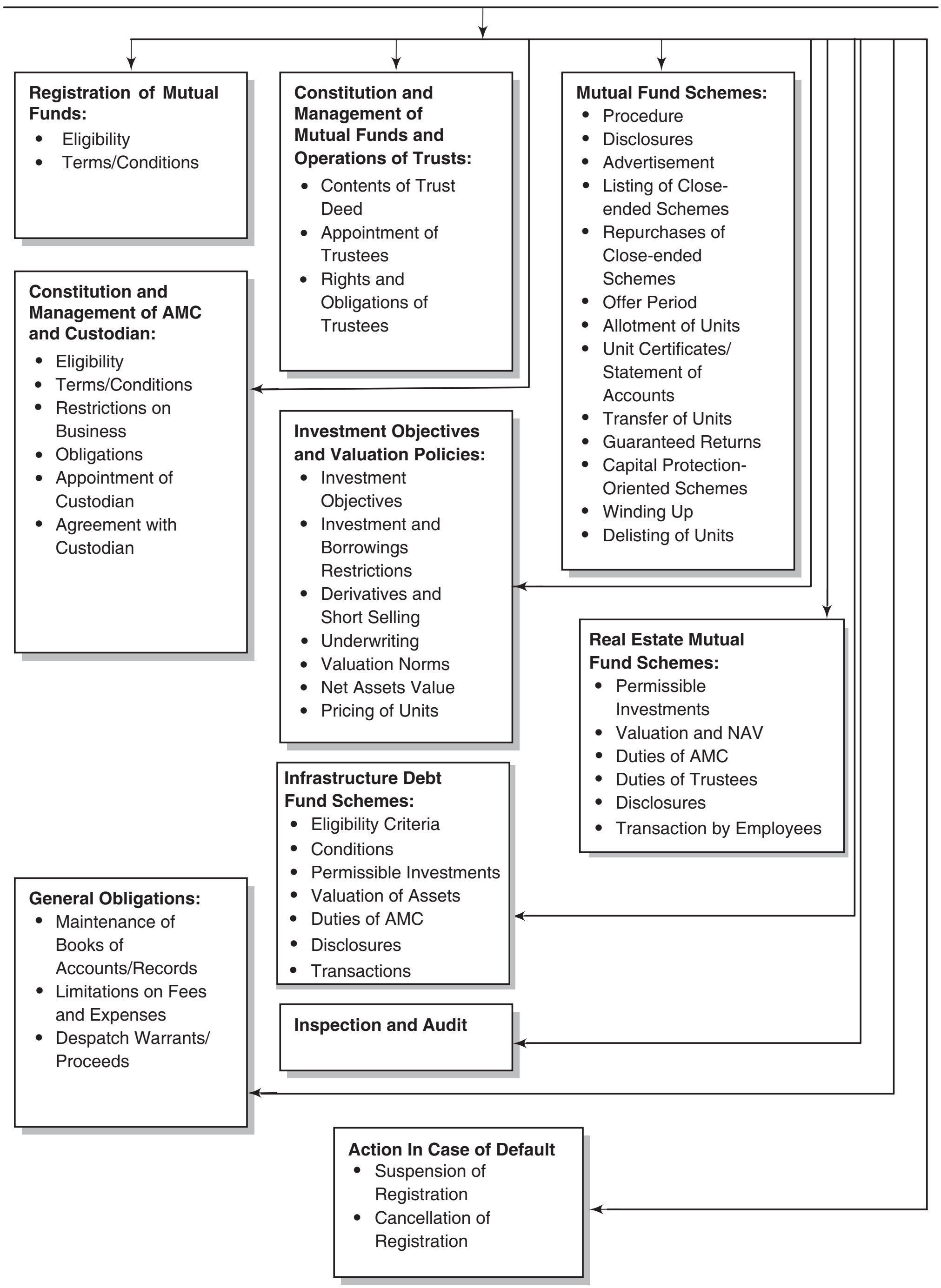
Registration of Mutual Funds

> **Mutual funds** are funds established as trust to raise money through sale of units to public under scheme(s) for investing in securities/gold or gold related instruments and real estate assets.

Mutual funds are defined by the SEBI regulations as funds established in the form of a trust to raise money through the sale of units—that is, the interest of the unit-holders in a scheme—to public under one/more scheme(s) for investing in securities, including money market instruments consisting of commercial papers, commercial bills, treasury bills, government securities having an unexpired maturity up to one year, call/notice money, certificate of deposits, usance bills and so on or gold or gold related instruments or real estate assets. To carry on business, mutual funds must be registered with the SEBI. The application for registration, together with a non-refundable fee of ₹25,000, should be made in the prescribed form. The procedure prescribed by the SEBI is outlined below.

Eligibility Criteria The eligibility criteria for registration of sponsors who can establish mutual funds are given below:

Exhibit 9.1 Regulatory Mechanism for Mutual Fund Operations



1. The applicant-sponsor should have a sound track-record and general reputation of fairness and integrity in all his business transactions and he should be a fit and proper person. The test of a sound track-record is:
   (i) carrying on business in financial services for at least five years;
   (ii) positive net worth in all the immediately preceding five years;
   (iii) net worth in the immediately preceding year should be more than the capital contribution of the sponsor in the asset management company and
   (iv) profit after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year.
2. The sponsor should contribute at least 40 per cent of the net worth of the asset management company.
3. The sponsor/any director/principal officer to be employed by the mutual fund should not have been guilty of any fraud/convicted of an offence involving moral turpitude/guilty of any economic offence.
4. Appointment of trustees/trustee company to act as trustees for the mutual fund who hold the property of the mutual fund in trust for the benefit of the unit holders.
5. Appointment of asset management company set up under the provisions of the Companies Act to manage the mutual fund and operate its schemes.
6. Appointment of custodian in order to keep custody of the securities or gold/gold related instruments (i.e. instrument having gold as the underlying as specified by the SEBI) or other assets of the mutual fund and provide such other custodial activities as may be authorised by the trustees. He should be registered with the SEBI under the SEBI Custodian of Securities Regulations, 1996.
7. For determining whether an applicant mutual funds is a fit and proper person, the SEBI may take into account the criteria specified in the SEBI Intermediaries Regulations, 2008.

Terms and Conditions of Registration The registration of mutual funds with the SEBI is subject to certain terms and conditions, namely **(i)** trustee/sponsor/asset management company/custodian would have to comply with the SEBI regulations, **(ii)** the mutual fund would immediately/forthwith inform the SEBI if any information/particulars previously submitted were misleading/false in any material respect as also of any material change in the information/particulars previously furnished, which have a bearing on the registration granted by it, and **(iii)** payment of **(a)** application fee of ₹5 lakh, **(b)** registration fee of ₹25 lakh and **(c)** annual fee based on average assets under management (AAUM) as follows: **(i)** AAUM upto ₹10,000 crore, 0.0015 per cent, **(ii)** Part of AAUM above ₹10,000 crore, 0.0010 per cent.

The SEBI may not permit a mutual fund who has not paid the annual fee to launch any scheme.

Constitution and Management of Mutual Fund and Operation of Trusts

A mutual fund can be constituted in the form of a trust and the instrument of trust should be in the form of a deed, duly registered under the Indian Registration Act, 1908, executed by the sponsor in favour of the trustees named in the instrument.

The trust deed should contain, in addition to the clauses prescribed by the SEBI, such other clauses that are necessary for safeguarding the interests of the unit-holders. However, no trust deed should contains clause(s) that has the effect of **(i)** limiting/extinguishing the obligations/

liabilities of the trust in relation to any mutual fund/unit-holder or **(ii)** indemnifying the trustees/asset management company for loss/damage caused to the unit-holders by their acts of negligence/commission/omission.

Contents of Trust Deed The contents of trust deed, prescribed by the SEBI, are as follows:

1. **(i)** A trustee, in carrying out his responsibilities as a member of the Board of Trustees/Trustee Company, should maintain an arms' length relationship with companies/institutions/financial intermediaries/any body corporate with which he may be associated.
   (ii) No trustee should participate in the meetings of the Board of Trustees/Trustee Company when any decisions for investment, in which he may be interested are taken.
   (iii) All the trustees must furnish to the Board of Trustees/Trustee Company particulars of interest that they may have in any other company/ institution/financial intermediary/any corporate body by virtue of their position as director, partner or with which they may be associated in any other capacity.
2. The minimum number of trustees would be four.
3. The trustees must take into their custody/under their control all the property of the schemes of the mutual fund and hold it in trust for the unit-holders.
4. Unit-holders would have beneficial interest in the trust property to the extent of individual holding in respective schemes only.
5. It would be the duty of the trustees to act in the interests of the unit-holders.
6. It is also the duty of trustees to provide or cause to provide information to unit-holders and the SEBI, as may be specified by the SEBI.
7. The trustees should appoint an asset management company (AMC), approved by the SEBI, to float schemes for the mutual fund after approval by the trustees and the SEBI, and manage the funds mobilised under various schemes, in accordance with the provisions of the trust deed and the SEBI regulations. They should enter into an investment management agreement with the AMC for this purpose, and should enclose the same with the trust deed.
8. It is the duty of the trustee to take reasonable care to ensure that the funds under the schemes floated and managed by the AMC are in accordance with the trust deed and the SEBI regulations.
9. The trustees have the power to dismiss the AMC under specific events only with the approval of the SEBI, in accordance with these regulations.
10. Appointment of a custodian and responsibility for the supervision of its activities in relation to the mutual fund, and enter into a custodian agreement for this purpose.
11. The auditor for the mutual fund must be different from the auditor of the AMC.
12. The responsibility of the trustees to supervise the collection of any income due to be paid to the scheme and for claiming any repayment of tax and holding any income received in trust for the holders in accordance with the trust deed and the SEBI regulations.
13. Broad policies regarding allocation of payments to capital or income.
14. Explicitly forbid the acquisition of any asset out of the trust property that involves the assumption of any unlimited liability or should not result in encumbrance of the trust property in any way.
15. Forbid the mutual fund from making or guaranteeing loans to take up any activity in contravention of the SEBI regulations.
16. Trusteeship fee, if any, payable to trustees.

17. No amendment to the trust deed can be carried out without the prior approval of the SEBI and unit-holders. However, in case of subsequently conversion of Board of Trustees into a Trustee Company, such conversion would not require the approval of the unit-holders.
18. The removal of the trustee in all cases would require the prior approval of the SEBI.
19. The procedure for seeking approval of the unit-holders under such circumstances as are specified in the SEBI regulations.
20. A meeting of the trustees would be held at least once in every two calendar months and at least six meetings should be held every year.
21. The quorum for a meeting should be specified with at least one independent trustee/director present.
22. The Minimum number of trustees would be four.

Trustees hold the property of the mutual fund in trust for the benefit of the unitholders.

Appointment of Trustees According to the SEBI regulations, **trustees** mean the Board of Trustees or the Trustee Company who hold the property of the mutual fund in trust for the benefit of the unit-holders. Any person can be appointed as a trustee if he **(i)** is a person of ability, integrity and standing; **(ii)** has not been guilty of moral turpitude, **(iii)** has not been convicted of any economic offence/violation of any securities laws such as the SEBI Act, 1992, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996 and such other laws as may be enacted from time to time and **(iv)** has furnished the particulars specified in Form C, such as:

- Details of trustees, that is, trust company; debenture trustees/bank/financial institutions, individual trustees
- Draft trust deed to, inter-alia, provide:
  (a) Responsibilities, obligations and rights of the trustees for the protection of the mutual fund's assets.
  (b) A statement that investments should be of the permitted kind and within set limits.
  (c) Responsibilities, obligations and rights of the fund manager, that is, the AMC.
  (d) Policies for investments; the creation, issue and cancellation of units; pricing and redemption of units; listing of units in case of close-ended schemes; expenses of the mutual fund, including payment of fees and distribution of income and gains and accounting.
  (e) Policies for disclosure of scheme objectives and investment objectives in offer documents and advertisements, and annual and half-yearly reporting requirements to the investors of various schemes of the mutual fund.
  (f) Right of the trustees to obtain necessary information, besides obtaining a quarterly report from the AMC.
  (g) Right to make spot checks on the AMC regarding pricing of units and payment into and out of the fund, proper accounting of the income of the fund, charging of expenses and distribution of income as permitted.
  (h) Public availability of the trust deed.

An AMC/any of its officers/or employers are not eligible to act as trustee. A trustee of one mutual fund is not eligible to be appointed as trustee of another mutual fund. Two-thirds of the trustees should be independent persons and should not be associated with the sponsors or be associated with them in any manner whatsoever. In case a company is appointed as a trustee of a mutual fund, its directors can act as a trustee of any other trust, provided the object of the trust is not in conflict with the object of the mutual fund. The appointment of trustees requires prior approval of the SEBI.

Rights and Obligations of Trustees The trustees and the AMC should, with the prior approval of the SEBI, enter into an investment management agreement containing, in addition to the clauses specified below, such other clauses as are necessary for the purpose of making investments.

Contents of Investment Management Agreement The AMC appointed by the trustees, with the prior approval of the SEBI, would be responsible for floating schemes for the mutual fund after approval of the same by the trustees, and for managing the funds mobilised under various schemes, in accordance with the provisions of the trust deed and the SEBI regulations.

It would not undertake any other business activity other than the management of mutual funds and such other activities as financial service consultancy, exchange of research and analysis on a commercial basis as long, as these are not in conflict with the fund management activity itself, without the prior approval of the trustees and the SEBI.

The funds raised under various schemes would be invested by it in accordance with the provisions of the trust deed and the SEBI regulations.

The AMC would not **(i)** acquire any of the assets out of the scheme property that involves the assumption of any unlimited liability or which may result in encumbrance of the scheme property in any way, or **(ii)** take up any activity in contravention of the SEBI regulations.

No loss or damage or expenses incurred by the AMC, its officers or any person delegated by it should be met out of the trust property.

The AMC should ensure that no offer document of a scheme, key information memorandum, abridged half-yearly and annual result is issued or published without the trustees' prior approval in writing; that it does not and contain any statement or matter extraneous to the trust deed or offer document scheme particulars approved by the trustees and the SEBI and that it should provide an option of nomination to the unit-holders in the prescribed form. It should also disclose the basis of calculating the repurchase price and NAV of the various schemes of the mutual fund in the scheme particulars and the investors of the same, at such intervals as may be specified by the trustees and the SEBI.

The trustees would have the right to obtain from the AMC all information concerning the operations of the various schemes of the mutual fund managed by it at such intervals and in such manner as required by them to ensure that the AMC is complying with the provisions of the trust deed and the SEBI regulations.

1. The AMC should submit quarterly reports on the functioning of the schemes of the mutual fund to the trustees, or at such intervals as may be required by the trustees or the SEBI.
2. The trustees would have the power to dismiss the AMC under specific events, with the approval of the SEBI, in accordance with the SEBI regulations.
3. The trustees would have a right to obtain from the AMC such information as is considered necessary by them.
4. They should ensure before the launch of any scheme that the AMC has:
   (a) systems in place for its back office, dealing room and accounting;
   (b) appointed all key personnel, including fund manager(s) for the scheme(s), and submitted their bio-data, containing their educational qualifications and past experience in the securities market, to the trustees, within 15 days of their appointment;
   (c) appointed auditors to audit its accounts;
   (d) appointed a compliance officer who would be responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications, guidelines, instructions and so on

issued by the SEBI/government and for redressal of investors grievances. He would immediately and independently report to the SEBI any non-compliance observed by him;

(e) appointed registrars and laid down parameters for their supervision;

(f) prepared a compliance manual and designed internal control mechanisms, including internal audit systems;

(g) specified norms for empanelment of brokers and marketing agents;

(h) obtained, wherever required under these regulations, prior in-principle approval from the recognised stock exchange(s) where units are proposed to be listed.

5. They should also ensure that the AMC has been diligent in empanellng the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

6. They are also required to ensure that the AMC has not given any undue or unfair advantage to any associate or deals with any of its associates in any manner detrimental to the interests of the unit-holders.

7. The transactions entered into by the AMC must be in accordance with these regulations and the scheme(s) of the mutual fund.

8. The AMC has been managing mutual fund schemes independently of other activities and has taken adequate steps to ensure that the interests of investors of its one scheme are not being compromised by those of any other scheme or by its other activities.

9. The trustees should ensure that all the activities of the AMC are in accordance with the provisions of these regulations.

10. Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with the SEBI mutual fund regulations and the mutual fund scheme, they should forthwith take such remedial steps as are necessary by them and immediately inform the SEBI of the violation and the action taken by them.

11. Each trustee should file a quarterly report giving the details of his transactions in the securities with the mutual fund.

12. The trustees would be accountable for, and be the custodian of, the funds and property of the respective schemes and should hold the same in trust for the benefit of the unit-holders, in accordance with these regulations and the provisions of the trust deed.

13. They should take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.

14. They would be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the unit-holders of any scheme, in accordance with these regulations and the trust deed.

15. The trustees should obtain the consent of the unit-holders:

(a) whenever required to do so by the SEBI in the interest of the unit-holders; or

(b) whenever required to do so on the requisition made by three-fourths of the unit-holders of any scheme; or

(c) when the majority of the trustees decide to wind up or prematurely redeem the units.

15-A The trustees should ensure that no change in the fundamental attributes of any scheme/the trust or fees/expenses payable or any other changes that would modify the scheme and affect the interests of the unit-holders should be carried out, unless **(i)** a written communication about the proposed change is sent to each shareholder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of region where the head office of the mutual fund is situated and **(ii)** the unit-holders are given an option to exit at the prevailing NAV, without any exit load.

16. They should call for the details of transactions in securities by the key personnel of the AMC, in his own name or on behalf of the AMC, and should report to the SEBI, as and when required.

17. They should review, quarterly, all transactions carried out between the mutual fund, AMC and its associates.

18. They should review, quarterly, the networth of the AMC and in case of any shortfall, ensure that it makes up for the shortfall as stipulated by the SEBI within a period of 12 months to a level of ₹10 crore.

19. They should also periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy themselves that such contracts are executed in the interest of the unit-holders.

20. They should ensure that there is no conflict of interest between the manner of deployment of its net worth by the AMC and the interest of the unit-holders.

21. They should periodically review the investor complaints received and the redressal of the same by the AMC.

22. ***Code of Conduct*** The trustees should abide by the code of conduct as specified below:

(a) Mutual funds schemes should not be organised, operated, managed or the portfolio of securities selected—in the interest of sponsors, directors of AMC, members of Board of Trustees or directors of Trustee Company, and associated persons—as in the interest of special class of unit-holders other than in interest of all classes of unit-holders of the scheme.

(b) Trustees and AMCs **(i)** must ensure the dissemination, to all unit-holders, of adequate, accurate, explicit and timely information, fairly presented in a simple language about the investment policies, investment objectives, financial position and general affairs of the scheme; **(ii)** should avoid excessive concentration of business with broking firms, affiliates and also excessive holding of units in a scheme among a few investors; **(iii)** must avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unit-holders paramount in all matters; **(iv)** must ensure schemewise segregation of bank accounts and securities accounts; **(v)** should carry out the business and invest in accordance with the investment objectives stated in the offer documents and take investment decisions solely in the interest of unit-holders; **(vi)** must not use any unethical means to sell, market or induce any investor to buy their schemes; **(vii)** should maintain a high standard of integrity and fairness in all their dealings and in the conduct of their business; **(viii)** render at all times a high standard of service, exercise due diligence, ensure proper care and exercise independent professional judgement and **(ix)** the AMCs should not make any exaggerated oral/written statement either about their qualifications or capability to render investment management services or their achievements.

The sponsor of the mutual fund/trustees/AMC or any of their employees should not, directly/indirectly, render any investment advice about any security in the publicly accessible media, whether real-time or non-real-time without disclosing his interest (long/short position) in the security while rendering such advice. An employee who renders such advice should also disclose the interest of his dependent family members and the employer, including their long/short-term position in the security.

23. The trustees should furnish to the SEBI on a half-yearly basis the following documents:
- A report on the activities of the mutual fund
- A certificate stating that the trustees have satisfied themselves that there have been no instances of self-dealing or front-running by any of the trustees, directors and key personnel of the AMC
- A certificate to the effect that the AMC has been managing the schemes independently of any other activities and in case any prohibited activities, as specified in these regulations have been undertaken by it adequate steps have to be taken to ensure that the interests of the unit-holders are protected.

24. The independent trustees should give their comments on the report received from the AMC regarding investments by the mutual fund in the securities of group companies of the sponsor, as defined in the Monopolies and Restrictive Trade Practices Act.

25. ***Due Diligence*** Trustees should exercise general and specific due diligence as under:

General Due Diligence They should **(i)** be discerning in the appointment of the directors on the Board of the AMC; **(ii)** review the desirability/continuance of the AMC if substantial irregularities are observed in any scheme, and not allow it to float new schemes; **(iii)** ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons; **(iv)** arrange for test checks of service contracts and **(v)** immediately report to the SEBI any special developments in the mutual fund.

Specific Due Diligence: The trustees should:
- Obtain internal audit reports at regular intervals from independent auditors appointed by them
- Obtain compliance certificates at regular intervals from the AMC
- Hold meetings of trustees more frequently
- Consider the reports of independent auditor(s) and compliance reports of the AMC at their meetings, for appropriate action
- Maintain records of decisions/minutes of their meetings
- Prescribe and adhere to a code of ethics by the trustees/AMC and its personnel
- Communicate in writing to the AMC about its deficiencies and check on the rectification of the deficiencies

26. The trustees would not be held liable for acts done in good faith if they have exercised adequate due diligence honestly.

27. The independent trustees/directors of the AMC should pay specific attention to the following: **(i)** the investment management agreement and the compensation paid under it; **(ii)** service contracts with affiliates to check whether the AMC has charged higher fee than an outside contractor for the same services; **(iii)** selection of the independent directors of the AMC; **(iv)** securities transactions with affiliates, to the extent permitted; **(v)** selection and nomination of individuals to fill vacancies of independent directors; **(vi)** designing a code of ethics to prevent fraudulent/deceptive/manipulative practices by insiders in connection with personal securities transactions; **(vii)** the reasonableness of fees paid to sponsors/AMC/others for service provided; **(viii)** principal underwriting contracts and the renewal and **(ix)** any service contract with the associates of the AMC.

Constitution and Management of an Asset Management Company (AMC) and Custodian

The sponsors of mutual funds or trustees would appoint the **AMC** with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or by 75 per cent of the unit-holders of the scheme. Any change in its appointment also requires prior approval of the SEBI as well as the unit-holders.

Eligibility Criteria For grant of approval of the AMC by the SEBI, the applicant has to fulfill the following:

(a) An existing AMC should have a sound track record/general reputation and fairness in transactions and should be a fit and proper person.

(b) The directors of the AMC should have adequate professional experience in finance and financial service related fields and have not be found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws.

(c) The key personnel of the AMC have not been found guilty of moral turpitude or been convicted of economic offence or violation of securities laws, or worked for any AMC or mutual fund or any intermediary during the period when its registration has been suspended or cancelled at any time by the SEBI.

(d) The Board of Directors of such AMC has at least fifty per cent directors who are not an associate of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees.

(e) The chairman of the AMC is not a trustee of any mutual fund.

(f) The AMC has a net worth (paid-up capital and free reserves minus miscellaneous expenditure not written off/adjusted or deferred revenue expenditure, intangible assets and accumulated losses) of not less than ₹50 crore. The minimum net worth of an AMC eligible to launch only infrastructure debt fund schemes should, however, be ₹10 crores. It may launch upto two new schemes per year.

Terms and Conditions The approval granted by the SEBI, to the AMC, is subject to the following conditions:

(a) Any director of the AMC would not hold the office of the director in another AMC unless he is an independent director and the approval of the Board of AMC, of which he is a director, has been obtained.

(b) The AMC should forthwith inform the SEBI of any material change in the information or particulars previously furnished, that have a bearing on the approval granted by it.

(c) The appointment of a director of an AMC can be made only with prior approval of the trustees.

(d) The AMC undertakes to comply with these regulations.

(e) No change can be made in the controlling interest of the AMC, unless **(i)** prior approval of trustees and the SEBI is obtained, **(ii)** a written communication about the proposed change is sent to each unit-holder and an advertisement is given in one English daily newspaper having nationwide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated and **(iii)** the unit-holders are given an option to exit at the prevailing NAV, without any exit load.

(f) The AMC would furnish such information and documents to the trustees as and when required by them.

Restrictions on Business Activities An AMC cannot **(i)** act as a trustee of any mutual fund; **(ii)** undertake any other business activities other than in the nature of management/advisory services to pooled assets including offshore/insurance/pension/provident if they do not conflict with those of mutual fund. The AMC itself/through subsidiaries can undertake them if it **(a)** satisfies the SEBI about activity-wise segregation of bank and securities account, **(b)** meets with the capital adequacy requirements separately for each of them, **(c)** ensures there is no material conflict of interest across different activities, **(d)** discloses the absence of the conflict of interest to the trustees/unitholders, **(e)** satisfies itself, in case of unavoidable conflict situations, that disclosures are made of the detailed parameters of source of conflict/potential material risk/damage to investor interests, **(f)** appoints separate fund manager for each separate fund if the investment objectives/asset allocation are not the same and the portfolio not replicated across all funds. The funds (which have at least 20 investors and no single investor accounts for more than 25 per cent of the corpus) managed by appropriately regulated broad-based foreign portfolio investors would be exempt, **(g)** ensures fair treatment of investors across different products including simultaneous buy/sell in the same equity security only through market mechanism and written trade order management system and **(h)** ensures independence to key personnel handling the relevant conflict of interest through removal of direct link between remuneration to personnel and revenue generated by the activity. An AMC may itself or through a subsidiary undertake portfolio management/advisory services. It may also become a proprietory member for carrying out trade in the debt segment of a stock exchange.

Obligations The AMC must take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of these regulations and the trust deed. It should: **(i)** exercise due diligence and care in all its investment decisions as would be exercised by the other persons engaged in the same business; obtain, wherever required under these regulations, prior in-principle approval from the recognised stock exchange(s) where units are proposed to be listed; **(ii)** be responsible for the acts of commission or omission by its employees or the persons whose services have been procured by it and **(iii)** submit to the trustees quarterly reports of each year of its activities and the compliance with these regulations.

The trustees, at the request of the AMC, may terminate its assignments at any time, which would become effective only after the trustees have accepted the termination of assignment and communicated their decision in writing. However, the directors and other officers would not be absolved of liability to the mutual fund for their acts of commission or omission, while holding such position or office.

The Chief Executive Officer (whatever his designation may be) of the AMC should ensure that the **(i)** mutual fund complies with all the provisions of the SEBI mutual fund regulations/guidelines/circulars issued from time to time and **(ii)** investments made by the fund managers are in the interest of the unitholders. He would also be responsible for the overall risk management function of the mutual fund.

The fund managers (whatever the designation may be) should ensure that the funds of the scheme are invested to achieve the objectives of the scheme and in the interest of the unitholders.

A mutual fund cannot, through any broker associated with the sponsor, purchase/sell securities that is an average of 5 per cent or more of the aggregate purchases/sales of securities (exclusive of sale and distribution of units issued) made by the mutual funds in all its schemes for a block of any three months. The justification for exceeding the 5 per cent limit, together with reports of all such investments, must be sent to the trustees on a quarterly basis. Similarly, it cannot utilise the services of the sponsor or any of its associates, employees or their relatives, for the purpose of any transaction, distribution and sale of securities unless a disclosure to that effect is made to the unit-holders, and the brokerage or commission paid is also disclosed in the half yearly/annual accounts of the mutual fund. Moreover, the mutual fund should disclose at the time of declaring half-yearly results: **(i)** any underwriting obligations of the schemes with respect to the issue of securities of associate companies, **(ii)** devolvement, if any, **(iii)** subscription in issues lead managed by associate companies and **(iv)** subscription to any issue of equity/debt or private placement basis where the sponsor/its associates companies have acted as arranger/manager. It has to file with the trustees the details of transactions in securities by its key personnel in their own name or on behalf of the AMC and also report to the SEBI as and when required. If the AMC enters into any securities transactions with any of its associates, a report to that effect must be sent to the trustees in their next meeting.

In case any company has invested more than 5 per cent of the net asset value of a scheme, the investment made by that scheme or by any other scheme of the same mutual fund in that company or its subsidiaries must be brought to the notice of the trustees by the AMC and disclosed in the half-yearly and annual accounts of the respective schemes, with justification for such investment, provided that the latter investment has been made within one year of the date of the former investment calculated on either side.

The AMC is required to file with the trustees and the SEBI: **(a)** detailed bio-data of all its directors along with their interest in other companies, within fifteen days of their appointment; **(b)** any change in the interests of directors, every six months and **(c)** a quarterly report to the trustees giving details and adequate justification about the purchase/sale of securities of the group companies of the sponsor/AMC by the mutual fund, during the relevant quarter.

Each director of the AMC should file the details of his transactions of dealing in securities with the trustees on a quarterly basis, in accordance with guidelines issued by SEBI.

The AMC is prohibited from appointing, as key personnel, any person who has been found guilty of any economic offence or is involved in violation of securities laws. It is allowed to appoint registrars and share transfer agents who are registered with the SEBI.

If the work relating to the transfer of units is processed in-house, the charges at competitive market rates may be debited to the scheme and for rates higher than the competitive market rates, the prior approval of the trustees should be obtained and reasons for charging higher rates disclosed in the annual accounts.

The AMC has to abide by the same code of conduct as specified above in the case of trustees.

The AMC should make full disclosure in the offer document of its intention to invest in any of its schemes. It would not be entitled to charge any fee for such investment. It also cannot carry out its operation's outside India.

The AMC should compute/carry out/publish valuation of investments in accordance with SEBI-specified valuation norms (**discussed later in this chapter**). The sponsor/AMC should be liable to compensate the affected investors/scheme for any unfair treatment to any investor resulting from inappropriate valuation. All the transactions in debt/money market securities including inter-scheme transfers should also be reported/disclosed as specified by the SEBI.

> **Custodian**
> carries out the custodial services for the mutual fund scheme/hold the securities in its custody.

Appointment of Custodian The mutual fund should appoint a **custodian** to carry out the custodial services for the scheme and send intimation of the same to the SEBI within fifteen days of the appointment. However, in case of a gold exchange traded fund scheme (i.e. a mutual fund scheme that invests primarily in gold/gold related instruments), the assets may be kept in custody of a bank registered as a custodian with the SEBI. In case of a real estate asset mutual fund scheme (i.e. a mutual fund scheme that invests directly/indirectly in real estate assets/other permissible assets), the title deed of the assets held by it may be kept in the custody of a SEBI-registered custodian.

A custodian in which the sponsor or its associates hold 50 per cent or more of the voting rights or the share capital or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates, cannot act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company. However, a custodian whose 50 per cent or more voting rights are held by the sponsor/its associates can act as a custodian for a mutual fund constituted by the same sponsor/associates/subsidiary if **(i)** net worth of the sponsor is ₹20,000 crores, **(ii)** its 50 per cent/more directors do not represent the interest of the sponsor/associates, **(iii)** the custodian and the AMC are not subsidiaries of each other and do not have common directors and they undertake to act independently in their dealings with the scheme.

Agreement with Custodian The mutual fund should enter into a custodian agreement, which should contain the clauses that are necessary for the efficient and orderly conduct of the affairs of the custodian. The agreement, the service contract, terms and appointment of the custodian can be entered into only with the prior approval of the trustees.

Schemes of Mutual Funds

The stipulations of the SEBI regulations pertaining to mutual fund schemes are outlined below.

Procedure An AMC can launch a scheme after its approval by the trustees and filing of the offer document with the SEBI, together with filing fee 0.005 per cent of the amount raised in the new fund offer or by way of private placement subject to a minimum and a maximum of ₹ two lakh and fifty lakh respectively. The sponsor/AMC should invest, in case of an open-ended scheme, the lower of ₹50 lakh or 1 per cent of the amount raised in the new fund offer in the growth scheme to be redeemed only in the winding up of the scheme.

Disclosures in the Offer Document The offer document should contain adequate disclosures to enable the investors to make an informed investment decision, including disclosure regarding the maximum investment proposed to be made by the scheme in the listed securities of the group companies of the sponsor. The SEBI can suggest modifications in the offer document, in the interest of the investors, which would be binding on the AMC. If, however, no modifications are suggested within 21 working days from the date of filing, it may issue the offer document to the public. No one should issue any form of application for units of a mutual fund unless the form is accompanied by the memorandum containing such information as specified by the SEBI. **The contents of a standard offer document prescribed by the SEBI are listed in Appendix 9-B on the website: The website address is http://www.mhhe.com/khanfs9e.** The offer document should contain the disclosures regarding the prior in-principle approval obtained from the recognised stock exchange(s) where units are proposed to be listed in accordance with these regulations. The AMC should provide an option to unit-holders to nominate a person in whom the units held by him would vest in the event of his death. In case of joint holding, the joint unit-holders may together make such nomination in the event of death of all joint unitholders.

Advertisement Material An **advertisement** should include all forms of communication issued by/on behalf of the AMC/mutual fund that may influence investment decision of any investor/prospective investors. All advertisements should conform to the advertisement code specified below and should be submitted to the SEBI within seven days from the date of issue.

> **Advertisement** should include all forms of communication issued by/on behalf of the AMC/mutual fund that may influence investment decision of any investor/prospective investors.

Advertisement Code The main elements of the code are listed below.

The advertisements should: **(i)** be accurate, true, fair, clear, complete, unambiguous and concise;, **(ii)** not contain statements which are false/misleading/biased/deceptive, based on assumptions/projections or any testimonials/ranking based on any criteria, **(iii)** not **(a)** be no designed as likely to be misunderstood/disguise the significance of any statement, **(b)** contain statements which directly/by implication/omission may mislead the investors, **(iv)** not carry any exaggerated/unwarranted, inconsistence with/unrelated to nature, risk/return profile of the product slogan, **(v)** be framed as to exploit the lack of experience/knowledge of the investors. Excessive use of technical/legal terminology/complex language/inclusion of excessive details which may detract investors should be avoided, **(vi)** contain information which is timely/consistent with the disclosures in the scheme information document/statement of additional information/key information memorandum, **(vii)** not directly/indirectly discredit other advertisements/make unfair comparisons, and **(viii)** be accompanied by a standard warning in legible fonts stating **Mutual Fund Investments are Subject to Market Risks, Read All Scheme-Related Documents Carefully**. In audio-visual media-based advertisement, the standard warning should be audible in a clear/understandable manner. For example, in standard warning both the visual and the voice over reiteration containing 14 words running for at least 15 seconds may be considered as clear/understandable. Finally, no celebrities should form part of the advertisement.

Misleading Statements The offer document and advertisement materials should not be misleading or contain any statement or opinion that is incorrect or false.

In-principle Approval The listed entity which intends to list units of its schemes should obtain in-principle approval in the specified manner by its concerned stock exchange. The mutual fund should execute an agreement with the stock exchange.

> **Close-ended scheme** is a mutual fund scheme in which the maturity period is specified.

Listing of Close-ended Schemes

A **close-ended scheme** is a scheme of a mutual fund in which the maturity period is specified. Every close-ended scheme, other than an equity linked savings scheme, has to be listed on a recognised stock exchange within such time period and subject to such conditions as specified by the SEBI. However, listing of a closed-ended scheme launched prior to April 2009 is not mandatory if:

(a) It provides for periodic repurchase facility to all the unitholders, with restriction, if any, on the extent of such repurchase;

(b) It provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows or physically handicapped or any special class of persons, providing for repurchase of units at regular intervals;

(c) The details of such repurchase facility are clearly disclosed in the offer document and

(d) It opens for repurchase within a period of six months from the closure of subscription;

(e) It is a capital protection oriented scheme, that is, a scheme designated as such and endeavours to protect the capital invested through suitable orientation of its portfolio structure.

In order to further strengthen the framework of close-ended schemes, all such schemes (excepting equity-linked savings schemes) launched after December 12, 2008 must be mandatorily listed. The trustees should ensure that before launch of the scheme, the in-principle approval for listing has been obtained from the stock exchange(s) and appropriate disclosures are made in the scheme information document. Moreover, NAV should be computed and published on daily basis. A close-ended debt scheme can invest only in such securities which mature on or before the date of maturity of the scheme.

Repurchase of Close-ended Schemes Units of a closed-ended scheme, other than those of equity linked savings scheme, launched after April 2009 cannot be repurchased before the end of its maturity period. The units of such schemes may be open for sale or redemption at fixed predetermined intervals if the maximum and minimum amount of sale or redemption of the units and the periodicity of such sale or redemption have been disclosed in the offer document. The units of such scheme may be converted into an open-ended scheme if: **(a)** the offer document of such scheme discloses the option and the period of such conversion; or **(b)** the unit-holders are provided with an option to redeem their units in full, and **(c)** the initial issue expenses of the scheme prior to 2008 have been amortised fully.

All close-ended schemes should be fully redeemed at the end of the maturity period. However, they can be rolled over if the purpose, period and other terms of roll-over and all other material details of the scheme, including the likely composition of assets immediately before the roll-over and the net assets/NAV are disclosed to the unitholders, and copy of the same is filed with the SEBI. The unit-holders who do not opt for the rollover or have not given their consent in writing should be allowed to redeem their holdings in full at an NAV based price.

Offering Period No scheme of a mutual fund, other than the initial offering period of any equity linked savings scheme, can be open for subscription for more than 15 days. The period would be 30 days in case of Rajiv Gandhi equity savings scheme.

Allotment of Units and Refunds of Money The AMC should specify in the offer document **(a)** the minimum subscription amount it seeks to raise under the scheme; and **(b)** in case of over subscription, the extent of subscription it may retain. Where the AMC retains the oversubscription, all the applicants applying up to 5,000 units should be given full allotment, subject to oversubscription. The mutual fund and AMC are liable to refund the application money to the applicants if: **(i)** the mutual fund fails to receive the minimum subscription amount and **(ii)** the monies received from the applicants for units are in excess of subscription. Any refundable amount should be refunded to the applicants within a period of six weeks from the date of closure of subscription list, by registered post with acknowledgement due, through a cheque or demand draft marked "A/c Payee". In the event of failure to refund the amount within the specified period, the AMC is liable to pay interest to the applicants at a rate of 15 per cent per annum from the expiry of 5 working days from the date of closure of the subscription list. The period would be 15 days in case of Rajiv Gandhi equity savings scheme.

Unit Certificates/Statement of Accounts The AMC should issue, to the applicant whose application has been accepted, a statement of accounts specifying the number of units allotted, as soon as possible, but not later than 5 days from the date of closure of the initial subscription list and or from the date of the receipt of the request from the unit-holders in any open-ended scheme. If, however, an applicant so desires, the AMC should issue the unit certificates to the applicant within 5 days of the receipt of request for the certificates.

An applicant in a close-ended scheme would have the option to receive the statement of accounts or hold units in demat form. The AMC should issue the statement of accounts specifying the number of units allotted or issue units in demat form within 5 days (15 days in case of Rajiv Gandhi equity savings scheme) from the date of closure of the initial subscription list. Units in demat form to a unitholder in a closed-ended scheme listed on a recognised stock exchange should be issued by the AMC within two working days of receipt of request from the unitholder.

The AMC should ensure that the consolidated account statement for each calendar month is issued before the tenth day of the succeeding month, giving details of all the transactions (i.e. purchase/redemption/switch/dividend payout/dividend reinvestment, systematic investment/withdrawal/transfer plan and bonus transactions) and holding at the month-end including transaction charges paid to the distributors, across all the schemes of the mutual fund to all the investors in whose folios transaction has taken place during the month. Similarly, it should be ensured that a consolidated account is issued every half-yearly (September/March) before the tenth day of the succeeding month detailing holding at the end of the sixth month. For the purpose of sending the consolidated statement, the AMC should identify common investors across fund houses by their permanent account number.

Transfer of Units A unit unless otherwise restricted or prohibited under the scheme is freely transferable by act of parties or by operation of law. A unitholder in a listed closed-ended scheme desirous of trading in units share hold units in demat form. The AMC should, on production of the instrument of transfer, together with relevant unit certificates, register the transfer and return the unit certificates to the transferee within thirty days from the date of such production. If the units are with the depository, such units are transferable in accordance with the provisions of the SEBI (Depositories and Participants) Regulations, 1996.

Guaranteed Returns Guaranteed returns can be provided in a scheme, if: **(a)** such returns are fully guaranteed by the sponsor or the AMC; **(b)** a statement indicating the name of the person who would guarantee the return is made in the offer document; and **(c)** the manner in which the guarantee is to be met has been stated in the offer document.

Capital Protection Oriented Schemes Such schemes may be launched subject to the following: **(i)** the units are rated by a registered credit rating agency from the viewpoint of the ability of the portfolio structure to attain protection of the invested capital, **(ii)** the scheme is close-ended, and **(iii)** compliance with other SEBI-specified requirements.

Winding Up A close-ended scheme is wound up on the expiry of the duration fixed in the scheme, on the redemption of the units, unless it is rolled over for a further period. A scheme of a mutual fund may be wound up, after repaying the amount due to the unitholders: **(a)** on the happening of any event that, in the opinion of the trustees, requires the scheme to be wound up; or **(b)** if 75 per cent of the unit-holders of a scheme pass a resolution that the scheme be wound up; or **(c)** if the SEBI so directs in the interest of the unitholders. Where a scheme is to be wound up, the trustees are required to give a notice disclosing the circumstances leading to the winding up of the scheme: **(i)** to the SEBI and **(ii)** in two daily newspapers having circulation all over India and a vernacular newspaper circulating at the place where the mutual fund is formed.

Effect of Winding Up On and from the date of the publication of notice, the trustee/AMC ceases **(a)** to carry on any business activities in respect of the scheme so wound up; **(b)** create or cancel units in the scheme and **(c)** issue or redeem units in the scheme.

Procedure and Manner of Winding Up The trustee should call a meeting of the unit-holders to approve by simple majority of the unit-holders present and voting at meeting for a resolution for authorising the trustees or any other person to take steps for winding up of the scheme. A meeting of the unit-holders is not necessary if the scheme is wound up at the end of the maturity of the scheme. The trustee or the person authorised should dispose off the assets of the scheme concerned in the best interest of the unit-holders of that scheme. The sale proceeds realised would be first utilised towards the discharge of such liabilities as are due and payable under the scheme and after making appropriate provisions for meeting the expenses connected with the winding up, the balance should be paid to the unit-holders in proportion to their respective interest in the asset of the scheme as on the date when the decision for winding up was taken.

On completion of the winding up, the trustee should forward to the SEBI and the unit-holders a report on the winding up containing particulars such as the circumstances leading to the winding up, the steps taken for disposal of assets of the fund before winding up, expenses of the fund for winding up, net assets available for distribution to the unit-holders and a certificate from the auditors of the mutual fund. However, the provisions of these regulations, with respect to disclosures in half-yearly/annual reports, would continue to be applicable until the winding up is completed, or the scheme ceases to exist.

Winding Up of the Scheme After the receipt of the report, if the SEBI is satisfied that all measures for winding up of the scheme have been complied with, the scheme ceases to exist.

Delisting of Units The units of a MF scheme can be delisted in accordance with the SEBI-specified guidelines in this regard.

Investment Objectives and Valuation Policies

The investment objectives and valuation policies of mutual funds as per the SEBI regulations are anlaysed below.

Investment Objective A mutual fund may invest money collected under any of its schemes only in: **(a)** securities, **(b)** money market instruments, **(c)** privately placed debentures, **(d)** securitised debt instruments, both asset-backed and mortgage-backed, **(e)** gold/gold related instruments; **(f)** real estate assets or **(g)** infrastructure debt instruments/assets. The investments should be in accordance with the investment objectives of the relevant scheme. Money collected under any money market scheme of a mutual fund should be invested only in money market instruments. Similarly, money collected under any gold exchange traded fund scheme should be invested only in gold/gold related instruments. Moreover, moneys collected under a real estate mutual fund scheme should be invested in accordance with the SEBI regulations (discussed later in this Chapter) applicable to it.

Investment and Borrowing Restrictions All investments and borrowings by mutual funds **except a gold exchange traded fund** scheme are subject to the restriction specified below.

Restrictions on Investments

1. A mutual fund scheme should not invest more than 10 per cent of its NAV in debt instruments comprising money/non-money market instruments of a single issuer rated not below investment grade by a SEBI-registered credit rating agency. With the prior approval of the Board of Trustees/AMC such limit may be extended to 12 per cent. These limits are not applicable for investments in Government securities, T-bills and collatoralised borrowing and lending obligations (CBLO). Within this limit, investments can be made in mortgage backed securitised debt rated not below investment grade by a SEBI-registered rating

agency. With the prior approval of their Boards of Directors, mutual fund schemes can invest in unrated debt instruments upto a maximum of 10 per cent in a single instrument and 25 per cent in total.

2. No mutual fund, under all its schemes, should own more than 10 per cent of any company's paid-up capital carrying voting rights.
3. Transfer of investments from one scheme to another scheme in the same mutual fund are allowed only if **(a)** such transfers are done at the prevailing market price for quoted instruments on spot basis, as specified by stock exchanges for spot transactions and **(b)** the securities so transferred should be in conformity with the investment objective of the scheme to which such transfer has been made.
4. A scheme may invest in another scheme under the same AMC or any other mutual fund without charging any fees. However, aggregate inter-scheme investment made by the schemes under the same management or in the schemes under the management of any other AMC should not exceed 5 per cent of the NAV of the mutual fund. However, this restriction would not apply to any fund of funds schemes.
5. Every mutual fund should buy and sell securities on the basis of deliveries and, in all cases of purchases, take delivery of securities and in all cases of sales, deliver the securities. However, it may enter into derivative transactions in a recognised stock exchange subject to the SEBI-specified framework. The sale of government securities already contracted for purchase should be permitted in accordance with the RBI guidelines in this regard.
6. It should get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.
7. Pending deployment of funds in securities in terms of its investment objectives, a mutual fund can invest the funds of the scheme in short-term deposits of scheduled commercial banks subject to the SEBI guidelines.
8. A mutual fund scheme should not invest in **(i)** any unlisted security **(ii)** or any security issued by way of private placement of any associate/group company of the sponsor, or **(iii)** listed security of group companies of the sponsor in excess of 25 per cent of the net assets. No scheme of a mutual fund would make any investment in any fund of funds scheme.

All mutual funds having an aggregate of securities worth ₹10 crore or more are required to settle their transactions only through dematerialised securities.

The maximum investment of a mutual fund scheme other than index fund/sector or industry specific scheme is equity shares/related instruments of any company can be 10 per cent of the NAV. A mutual fund scheme can invest upto 5 per cent of its NAV in unlisted equity shares/related instruments in case of an open-ended scheme and 10 per cent in case of close-ended schemes. Within these limits, mutual fund schemes can invest in the listed or unlisted securities or units of venture capital funds.

A fund of funds schemes should not invest in any other fund of funds scheme. A fund of funds scheme is a mutual fund scheme that invests primarily in other schemes of the same mutual fund or other mutual funds. It should also not invest its assets other than in schemes of mutual funds except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases/redemptions as disclosed in its offer document.

Restrictions on Borrowings Mutual funds are not permitted to borrow except to meet temporary liquidity needs for the purpose of repurchase, redemption of units or payment of interest or dividend to the unitholders. In any case, they cannot borrow more than 20 per cent of the net assets of the scheme for a period exceeding six months. They are prohibited from advancing any loans for any purpose. But they can borrow and lend securities in accordance with the SEBI framework relating to short selling and securities lending and borrowing.

A gold exchange traded scheme would be subject to the following restrictions : **(i)** the funds should be invested only in gold/gold related instruments in accordance with its investment objectives except to the extent necessary to meet liquidty requirements for honouring repurchases/ redemption as disclosed in the offer document and **(ii)** pending deplayment of funds, such funds may be inverted in short-term bank deposits.

Carry Forward, Derivatives and Short Selling Transactions The funds of a scheme should not in any manner be used in carry forward transactions. However, a mutual fund may enter into derivative transactions on a recognised stock exchange within the SEBI framework. It may enter into short selling transactions on a recognised stock exchange subject to the framework specified by the SEBI relating to short selling and securities lending/borrowing.

Underwriting of Securities Mutual funds may enter into an underwriting agreement after obtaining a certificate of registration in terms of the SEBI (Underwriters) Rules and Regulations, 1993, authorising it to carry on activities as underwriters. The underwriting obligation would be deemed as if investments are made in such securities. The capital adequacy norms for the purpose of underwriting would be the net assets of the scheme. The underwriting obligations of a mutual fund, however, cannot at any time exceed the total NAV of the scheme.

Computation of Net Asset Value Every mutual fund must compute on a daily basis the NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units of the valuation date and published in at least two daily newspapers having all-India circulation.

Valuation of Investments Every mutual fund should ensure that the AMC computes and carries out valuation of investments of its scheme(s) according to the investment valuation norms in terms of **(i)** principles of fair valuation and **(ii)** valuation guidelines.

Principles of Fair Valuation Mutual funds should value their investments according to the following overarching principles to ensure fair treatment to **all** investors:

- The valuation should be based on the principle of fair valuation, that is, reflective of the realisable value of the assets/securities. It should be done in good faith/true and fair manner through appropriate policies/procedures;
- The policies/procedure approved by the AMC should identify the methodologies to be used for valuing each type of assets/securities. The investments in new type of securities/assets should be made only after establishment of the AMC-approved methodologies for them;
- The assets should be consistently valued according to the policies/procedures which should also describe the process to deal with exceptional events where market quotations are no longer reliable for a particular security;
- The AMC should periodically review them to ensure their appropriateness/accuracy and effective implementation. The Board of Trustees/AMC should be updated of these developments at appropriate intervals. They should be regularly (at least once in a year) reviewed by an independent auditor to ensure their continued appropriateness.
- The AMC-approved policies/procedures should address conflict of interest. Their disclosure should be made in **Statement of Additional Information** on the website of the AMC/ mutual fund or other SEBI-speecified place to ensure transparency of the valuation norms;

- The AMC should be responsible for true/fair valuation and correct NAV. It may deviate, with appropriate reporting to the Board of the AMC/Trustees and appropriate disclosures to the investors, from the established policies/procedures to value the assets/securities at fair value;
- It should have policies/procedures to detect/prevent incorrect valuation and maintain/preserve documentation of rationale for valuation including inter-scheme transfers to enable audit trail;
- For fair valuation of debt/money market securities, the AMC should take into consideration prices of trades of same/similar security reported at all available public platform(s).

Valuation Guidelines In addition to the above, a mutual fund may value investments according to the following guidelines. In case of any conflict, the principles of fair valuation should prevail over the valuation guidelines.

The NAV of a scheme is determined by dividing the net assets by the number of outstanding units on the valuation day.

1. Traded Securities

(i) The securities should be valued at the last quoted closing price on the stock exchange.

(ii) When the securities are traded on more than one recognised stock exchange, they should be valued at the last quoted closing price on the stock exchange where the security is principally traded. It is left to the AMC to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. However, all scrips can be valued at the prices quoted on the stock exchange where a majority in value of the investments are principally traded.

(iii) Once a stock exchange has been selected for valuation of a particular security, reasons for its change must be recorded in writing by the AMC.

(iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

(v) When a security (other than debt securities) is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected exchange, or any other stock exchange, on the earliest previous day may be used, provided such date is not more than thirty days prior to the valuation date. When a debt security (other than Government securities) is not traded on any stock exchange, on any particular valuation day, the value at which it was traded on the principal stock exchange, or any other stock exchange on the earliest previous day may be used, provided such date is not more than 15 days prior to valuation date. When such a security is purchased by way of placement, the value at which it was bought may be used for a period of 15 days beginning from the date of purchaser.

2. Non-traded Securities

Non-traded security
is a security not traded on a stock exchange for 30 days prior to the valuation date.

(i) When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a **'non-traded'** scrip.

(ii) Non-traded securities should be valued "in good faith" on the basis of appropriate valuation methods, based on the principles approved by the Board of Directors of the AMC. For example, debt/money market securities may be valued on amortisation basis if it is reflective of their fair value and investors are fairly treated. Such decision of the Board of

Directors must be documented in the minutes and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at value "in good faith" should be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the mutual fund. For the purpose of valuation of non-traded securities, the following principles should be adopted:

- **(a)** Equity instruments should generally be valued on the basis of capitalisation of earnings solely, or in combination with the net asset value, using for the purpose of capitalisation, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;
- **(b)** Debt instruments should generally be valued on a yield to maturity basis, the capitalisation factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;
- **(c)** While investments in call money, bills purchased under rediscounting schemes and short-term deposits with banks should be valued at cost plus accrual, other money market instruments should be valued at the yield at which they are currently traded. For this purpose, non-traded instruments (those not traded for seven days) would be valued at cost plus interest accrued at the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments. Government securities should be valued at yield to maturity, based on the prevailing market rate;
- **(d)** In respect of convertible debentures and bonds, the non-convertible and convertible components should be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument while the convertible component should be valued as would be an equity instrument. If, after the conversion, the resultant equity instrument would be traded pari passu with an existing traded instrument, the value of the later instrument can be adopted after an appropriate discount for the non-tradability of the instruments during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;
- **(e)** Warrants to subscribe to shares attached to instruments can be valued at the value of the share, which would be obtained on exercise of the warrant as reduced by the amount that would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures as referred to above must be deducted to account for the period that must elapse before the warrant can be exercised;
- **(f)** Where the instruments have been bought on 'repo' basis, the instrument must be valued at the resale price after the deduction of applicable interest, up to the date of resale. Where an instrument has been sold on a 'repo' basis, adjustment must be made for the difference between the repurchase price (after the deduction of applicable interest upto the date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. Rights Shares Until they are traded, the value of the 'right' shares should be calculated as:

$$V_r = \frac{n}{m} x \,(P_{\text{ex}} - P_{\text{of}})$$

where V_r = Value of rights

n = Number of rights offered

m = Number of original shares held
P_{ex} = Ex-rights price
P_{of} = Rights offer price

where the rights are not treated pari passu with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

3-A Value of Gold The gold held by a gold exchange traded fund should be valued at the **AM** fixing price of the London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand subject to the **(a)** adjustment for conversion **(i)** to metric measure as per standard conversion rates, **(ii)** of US dollars into Indian rupees as the RBI reference rate declared by the Foreign Exchange Dealers Association of India (FEDAI), and **(b)** addition of **(i)** transportation/other charges, **(ii)** notional custom duty/other applicable taxes and levies normally incurred in bringing gold from London to the place where it is actually stored on behalf of the mutual fund. These adjustments may be made on the basis of a national premium that is usually charged for delivery of gold to the place where it is stored. Where the gold held has a grater fineness, the relevant LBMA prices of **AM** fixing should be taken on the reference price.

If the acquired gold is not in the form of standard bars, it should be assayed and converted into standard bars which comply with the good delivery norms of the LBMA.

4. Expenses and Incomes All expenses and incomes accrued up to the valuation date should be considered for the computation of the net asset value. For this purpose, while major expenses like management fees and other expenses should be accrued on a day-to-day basis, other minor expenses and income need not be so accrued, provided their non-accrual does not affect the NAV calculations by more than 1 per cent.

5. Any change in securities and in the number of units are to be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the NAV disclosure, the recording may be delayed up to a period of seven days following the date of the transaction, provided that as a result of non-recording, the NAV calculation should not be affected by more than 1 per cent.

6. In case the NAV of a scheme differs by more than 1 per cent due to non-recording of the transactions, the investors/scheme(s) should be paid the difference in amount in the following manner. If the investors are allotted units at a price higher than the NAV or given a price lower than the NAV at the time of sale of their units, they should be paid the difference in amount by the scheme. If they are charged a lower NAV at the time of purchase of their units or are given a higher NAV at the time of sale of their units, the AMC should pay the difference in amount to the scheme and may recover the difference from the investors.

7. Thinly traded securities should be valued in the manner as specified by the SEBI guidelines in this respect.

8. The aggregate value of illiquid securities should not exceed 15 per cent of the total assets of the scheme. Any excess holdings should be valued in the manner specified by the SEBI guidelines in this regard.

Computation of Net Asset Value Every mutual fund should compute the Net Asset Value (**NAV**) of each scheme by dividing the net asset of the scheme by the number of units outstanding on the valuation date. It should be calculated and published in at least two daily newspapers, at intervals not exceeding one week. However, the NAV of a close-ended scheme other than that of equity linked savings scheme should be calculated on a daily basis and published in at least two daily newspapers having circulation all over India.

> **NAV**
> is the net assets of a mutual fund scheme divided by the number of the outstanding units.

Pricing of Units The price at which the units may be subscribed or sold and repurchased by the mutual fund should be made available to the investors.

In case of an open-ended scheme that offers units for sale without specifying any duration of redemption, it should publish the sale and purchase price of units, at least once a week, in a daily newspaper with all India circulation. While determining the prices of the units, it must be ensured that the repurchase price is not lower than 93 per cent and the sale is not higher than 107 per cent of the NAV. The difference between the repurchase price and the sale price of the units should not exceed 7 per cent of the sale price.

A mutual fund should deduct from the repurchase proceeds of closed-ended schemes launched prior to April 2009 such proportion of the initial issue expenses of the scheme as are attributable to the units being purchased if **(i)** the scheme is launched after May 2006 but prior to Ma 2008 and **(ii)** initial issue expenses in respect of the scheme are accounted in the books of account of the scheme in accordance with the applicable regulations.

Amortisation of Initial Issue Expenses for Closed-Ended Schemes

(a) The AMCs/sponsor/trustees may launch schemes either on a 'load' or 'no load basis', or on a mixed basis with two classes of units in the same scheme—one with load and other without load—provided that the implications of such load on the NAV for the investors are clearly explained through a worked out example in the offer document. They may also launch 'partial load' schemes in which a part of the load would be borne by the AMCs/trustees/sponsor and the balance by the scheme. However, such schemes would not qualify to be 'no load' schemes and would be treated in the same manner as 'load' schemes. In the case of a no load scheme, the initial issue expenses would be borne by the AMC/trustees/sponsor.

(b) For a close-ended scheme floated on a 'load' basis, prior to May 2008, the initial issue expenses should be amortised on a weekly basis over the period of the scheme. But in case the scheme provides for partial redemption during its life, the amortisation has to take into account the number of outstanding units and the aggregate amount during the relevant periods.

(c) In case of close-ended schemes floated on a 'load' basis, prior to May 2008, the unamortised portion of the expenses are to be included in the calculation of the NAV. However, such portion cannot be included in the NAV for the purposes of determining the AMC's investment management and advisory fees or for determining the limitation of expenses under these regulations.

(d) All subsequent distribution charges must, in the case of load schemes, be borne by the scheme and, in the case of no load schemes, by the AMC.

Any excess over the 6 per cent initial issue expense would have to be borne by the AMC.

The price of units must be determined with reference to the last determined NAV, unless **(a)** the scheme announces the NAV on a daily basis and **(b)** the sale price is determined with or without a fixed premium added to the future NAV, which is declared in advance.

Real Estate Mutual Fund Schemes

> **Real estate asset** means immovable property **(i)** located in a specified city/ SEZ, **(ii)** usable and construction is complete, **(iii)** evidenced by valid title documents, **(iv)** legally transferable, **(v)** free from encumbrances and **(vi)** not subject-matter of litigation.

The SEBI stipulations relating to real estate mutual funds schemes (REMFS) and trustees and asset management companies in relation to such schemes are discussed below.

The SEBI would grant a certificate of registration to an applicant proposing to launch only real estate mutual fund scheme if he **(i)** has been carrying on business in real estate for at least 5 years and **(ii)** satisfies the eligibility criteria applicable to sponsors of other types of mutual fund schemes (**discussed earlier in the Chapter**). The REMFS should have key personnel having adequate professional experience in finance and financial services related fields. An existing mutual fund may launch a REMFS if it has an adequate number of key personnel and directors having adequate experience of working in real estate. All REMFSs would be close-ended and listed on a recognised stock exchange. However, redemption of a REMFS may be done in a staggered manner. The unitholders of the REMFS would have no right to use the real assets held by the scheme. **Real estate assets** means an identifiable immovable property which is **(i)** located within India in a city specified by the SEBI from time to time or in a special economic zone, **(ii)** is usable and construction is complete, **(iii)** evidenced by valid title documents, **(iv)** legally transferable, **(v)** free from all encumbrances, and **(vi)** not subject-matter of litigation. It does not include **(i)** a project under construction, **(ii)** vacant land, **(iii)** deserted property, **(iv)** agricultural land, and **(v)** a property reserved/attached by government/other authority or pursuant to a court order or the acquisition of which is otherwise prohibited under any law.

The title deeds pertaining to the real estate should be kept in safe custody with the custodian of the mutual fund. The REMFS cannot undertake lending or house finance activities. All financial transactions of such schemes should be routed through normal banking channels and should not be cash/unaccounted transaction.

Permissible Investments At least 25 per cent of the net assets of the scheme should be invested directly in real estate assets. Subject to this, at least 75 per cent of the net assets should be invested in real estate assets, mortgage backed securities (but not directly in mortgages) and equity shares/debentures of listed/unlisted companies engaged in dealing in real estate assets/ undertaking real estate development projects and the balance in other securities. No mutual fund should invest:

- Under all its REMFSs more than **(i)** 30 per cent of its net assets in a single city, **(ii)** 15 per cent in a single project, that is, a project by a builder in a single location within a city and **(iii)** 25 per cent of the total issued capital of an unlisted company;
- More than 15 per cent of the assets of any REMFS in the equity shares/debentures of an unlisted company;
- Any **(i)** unlisted security of the sponsor/associate/group company, **(ii)** listed security issued by way of preferential allotment by the sponsor/associate/group company, and **(iii)** any listed security of the sponsor/associate/group company exceeding 25 per cent of the net assets of the scheme;

- Transfer real estate assets amongst its schemes; and
- In any real estate asset which was owned by the sponsor/AMC/any associate during the last 5 years or in which they hold tenancy/lease rights.

Valuation of Real Estate Assets and Declaration of NAV **(1)** The real assets held by a REMFS should be valued at cost price on the date of acquisition and at fair price on every 90th day from the date of its purchase in accordance with the norms specified below:

Direct Investment in Real Estate Assets **Fair value** means the amount for which an asset could be exchanged between knowledgeable parties in an arms' length transactions and certified by the real estate valuer. **Knowledgeable** means that both the buyer and the seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and market conditions at the balance sheet date. A **real estate valuer** means a qualified valuer of real estate assets accredited by a SEBI-registered credit rating agency.

> **Fair value** means the amount for which an asset could be exchanged between knowledge-able parties at an arms' length transaction and certified by a real estate valuer.

The REMFS should account for, separately, the portions of estate asset held to earn rentals or for capital appreciation if they can be sold/leased separately.

Initial Recognition A real estate asset should be recognised if it is probable that the future economic benefits associated with it would flow to the REMFS and its cost can be measured reliably. The REMFS should evaluate their costs including those incurred initially to acquire as well as those incurred subsequently to add to/replace part of or service a real estate asset at the time they are incurred. However, the cost of the day-to-day servicing of the asset should be recognised in the revenue account as incurred.

A REMFS should recognise the cost of replacing part of an existing real estate asset at the time of its incurrence. The carrying amount of the replaced parts should be derecognised (according to the derecognition provisions discussed later).

The asset should be recognised on the date of completion of the process of transfer of ownership, that is, the date on which an enforceable right including all significant risks and rewards of ownership are obtained by the REMFS.

Measurement at Initial Recognition A real estate asset (REA) should be measured initially at cost comprising purchase price, any other directly attributable expenditure such as professional fee for legal services/registration expenses and asset transfer taxes. In case of deferred payment, the cost of the REAs is the cash price equivalent. The difference between this amount and the total payments as internal expenses over the period of credit should be recognised.

The cost of the REAs acquired in exchange for non-monetary asset(s)/a combination of monetary and non-monetary assets should be measured at fair value unless the exchange transaction lacks commercial substance or the fair value of the assets received/given up is reliably measurable. If the acquired REA cannot be measured at fair value, its cost should be measured at the carrying cost of the asset given up. Whether an exchange transaction has commercial substance would depend on the extent to which its future cashflows are expected to change as a result of the transaction. An exchange transaction has commercial substance if **(i)** the risk, timing and amount of the cash flows of the assets received/transferred differ, **(ii)** the REMFS-specific value of the portion affected by the transaction changes as a result of the exchange, and **(iii)** the difference in **(i)** or **(ii)** is significant relative to the fair value of the asset exchanged.

The fair value of an asset for which comparable market transactions do not exist is reliably measurable if **(a)** the variability in the range of reasonable fair value estimates is not significant for that asset or **(b)** the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If the fair value of either the asset received/given up can be reliably determined, the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Subsequent Measurement After initial recognition, a real estate held by a REMFS should be measured at its fair value. A gain/loss arising from a change in its fair value should be recognised in the revenue account of the period in which it arises. The gain arising from the appreciation in its value is an unrealised gain which should not be distributed.

The fair value should specifically exclude an estimated price inflated/deflated by specified terms/circumstances such as typical financing, sale and lease back arrangements, special considerations/concessions granted by any one associated with the sale. It should reflect market conditions on the balance sheet date. It reflects, inter-alia, rental income as also the expected cash outflows. The best evidence of fair value is given by the current prices in an active market for similar real estate assets in the same location/condition and subject to similar lease/other contracts. In the absence of current prices in an active market, information from a variety of sources should be considered including **(1)** current prices in an active market for properties of different nature, condition/location (or subject to different lease/other contracts) adjusted to reflect these differences, **(2)** recent prices of similar properties on less active markets, **(3)** discounted cash flow projections, using discount rates reflecting current market assessment of the uncertainty in the amount/timing of the cashflows.

Where the fair value of the real estate is not reliably determinable on a continuing basis, the REMFS should measure the real asset at cost as per **AS-10: Accounting for Fixed Assets**. Its residual value should be assumed to be zero. The **AS-10** should be applied until its disposal. The fair value would be considered to be not reliably determinable, if the variability in the range of fair value estimates is large and the probabilities of the various outcomes difficult to assess, such that the usefulness of a single estimate of fair value is negated.

In determining the fair value, there should be no double counting of assets/liabilities. The future capital expenditures and the related future benefits are not reflected in the real assets.

Where a REMFS expects that the present value of its payments will exceed the present value of the related cash receipts, it should apply the **AS-29: Provisions, Contingent Liabilities, and Contingent Assets** to determine whether to recognise a liability and how to measure it.

To determine the fair value of a real estate asset according to the above stipulations, a REMFS should use the services of two independent and approved valuers and use the lower of the two valuations.

For accounting for rental income, **AS-19: Leases** should be followed. Such income should accrue on a daily basis.

Where the rental income has accrued but has not been received for the specified period, provisions should be made by debiting to the revenue account the accrual income in the manner specified by the SEBI.

Derecognition of Real Estate Asset A real estate asset should be derecognised by a REMFS on disposal or when the asset is permanently withdrawn from use and no future benefits are expected from its disposal. The criteria in **AS-19: Revenue Recognition** should be applied for determining the date of disposal of the asset by way of sale. Gains/losses from the disposal/

retirement of the asset would be the difference between the net disposal proceeds and its carrying amount, and recognised in the revenue account in the period of disposal/retirement. The consideration receivable on disposed is to be recognised initially at fair value. If, however, payment is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the normal amount of the consideration and the cash price equivalent should be recognised as interest revenue over the period of credit.

(2) The AMC/its directions/the trustees/the real estate valuer should ensure that the valuation of the assets held by a REMFS are done in good faith in accordance with the norms specified above and that its accounts are prepared according to the accounting principles specified by the SEBI.

(3) The NAV of every REMFS should be declared at the close of each business day on the basis of the most current valuation of the assets held and the accrued income.

Duties of Asset Management Company (AMC) The AMC of a mutual fund having a REMFS should **(i)** appoint a suitable number of qualified key personnel with relevant experience, **(ii)** appoint advisors to advise it on the acquisition of real estate assets, **(iii)** exercise due care while appointing the valuers and ensure that there is no conflict of interest, **(iv)** lay down an adequate system of internal controls and risk management, **(v)** put in place systems to ensure that all financial transactions are done through banking channels and exclude transactions in cash/accounted transactions, **(vi)** exercise due diligence in maintenance of the assets and ensure that there is no avoidable deterioration in their value, **(vii)** ensure that the assets held are adequately insured against impair, damage/destruction, **(viii)** ensure that the cost of maintenance/insurance is within reasonable limits and no funds are utilised towards development of the assets, and that a real estate valuer certifies compliance with this on an annual basis, **(ix)** ensure that no valuer **(a)** continues with the valuation of a particular asset for more than 2 years, **(b)** values the safe asset for at least 3 years thereafter, **(x)** record in writing the details of its decision-making process in buying/selling assets together with the justification for such decisions and forward the same to the trustees, and **(xi)** ensure that investment of funds is not made contrary to these provisions and the trust deed; **(xii)** obtain, wherever required under these regulations, prior in-principle approval from the stock exchange(s) where units are proposed to be listed.

Usage of Real Estate Assets The AMC may let out/lease the assets if the term of the lease/letting does not extend beyond the period of maturity of the REMFS. It should diligently collect the rents/other income in a timely manner. The assets may be let out to the sponsor/AMC associates at market price/on commercial terms. However, not more than 25 per cent of the total rental income of the REMFS should be derived from letting out the assets.

Duties of Trustees The trustees should:

- Ensure that the AMC has the necessary expertise, internal control systems and risk management mechanism to invest in, and manage, investments in real estates on a continuous basis,
- Monitor whether due diligence is exercised by the AMC in managing the investments,
- Review the market price of the units during the year and recommend proportionate buy-back of units from unitholders if the units are traded at deep discounted to the NAV. The magnitude of discount amounting to deep discount should be disclosed in the offer document,
- Ensure that only permissible investments are made by the AMC,
- Ensure that all financial transactions are made only through banking channels and systems exist to exclude transaction in cash/unaccounted transactions,

- Lay down the criteria for empanelment of real estate brokers,
- Lay down the broad procedures to be followed by the AMC while transacting in real estate assets,
- Require the AMC to set up such system and submit such reports to trustees as may be necessary for them to effectively monitor the performance and functioning of the REMFS. The trustees should include a confirmation on compliance with this stipulation in their half yearly reports to the SEBI.
- Obtain, wherever required under these regulations, prior in-principle approval from the stock exchange(s) where units are proposed to be listed.

Disclosure in Offer Document and Other Disclosures The offer document of REMFs should contain adequate disclosures for investors to make informed investment decisions and such further disclosures as are specified by the SEBI. The portfolio disclosures and financial results should contain such further disclosures as are specified by the SEBI. Advertisements in respect of REMFSs should conform to such guidelines as may be prescribed by the SEBI.

Transactions By Employees Etc. All transactions by the trustees/employees/directors of the AMC/trustee company in real estate assets should be disclosed by them to the compliance officer within a month. The compliance officer should make a report from the viewpoint of possible conflict of interest and submit it to the trustees with his recommendations. The trustees/employees/directors of the AMC may obtain the view of trustees before entering into transactions by making a suitable request to them.

Infrastructure Debt Fund Schemes

Infrastructure Debt Fund Schemes (IDFSs) means a mutual fund scheme that invests primarily (i.e. 90 per cent of the assets of the scheme) in debt securities/securitised debt instruments of infrastructure/infrastructure capital companies/projects or special purpose vehicles (SPVs) created for facilitating/promoting investment in infrastructure and other permissible assets or bank loans in respect of completed and revenue generating projects of infrastructure companies/projects/SPVs. Such schemes would be governed by the stipulations discussed below. **The other provisions of the SEBI mutual fund regulations/guidelines/circulars, unless the context otherwise require or repugnant to these stipulations would also apply to them/trustees/AMCs in relation to them.** The main elements of the **IDFSs** are: **(i)** eligibility criteria, **(ii)** conditions, **(iii)** permissible investments, **(iv)** valuation of assets and NAV, **(v)** duties of AMC, and **(vi)** disclosures.

> **IDFS**
> means a mutual fund scheme that invests primarily (i.e. 90 per cent of the assets of the scheme) in debt securities/securitised debt instruments of infrastructure/infrastructure capital companies/projects or special purpose vehicles (SPVs) created for facilitating/promoting investment in infrastructure and other permissible assets or bank loans in respect of completed and revenue generating projects of infrastructure companies/projects/SPVs.

Eligibility Criteria An existing mutual fund may launch an IDFS if it has adequate number of key personnel having adequate experience in infrastructure sector **(sectors included in infrastructure are discussed in Chapter 1**). The SEBI would grant a certificate of registration if the sponsor/its **parent company** (i.e. a company holding 75 per cent of the capital of the sponsor) **(a)** has been carrying on activities/business in infrastructure financing sector for at least 5 years and **(b)** fulfils the eligibility criteria applicable to other mutual funds (**discussed in an earlier Section**).

> **Parent company** means a company holding 75 per cent of the capital of the sponsor

> **Strategic investors** is an RBI-registered infrastructure finance company as NBFC/a bank/international multilateral financial institutions which contributes at least ₹25 crore before allotment of units to other investors.

Offer Period The offer period for subscription in case of a public offer would not be more than 5 days.

Conditions An IDFS can be launched either as a close-ended scheme with a maturity exceeding 5 years or interval scheme with lock-in of 5 years and specified transaction period of not more than 45 days. The tenure may be extended to two years subject to approval of two-thirds of the unitholders by value of their investment. Their units would be listed after being fully paid-up. The mutual fund(s) may disclose to its potential investors the indicative portfolio in terms of the type of assets in which the fund would be invested. The minimum number of investors in any IDFS would be five subject to a 50 per cent ceiling on holdings of one single investor. The minimum investment limit would be rupees five crore with a minimum size unit of rupees 10 lakh. Each IDFS should have firm commitment from **strategic investors** [i.e. an RBI-registered infrastructure finance company (as NBFC)/a bank/international multilateral financial institutions, RBI-registered systematically important NBFCs and foreign portfolio investors] for contribution of at least rupees twenty five crore before the allotment of units to the other potential investors. Partly-paid units may be issued to investors subject to the conditions that **(i)** the AMC would call for the unpaid portion depending upon the deployment opportunities, **(ii)** disclosure in the offer document of the interest/penalty to be deducted in case of non-payment of call money by the investors within the stipulated time, and **(iii)** the interest/penalty would be retained in the scheme.

Private Placement The units of an IDF scheme may be offered through private placement to less than 50 persons subject to approval of the trustees/AMC. The mutual fund would file a SEBI-specified placement memorandum together with the specified fee at least seven days prior to the launch of the scheme.

Permissible Investments At least 90 per cent of the net assets of the IDFS should be invested in the specified debt securities/securitised debt instruments of infrastructure companies/projects or SPVs created facilitating/promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of infrastructure companies/SPVs. Funds received on account of repayment of principal with respect to the underlying assets of the scheme would be similarly invested. They would also be invested in bonds of public financial institutions/IFCs. The balance amount may be invested in listed/unlisted equity shares/convertibles including mezzanine financing instruments or bank deposits and money market instruments. These restrictions would be applicable on the life-cycle and reckoned with reference to the total amount raised by the IDFSs. The maximum investment under all the IDFSs of a mutual fund in a single entity/bank loan would be restricted to 30 per cent of its net assets. The investment limit in debt instruments/assets of a single such entity/bank loan would be 30 per cent. The ceiling on overall investment in instruments rated below investment grade/unrated would be 30 per cent of the net assets which may be increased upto 50 per cent with the prior approval of trustees/AMC.

The IDFSs are prohibited from investing in any **(i)** unlisted security/listed security issued by way of preferential allotment of the sponsor/associate/group company, **(ii)** with the approval of the trustees and full disclosures to investors not more than 25 per cent in any listed security of the sponsor/associate/group company or bank loan, **(iii)** any assets/securities owned by the sponsor/AMC/their associates in excess of 30 per cent of the net assets if investment is not below investment grade, the sponsor/associate retains atleast 30 per cent till the assets/securities are held in the scheme portfolio and trustees have approved and full disclosures made to the investors.

Valuation of Assets and Declaration of NAV The assets held by an IDFS should be valued in **good faith** by the AMC on the basis of appropriate valuation methods based on principles approved by the trustees. The valuation should be documented and the supporting data preserved for at least 5 years after the expiry of the scheme. The valuation method used should be periodically reviewed by the trustees/statutory auditors of the mutual fund. The valuation policy approved by the AMC should be disclosed in the scheme information document. The NAV of the IDFS should be calculated/declared at least once in every quarter.

Duties of AMC The AMC should: **(i)** lay down an adequate system of internal controls/risk management; **(ii)** exercise due diligence in maintenance of the assets of the IDFS and ensure that there is no avoidable deterioration in their value; **(iii)** record in writing the details of the decision-making process in buying/selling assets together with the justification for such decisions and forward them periodically to the trustees; **(iv)** ensure that the investments of funds is not contrary to the SEBI regulations/trust deed, **(v)** obtain prior in-principle approval from the stock exchange where units are proposed to be listed and **(vi)** institute mechanism to ensure proper care for collection/monitoring/supervision of the debt assets by appointing a service provider having extensive experience.

Disclosures in Offer Document and Other Disclosures The offer documents of IDFSs should contain **(i)** adequate disclosures for investors to make informed investment decisions and **(ii)** further disclosures specified by the SEBI. The portfolio disclosures and financial results should also contain further disclosures and advertisements should conform to the SEBI guidelines.

Transactions The trustees or the employees/directors of the AMC/trustee company should disclose within one month all their transactions in the investee company to the compliance officer who should submit a report with recommendation to the trustees from the viewpoint of conflict of interest. The person(s) concerned may obtain views of the trustees before entering into the transaction.

General Obligations

The general obligations of AMCs/mutual funds, stipulated by the SEBI regulation, are detailed below.

Maintain Proper Books of Accounts and Records Every AMC should keep, maintain and preserve proper books of accounts, records and documents, for eight years, for each scheme so as to explain its transactions and to disclose at any point of time the financial position and, in particular, give a true and fair view of the state of affairs of the mutual fund and intimate to the SEBI the place where such books of accounts, records and documents are maintained. Moreover, it should follow the accounting policies and standards, as specified below, so as to provide the appropriate details of the schemewise disposition of the asset at the relevant accounting date, and the performance during the period together with information regarding the distribution and accumulation of income accruing to the unitholders, in a fair and true manner.

Accounting Policies and Standards

(a) For the purpose of the financial statements, the mutual funds should mark all investments to the market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provisions have to be made for the exclusion of this item when arriving at distributable income.

(b) Dividend income earned by a scheme should be recongised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments that are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.

(c) In respect of all interest bearing investments, income must be accrued on a day to day basis, as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date up to the date of purchase must not be treated as a cost of purchase but must be debited to interest recoverable account. Similarly, interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to the sale value but must be credited to the interest recoverable account.

(d) In determining the holding cost of investment and the gains or loss on sale of investments, the 'average cost' method must be followed.

(e) Transactions for the purchase or sale of investments should be recognised as of the trade date not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transactions should be recorded in the event of a purchase, as of the date on which the scheme obtains an enforceable obligation to pay the price or, in the event of sale, when the scheme obtains an enforceable right to collect the proceeds of sale, or an enforceable obligation to deliver the instruments sold.

(f) Bonus shares to which the scheme becomes entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the rights entitlement accrues are traded on the stock exchange on an ex-rights basis.

(g) Where income receivable on investments has accrued and has not been received for the period specified in the SEBI guidelines, provision should be made by debiting to the revenue account the income so accrued, in the manner specified by SEBI guidelines.

(h) When units are sold, in the case of an open-ended scheme, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves, and if negative, they should be debited to the reserves, the face value should be credited to the capital account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the repurchase price and face value of the unit, if positive, should be debited to reserve and, if negative, should be credited to reserves, the face value being debited to the capital account.

(i) In the case of an open-ended scheme, when units are sold, an appropriate part of the sale proceeds should be credited to an equalisation account, and when units are repurchased, an appropriate amount should be debited to the equalisation account. The net balance on this account should be credited or debited to the revenue account. The balance on the equalisation account debited or credited to the revenue account should not decrease or increase the net income of the mutual fund but is only an adjustment to the distributable surplus. It should, therefore, be reflected in the revenue account only after the net income of the mutual fund is determined.

(j) In a close-ended scheme launched prior to April 2009 that provides the unit-holders with the option for an early redemption or repurchase its own units, the par value of the unit has to be debited to the capital account and the difference between the purchase price and par value, if positive, should be credited to reserve, and if negative, it should be debited to the reserves. A proportionate part of the unamortised initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

(k) The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments, any front-end discount offered should be reduced from the cost of the investment.

(l) Underwriting commission should be recognised as a revenue only when there is no devolvement on the scheme. Where there is devolvement, the full underwriting commission received, and not merely the portion applicable to the devolvement, should be reduced from the cost of investment.

(m) In case of real estate mutual funds schemes, investments in unlisted equity shares would be valued as per the specified norms (**discussed earlier in this chapter)**.

Financial Year The financial year for all the schemes should end as of March 31 of each year. However, for a new scheme commencing during a financial year, the disclosure and reporting requirements would apply for the period beginning from the date of its commencement and ending on March 31 of that financial year.

Credit of Exit Load The exit load charged should be credited to the scheme.

Limitations on Fees and Expenses on Issue of Schemes All expenses should be clearly identified and appropriated in the individual schemes. The AMC may charge the scheme with investment and advisory fees that should be fully disclosed in the offer document. In addition, it may charge the scheme with the following recurring expenses, including: **(i)** marketing and selling expenses, including agents' commission, if any; **(ii)** brokerage and transaction cost; **(iii)** registrar services for the transfer of units sold or redeemed; **(iv)** fees and expenses of trustees; **(v)** audit fees; **(vi)** custodian fees; **(vii)** costs related to investor communication; **(viii)** costs of funds transfer from location to location; **(ix)** cost of providing account statement and dividend/redemption cheques and warrants; **(x)** insurance premium paid by the mutual fund; **(xi)** winding up costs for terminating a mutual fund/scheme; **(xii)** cost of statutory advertisements, **(xiii)** recurring expenses incurred towards storage and handling of gold in case of gold exchange traded fund scheme, rating fee in case of capital protection oriented scheme; and insurance premia and costs of maintenance of the real assets (excluding cost of their development) to the extent declared in the offer document, **(xiv)** listing fee in case of schemes listed on a recognised stock exchange and **(xv)** such other costs as may be approved by the SEBI.

The total expenses (inclusive of investment management/advisory fee) of the scheme excluding issue/redemption expenses are subject to the limits specified below:

(A) In case of fund of funds scheme: Total expenses of the scheme including weighted average of charges levied by the underlying schemes, not to exceed 2.5 per cent of the daily net assets of the scheme;

(B) In case of index fund scheme/exchange traded fund: Upto a maximum of 1.5 per cent of the daily net assets;

(C) in case of other schemes (as per cent of daily net assets): on the **(i)** first ₹100 crore, 2.5, **(ii)** next ₹300 crore, 2.25, **(iii)** next ₹300 crore, 2.0 and **(iv)** balance 1.75. However, in a scheme investing in bonds, the limit would be at least 0.25 per cent lesser. Any expenditure in excess of the above limits should be borne by the AMC/trustees/sponsor.

In addition to the above, the following costs/expenses may be charged to a scheme: **(i)** brokerage/transaction costs incurred for execution of trade and including in cost of investment, upto 0.12 per cent and 0.05 per cent respectively in cash market and derivative transactions; **(ii)** expenses upto 0.30 per cent of daily net assets if the new inflows from the SEBI-specified cities are the higher of **(a)** 30 per cent of the gross inflow in, **(b)** 15 per cent of the assets under management of the scheme. They should be charged on a proportionate basis if the inflows are less than these (30 and 15) percentages. Such expenses should be utilised for distribution expenses for bringing inflows from these cities. In case these inflows are redeemed within one year, the amount would be credited back to the scheme; **(iii)** additional expenses, upto 0.20 per cent of the daily net assets. Any expenditure in excess of the above limits would be borne by the AMC/trustees/sponsors.

Declaration of Dividends A mutual fund may declare dividends in accordance with the offer document are subject to any guidelines specified by the SEBI.

Despatch of Warrants and Proceeds Every mutual fund and AMC should **(a)** despatch to the unit-holders the dividend warrants, within 42 days of the declaration of the dividend and **(b)** despatch the redemption or repurchase proceeds within ten working days from the date of redemption or repurchase. In the event of failure to despatch the redemption/repurchase proceeds within the specified period, the AMC would be liable to pay interest to the unit-holders at such rate as may be specified by the SEBI for the period of such delay. It may also be liable for penalty for such failure.

Annual Report

Every mutual fund or the AMC must prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the mutual fund, as specified in **Appendix 9-A on the website. The website address is http://www.mhhe.com/khanfs9e.**

Auditor's Report The annual statement of accounts of mutual funds should be audited by an auditor who is not in any way associated with the auditor of the AMC. He should be appointed by the trustees and should forward his report to the trustees to form a part of the annual report of the mutual fund. The auditor's report should comprise of a certificate to the effect that:

(i) He has obtained all information and explanations that, to the best of his knowledge and belief, were necessary for the purpose of the audit;

(ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the mutual fund for the accounting period to which the balance sheet or the revenue account relates and

(iii) The statement of accounts has been prepared in accordance with accounting policies and standards, as specified by the SEBI.

Mailing of Annual Report The scheme wise annual report of a mutual fund or its abridged summary should be mailed to all unit-holders as soon as may be but not later than four months from the date of closure of the relevant accounting year. They may be sent in electronic form. They should contain all details as specified in **Appendix 9-A (on the website)** and as are necessary for the purpose of providing a true and fair view of the operations of the mutual fund. However, the abridged schemewise annual report mailed to the unit-holders should be in the format prescribed by the SEBI in this regard. If the full accounts are published in newspapers, the full portfolio disclosure is not required. The report mailed in abridged summary form should carry a note that for the unit-holders of a scheme, the full annual report would be available for inspection at the head office of the mutual fund and a copy would be made available to the unit-holders on payment of such nominal fees as may be specified by the mutual fund. The AMC should display the link of the full scheme-wise annual reports prominently on their website.

Every mutual fund should, within four months from the date of closure of each financial year, forward to the SEBI a copy of the annual report and other information, including the details of investments and deposits held so that the entire schemewise portfolio of the mutual funds is disclosed to it.

Half-yearly Disclosures A mutual fund/AMC should within one month from the close of each half-year (March 31/September 30) host a soft copy of the unaudited financial results on the website and advertise it in at least one English daily newspaper having nation-wide circulation and one newspaper with wide circulation in the regional language where the head office is situated.

Inspection and Audit

The SEBI may appoint an inspecting officer to undertake the inspection of the books of accounts, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and AMC for any of the following purposes:

(a) to ensure that the books of accounts are being maintained in the manner specified in these regulations;
(b) to ascertain whether the provisions of the SEBI Act and these regulations are being complied with;
(c) to ascertain whether the systems, procedures and safeguards followed are adequate;
(d) to ascertain whether the provisions of the SEBI Act or any rules or regulations have been violated;
(e) to investigate into the complaints received from the investors or any other person on any matter having a bearing on their activities and
(f) to suo moto ensure that their affairs are being conducted in a manner that is in the interest of the investors or the securities market.

The SEBI also has powers to appoint an auditor to conduct inspection/investigation with the powers of the investigating officer and is entitled to recover the expenses/fee paid to the auditors from the party concerned.

Procedure for Action in Case of Default

Liability for Action in Case of Default A mutual fund which:

- contravenes any of the provisions of the SEBI Act and these regulations
- fails to furnish any information or furnish the wrong information relating to its activities
- fails to submit periodical returns
- does not cooperate in any inquiry/inspection
- fails to comply with directions

- fails to resolve investors complaints/to give satisfactory reply in this regard,
- indulges in insider practices in securities, in terms of the SEBI (Fraudulent and Unfair Trade Practices in Securities Market) Regulations, 1995,
- is guilty of misconduct/improper/unbusiness like/unprofessional conduct, inconsistent with EBI code
- fails to pay any fees
- violates the conditions of registration
- does not carry out its obligations
- fails to maintain net worth of the AMC

would be dealt with according to the **SEBI Intermediaries Regulations**.

Action Against Intermediaries The SEBI can also initiate action for the suspension/cancellation of registration of an intermediary holding a certificate of registration for failure to exercise due diligence or to comply with the obligations under these regulations.

Action Against Mutual Fund/AMC In addition to the liability for action in default, a mutual fund/AMC would be liable for action under the applicable provisions of the SEBI Act/regulations in case the **(i)** issued advertisement is in contravention with the specified code and **(ii)** valuation of securities contravenes the principles of fair valuation.

MUTUAL FUND SCHEMES/PRODUCTS

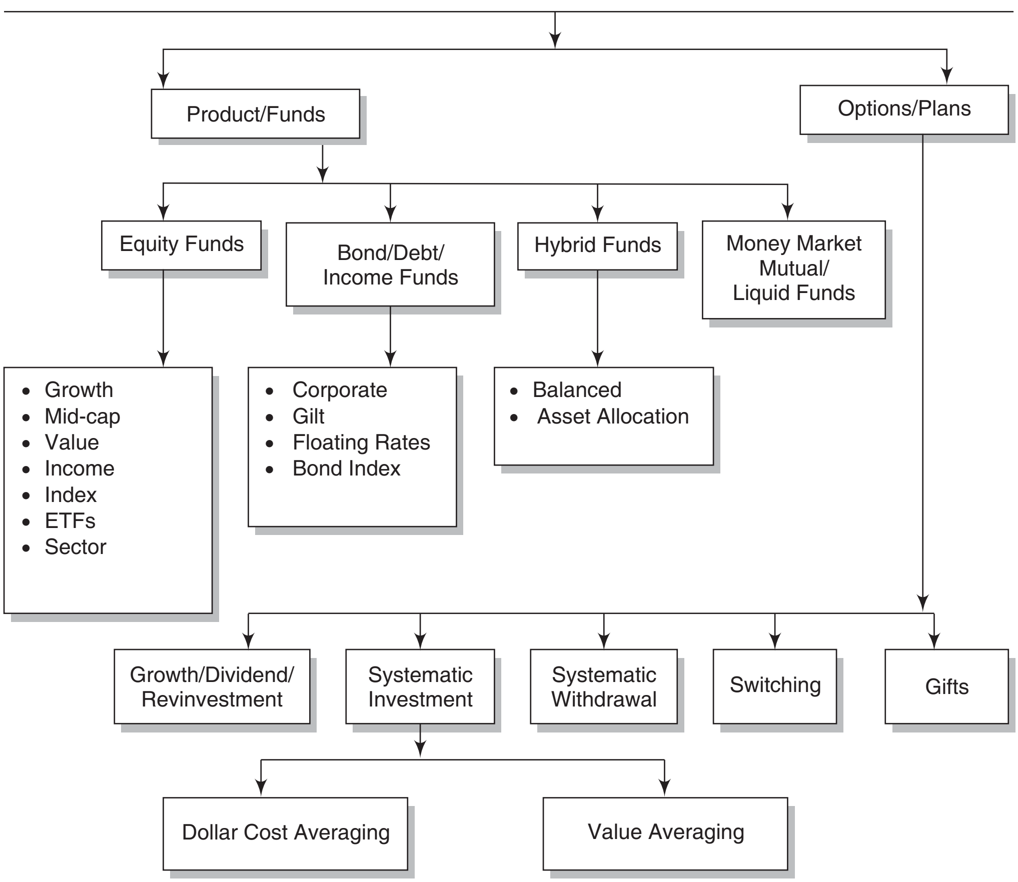
> **Open-ended scheme** has a perpetual existence and investors are free to buy/sell units at any time at NAV-linked prices.

Subject to SEBI regulations, a mutual fund is free to design its schemes/products to suit the needs of the various types of investors. Mutual funds in India presently offer more than 400 products/services/options/plans across various categories. They consist of open-ended and closed-ended schemes. The difference between these two types of schemes is structural. In an **open-ended scheme,** an investor can buy/sell units on a daily basis; the scheme has a perpetual existence and a flexible, everchanging corpus. The investors are free to buy and sell any number of units at any point of time, at prices that are linked to their NAV. They can invest/disinvest any amount any time after a short initial lock-in period. They give to the investors almost instant liquidity as the fund announces the sale and repurchase prices daily. They are, however, not listed on a stock exchange and can be bought and sold only from, and to the mutual fund. A **close-ended scheme** is one in which the subscription period remains open only for the specified period. At the end of this period, the entire corpus is disinvested and the proceeds distributed to the unitholders. Thus, after the final payment, the scheme ceases to exist. However, such schemes can be rolled over with the approval of the unitholders. The units are listed on a stock exchange for dealing in the secondary markets. A brief account of the variety of products/services offered by mutual funds is given in this Section, with reference to **(1)** product variety and **(2)** variety in terms of options and plans/services. **They are depicted in *Exhibit 9.2*.**

Product Variety

The funds, from the viewpoint of product variety, can be categorised into: **(a)** Equity funds, **(b)** Bond funds, **(c)** Hybrid funds and **(d)** Money market funds.

Exhibit 9.2 Mutual Fund Products/Schemes/Options/Plans



Equity Funds Equity funds invest in equity shares. Classified by objectives, such funds can be grouped into 8 broad categories, namely, Growth funds, Mid-cap funds, Value funds, Equity-income funds, Index funds, Exchange traded funds (ETFs), Sector funds and Equity-linked savings schemes (ELSSs).

Growth Funds The investments of **growth funds** is mainly in equity shares of companies which are expected to fare better than the market. The shares typically provide little or no dividends as earnings are re-invested for growth/expansion. Included in this category are companies of different sizes, ages and growth rates. The primary objective of such funds is capital appreciation. Growth funds involve moderate to high risk for the investors and reflect aggressive investing by them.

> **Growth funds** aim at capital appreciation.

Mid-Cap Funds Similar to growth funds in the investment strategy, such funds invest in equity shares of mid-sized companies which grow faster than large companies as their expansion takes place on a smaller base of assets/revenues. Such companies usually have a narrower business focus than the large companies. Mid-cap funds have a growth orientation and invest in shares which generally have above average P/E ratios. Some such funds also follow **'value orientation'.**

Value Funds Investment of these funds is mainly in shares whose current valuation does not reflect the underlying value proposition. Their investment philosophy is 'value investing' and they seek securities with the most promising potential for growth.

Equity Income Funds Their investment objective is to provide a major portion of the total return to an investor through income. The portfolio focuses primarily on dividend yield and seeks yield significantly higher on an overall market yardstick, such as the BSE 30 or Nifty.

Index Funds **Index funds** are specifically designed to represent the characteristics/ attributes of a chosen target index. They can be constructed in several ways. An index fund/portfolio consisting of all shares comprised in the index in the same proportion is known as a **Fully Replicated Index Fund.** A **Sampled Index Fund,** in contrast, invests only in shares included in the index. An index fund closely replicates the composition as well as the return on the index and follows the swings of the stock market.

> **Index funds**
> represent attributes of a chosen target index.

Exchange Traded Funds (ETFs) The **ETFs** can be bought and sold on the stock exchange(s), at prices that are usually close to the actual intra-day NAV of the scheme. They provide to the investors a fund that closely tracks the performance of an index, with the ability to buy/sell on an intra-day basis. They are structured in a manner which allows the creation of new units and the redemption of outstanding units directly with the fund, thereby ensuring that ETFs trade close to their actual NAVs. The ETFs are usually passively managed funds, wherein the subscription/redemption of units work on the concept of exchange with the underlying securities. In other words, large investors/institutions can purchase units by depositing the underlying securities with the fund and can redeem by receiving the underlying shares in exchange of units. Units can also be bought and sold directly on the stock exchange. The ETFs are highly flexible and can be used as a tool for gaining instant exposure to equity markets, equalising cash or for arbitrarying between the cash and future market.

> **ETFs**
> are a fund that closely tracks the performance of an index.

Sector/Segment Specific Funds Such funds invest mainly in shares of a specific sector. They concentrate on a particular industry, such as that of technology, telecommunications, FMCG, petroleum and so on. Another variety of specific funds is making investments within a particular segment of the market, for example, large-caps, mid-caps or small-caps funds. A large-cap fund invests only in bluechip companies; a mid-cap fund invests in companies with capitalisation in medium ranges; and small-cap fund invests in shares of companies with low market capitalisation. Yet another category of sector/segment specific funds are **Primary Market Funds,** which invest in shares only during primary market offering. **Gold Funds** and **Real Estate Funds** are also examples of such funds.

Equity Linked Savings Schemes (ELSS) Such schemes/funds invest in equity/equity related instruments for long-term capital appreciation, with a minimum 3-year lock-in period and tax benefit under Section 88 of the Income-tax Act.

Bond/Income/Debt Funds Debt funds concentrate their investments in debt securities. The principal source of their income return is the interest earned on the fixed income securities in the portfolio. The NAV of such funds is directly influenced by changes in interest rates. As interest rates decline, the prices of bonds go up, causing an upward movement in the NAV of the fund and *vice versa*. The income/bond/debt funds can be categorised into **(a)** Corporate bond funds, **(b)** Gilt schemes, **(c)** Floating rate schemes and **(d)** Bond index funds.

Corporate Bond Funds Such funds invest in bonds issued by companies, so as to earn high incomes and these can be categorised into **High Grade Bond Funds** and **High Yield Bond Funds.** Also known as **AAA (Triple-A) Bond Funds,** the former type of funds invest mostly in **AAA** rated bonds, while the latter invest in instruments with high yield, consistent with risk tolerance.

Gilt Schemes/Funds They invest only in securities issued by the Government (G-Sec). A portfolio of G-Sec is free of credit risk but it is exposed to interest rate risk. Income for such funds may be generated through the **(i)** receipt of coupon payments, **(ii)** amortisation of the discount on the instrument and **(iii)** purchase/sale of securities in the underlying portfolio. The schemes also offer some capital appreciation.

> **FRFs** invest primarily in floating rate debt instruments.

Floating Rate Scheme/Funds (FRFs) The FRFs provide a hedge to the investors against volatile interest rates. They invest primarily in floating rate debt instruments, that is, **Floaters,** whose interest rates are reset at periodic intervals. They enable investors to avoid potential capital losses arising out of volatility in interest rates in case of fixed interest rate securities.

Bond Index Funds Like an equity index fund, a bond index fund invests in instruments comprising of the underlying bond index in the same proportion, to replicate the return on the same.

Hybrid Funds Funds in this category have a dual composition of share/bond funds. Included in this category are **(a)** Balanced funds and **(b)** Asset Allocation Funds.

Balanced Funds Such funds invest in a portfolio of securities consisting of shares and bonds, to offer to the investors current income, and moderate growth, with low levels of risk. The NAVs of balanced funds generally move in a narrow range and are not as volatile as those of equity funds. They are likely to outperform an equity fund in a bearish phase but do less well in a bullish market.

Asset Allocation Fund (AAF) An asset allocation fund invests in a variety of securities in different asset classes, to provide to the investors truly diversified holdings and consistent returns. A **Stable Allocation Portfolio** follows a specific breakdown of assets, which they try to maintain over time. The composition of the assets is varied as opportunities and circumstances change in a **Flexible Asset Allocation.** The AAFs may range from very conservative (i.e., less proportion devoted to equity) to very aggressive (i.e., high proportion of equity) funds.

Money Market Mutual/Liquid Funds (MMM/LFs) The MMM/LFs invest mainly in short-term, liquid instruments, to offer to the investors stability of principal, higher liquidity and shorter investment horizon. The eligible instruments are CPs, commercial bills, T-bills, CDs, permitted securities under a repo/reverse repo agreement and other instruments permitted from time to time by the RBI/SEBI.

> **MMM/LFs** invest mainly in short-term liquid instruments

Options/Plans

The various schemes/products of the mutual funds in India, detailed above, offer several options/plans/services. These are: **(a)** Growth/Dividend/Reinvestment; **(b)** Systematic investment; **(c)** Systematic withdrawal; **(d)** Switching; and **(e)** Gift.

Growth/Dividend/Reinvestment Option Under the **growth option,** the scheme does not declare dividend and the investors would not receive any income from the scheme, which would be reflected in the NAV. While the number of units held by an investor remains constant, their value varies with the value of the portfolio of the scheme. Under the **dividend option,** the scheme declares and the investors receive dividends. Unitholders have the option to reinvest the dividend in additional units of the scheme at the prevailing NAV, without any load charges, under the **reinvestment option.** The number of units held by the investors increases with every additional purchase of (reinvestment in) units.

> **SIP**
> is a plan in which investors can invest a fixed amount every month for a pre-determined period at the applicable NAV-related prices.

Systematic Investment Plan (SIP) Under the **SIP**, an investor can invest a fixed amount every month, for a pre-decided period of time, usually 6 months to 1 year, through post-dated cheques, at the applicable NAV-related prices. It helps the investors to average out the cost of investment over the period and, thus, overcome the short-term fluctuations in the market. There are two strategies to accomplish it: Dollar cost of averaging and Value averaging.

> **Dollar cost averaging**
> eliminates the market timing decision, that is, get-in at the bottom and get-out at the top.

Dollar Cost of Averaging **Dollar cost averaging** eliminates the market timing decision, namely, get-in at the bottom and got-out at the top for a fat profit. This is illustrated in Exhibit 9.3.

Exhibit 9.3 Dollar Cost of Averaging

Regular investment (on 10th of every month)	*Unit prices*	*Units acquired*
₹100	₹11.79	8.48
100	12.11	8.26
100	11.17	8.95
100	11.62	8.61
100	13.59	7.36
100	13.82	7.24
100	11.82	8.46
100	10.30	9.71
100	10.38	9.63
100	9.74	10.27
₹1,000	₹116.34	86.79

Average unit cost = ₹11.50
Average unit price = ₹11.63

Thus, the investor owns 87 units of the scheme/fund by investing ₹1,000. The average price of his investment is ₹11.63. He has acquired these units at a cost of ₹11.50. These units have become worth more than what the investor has paid for.

The idea behind dollar cost of averaging is to invest for the long term to ensure that the investor would catch the down markets and be fully invested in the upmarkets. He should, however, stick with the investment in the down market, otherwise he would suffer a loss on the sale of units.

Value Averaging It is an aggressive form of dollar cost of averaging. It is suitable for investors who can tolerate greater price volatility. Instead of investing a fixed amount regularly, the investor has to specify the investment value increase by a specified amount over a period of time. In other words, the investor would be investing more in some months when the investment has declined and less when the investment has increased beyond his expectations. **This is illustrated in Exhibit 9.4.**

Exhibit 9.4 Value Averaging

Investment value desired on 10th of every month	*Unit price at 10th of every month*	*Units acquired*	*Value of investment on 10th of every before additional units are acquired*	*Investment to be made on 10th of every month*	*Additional units acquired*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
₹100	₹11.79	8.49	–	₹100	
100	12.11	16.51	103	97	8
100	11.17	28.86	184	116	10
100	11.62	34.44	312	88	8
100	13.59	36.80	468	32	2
100	13.82	43.40	509	91	7
100	11.82	59.22	513	187	16
100	10.30	77.69	610	190	18
100	10.38	86.73	806	94	9
₹1,000	₹9.74	102.65	845	155	16
Total investment				₹1,150	
Average unit cost = ₹11.21					
Average unit price = ₹11.63					

Thus, the average unit cost to the investor is lower with value averaging, that is, ₹11.21 against the average price of ₹11.63.

Systematic Withdrawal Plan (SWP) Under this plan, the investor withdraws a fixed amount of money periodically. It is a mirror image of SIP.

Switch Facility Unitholders under a scheme can opt to switch units between dividend plan, growth plan and any other plan and also options within a plan under a scheme, at the applicable NAV-based prices. In addition, they may exchange their units under a scheme for units of other scheme(s).

Gift Facility Gift facility to the extent provided in the Mutual Fund Regulations is available to the unitholders.

RECAPITULATION

- A mutual fund pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. It issues units (securities) to unitholders (investors) according to the quantum of money invested by them. The profits/losses are shared by the unitholders in proportion of their investments.
- According to the SEBI, mutual funds are funds established in the form of a Trust to raise money through the sale of units to the public under various schemes for investing in securities including money market instruments or gold/gold related instruments or real estate assets.
- A mutual is set up in the form of a trust which has (i) a sponsor, (ii) trustees, (iii) an asset management company (AMC) and (iv) custodians. The sponsors set up the trust as promoters. The trustees hold the property in trust for the benefit of the unitholders. They are vested with general powers of superintendence and direction over the AMC and they monitor their performance and compliance with the SEBI regulations. The AMC manages the funds. The custodian holds the securities of the fund in its custody.
- As an investment intermediary, mutual funds offer a variety of services/benefits to the investors: convenience, low risk through diversification, expert management and lower cost due to economies of scale.
- The main elements of the regulatory mechanism for mutual funds in India in terms of the SEBI regulations are: **(i)** registration of mutual funds, **(ii)** constitution and management of mutual funds, **(iii)** constitution and management of AMCs/custodians, **(iv)** mutual fund schemes, **(v)** investment objectives/valuation policies, **(vi)** real estate mutual fund schemes, **(vii)** inspection and audit, **(viii)** general obligations, and **(ix)** action in case of default.
- To carry on their business, mutual funds must be registered with the SEBI, which registration is granted on the fulfilment of the prescribed eligibility criteria for the sponsors in terms of track record, contribution to the networth of the AMC; appointment of trustees, AMC and custodian; and so on.
- A mutual fund must be constituted in the form of a trust and the instrument of trust should be in the form of a deed duly registered and executed by the sponsor in favour of the trustees. The contents of the trust deed have been prescribed by the SEBI.
- A person can be appointed as a trustee on the fulfilment of the prescribed conditions, such as that he should be a person of ability, integrity and standing, who has not been guilty of moral turpitude/convicted of any economic offence/violation of any securities laws and so on. Two-thirds of the trustees of a mutual fund must be independent persons and not associated with the sponsors in any manner. The trustees should enter into an investment management agreement with the AMC for the purpose of making investments. The trustees would have the right to obtain from the AMC, all information concerning the operations of the various schemes of the mutual fund managed by it.
- The sponsor of the mutual funds/trustees would appoint the AMC, with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or 75 per cent of the unitholders of the scheme. The eligibility criteria for the appointment of an AMC include sound track record, adequate professional experience, not guilty of moral turpitude, non-conviction of

any economic offence/violation of any securities laws, inclusion of 50 per cent independent directors and networth of at least ₹10 crore.

- An AMC cannot act as a trustee of a mutual fund. It can undertake other business activities in the nature of portfolio management services, management and advisory services to offshore funds/pension funds/provident funds/venture capital funds, management of insurance funds, financial consultancy and exchange of research on a commercial basis, if any of these activities do not conflict with the activities of the mutual fund.
- It is obligatory for an AMC to take all reasonable steps and exercise due diligence to ensure that the investment of funds conforms to the provisions of the SEBI regulations and the trust deed. It can purchase/sell securities upto a maximum of 5 per cent of the total, through a broker associated with the promoter. It should disclose details of all transactions with/through the sponsor/associate companies. The AMC has to file details of securities transactions by its key personnel in their own name or on behalf of the AMC, to the trustees/SEBI. Details of transactions with associates should also be filed/reported. The AMC has to file details of its directors and transactions with sponsor/associate companies, with the trustees/SEBI. The AMCs are prohibited from appointing as a key personnel, any person found guilty of any economic offence or involved in a violation of securities laws.
- The mutual fund should appoint a custodian to carry out the custodial services for the scheme. A mutual fund cannot appoint a custodian in which 50 per cent or more of the voting rights/directorships is held by the sponsor/associate companies. The custodian agreement, the service contract and terms of appointment require prior approval of the trustees.
- An AMC can launch a mutual fund scheme after its approval by the trustees and filing of the offer document with the SEBI. The offer document should contain adequate disclosures to enable the investors to make an informed investment decision. All advertisements pertaining to mutual fund schemes should conform to the advertisement code specified by SEBI. The advertisement should also disclose the investment objective of the scheme. The offer document and advertisement materials should not be misleading or contain incorrect/false information.
- A close-ended scheme is one in which the maturity period is specified. Every such scheme must be listed on a recognised stock exchange. A close-ended scheme may be converted into an open-ended scheme. All close-ended schemes should be fully redeemed on maturity, but they can be rolled over.
- Guaranteed returns can be provided in a scheme if they are fully guaranteed by the AMC. The name of the guarantor and the manner in which the guarantee is to be met should be disclosed in the offer document.
- Every mutual fund should compute the NAV of each scheme by dividing the net assets of the scheme by the number of unit outstanding on the valuation date.
- The sale and repurchase price of units should be made available to the investors. The repurchase price should not be lower than 93 per cent and the sale price should not be higher than 107 per cent of the NAV. The repurchase price cannot be lower than 95 per cent of the NAV in a close-ended scheme. The difference between the repurchase and sale price should not exceed 7 per cent of the sale price.
- Mutual funds can invest only in transferable securities in the capital/money market or in privately placed debentures or securitised debts in asset-backed securities (ABS) and mortgage-backed securities (MBSs).

- The restrictions on investments by mutual funds relate to ceilings in rated/unrated debt instruments, equity shares, inter-scheme transfers/investments, short-term deployment of funds, investment in unlisted/listed group companies, thinly traded securities and so on.
- The ceiling on investment in a rated debt instrument not below investment grade, is 15-20 per cent of the NAV in a single instrument. The limit for a single unrated debt instrument is 10 per cent and that for the total is 25 per cent. The Investments of a mutual fund in equity capital of a company, can be upto 10 per cent. Inter-scheme transfer of funds are permitted at the prevailing market price and the securities should fit into the investment objectives of the transferee scheme. The aggregate inter-scheme investment should not exceed 5 per cent of the NAV of the mutual fund. Mutual funds should buy/sell securities on the basis of delivery. Upto 25 per cent of the net assets of a mutual fund can be invested in unlisted securities/ securities issued by way of placement of an associate company of the sponsor/listed securities of the sponsor. Pending deployment of funds in securities, mutual funds can invest funds in short-term deposits with banks. The permitted investment in unlisted equity shares/related instruments in case of open-ended and close-ended schemes is 5 per cent and 10 per cent of the NAV of the mutual fund, respectively.
- Mutual funds can borrow only to meet temporary liquidity needs for repurchase/ redemption/ payment of dividend and so on, upto a maximum of 20 per cent of their net assets, for upto 6 months. They cannot advance any loans but they can lend securities under the stock lending scheme. They cannot enter into option trading/short selling/carry forward transactions. But they can enter into derivative trading for hedging and portfolio balancing. They can also carry on underwriting business.
- The investment valuation norms for mutual funds relate to traded securities, non-traded securities and rights shares.
- Traded securities should be valued at the last closing price on a stock exchange. When a security is not traded on any stock exchange on a particular valuation day, the closing price on the available earliest previous day (i.e., 30 days in case of shares and 15 days in case of a debt security) may be used.
- A non-traded security/scrip means a security not traded for 30 days prior to the valuation date. Such securities should be valued 'in good faith' on the basis of the appropriate valuation models based on the valuation principle approved by the AMC. The selected method should be fair and reasonable. Included in this category are equity instruments, debt instruments, call money/bills/deposits, convertible bonds, warrants and repos.
- Equity instruments should generally be valued on the basis of capitalisation of earnings, using the P/E ratio of a comparable traded security, with an appropriate discount for lower liquidity. Debt instruments should generally be valued on the yield to maturity basis, using the capitalisation factor for a comparable traded security, with an appropriate discount for lower liquidity. Call money, bills and short-term deposits should be valued at cost plus accrual. Other money market instruments and Government securities should be valued at yield to maturity based on the prevailing market rate. The convertible and non-convertible components of a convertible instrument should be valued as an equity and debt instrument respectively. Warrants can be valued at the value of the share obtained on exercise of the warrant, minus the amount payable on exercise of the warrant. An instrument bought on repo basis should be valued at the resale price, minus the applicable interest upto the date of resale.
- Until they are traded, the value of the rights shares should be calculated as $Vr = n/m \times (P_{ex} - P_{of}))$, where V_r = value of rights, n = number of rights offered, m = number of original shares held, P_{ex} = Ex-rights price, P_{of} = rights offer price.

- All expenses and incomes accrued upto the valuation date should be considered for the computation of the net asset value.
- Thinly traded securities should be valued as per SEBI guidelines.
- The aggregate value of illiquid securities should not exceed 15 per cent of the total assets of the scheme. Any excess holding should be valued as per SEBI guidelines.
- The general obligations of AMCs/mutual funds relate to maintenance of proper books of accounts/records, fees and expenses on issue of schemes, despatch of warrants and proceeds and annual report.
- Every AMC should keep, maintain and preserve proper books of accounts/records/ documents for 8 years, for each scheme. It should follow the specified accounting policies and standards so as to provide the appropriate details of the schemewise disposition of the assets at the relevant accounting date and the performance during the period, together with information regarding the distribution and accumulation of the income accruing to the unitholders, in a fair and true manner.
- All expenses should be clearly identified and appropriated in the individual schemes. The AMC may charge the mutual fund with investment and advisory fees, which should be fully disclosed in the offer document. All other expenses would be borne by the AMC/trustees/ sponsor. Initial issue expenses of floating a scheme cannot exceed 6 per cent of the initial resources raised and must be accounted in the books of account of the scheme. An AMC may launch schemes on a 'load' or 'partial load' basis. In case of a no load scheme, the initial issue expenses should be borne by the AMC. A part of the load would be borne by the AMC and the balance by the scheme in a partial load scheme. In a load scheme, the entire expense would be borne by the scheme.
- The dividend warrants should be despatched by the AMC, within 42 days of the declaration of dividend and the redemption/repurchase proceeds, within 10 days, failing which it would have to pay interest for the period of delay and would also be liable for penalty for such failure.
- The books of accounts/records/documents and infrastructure, systems and procedures of a mutual fund/trustees/AMC can be inspected or their affairs investigated by an inspecting official/ auditor appointed by SEBI. In case of default, the SEBI can suspend/cancel the registration of a mutual fund.
- A real estate mutual fund scheme (REMFS) invests directly/indirectly in real estate assets/ other permissible assets. Real estate asset means an identifiable immovable property, which is located in India in a city notified by the SEBI/a special economic zone. It does not include a project under construction/vacant land, deserted property/agricultural land and property reserved/attached by government/other authority or pursuant to a court order or the acquisition of which is prohibited under any law. The REMFS cannot undertake lending/home finance activities.
- The permissible investments of a REMFS are: **(i)** at least 35 per cent of the net assets directly in real estate assets; **(ii)** 75 per cent of net assets in real estate assets, mortgage backed securities and equity shares/debentures of listed companies dealing in real estate assets and the balance in other securities, **(iii)** Not more than 30 per cent of its net assets in a single city, 15 per cent in a single project and 25 per cent of the issued capital of an unlisted company, **(iv)** Not more than 15 per cent of its net assets in shares/debentures of the unlisted company, **(v)** Not more than 25 per cent of its net assets in **(a)** unlisted securities of the sponsor/associated/group company, **(b)** listed security issued by way of preferential allotment by the sponsor/ associate/group company and **(c)** any listed security of the sponsor/associate/group; **(vi)** No

inter-scheme transfer of real estates assets and **(viii)** prohibition on investment in any real estate assets owned by the sponsor/associate/AMC during the last 5 years or in which they hold tenancy/lease rights.

- The real assets held by the REMFS should be valued at cost price on the date of acquisition and at fair price every 3 months.
- **IDFSs** means a mutual fund scheme that invests primarily (i.e. 90 per cent of the assets of the scheme) in debt securities/securitised debt instruments of infrastructure/infrastructure capital companies/projects or special purpose vehicles (SPVs) created for facilitating/promoting investment in infrastructure and other permissible assets or bank loans in respect of completed and revenue generating projects of infrastructure companies/projects/SPVs. The main elements of the **IDFSs** are: **(i)** eligibility criteria, **(ii)** conditions, **(iii)** permissible investments, **(iv)** valuation of assets and NAV, **(v)** duties of AMC, and **(vi)** disclosures.
- The SEBI would grant a certificate of registration if the sponsor/its **parent company** (i.e. a company holding 75 per cent of the capital of the sponsor) **(a)** has been carrying on activities/business in infrastructure financing sector for at least 5 years and **(b)** fulfils the eligibility criteria applicable to other mutual funds.
- An IDFS can be launched either as a close-ended scheme with a maturity exceeding 5 years or interval scheme with lock-in of 5 years and interval period upto one month. Each IDFS should have firm commitment from **strategic investors** [i.e. an RBI-registered infrastructure finance company (as NBFC)/a bank/international multilateral financial institutions] for contribution of at least rupees twenty five crore before the allotment of units to the other potential investors.
- At least 90 per cent of the net assets of the IDFS should be invested in the specified debt securities/securitised debt instruments. The balance amount may be invested in listed/unlisted equity shares/convertibles including mezzanine financing instruments or bank deposits and money market instruments. The maximum investment under all the IDFSs of a mutual fund in a single entity/bank loan would be restricted to 30 per cent of its net assets. The investment limit in the debt securities/assets of a single entity/bank loan rated below investment grade/unrated would be 30 per cent. This limit could be upto 50 per cent with the prior approval of the AMC/trustees.
- The assets held by an IDFS should be valued in **good faith** by the AMC on the basis of appropriate valuation methods based on principles approved by the trustees.
- The trustees or the employees/directors of the AMC/trustee company should disclose within one month all their transactions in the investee company to the compliance officer who should submit a report with recommendation to the trustees from the viewpoint of conflict of interest. The person(s) concerned may obtain views of the trustees before entering into the transaction.
- Mutual fund schemes/relate to **(1)** product variety and **(2)** options/plans.
- The funds/schemes, from the point of view of product variety, are categorised into **(i)** equity, **(ii)** bonds/debts, **(iii)** hybrid and **(iv)** money market.
- Based on the objectives, equity funds are grouped into growth, mid-cap, value, equity-income, index, ETFs, sector and ELSS.
- Bonds/debt/income funds are categorised into: corporate funds, gilt, floating rates and bond index.
- Hybrid funds consists of **(1)** balanced funds and **(2)** asset allocation fund.
- The options associated with the various funds are: growth/dividend/reinvestment; SIPs in terms of **(i)** dollar cost of averaging and **(ii)** value averaging; SWPs; switch facility; and gift facility.

REVIEW QUESTIONS

9.1 Describe briefly the structure of a mutual fund.
9.2 What are the advantages/services provided by mutual funds to the investors.
9.3 How is a mutual fund constituted?
9.4 Explain briefly
- Trust deed
- Investment management agreement

9.5 Explain briefly the constitution and management of an AMC with reference to the eligibility criteria, restriction on business activities and obligations.
9.6 Define NAV. How are mutual fund units priced?
9.7 Discuss the investment objectives of a mutual fund. Outline the restrictions on investments and borrowings by mutual funds.
9.8 Explain clearly the methods of valuation of investments of mutual funds.
9.9 Write a note on the general obligations of mutual funds/trustees/AMCs.
9.10 Briefly explain the main features of the real estate mutual fund schemes.
9.11 Explain briefly the main features of the infrastructure development mutual fund schemes.
9.12 Explain briefly the salient features of the mutual fund products/schemes in India.
9.13 Outline the options/plans associated with the mutual fund schemes.

PART 3

MERCHANT BANKING AND OTHER FEE-BASED/ ADVISORY FINANCIAL SERVICES

The second type of financial services, namely, merchant banking and the other fee-based/advisory services are covered in Part Three.

Merchant banks play a significant role in the financial services sector. However, merchant banking, as an advisory financial services, emerged rather late. Formal merchant banking service/activity in India originated with the setting-up of the merchant banking division by the Grindlays Bank in 1969 for undertaking management of public issue and financial consultancy, followed by other foreign banks. Pursuant to the recommendations of the Banking Commission (1972), State Bank of India started merchant banking service in 1973. The ICICI Ltd was the first development finance institution to initiate such service in 1974. The period following the mid-seventies witnessed a boom in the growth of merchant banking organisations in the country which were sponsored by banks, financial institutions, NBFCs brokers and so on. This led to diversification into the scope of these activities/services such as loan syndication, portfolio management, corporate counselling, project counselling, debenture trusteeship, mergers/amalgamations and takeovers/acquisitions and so on.

But the scope of such services was neither defined/delineated nor a set of rules and regulations governing them was in place. The formation of SEBI in 1992 was a landmark in the evolution of merchant banking as a professional service in the country. Merchant banking organisations have to be mandatorily registered with SEBI. While merchant bankers are currently providing a variety of services, registration with SEBI is required for (i) capital issues related activities: both pre-issue and post-issue, (ii) mergers and acquisitions, and (iii) portfolio management.

The broad framework of SEBI regulations relating to intermediaries and issue procedures/activities is described in Chapter 10 and 11 respectively. Finally, Chapter 12 explains corporate restructuring.

The evolution of an articulate and sophisticated financial system in the country has/is also witnessed/witnessing the emergence of other advisory services. They have developed in response to the requirements of a matured financial system. Stock-broking has assumed the character of a professional financial service in contrast to its traditional nature of a family business. Chapter 13 examines the current framework of stock-broking. Crediting rating, which has outgrown the mandated segments, is the theme of Chapter 14.

CHAPTER 10

Issue Management: Intermediaries

Learning Objectives

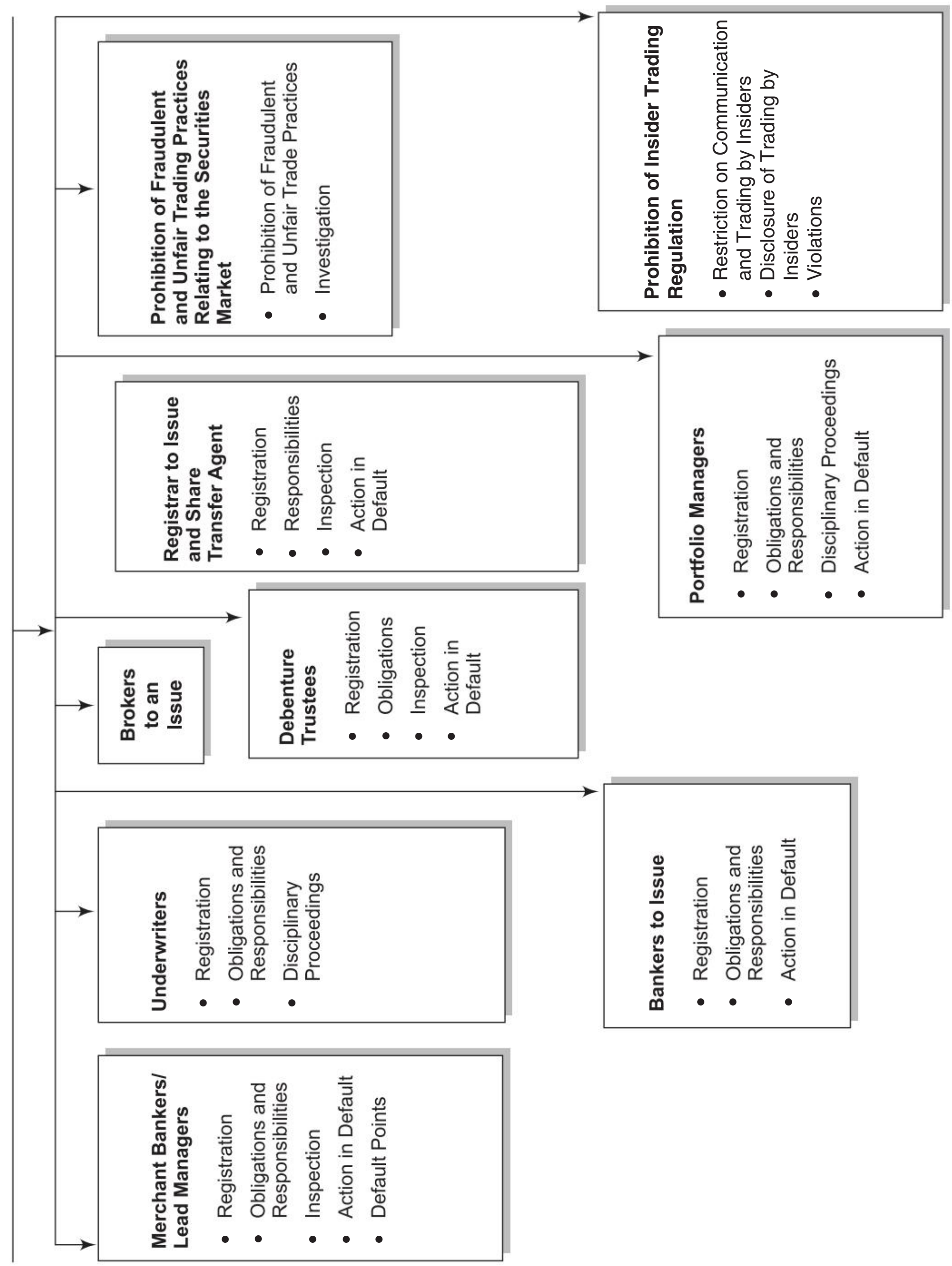
- Review the framework of regulation and operation of merchant bankers/lead managers.
- Discuss the SEBI regulations relating to registration, obligations and responsibilities, and disciplinary proceedings against underwriters of issues of capital.
- Understand the procedure for registration of bankers to an issue, their obligations and responsibilities and action in case of default by them.
- Outline the SEBI framework of regulation and operation of debenture trustees.
- Examine the operational and regulatory framework of registrars to issue and share transfer agents.
- Explain the SEBI regulations relating to portfolio managers.
- Analyse the main elements of the prohibition of insider trading regulations
- Explain the basic framework of prohibition on dealing/communicating/ counselling on matters relating to insider trading.

INTRODUCTION

The new issue market/activity was regulated by the Controller of Capital Issues (CCIs) under the provisions of the *Capital Issues (Control) Act, 1947* and the exemption orders and rules made under it. With the repeal of the Act and the consequent abolition of the office of the CCI in 1992, the protection of the interest of the investors in securities market and promotion of the development and regulation of the market/activity became the responsibility of the SEBI. To tone up the operations of the new issues in the country, it has put in place rigorous measures. These cover both the major intermediaries as well as the activities. The SEBI framework regulating the intermediaries is comprehensively examined in this chapter. They have to conform to regulations prescribed by the SEBI. The operational framework of the primary market in terms of activities is discussed in detail in the next chapter.

A significant organisational development in the Indian primary market has been the emergence of an array of intermediaries which play a critical role in the process of selling new issues. The legal framework for their operations has been prescribed by the SEBI. **It is depicted in Exhibit 10.1.** The framework in terms of guidelines provides the ground rules for the intermediaries. The major new issue market intermediaries are covered in Sections 1-7. The discussions focus on the lead managers, underwriters, bankers to an issue, registrars and share transfer agents,

Exhibit 10.1 Issue Management: Intermediaries



debenture trustees, and portfolio managers. While the fraudulent and unfair trade practices regulation is described in Section 8, a brief outline of the insider trading regulation is given in Section 9. Some concluding observations are given in the last Section.

MERCHANT BANKERS/LEAD MANAGERS

A **merchant banker** means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant/advisors or rendering corporate advisory service in relation to such issue management. **Issues** means an offer for sale/purchase of securities by any body corporate/ other person or group of persons on its/his/their behalf to, or from the public or from the holders of their securities, through a merchant banker. The importance of merchant bankers as sponsors of capital issues is reflected in their major services/functions such as, determining the composition of the capital structure (type of securities to be issued), draft of prospectus (offer documents) and application forms, compliance with procedural formalities, appointment of registrars to deal with the share application and transfers, listing of securities, arrangement of underwriting/sub-underwriting, placing of issues, selection of brokers and bankers to the issue, publicity and advertising agents, printers, and so on. In view of the overwhelming importance of merchant bankers in the process of capital issues, it is now mandatory that all public issues should be managed by merchant banker(s) functioning as the lead manager(s). In the case of rights issues not exceeding ₹50 lakh, such appointments may not be necessary. The salient features of the SEBI framework of their operations are summarised in this Section.

Merchant banker means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant/ advisors or rendering corporate advisory service in relation to such issue management.

Issue means an offer for sale/purchase of securities by any body corporate/ other person or group of persons on its/his/their behalf to, or from the public or from the holders of their securities, through a merchant banker.

Registration

Compulsory Registration Merchant bankers require compulsory registration with the SEBI to carry out their activities. Application for initial registration should be made to the SEBI in the prescribed form accompanied by non-refundable fee. They fall under four categories. Category I merchant bankers can carry on any activity related to issue management, that is, the preparation of prospectus and other information relating to the issue, determining the financial structure, tie-up of financiers, final allotment of securities, refund of the subscription and so on. They could also act as advisors, consultants, managers, underwriters or portfolio managers. Category II merchant bankers can act as advisors, consultants, co-managers, underwriters and portfolio managers; and Category III merchant bankers can act as underwriters, advisors, and consultants to an issue; Category IV merchant bankers can act only as adviser or consultant to an issue. Thus, only Category I merchant bankers could act as lead managers to an issue. With effect from December 9, 1997, however, only Category I merchant bankers are registered by the SEBI. To carry on activities as portfolio managers, they have to obtain separate certificates of registration from the SEBI.

Grant of Certificate The SEBI grants a certificate of registration on consideration of all matters that are relevant to the activities related to the merchant banker: **(a)** merchant bankers should also be a body corporate other than a non-banking financial company. However, a merchant banker who has been granted registration by the RBI to act as Primary Dealer may carry on such activity subject to the condition that it would not accept/hold public deposit, **(b)** they are expected to have the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge their activities; **(c)** they should have employed at least two persons with experience to conduct merchant banking business; **(d)** any person directly or indirectly connected with the applicant, that is, an associate/subsidiary/interconnected or group company, does not have a certificate of registration from the SEBI; **(e)** they fulfil the capital adequacy requirement of a minimum networth (i.e. paid-up capital and reserves) of ₹5 crore; **(f)** they/partners/directors/principal offices should not be involved in any litigation connected with the securities market, which has an adverse effect on their business; **(g)** have recognised professional qualification in finance, law or business management and or their registration is in the interest of the investors; **(gg)** grant of certificate is in the interest of investors; and **(h)** the applicant is a fit and proper person. **For determining whether an applicant/merchant banker is a fit and proper person, the SEBI would take into account the criteria specified in the SEBI Intermediaries Regulation 2008[@]**.

On being satisfied that the applicant is eligible, the SEBI would grant on payment of the prescribed fee a certificate of initial registration which should be valid for five years. Three months before the expiry of the period of initial registration, an application in the prescribed form accompanied by the prescribed non-refundable fee should be made for permanent registration. It should be accompanied by details of the changes that have taken place in the information submitted while seeking initial registration and a declaration that no changes other than those mentioned in such details have taken place. On being satisfied, the SEBI should grant permanent registration on payment of the requisite fee.

Fee A marchant banker has to pay **(i)** registration fee for initial registration, ₹2,00,000,within 15 days from the date of intimation from the SEBI; **(ii)** to keep permanent registration in force, ₹9,00,000 every three years from the sixth year from the date of initial registration within 15 days from the date of intimation from the SEBI and thereafter three months before the expiry of the block for which fee has been paid; **(iii)** non-refundable fee for initial/permanent registration, ₹50,000.

Conditions of Registration The registration/renewal of certificate of a merchant banker would be subject to the following conditions:

- Prior approval of the SEBI would be necessary to continue to act as a merchant banker after change in control. **Change in control** means **(i)** if its shares are listed, change of control in terms of stipulations of the SEBI Takeover Regulations, **(ii)** change in its controlling interest in any other case. In case of a non-body corporate, it would be construed as any change in its legal formation ownership. **Controlling interest** means direct/indirect interest to the extent of at least 51 per cent of voting rights.
- Enter into a legally binding contract with the issuer specifying their mutual duties and responsibilities.
- Pay the initial and permanent registration fee in the prescribed manner.
- Take adequate steps for redressal of investors grievances within one month of the complaint and keep the SEBI informed about the number, nature and other particulars of such complaints together with the manner of their redressal.
- Abide by the relevant regulations under the SEBI Act.

@For an account of these, refer to Khan, M Y, Indian Financial System, McGraw Hill Education (India), 2017, Chapter 4.

Obligations and Responsibilities

Code of Conduct for Merchant Bankers A merchant banker should:

1. Make all efforts to protect the interests of investors.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfill its obligations in a prompt, ethical, and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Endeavour to ensure that: **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to him under the regulatory system.
6. Ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.
7. Endeavour to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risk before taking any investment decision.
8. Endeavour to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.
9. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
10. Not make any statement, either oral or written, which would misrepresent the services that the merchant banker is capable of performing for any client or has rendered to any client.
11. Avoid conflict of interest and make adequate disclosure of its interest.
12. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
13. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as merchant banker which would impair its ability to render fair, objective and unbiased services.
14. Always endeavour to render the best possible advice to the clients having regard to their needs.
15. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
16. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in the merchant banker's financial status, which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
17. Not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other merchant bankers or investors or is likely to place such other merchant bankers in a disadvantageous position while competing for or executing any assignment.

18. Maintain arms length relationship between its merchant banking activity and any other activity.
19. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
20. Not make untrue statement or suppress any material fact in any documents, reports or information furnished to the SEBI.
21. Maintain an appropriate level of knowledge and competence and abide by the provisions of the SEBI Act/regulations/circulars and guidelines, which may be applicable and relevant to the activities carried on by it. They should also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
22. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
23. **(a)** Not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time or non real-time, unless a disclosure of his interest including a long or short position, in the security has been made, while rendering such advice; **(b)** In the event of an employee of the merchant banker rendering such advice, the merchant banker should ensure that such employee should also disclose the interests, if any, of himself, his dependent family members and the employer merchant banker, including their long or short position in the security, while rendering such advice.
24. Demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.
25. Provide adequate freedom and powers of its compliance officer for the effective discharge of his duties.
26. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance or resolution of conflict of interests, disclosure of shareholdings and interests, etc.
27. Ensure that good corporate policies and corporate governance are in place.
28. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).
29. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it in the conduct of its business, in respect of dealings in securities market.
30. That the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
31. Not be a party to or instrument for: **(a)** creation of false market; **(b)** price rigging or manipulation or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

Restriction on Business No merchant banker, other than a bank/public financial institution (PFI) is permitted to carry on business other than that in the securities market. In other words, he is prohibited from carrying on fund/asset-based business such as leasing and so on. However, a merchant banker who is registered with RBI as a Primary Dealer/Satellite Dealer may carry on such business as may be permitted by the RBI. A merchant banker may also ensure market making in respect of issue of specified securities by small and medium enterprises (**discussed in Chapter 11**)

Responsibilities of Lead Managers Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relating to such issues, and in particular to disclosures allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. In case of more than one lead manager/merchant banker, the statement has to provide details about their respective responsibilities. He can not associate with a merchant banker who does not hold a certificate of registration with the SEBI.

A merchant banker should not lead manage an issue/be associated with any activity undertaken under any other SEBI regulation if he is a promoter/director/associate of the issuer/any person making an offer to sell/purchase securities in terms of any SEBI regulation. However, he may be appointed if he is involved only in the marketing of the issue/offer. A merchant banker would be deemed to be an **associate of the issuer/person** if **(a)** either of them directly/indirectly **(i)** through its subsidiary/holding controls at least 15 per cent of the voting rights in the other, **(ii)** by itself/in combination with other persons exercises control over the other or **(b)** there is a common director (excluding nominee director) amongst the issuer, its subsidiary/holding company to the merchant banker.

It is necessary for a lead manager to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or ₹25 lakh, whichever is lesser. If he is unable to do so, he has to make arrangements for underwriting an equal amount by a merchant banker associated with that issue under intimation to the SEBI. In any issue by a small and medium enterprise (**detailed in Chapter 7**), he has to himself/jointly with others associated with the issue underwrite at least 15 per cent of the issue size.

Acquisition of Shares A merchant banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment either from the client or otherwise. He has to submit to the SEBI, the complete particulars of any acquisition of securities of a company whose issue is being managed by him, within 15 days from the date of transaction. Complete particulars of any acquisition of securities in pursuance of underwriting/market making obligations in respect of issues by small and medium enterprises should be submitted to the SEBI on quarterly basis.

Disclosures to the SEBI As and when required, a merchant banker has to disclose to the SEBI; **(i)** his responsibilities with regard to the management of the issue, **(ii)** any change in the information/particulars previously furnished, which have a bearing on the certificate of registration granted to it, **(iii)** the names of the companies whose issues he has managed or has been associated with, **(iv)** the particulars related to the breach of capital adequacy requirements and **(v)** information related to his activities as manager, underwriter, consultant or adviser to an issue.

The merchant banker should submit a periodic report in a manner specified by the SEBI.

Compliance Officer Every merchant banker should appoint a compliance officer who would be responsible for monitoring compliance with SEBI acts/rules/regulations/ notification/guidelines/ instructions, issued by the SEBI/Government, and for redressal of investors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him and ensure that the observations made/deficiencies pointed out by the SEBI on/in the draft prospectus/letter of offer do not recur.

Procedure for Inspection

The SEBI can undertake the inspection of the books of accounts, records and documents of a merchant banker to ensure that the books are maintained in the manner required, the provisions of the SEBI Act, rules and regulations are being complied with, and to investigate complaints from investors/other merchant bankers/any other person or any matter having a bearing on his activities as a merchant banker and, *suo moto*, in the interest of the securities business/investor's interest into the affairs of the merchant banker.

The merchant banker has an obligation to furnish all the information called for, allow reasonable access to the premises, extend reasonable facility for the examination of books/records/ documents/ computer data and provide copies of the same and give all assistance to the inspecting authority in connection with the inspection.

On the basis of the inspection report and after giving him an opportunity to make an explanation, the SEBI can call upon the merchant banker to take such measures as it deems fit in the interest of the securities market and for due compliance with the provisions of the SEBI Act, rules and regulations. In place of the inspection authority, the SEBI can appoint a qualified auditor, with the above powers of the inspection committee, to investigate into the books of accounts or the affairs and obligations of the merchant banker.

Liability for Action in Case of Default

A merchant banker who contravenes any provision of the SEBI Act/Regulations would be liable for action(s) specified therein including the action(s) under the **SEBI Intermediaries Regulation (2008)**.

UNDERWRITERS

> **Underwriters** make a commitment to get the issue subscribed either by others or by themselves.

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

Registration

To act as underwriter, a certificate of registration must be obtained from the SEBI. A SEBI-registered merchant banker/broker would not require a separate registration. The procedure for initial as well as permanent registration applicable to merchant bankers is also applicable to underwriters. The initial registration fee would be ₹13,33,300. The fee to keep permanent registration in force would be ₹5,00,000 every three years from the sixth year from the date of initial registration/completion of the period of renewal of registration. The non-refundable application fee for registration would be ₹25,000. In granting the certificate of registration, the SEBI considers all matters relevant/relating to the underwriting and in particular, **(a)** the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge the activities: **(b)** past experience in underwriting/employment of at least two persons with experience in underwriting: **(c)** any person directly/indirectly connected with the applicant is not registered with the SEBI as underwriter or a previous application of any such person has been rejected or any disciplinary action has been taken against such person under the SEBI Act/rules/regulations, **(d)** capital adequacy requirement of not less than the net worth (capital + free reserves) of ₹20 lakh; the capital adequacy requirement of a broker-underwriter would be specified by the stock exchange concerned; **(e)** the applicant/director/principal officer/partner has been convicted of offence involving moral turpitude or found guilty of any economic offence; and is a fit and proper person. **For determining whether an applicant/underwriter is a fit and proper person, the SEBI may take into account the criteria specified in the SEBI Intermediaries Regulation, 2008.** Failure to pay the fee would result in the suspension of the certificate of registration.

Conditions of Registration The conditions of registration applicable to merchant bankers are also applicable to underwriters.

General Obligations and Responsibilities

Code of Conduct for Underwriters An underwriter should:

1. Make all efforts to protect the interests of its clients.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).
4. Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
5. At all times render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
6. Not make any statement, either oral or written, which would misrepresent **(a)** the services that the underwriter is capable of performing for its client, or has rendered to any other issuer company; **(b)** his underwriting commitment.
7. Avoid conflict of interest and make adequate disclosure of his interest.
8. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in the an equitable manner.
9. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as underwriter which would impair its ability to render fair, objective and unbiased services.
10. Not divulge to other issuer, press or any party any confidential information about its issuer company, which has come to its knowledge and deal in securities of any issuer company without making disclosure to the SEBI as required under these regulations and also to the Board directors of the issuer company.
11. Not discriminate amongst its clients, save and except on ethical and commercial considerations.

12. Ensure that any change in registration status/any penal action taken by SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
13. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI. The underwriter should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.
14. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc. initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
15. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.
16. **(a)** Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including its long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of an underwriter is rendering such advice, the underwriter should ensure that he should disclose his interest, the interest of his dependent family members and that of the employer including their long or short position in the security, while rendering such advice.
17. Not either through its account or their respective accounts or through their associates or family members, relatives or friends indulge in any insider trading.
18. Not indulge in any unfair competition, which is likely to be harmful to the interest of other underwriters carrying on the business of underwriting or likely to place such other underwriters in a disadvantageous position in relation to the underwriter while competing for, or carrying out any assignment.
19. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
20. Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
21. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interest, disclosure of shareholdings and interests, etc.
22. Ensure that good corporate policies and corporate governance is in place.
23. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).
24. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.
25. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

26. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
27. Not be party to or instrumental for **(a)** creation of false market; **(b)** price rigging or manipulation, or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

Agreement with Clients Every underwriter has to enter into an agreement with the issuing company. The agreement, among others, provides for the period during which the agreement is in force, the allocation of duties and responsibilities between the underwriter and the client, the amount of underwriting obligations, the period within which the underwriter has to be subscribe to the issue after being intimated by/on behalf of the issuer, the amount of commission/brokerage, and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations.

General Responsibilities An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all under-writing agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

Compliance Officer Every underwriter should appoint a compliance officer who should be responsible for monitoring the compliance of the SEBI Act/rules/regulations/ notifications/ guidelines/ instructions issued by the SEBI/Government and for redressal of invertors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

Power to Call for Information The SEBI may at any time call for any information from an underwriter with respect to any matter relating to underwriting business who would be duty bound to furnish the information.

Inspection and Disciplinary Proceedings

The framework of the SEBI's right to undertake the inspection of the books of accounts, other records and documents of the underwriters, the procedure for inspection and obligations of the underwriters is broadly on the same pattern as applicable to the lead managers.

Liability for Action in Case of Default The liability for action in case of default arising out of contravention of any provision of the SEBI Act/rules/regulations, would be action(s) specified therein including the action(s) specified in the **SEBI Intermediaries Regulation 2008.**

BANKERS TO AN ISSUE

The **bankers to an issue** are engaged in activities such as acceptance of applications alongwith application money from the investors in respect of issues of capital and refund of application money. The term **issue** means an offer of sale/purchase of security by any body corporate/person/group of persons on his/its/their behalf to or from the public/the holders of securities of the body corporate/person/group of persons.

> **Bankers to an issue** are engaged in activities such as acceptance of applications alongwith application money from the investors in respect of issues of capital and refund of application money.

Registration

To carry on activity as a banker to issue, a person must obtain a certificate of initial as well as permanent registration from the SEBI. The SEBI grants registration on the basis of all the activities relating to banker to an issue in particular with reference to the following requirements: **(a)** the applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities, **(b)** the applicant/any of the directors of the applicant is not involved in any litigation connected with the securities market/has not been convicted of any economic offence; **(c)** the applicant is a scheduled bank; **(d)** grant of a certificate is in the interest of the investors; and **(e)** the applicant is a fit and proper person. For determining whether an applicant/banker to issue is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**.

The procedure for initial as well as permanent registration and the fee for application/registration applicable to merchant bankers is also applicable to bankers to an issue.

Conditions of Registration The registration of a banker to an issue would be subject to the same conditions as are applicable to merchant bankers:

General Obligations and Responsibilities

Furnish Information When required, a banker to an issue has to furnish to the SEBI the following information: **(a)** the number of issues for which he was engaged as a banker to an issue; **(b)** the number of applications/details of the application money received; **(c)** the dates on which applications from investors were forwarded to the issuing company/registrar to an issue; **(d)** the dates/amount of refund to the investors.

Books of Account/Record/Documents A banker to an issue is required to maintain books of accounts/records/documents for a minimum period of three yeas in respect of, inter alia, the number of applications received, the names of the investors, the time within which the applications received were forwarded to the issuing company/registrar to the issue and dates and amounts of refund money to investors.

Agreement with Issuing Companies Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centres at which applications/application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the banker stating the number of applications and the amount of money received from the investors.

Disciplinary Action by the RBI If the RBI takes any disciplinary action against a banker to an issue in relation to issue payment, the latter should immediately inform the SEBI. If the banker is prohibited from carrying on his activities as a result of the disciplinary action, the SEBI registration is automatically deemed as suspended/cancelled.

Code of Conduct for Bankers to Issue A banker to an issue should:

1. Make all efforts to protect the interest of investors.
2. In the conduct of its business, observe high standards of integrity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.

4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment
5. Not any time act in collusion with other intermediaries or the issuer in a manner that is detrimental to the investor
6. Endeavour to ensure that **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.
7. Not **(a)** allow blank applications forms bearing brokers stamp to be kept the bank premises or peddled anywhere near the entrance of the premises; **(b)** accept applications after office hours or after the date of closure of the issue or on bank holidays; **(c)** after the closure of the public issue accept any instruments such as cheques/demand drafts/stock invests from any other source other than the designated registrar to the issue; **(d)** part with the issue proceeds until listing permission is granted by the stock exchange to the body corporate; **(e)** delay in issuing the final certificate pertaining to the collection figures to the registrar to the issue, the lead manager and the body corporate and such figures should be submitted within seven working days from the issue closure date.
8. Be prompt in disbursing dividends, interests or any such accrual income received or collected by him on behalf of his clients.
9. Not make any exaggerated statement whether oral or written to the client, either about its qualification or capability to render certain services or its achievements in regard to services rendered to other clients.
10. Always endavour to render the best possible advice to the clients having regard to the clients' needs and the environments and his own professional skill.
11. Not divulge to any body either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients except where such disclosures are required to be made in compliance with any law for the time being in force.
12. Avoid conflict of interest and make adequate disclosure of his interest.
13. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
14. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as banker to an issue which would impair its ability to render fair, objective and unbiased services.
15. Not indulge in any unfair competition, which is likely to harm the interests of other bankers to an issue or investors or is likely to place such other bankers to an issue in a disadvantageous position while competing for or executing any assignment.
16. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
17. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
18. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines of the SEBI. The banker to an issue

should also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.

19. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of any material breach of non-compliance by it, of any law, rules, regulations, and directions of the SEBI or of any other regulatory body.

20. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.

21. Not neglect or fail or refuse to submit to the SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.

22. Abide by the provisions of such acts and rules, regulations, guidelines, resolutions, notifications, directions, circulars and instructions as may be issued from time to time by the Central Government, the Reserve Bank of India, the Indian Banks Association or the SEBI and as may be applicable and relevant to the activities carried on the banker to an issue.

23. **(a)** Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of its interest including long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of the banker to an issue is rendering such advice, the banker to an issue should ensure that he discloses his interest, the interest of his dependent family members and that of the employer including employer's long or short position in the security, while rendering such advice.

24. A banker to an issue or any of its directors, or employee having the management of the whole or substantially the whole of affairs of the business, should not, either through its account or their respective accounts or through their family members, relatives or friends indulge in any insider trading.

25. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

26. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

27. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties as a banker to an issue and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholding and interests, etc.

28. Ensure that any person it employs or appoints to conduct a business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

29. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.

30. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

31. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

32. Endeavour to ensure that arms length relationship is maintained in terms of both man-power and infrastructure between the activities carried out as banker to an issue and other permitted activities.

33. Not be a party to or instrumental for **(a)** creation of false market; **(b)** price rigging or manipulation; or **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

Compliance Officer Every banker to an issue should appoint a compliance office who would be responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications/ guidelines/ instruction's issued by SEBI/Government and for redressal of investors' grievances.

Inspection Such inspection is done by the RBI upon the request of the SEBI. The purpose of inspection is largely to ensure that the required books of accounts are maintained and to investigate into the complaints received from the investors against the bankers to an issue.

After consideration of the inspection/investigation report, the SEBI can take such action as it may deem fit and appropriate including action under the SEBI Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulations.

Liability for Action in Case of Default

A banker to an issue who controvenes any provision of the SEBI Act/Rules/Regulations would be liable for action(s) specified therein including the action(s) under the **SEBI Intermediaries Regulation, 2008**.

BROKERS TO THE ISSUE

Brokers are the persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of brokers is not compulsory and the companies are free to appoint any number of brokers. The managers to the issue and the official brokers organise the preliminary distribution of securities and procure direct subscriptions from as large or as wide a circle of investors as possible. The stock exchange bye-laws prohibit the members from acting as managers or brokers to the issue and making preliminary arrangement in connection with any flotation or new issue, unless the stock exchange of which they are members gives its approval and the company conforms to the prescribed listing requirements and undertakes to have its securities listed on a recognised stock exchange. The permission granted by the stock exchange is also subject to other stipulations which are set out in the letter of consent. Their active assistance is indispensable for broad basing the issue and attracting investors. By and large, the leading merchant bankers in India who act as managers to the issue have particulars of the performance of brokers in the country. The company in consultation with the stock exchange writes to all active brokers of all exchanges and obtains their consent to act as brokers to the issue. Thereby, the entry of experienced and unknown agencies in to the field of new issue activity as issue managers, under-writers, brokers, and so on, is discouraged. A copy of the con-sent letter should be filed along with the prospectus to the ROC. The names and addresses of the brokers to the issue are required to be disclosed in the prospectus.

Brokers
are the persons mainly concerned with the procurement of subscription to the issue from the prospective investors.

Brokerage may be paid within the limits and according to other conditions prescribed. The brokerage rate applicable to all types of public issue of industrial securities is fixed at 1.5 per cent, whether the issue is underwritten or not. The mailing cost and other out-of-pocket expenses for canvassing of public issues have to be borne by the stock brokers and no payment on that account is made by the companies. A clause to this effect must be included in the agreement to be entered into between the broker and the company. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5 per cent. Brokerage is not allowed in respect of promoters quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders. Brokerage is not payable when the applications are made by the institutions/bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the underscription of the issues.

The issuing company is expected to pay brokerage within two months from the date of allotment and furnish to the broker, on request, the particulars of allotments made against applications bearing their stamp, without any charge. The cheques relating to brokerage on new issues and underwriting commission, if any, should be made payable at par at all centres where the recognised stock exchanges are situated. The rate of brokerage payable must be disclosed in the prospectus.

The SEBI guidelines relating to stockbrokers and sub-brokers as important intermediaries in the stock markets are **detailed in Chapter 13**.

REGISTRARS TO AN ISSUE AND SHARE TRANSFER AGENTS

Registration

Registrars to an issue collects application from the investors, keeps a proper record of applications and money received from investors or paid to the seller of securities and assists companies in determining the basis of allotment of securities in consultation with stock exchanges, finalises the allotment of securities and processing/despatching allotment letters, refund orders, certificates and other related documents in respect of issues of capital.

The **registrars to an issue**, as an intermediary in the primary market, carry on activities such as collecting application from the investors, keeping a proper record of applications and money received from investors or paid to the seller of securities and assisting companies in determining the basis of allotment of securities in consultation with stock exchanges, finalising the allotment of securities and processing/despatching allotment letters, refund orders, certificates and other related documents in respect of issue of capital. The share transfer agents maintain the records of holders of securities or on behalf of companies, and deal with all matters connected with the transfer/redemption of its securities. To carry on their activities, they must obtain initial/permanent registration certificate from the SEBI on payment of the requisite fee. The procedure for initial/permanent registration applicable to merchant bankers is applicable to them also. They are divided into two categories: **(a)** Category I, to carry on the activities as a registrar to an issue and share transfer agent; **(b)** Category II; to carry on the activity either as a registrar or as a share transfer agent. The registration is granted by the SEBI on the basis of consideration of all relevant matters and, in particular, the necessary infrastructure, past experience and capital adequacy. It also takes into account the fact that any connected person has not been granted registration and any director/partner/principal officer has not been convicted for any offence involving moral turpitude or has been found guilty of any economic offence. Moreover, it is a fit and proper person. For determining whether an applicant/registrar to an issue and share transfer agent is fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008.

Capital Adequacy and Fee The capital adequacy requirement in terms of net worth (capital and free reserves) is ₹50 lakh and ₹25 lakh for Category I and Category II of registrars and share transfer agents respectively. However, the capital adequacy requirements are not applicable for a department/division of a body corporate maintaining the records of holders of securities issued by them and deal with all matters connected with transfer/redemption of securities. While Category I is required to pay a registration fee of ₹6,00,000. Category II has to pay ₹2,00,000. The non-refundable application fee for registration is ₹20,000. To keep the permanent registration in force, category I and II should pay respectively ₹2,00,000 and ₹90,000.

Conditions of Registration The conditions of registration applicable to merchant bankers/underwriters/bankers to an issue are also applicable to registrars to an issue and share transfer agent.

General Obligations and Responsibilities

Code of Conduct A registrar to an issue and share transfer agent should:

1. Maintain high standards of integrity in the conduct of its business.
2. Fulfil its obligations in a prompt, ethical and professional manner.
3. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
4. Exercise adequate care, caution and due diligence before dematerialisation of securities by confirming and verifying that the securities to be dematerialised have been granted listing permission by the stock exchange(s).
5. Always endeavour to ensure that **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed without any delay; **(c)** transfer of securities held in physical form and confirmation of dematerialisation/rematerialisation requests and distribution of corporate benefits and allotment of securities is done within the time specified under any law.
6. Make reasonable efforts to avoid misinterpretation and ensure that the information provided to the investors is not misleading.
7. Not reject the dematerialisation/rematerialisation requests on flimsy grounds. Such requests could be rejected only on valid and proper grounds and supported by relevant documents.
8. Avoid conflict of interest and make adequate disclosure of its interest.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its source or potential areas of conflict of duties and interest which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other registrar to the issue and share transfer agent or investors or is likely to place him in disadvantageous position while competing for or executing any assignment.
12. Always endeavour to render the best possible advice to the clients having regard to their needs.

13. Not divulge to other clients, press or any other person any confidential information about its clients which as come to its knowledge except with the approval/authorisation of the client or when it is required to disclose the information under any law for the time being in force.

14. Not discriminate among its clients, save and except on ethical and commercial considerations.

15. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financials which may adversely affect the interest of clients/investors is promptly informed to the clients.

16. Maintain the required level of knowledge and competency and abide by the provisions of the SEBI Act, rules, regulations, circulars and directions issued by the SEBI and also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.

17. Cooperate with the SEBI as and when required.

18. Not neglect or fail or refuse to submit to the SEBI or other agencies with which he is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.

19. Ensure that the SEBI is promptly informed about any action, legal proceeding, etc. initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.

20. Take adequate and necessary steps to ensure that continuity in data and record-keeping is maintained and that the data or records are not lost or destroyed. Further, it should ensure that for electronic records and data, up-to-date back up is always available with it.

21. Endeavour to resolve all the complaints against it or in respect of the activities carried out by it as quickly as possible.

22. **(a)** Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real time, unless a disclosure of its long or short position in the securities has been made, while rendering such advice; **(b)** In case an employee of a registrar to an issue and share transfer agent is rendering such advice, the registrar to an issue and share transfer agent should ensure that it also discloses its own interest, the interests of his dependent family members and that of the employer including their long or short position in the security, while rendering such advice.

23. Handover all the records/data and all related documents which are in its possession in its capacity as a registrar to an issue and/or share transfer agent to the respective clients, within one month from the date of termination of agreement with the respective clients within or within one month from the date of expiry/cancellation of certificate of registration as registrar to an issue and/or share transfer agent, whichever is earlier.

24. Not make any exaggerated statement, whether oral or written, to the clients either about its qualifications or capability to render certain services or about its achievements in regard to services rendered to other clients.

25. Ensure that it has satisfactory internal control procedures in place as well as adequate financial and operational capabilities which can be reasonably expected to take care of any losses arising due to theft, fraud and other dishonest acts, professional misconduct or omissions.

26. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

27. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out its duties as a registrar to an issue and share transfer agent and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.

28. Ensure that good corporate policies and corporate governance are in place.

29. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

30. Be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

31. Not in respect of any dealings in securities be party to or instrumental for: **(a)** creation of false market; **(b)** price rigging or manipulation; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

A registrar should not act for any issue in case he is an **associate** of the issuer, that is, **(a)** he/it controls directly/indirectly at least 10 per cent of the voting power of the issuer/registrar or **(b)** he/any of his relatives is a director/promoter of the issuer/registrar to an issue.

Maintenance of Records The registrars and share transfer agents have to maintain records relating to all applications received from investors in respect of an issue, all rejected applications together with reasons, basis of allotment of securities in consultation with the stock exchanges, terms and conditions of purchase of securities, allotment of securities, list of allottees and non-allottees, refund orders, and so on. In addition, they should also keep a record to the list of holders of securities of corporates, the names of transferors and transferees, and the dates of transfer of securities. The SEBI can require the regis-trars and transfer agents to file the books of accounts, and records, and so on. These have to be preserved by them for a period of three years.

Compliance Officer Every registrar to an issue and share transfer agent should appoint a compliance officer responsible for redressal of inverter's grievances and for monitoring the compliance of the SEBI Act/rules/regulations/notifications/guidelines/instructions issued by the SEBI/Government.

Inspection

The SEBI is authorised to undertake the inspection of the books of accounts, other records, and documents of the registrars and share transfer agents to ensure that they are being maintained in a proper manner and the provisions of the SEBI Act, rules, regulations and the provisions of the SCRA and the relevant rules are complied with, to investigate into complaints from investors/other registrars and share transfer agents/other intermediaries in the securities market or any matter relating to their activities, and to investigate on its own in the interest of securities market/investors into their affairs. On the basis of the inspection report, the SEBI can direct the concerned partly to take such measures as it deems fit in the circumstances. It can also appoint a qualified auditor to investigate into the books of accounts and affairs of the registrars and share transfer agents.

Action in Default

A registrar to an issue/share transfer agent who fails to comply with any condition subject to which registration is granted, or contravenes any of the provisions of the SEBI Act/SCRA, rules/ regulations Depositories Act/rules and stock exchange bye-laws, rules and regulations would be dealt with in the manner provided under the **SEBI Intermediaries Regulation**, 2008.

DEBENTURE TRUSTEES

Registration

Debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed/proposed to be listed company.

A **debenture trustee** is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debentureholders. An issue means an offer of sale or purchase of securities by any body corporate/other person/ group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons. To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of ₹2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not writ-ten off)] as per the latest audited balance sheet can act as trustees. While considering the application for registration, the SEBI takes into account **(i)** the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge duties, **(ii)** any past experience as a debenture trustee or employment of minimum two persons with experience in matters relevant to a debenture trustee, **(iii)** any person directly/ indirectly connected with the applicant has not been granted registration by the SEBI under the SEBI Act, **(iv)** employment of at least one person who possesses the professional qualification in law from a government recognised institution, **(v)** any of its directors/principal officer (i.e. a secretary/manager/director of the body corporate or any person connected with the management/administration of the body corporate upon whom the Board of Directors has served notice of its intention of treating him as its principal officer) is/has any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence and **(vi)** is a fit and proper person. For determining whether an applicant/debenture trustee is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008. The procedure to obtain initial as well as permanent registration and the payment of the requisite fee is the same as applicable to merchant bankers.

Conditions of Registration The conditions of registration applicable to merchant bankers are also applicable to debenture trustees.

Responsibilities and Obligations

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

Obligation before Appointment A debenture trustee has to enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures. The agreement should, *inter alia*, contain **(i)** that the debenture trustee has agreed to act as the trustee under the trust deed for securing an issue of debentures for the body corporate and **(ii)** the time limit within which the security for the debentureholders would be created. However, a debenture trustee cannot act as trustee for any issue of debenture if **(a)** it is an associate [i.e. **(i)** who directly/indirectly by himself or in combination with relatives exercises control in terms of Regulations 2(C) of the SEBI Substantial Acquisition of Shares and Takeover Regulations over the debenture trustee/the body corporate or **(ii)** in respect of whom the debenture trustee/body corporate directly/indirectly exercises control or **(iii)** whose director is also a director of the debentures trustee/body corporate], **(b)** it has lent and the loan is yet not fully rapid/is proposing to lend money to the body corporate.

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

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

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

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

Details of Charged Securities (Existing or Future) This section, should, *inter alia*, state the details regarding the following:

(i) Nature of charge, examination of title,
(ii) Rank of charge of assets, namely, first, second, *pari passu*, residual and so on,
(iii) Charging of future assets,
(iv) Time limit within which the future security for the issue of debentures would be created as specified in SEBI Disclosure and Investor Protection Guidelines, 2000,
(v) Enforceability of securities, events under which security becomes enforceable,
(vi) Obligation of company not to create future security for the issue of debentures would be created as specified in SEBI Disclosure and Investor Protection Guidelines, 2000,
(vii) Minimum security cover required,
(viii) Provision for subsequent valuation,
(ix) Circumstances when the security would become enforceable,
(x) Method and mode of preservation of assets charged as security for debentureholders,
(xi) Circumstances specifying when the security may be disposed of or leased out with the approval of trustee, and

(xii) Procedure for allowing inspection of charged assets, books of account, by debenture trustee or any person or persons authorised by it.

Events of Defaults This section should clearly define the event of default which, if occurs, would invite the action by debenture trustee. It should also contain the steps which would be taken by debenture trustee in the event of defaults.

Rights of Debenture Trustees This section should, *inter alia*, provide that the debenture trustee **(i)** is entitled to inspect the registers of the company and to take copies and extracts thereof; and **(ii)** has a right to appoint a nominee director.

Obligations of Body Corporates This section should, *inter alia*, state the following with respect to company's duties:

1. To maintain register of debentureholders with address with record of subsequent transfers and changes of ownership.
2. To keep proper books of account open for inspection by the debenture trustee.
3. To furnish whatever required information to debenture trustee including copies of reports, balance sheets, profit and loss accounts and so on.
4. To keep charged property/security adequately insured and in proper condition.
5. To permit debenture trustee to enter and inspect the state and condition of charged assets.
6. To pay all taxes, cases, insurance premia with respect to charged property/security, on time.
7. To inform debenture trustee before declaring or distributing dividend.
8. To comply with all guidelines/directions issued by any regula-tory authority, with respect to the instant debenture issue.
9. To create debenture redemption reserve as per the SEBI Disclosure and Investor Protection Guidelines, 2000 and the provisions of Companies Act and submit an auditor's certificate to the trustee.
10. To convert the debenture into equity in accordance with the terms of the issue, if applicable.
11. To inform debenture trustee about any change in nature and conduct of business by company before such change.
12. To keep the debenture trustee informed of all orders, directions, notices, of Court/Tribunal affecting or likely to affect the charged assets.
13. To inform debenture trustee of any major change in composition of its Board of Directors, which may amount to change in control as defined in SEBI Substantial Acquisition of Shares and Takeovers Regulations, 1997.
14. To submit any such information, as required by the debenture trustee.
15. Fee or commission of debenture trustees.
16. Obligation to inform debenture trustee about any change in nature and conduct of business by the body corporate before such change.
17. Obligation of the body corporate to forward a quarterly report to debenture trustees containing the following particulars:
    - **(i)** updated list of the names and addresses of the debentureholders;
    - **(ii)** details of interest due but unpaid and reasons thereof;
    - **(iii)** the number and nature of grievances received from debentureholders and resolved by the body corporate;

(iv) a statement that the assets of the body corporate which are available by way of security and sufficient to discharge the claims of the debentureholders as and when they become due.

Miscellaneous **(a)** Procedure for appointment and removal of trustee including appointment of new trustees; **(b)** Provision that the debenture trustee would not relinquish from its assignment unless another debenture trustee has been appointed; **(c)** Procedure to remove debenture trustee by debentureholders providing for removal on a resolution passed by at least 75 per cent of the total debentureholders of a body corporate; **(d)** Provisions for redressal of grievance of debentureholders.

Note: The debenture trustee may incorporate additional clause(s), provided they do not dilute or contravene the provisions of the above clauses.

Duties The duties of the debenture trustees include the following:

1. (a) Call for period reports from the body corporate,

(b) Take possession of trust property in accordance with the provisions of the trust deed,

(ba) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption fund.

(c) Enforce security in the interest of the debentureholders,

(d) Do such acts as are necessary in the event the security becomes enforceable,

(e) Carry out such acts as are necessary for the protection of the debentureholders and do all things necessary in order to resolve the grievances of the debentureholders,

(f) Ascertain and satisfy itself that

- **(i)** in case where allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificate has been despatched by the body corporate to the debentureholders within 30 days of the registration of the charge with the Registrar of Companies,
- **(ii)** debenture certificates have been despatched to the debentureholders in accordance with the provisions of the Companies Act,
- **(iii)** interest warrants for interest due on debentures have been despatched to the debentureholders on/before the due dates,
- **(iv)** debentureholders have been paid the money(ies) due to them on the date of the redemption of the debentures.

(g) Ensure on a continuous basis that the property charged to the debentures is available and adequate at all times to discharge the interest and principal amount payable to them and that the property is free from any other encumberances save and except those which are specifically agreed to by the debenture trustee,

(h) Exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement/trust deed,

(i) Take appropriate measures for protecting the interest of the debentureholders as soon as any breach of the trustee deed law comes to its notice,

(j) Ascertain that the debentures have been converted/redeemed according to the provisions/conditions under which they are offered to the debentureholders,

(k) Inform the SEBI immediately of any breach of trust deed/provisions of any law,

(l) Appoint a nominee director on the Board of Directors of the body corporate in the event of

- **(i)** two consecutive defaults in payment of interest to the debentureholders,

- **(ii)** default in creation of security for debentures,
- **(iii)** default in redemption of debentures.

(m) Communicate to the debentureholders on half yearly basis the compliance of the terms of the issue by the body corporate, defaults, if any, in payment of interest or redemption of debentures and action taken theoron.

1-A The debenture trustee should **(i)** obtain reports from the lead bank regarding progress of the projects; **(ii)** monitor utilisation of funds raised in the issue; **(iii)** obtain a certificate from the issuer's auditors **(a)** in respect of utilisation of funds during the implementation period and **(b)** in case of debentures issued for financing working capital at the end of each accounting year.

2. A debenture trustee should call or cause to be called by the corporate body a meeting of all debentureholders on **(a)** a requisition in writing signed by at least 10 per cent of the debentureholders in value for the time being outstanding and **(b)** the happening of any event which constitutes a default or which in the opinion of the debenture trustee affects the interest of the debentureholders.

3. No debenture trustee should relinquish its assignments as debenture trustee in respect of the debenture issue of any body corporate, unless and until another debenture trustee is appointed in its place by the body corporate.

4. A debenture trustee should maintain the networth requirements as specified in these regulations on a continuous basis and should inform the SEBI immediately in respect of any shortfall in the networth and in such a case it would not be entitled to undertake new assignments until it restores the networth to the level of specified requirement within the time specified by the SEBI.

5. A debenture trustee may inspect books of account, records, registers of the body corporate and the trust property to the extent necessary for discharging its obligations.

Code of Conduct for Debenture Trustees A debenture trustee should:

1. Make all efforts to protect the interest of debentureholders.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation and maintain record of the same.
6. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financial position which may adversely affect the interests of clients/debenture-holders is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
7. Avoid conflict of interest and make adequate disclosure of its interest.
8. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.

10. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as debenture trustee which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other trustees or debentureholders or is likely to place such other debenture trustees in a disadvantageous position while competing for or executing any assignment nor should it wean away the clients of another trustee on assurance of lower fees.
12. Not discriminate among its clients, except and save on ethical and commercial considerations.
13. Share information available with it regarding client companies, with registered credit rating agencies.
14. Provide clients and debenture-holders with adequate and appropriate information about its business, including contact details, services available to clients, and the identity and status of employees and others acting on its behalf with whom the client may have to contact.
15. Ensure that adequate disclosures are made to the debenture-holders, in a comprehensible and timely manner so as to enable them to make a balanced and informed decision.
16. Endeavour to ensure that **(a)** inquiries from debenture-holders are adequately dealt with; **(b)** grievances of debenture-holders are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the debenture-holder is advised of any further steps which may be available to the debenture-holder under the regulatory system.
17. Make reasonable efforts to avoid misrepresentation and ensure that the information provided to the debenture-holders is not misleading.
18. Maintain required level of knowledge and competency and abide by the provisions of the SEBI Acts/regulations, circulars and guidelines. He should also comply with the award of Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
19. Not make untrue statement or suppress any material fact in any document, reports, papers or information furnished to the SEBI.
20. A debenture trustee or any of its directors, partners or manager having the management of the whole or substantially the whole of affairs of the business, should not either through its account or their respective accounts or through their associates or family members, relatives or friends indulge in any insider trading.
21. Ensure that the SEBI is promptly informed about any action, legal proceeding, etc., initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
22. **(a)** Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non real-time unless a disclosure of his interest including long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of the debenture trustee is rendering such advice, the debenture trustee should ensure that he discloses his interest, the interest of his dependent family members and that of the employer, including their long or short position in the security, while rendering such advice.
23. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).
24. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.
25. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, debenture-holders and other

registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

26. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

27. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

28. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

29. That good corporate policies and corporate governance is in place.

30. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct of its employees and offers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.

31. Not be a party to or instrument for **(a)** creation of false market; **(b)** price rigging or manipulation or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

Maintenance of Books of Records A trustee should keep and main-tain proper books of account, records and documents relating to the trusteeship function for at least 5 financial years preceding the current financial year. It should intimate to the SEBI the place where they are mentioned.

Compliance Officer Every trustee should appoint a compliance officer to monitor the compliance of the SEBI Act/rules/regulations, notification/guidelines/instructions issued by SEBI/Government and for redressal of investors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him. He should also report any non-compliance of the requirements in the listing agreement with respect to the debenture issue and debentureholders by the body corporate to the SEBI.

Information to SEBI Every trustee would be duty bound, as and when required by the SEBI, to submit the following information and documents; **(i)** number and nature of grievances of the debentureholders received/resolved, **(ii)** copies of the trust deed, **(iii)** non/delayed payment of interest to debentureholders, **(iv)** details of despatch/transfer of debenture certificates and **(v)** any other details relevant to the trustee.

Inspection by SEBI

The SEBI is empowered to undertake an inspection of the books of accounts, other records and documents of the debenture trustees. The purpose of inspection can be to **(i)** ensure that they are maintained in the manner required by the SEBI and that the provisions of the Companies Act are being complied with, **(ii)** ascertain where circumstances warrant in eligibility of the trustee for the continuance of registration, **(iii)** investigate into complaints from investors/other trustees/any other person against the trustee's activities, and also *suo motu* in the interest of the securities business/investors into the affairs of the trustee. The SEBI can alternatively appoint a qualified auditor to investigate into the accounts or the affairs of the trustee.

On the basis of the inspection report, the SEBI can call upon the trustee to take measures in the interests of the securities market and for due compliance with the provisions of the SEBI Act, rules and regulations. It can also give direction to the effect that he should not act as a trustee for any issue of debenture, or that the trustee should act as per the covenants of the trust deed. Appropriate action against the trustee in accordance with the relevant regulations can also be taken by the SEBI.

Action for Default

A debenture trustee who **(a)** fails to comply with any condition subject to which certificate has been granted, **(b)** contravenes any provision of the SEBI Act/rules/regulations, **(c)** contravenes the provisions of the Companies Act/rules would be dealt with in the manner provided under the **SEBI Intermediaries Regulation**, 2008.

PORTFOLIO MANAGERS

> **Portfolio managers** are persons who, advise/direct/undertake, on behalf of the client(s), whether discretionary portfolio manager or otherwise, the management/administration of portfolio of securities/funds of clients.

Portfolio managers are defined as persons who, in pursuance of a contract/arrangement with clients, advise/direct/ undertake, on behalf of the client(s), whether discretionary portfolio manager or otherwise, the management/administration of portfolio of securities/funds of clients. The term portfolio means the total holdings of securities belonging to any person. Portfolio management can be **(i)** Discretionary or **(ii)** Non-discretionary. The first type of portfolio management permits the exercise of discretion with regard to investment/management of the portfolio of the securities/funds. A non-discretionary portfolio manager manages funds in accordance to the directions of the clients. In order to act as a portfolio manager, a certificate of registration from the SEBI is mandatory. The SEBI is authorised to grant and renew the certificate of registration, as a prior permission to portfolio managers, on the payment of the requisite application/registration/renewal fee. A certificate/renewal of registration is valid for three years. An application for renewal must be made three months before the expiry of the validity of the certificate. The non-refundable application fee is ₹1,00,000. The registration fee, and renewal fee after every three years, is ₹10 lakh and ₹5 lakh respectively. The portfolio manager has to also give an undertaking to take adequate steps for the redressal of grievances of clients within one month of the receipt of the complaint, keep the SEBI informed about the number, nature and other particulars of the complaints and abide by its rules and regulations.

Procedure for Registration

While considering the application for registration made in the prescribed form, the SEBI takes into account all matters relevant to the activities related to the portfolio manager, and in particular: **(a)** necessary infrastructure like adequate office staff, equipment and manpower to discharge his activities; **(b)** employment of a minimum of two persons who between them have at least five years experience in related activities in portfolio management/stock broking/investment management; **(c)** a person directly/indirectly connected with the applicant, that is, associate/ subsidiary/inter-connected or group company that has not been refused registration; **(d)** capital adequacy of not less than a net worth of ₹2 crore, in terms of capital plus free reserves excluding revaluation reserves minus accumulated losses an deferred expenditure not written off; **(e)** that the applicant/partner/director/principal officer has not been convicted for any offence involving moral turpitude/guilty of any economic offence; **(f)** the applicant/partner/director/partner/

principal officer is not involved in any litigation connected with the securities market; **(g)** the principal officer of the applicant has professional qualification in finance/law/accounting/business management or an experience of at least 10 years in related activities in the securities market including in portfolio manager/stock broker/fund manager, and **(h)** the grant of certificate is in the interest of the investors; **(i)** the applicant is a body corporate; **(j)** no disciplinary action has been taken by the SEBI against any person directly/indirectly connected with the applicant, that is, an associate/subsidiary/inter-connected company/company under the same management, under the SEBI Act/rules/regulations; and **(k)** the applicant is a fit and proper person. For determining whether an applicant/portfolio manager is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**. The portfolio manager should fulfil the capital adequacy requirement separately and independently of capital adequacy requirement for each activity undertaken by him under the relevant regulations.

Conditions of Registration The registration/renewal of portfolio managers is subject to the following conditions: **(i)** Prior approval of the SEBI would be required for change of its status/constitution including amalgamation/demerger/consolidation/any other kind of corporate restructuring, change in its managing/whole-time director(s), and any change in control over the body corporate, that is, **(a)** in case of listed shares, change in control in terms of the SEBI Substantial Acquisition of Shares and Takeover Regulations, **(b)** in any other case, change in controlling interest in the body corporate to the extent of atleast 51 per cent of its voting rights; **(ii)** Payment of fee; **(iii)** Adequate steps for redressal of investors grievances within one month of the receipt of the complaint and keep the SEBI informed about the number/nature/other particulars of these complaints; **(iv)** Maintenance of the specified capital adequacy requirements; and **(v)** Abide by the regulations under the SEBI Act in respect of its activities.

General Obligations and Responsibilities

The general obligations and responsibilities of a portfolio manager are as given below.

Code of Conduct A portfolio manager has to, in the conduct of business, observe high standards of integrity and fairness in all his dealings with his clients and other portfolio managers. The money received by him from a client, for investment purposes should be deployed as soon as possible and money due and payable to a client should be paid forthwith.

A portfolio manager has to render, at all times, high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement. He should either avoid any conflict of interest in his investment or disinvestment decision, or where any conflict of interest arises, ensure fair treatment to all his customers. He must disclose to the clients, possible sources of conflict of duties and interest, while providing unbiased services. A portfolio manager should not place his interest above those of his clients.

He should not make any statement or become privy to any act, practice or unfair competition that is likely to be harmful to the interests of other portfolio managers or is likely to place them in a disadvantageous position in relation to the portfolio manager himself, while competing for or executing any assignment.

Any exaggerated statement, whether oral or written, should not be made by him to the clients, about his qualification or capability to render certain services or his achievements in regard to services rendered to the other clients.

At the time of entering into a contract, he should obtain in writing from the client, the latters interest in various corporate bodies, which would enable him to obtain unpublished price sensitive information of the body corporate.

A portfolio manager should not disclose, to any client or the press, any confidential information about his clients, which has come to his knowledge.

Where necessary, and in the interest of the client, he should take adequate steps for the registration of transfer of the clients' securities and for claiming and receiving dividends, interest payments and other rights accruing to the client. He must also take necessary action for the conversion of securities and subscription/ renunciation of/or rights in accordance with the clients' instructions.

A portfolio manager has to endeavour to:

- **(a)** Ensure that investors are provided with true and adequate information, without making any misguiding or exaggerated claims, and are made aware of the attendant risks before any investment decision is taken by them;
- **(b)** Render the best possible advice to the client, taking into account to the client's needs and the environment, and his own professional skills;
- **(c)** Ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

A portfolio manager should not be party to: **(a)** creation of false market in securities; **(b)** price rigging or manipulation of securities; **(c)** passing of price sensitive information to brokers, members of the stock exchanges and any other intermediaries in the capital market, or take any other action which is prejudicial to the interest of the investors. No portfolio manager or any of its directors, partners or managers should, either on their respective accounts or through their associates or family members/relatives, enter into any transaction in securities of companies on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment.

A portfolio manager or any of his employees should not render, directly or indirectly, any investment advice about any security in publicly accessible media, whether real-time or non-real-time, without disclosing his long/short position in the security while rendering such advice. The employee should also disclose the interest of his dependent family members and the employer, including their long/short position in the security.

Contract with Clients Every portfolio manager is required, before taking up an assignment of management of portfolio on behalf of a client, to enter into an agreement with such client clearly defining the *inter se* relationship, setting out their mutual rights, liabilities and obligations relating to the management of the funds/portfolio of the securities containing the details specified in the SEBI regulations. The agreement should, *inter-alia*, contain:

- **(i)** The investment objectives and the services to be provided;
- **(ii)** Areas of investment and restrictions, if any, imposed by the client with regard to investment in a particular company or industry;
- **(iii)** Attendant risks involved in the management of the portfolio;
- **(iv)** Period of the contract and provision of early termination, if any;
- **(v)** Amount to be invested;
- **(vi)** Procedure of settling the client's account, including the form of repayment on maturity or early termination of contract;
- **(vii)** Fee payable to the portfolio manager;
- **(viii)** Custody of securities.
- **(ix)** Type of instruments and proportion of exposure;
- **(x)** Tenure of portfolio investment;

(xi) Terms of early withdrawal of funds/securities by the clients;
(xii) Quantum and manner of fee payable by the client for each activity for which service is rendered by the portfolio manager directly/indirectly (where such service is outsourced);
(xiii) In case of a discretionary portfolio manager a condition that the liability of a client would not exceed his investment with the portfolio manager;
(xiv) Terms of accounts/audit and furnishing of reports to the clients; and
(xv) Other terms of the portfolio investments.

The portfolio manager should provide to the client(s) the Disclosure Document specified by the SEBI along with the specified certificate at least two days prior to entering into the agreement with the client. The disclosure document should *inter-alia*, contain **(i)** quantum/manner of payment of fee payable by the client for each activity for which service is rendered directly/indirectly, **(ii)** portfolio risks, **(iii)** complete disclosures in respect of transactions with related parties as per the accounting standards of the ICAI, **(iv)** performance of the portfolio manager; the performance of the discretionary portfolio manager should be calculated using weighted average method taking each individual category of investments for the immediately preceding three years and in such cases performance indicators should also be disclosed, and **(v)** audited financial statements of the portfolio manager for the immediately preceding three years. These contents should be certified by an independent chartered accountant. The portfolio manager should file with the SEBI a copy of it before it is circulated/issued to any person and every six months thereafter or whenever any material change is effected whichever is earlier.

The portfolio manager can charge an agreed fee from the client for rendering portfolio management services without guaranteeing or assuring, either directly or indirectly, any return, and such fee may be a fixed fee or a return-based fee or a combination of both. He may charge such fee for each activity for which service is provided directly/indirectly.

Profit sharing/performance-related fee are usually charged by the portfolio managers upon exceeding a hurdle rate/benchmark as specified in the agreement. Profit/performance should be computed on the basis of **high-water mark (HWM) principle** over the life of the investment for charging of performance/profit-sharing fee. The **HWM** would be the highest value that the portfolio account has reached on the date when performance fee is charged. The fee should be charged only on increase in portfolio value in excess of the previously achieved high-water mark and the frequency should not be less than quarterly. To illustrate, assuming annual frequency, and initial contribution of a client of ₹10,00,000 which rises to 12,00,000 in its first year, the performance fee/profit sharing would be payable on ₹2,00,000 (₹12,00,000 – ₹10,00,000) return. If the portfolio drops to ₹11,00,000 next year, no such fee would be payable. The fee would be payable only on ₹1,00,000 if the portfolio rises to ₹13,00,000 in the third year (₹13,00,000 – ₹12,00,000 i.e. high-water mark achieved previously) rather than one the full return.

All fee/charges would be levied on the actual amount of the asset under management of the client and the **HWM** will be applicable only to discretionary and non-discretionary but not to advisory services. The liability of a client in a discretionary portfolio cannot exceed his portfolio investment.

To ensure transparency and adequate disclosure, the client agreement should contain a separate annexure listing all fees/charges. It should contain details of levy of all applicable charges on a sample portfolio of ₹10 lakh over a one-year period for three scenarios, that is, change in the portfolio: **(i)** 20 per cent increase, **(ii)** 20 per cent decrease, and **(iii)** no change. This is illustrated below:

Portfolio performance: gain of 20 per cent

Nature of fee		*Amount (₹)*
Capital contribution	10,00,000	
Less: Up front fee	20,000	
Any other fee (mention)	—	
Asset under management	9,80,000	
Add: Profit on investment during the year (0.20)	1,96,000	
Gross portfolio value at the end of the year		11,76,000
Less: Brokerage/Depository participant (DP) charges (0.02 × ₹9,80,000)	19,600	
: Management fee (0.02 × ₹9,80,000)	19,600	
: Performance fee (0.20 × ₹9,80,000)	19,600	
: Any other fee (mention)	—	
Total charges during the year		58,800
Net value of the portfolio at the year-end		11,17,200
Percentage change over capital contributed		11.72

General Responsibilities The discretionary portfolio manager should individually and independently manage the funds of each client in accordance with the needs of the client in a manner that does not partake the character of a mutual fund, whereas the non-discretionary portfolio manager should manage the funds in accordance with the directions of the client. He should not accept from the clients funds/securities worth less than ₹25 lakhs. He should act in a fiduciary capacity with regard to the client's funds, and transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934. The funds of all clients must be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank. He should not derive any direct or indirect benefit out of the client's funds or securities. He cannot lend securities, held on behalf of clients, to a third person except as provided in the SEBI regulations. He should not borrow funds/securities on behalf of his client(s). He should ensure proper and timely handling of complaints from his clients and take appropriate action immediately.

Investment of Clients' Moneys The money/securities accepted by a portfolio manager should be invested/managed only in accordance with the agreement with the client. Any renewal of portfolio fund on the maturity of the initial period is deemed as a fresh placement. Portfolio funds can be withdrawn or taken back by the portfolio client, before the maturity date of the contract, under the following circumstances:

(a) Voluntary or compulsory termination of portfolio management services by the portfolio manager/client.

(b) Suspension or termination of registration of portfolio manager by the SEBI.

(c) Bankruptcy or liquidation of the portfolio manager.

The portfolio manager can invest funds of his clients in money market instruments (i.e. CPs/CDs/T-bills/trade and usance bills) or derivatives or as specified in the contract, but not in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies. Leveraging of portfolio is not permitted in respect of investment in derivatives.

While dealing with clients' funds, he should not indulge in speculative transactions, that is, not enter into any transaction for the purchase or sale of any security in which transaction is periodically or ultimately settled otherwise than by actual delivery or transfer of security except transaction's in derivatives.

He should ordinarily purchase or sell securities separately for each client. However, in the event of aggregation of purchase or sales for economy of scale, *inter se* allocation should be done on a pro rata basis and at the weighted average price of the day's transactions. The portfolio manager should not keep any position open in respect of allocation of sales or purchases effected in a day.

Any transaction of purchase or sale, including that between the portfolio manager's own accounts and client's accounts or between two clients' accounts, should be at the prevailing market price. He should segregate each clients' funds and portfolio of securities and keep them separately from his own funds and securities and be responsible for the safekeeping of clients' funds and securities. He should not hold the listed/unlisted securities, belonging to the portfolio account, in its own name on behalf of the clients by virtue of a contract or otherwise. The portfolio manager on authorisation from his client may participate in securities lending scheme. The SEBI-registered Foreign portfolio managers may avail of the services of portfolio managers.

Every portfolio manager should appoint a custodian in respect of the securities managed/administered by it. However, portfolio managers who manage a portfolio of less than ₹500 crore or who performs purely advisory functions would be exempt from this stipulation.

Maintenance of Books of Accounts/Records Every portfolio manager must keep and maintain the following books of accounts, records and documents.

(a) A copy of balance sheet at the end of each accounting period;
(b) A copy of the profit and loss account for each accounting period;
(c) A copy of the auditor's report on the accounts for each accounting period;
(d) A statement of financial position; and
(e) Records in support of every investment transaction or recommendation, which indicate the data, facts and opinion leading to that investment decision.

After the end of each accounting period, copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years, when required, must be submitted to the SEBI. Half-yearly unaudited financial results, when required, with a view to monitor the capital adequacy have also to be submitted to the SEBI. The books of account and other records and documents must be preserved for a minimum period of five years.

Audit of Accounts The portfolio manager is required to maintain separate client-wise accounts. The funds received from the clients, investments or disinvestment and all the credits to the account of the client, like interest, dividend, bonus or any other beneficial interest received on investments and debits, for expenses, if any, have to be properly accounted for and details properly reflected in the client's account. The tax deducted at source should be recorded in the portfolio account. The books of accounts have to be audited yearly by a qualified auditor to ensure that the proper accounting methods and procedures have been followed, and that the portfolio manager has performed his duties in accordance with the law. A certificate to this effect, if so specified, has to be submitted to the SEBI within six months closing the accounting period. The portfolio accounts of the portfolio manager should be audited by an independent chartered accountant and a copy of the certificate issued by him should be given to the client. The client may appoint a chartered accountant to audit the books of accounts of the portfolio manager relating to his transactions and the portfolio manager should extend full cooperation in such audit.

Reports to be Furnished to the Clients The portfolio manager should furnish a periodical report to the client, as agreed in the contract, but not exceeding a period of six months, (and as and when required by the client) containing the following details:

(a) The composition and the value of the portfolio, description of security, number of securities, value of each security held in the portfolio, cash balance and aggregate value of the portfolio as on the date of report;
(b) Transactions undertaken during the period of report, including the date of transaction and details of purchases and sales;
(c) Beneficial interest received during that period in respect of interest, dividend, bonus shares, rights shares and debentures;
(d) Expenses incurred in managing the portfolio of the client; and
(e) Details of risk foreseen by the portfolio manager and the risk related to the securities recommended by the portfo1io manager, for investment or disinvestment.

The report may be made available on the website of the portfolio manager with restricted access to each client.

He should also furnish in terms of the agreement the client with documents and information relating only to the management of a portfolio. On termination of the contract, the portfolio manager should give a detailed statement of accounts to the client and settle the account with the client, as agreed in the contract. The client has the right to obtain the details of his portfolio from the portfolio manager.

Every portfolio manager should, within two months from the date of the auditors' report, take steps to rectify the deficiencies made out in the auditor's report.

Disclosures to the SEBI A portfolio manager must disclose the following information to the SEBI, as and when required.

(i) Particulars regarding the management of a portfolio;
(ii) Any change in the information or particulars previously furnished, which have a bearing on the certificate granted to him;
(iii) Names of the clients whose portfolio he has managed and
(iv) Particulars relating to the capital adequacy requirement.

Appointment of Compliance Officer Every portfolio manager should appoint a compliance officer for **(i)** monitoring compliance with the SEBI Act/rules/regulations/notifications/guidelines/instructions and so on issued by SEBI/Government and **(ii)** redressal of investors' grievances. He should immediately and independently report any non-compliance observed by him to the SEBI.

Inspection and Disciplinary Proceedings

Right to Inspection The SEBI may appoint one or more persons as the inspecting authority to undertake the inspection of the books of account, records and documents of the portfolio manager:

(a) To ensure that the books of account are being maintained in the manner required;
(b) That the provisions of the SEBI Act, rules and regulations are being complied with;

(c) To investigate into the complaints received from investors, other portfolio managers or any other person or any matter having bearing on his activities as a portfolio manager; and

(d) To investigate, *suo motu*, in the interest of securities business/investors' interest into his affairs.

The inspection of portfolio managers can be undertaken by the SEBI, after giving reasonable notice, or in the interest of investors, without notice. During the course of investigation, every director/proprietor/partner/officer/employee has an obligation to produce to the inspecting authority, within the specified time, books, accounts and other documents in his custody/control and furnish statements of information relating to the activities of the portfolio manager. He should allow reasonable access to his premises and extend reasonable facilities for the examination of books/records/documents/computer data in his possession and also provide copies of documents/other material relevant to the purpose of inspection. The inspection authority is also entitled to examine/record statements of any principal officer, director, partner, proprietor and employee who should provide all assistance in connection with the inspection. The inspection can also be conducted by a qualified auditor approved by the SEBI. On the basis of the inspection, and for due compliance with the provisions of the SEBI Act, rules and regulations the SEBI is authorised to take appropriate measures in the interest of the securities market.

Action in Case of Default

A portfolio manager who contravenes any of the provisions of the SEBI Act, rules or regulations would be liable for action(s) specified therein including the actions under the **SEBI Intermediaries Regulation, 2008.**

PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO THE SECURITIES MARKET REGULATION, 2003

In order to prohibit fraudulent and unfair practices relating to the securities market, the SEBI had issued regulations in October 1995. These were repealed in 2003. A new set of regula-tions were issued in July 2003. The scheme of regulation contained in these is briefly discussed in this Section.

Prohibition of Fraudulent and Unfair Trade Practices

The prohibition of fraudulent and unfair trade practices relates to **(i)** prohibition of certain dealings in securities and **(ii)** prohibition of manipulative, fraudulent and unfair trades practices.

Prohibition of Certain Dealings in Securities Dealing in securities includes an act of buying, selling or subscribing pursuant to any issue of any security or agreeing to buy, sell or sub-scribe to any issue of any security or otherwise transacting in any way in any security by any person as principal, agent or intermediary referred to in Section 12 of the SEBI Act (discussed in Chapter 4). No person should directly or indirectly

(a) buy, sell or otherwise deal in securities in a fraudulent manner;

(b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the SEBI Act or the rules or the regulations made thereunder;

(c) employe any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognised stock;

(d) engage in any act, practice, course of business which operates/would operate as a fraud/deceit on any person in contravention of the provisions of the SEBI Act/regulations.

"Fraud" includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or his agent, while dealing in securities in order to include another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and would also include:

1. A knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;
2. A suggestion as to a fact which is not true by one who does not believe it to be true;
3. An active concealment of a fact by a person having knowledge or belief of the fact;
4. A promise made without any intention of performing it;
5. A representation made in a reckless and careless manner whether it be true or false;
6. Any such act or omission as any other law specifically declares to be fraudulent;
7. Deceptive behaviour by a person depriving anothers of informed consent or full participation;
8. A false statement made without reasonable ground for believing it to be true;
9. The act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price.

And "fraudulent" would be construed accordingly. However, nothing contained in this clause would apply to any general comments made in good faith in regard to: **(a)** the economic policy of the Government; **(b)** the economic situation of the country; **(c)** trends in the securities market; or **(d)** any other matter of a like nature, whether such comments are made in public or in private.

Prohibition of Manipulative, Fraudulent and Unfair Trade Practices No person should indulge in a fraudulent or an unfair trade practice in securities. Dealing in securities would be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following, namely:

(a) Indulging in an act which creates false or misleading appearance of trading in the securities market;

(b) Dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;

(c) Advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;

(d) Paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuations in the price of such security;

(e) Any act or omission amounting to manipulation of the price of a security;

(f) Publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities;

- **(g)** Entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security;
- **(h)** Selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialised form;
- **(i)** An intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself;
- **(j)** An intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security:
- **(k)** An advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors;
- **(l)** An intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage;
- **(m)** An intermediary not disclosing to his client transactions entered into on his behalf including taking an option position;
- **(n)** Circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security;
- **(o)** Encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.
- **(p)** An intermediary predating or otherwise falsifying records such as contract notes;
- **(q)** An intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract; and
- **(r)** Planting false or misleading news which may induce sale or purchase of securities.
- **(s)** Mis-selling of units of a mutual fund scheme, that is, direct/indirect sale by any person by: **(a)** making a false/misleading statement, **(b)** concealing/omitting material facts of the scheme, **(c)** concealing the associated risk factors of the scheme, and **(d)** not making reasonable care to ensure suitability of the scheme to the buyer.
- **(t)** Illegal mobilisation of funds by sponsoring/causing to the sponsored or carrying on/causing to be carried on any collective investment scheme by any person.

The acts/omissions listed above are not exhaustive and any act/omission is prohibited if it falls within the purview of this regulation notwithstanding that it is not included here or is described as having been committed only by a certain category of persons.

Investigation

Where the SEBI, the Chairman, the member or the Executive Director (i.e. 'appointing authority') has reasonable ground to believe that **(a)** the transactions in securities are being dealt with in a manner deterimental to the investors or the securities market in violation of these regulations; **(b)** any intermediary or any person associated with the securities market has violated any of the provisions of the SEBI Act or the rules or the regulations, it may, at any time by order in writing, direct any officer not below the rank of Division Chief (i.e. the 'Investigating Authority') specified in the order to investigate the affairs of such intermediary or persons associated with the securities market or any other person and to report thereon to the SEBI in the manner provided in Section 11(C) of the SEBI Act.

The Investigating Authority would have the following powers for the conduct of investigation, namely:

1. To call for information or records from any person specified in Section 11(2)(i) of the SEBI Act;
2. To undertake inspection of any book, or register, or other document or record of any listed public company or a public company (not being intermediaries referred to in Section 12 of the SEBI Act) which intends to get its securities listed on any recognised stock exchange where the Investigating Authority has reasonable grounds to believe that such company has been conducting in violation of these regulations;
3. To require any intermediary or any person associated with securities market in any manner to furnish such information to, or produce such books, or registers, or other documents, or record before him or any person authorised by him in this behalf as he may consider necessary if the furnishing of such information or the production of such books, or registers, or other documents, or record is relevant or necessary for the purposes of the investigation;
4. To keep in his custody any books, registers, other documents and record produced under this regulation for a maximum period of one month which may be extended up to a period of six months by the SEBI. However, the Investigating Authority may call for any book, register, other document or record if the same is needed again. If the person on whose behalf the books, registers, other documents and record are produced requires certified copies of the books, registers, other documents and record produced before the Investigating Authority, he should give certified copies of such books, registers other documents and record to such person or on whose behalf the books, registers, other documents and record were produced;
5. To examine orally and to record the statement of the person concerned or any director, partner, member or employee of such person and to take notes of such oral examination to be used as an evidence against such person. These notes should be read over to, or by, and signed by, the person so examined.
6. To examine on oath any manager, managing director, officer or other employee of any intermediary or any person associated with securities market in any manner in relation to the affairs of his business and may administer an oath accordingly and for that purpose may require any of those persons to appear before him personally.

The Investigating Authority may, after obtaining specific approval from the Chairman or Member, also exercise all or any of the following powers, namely:

(a) To call for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which are under investigation;

(b) To make an application to the Judicial Magistrate of the First Class having jurisdiction for an order for the seizure of any books, registers, other documents and record, if in the course of investigation, the Investigating Authority has reasonable ground to believe that such books, registers, other documents and record of, or relating to, any intermediary or any person associated with securities market in any manner may be destroyed, mutilated, altered, falsified or secreted;

(c) To keep in his custody the books, registers, other documents and record seized under these regulations for such period not later than the conclusion of the investigation as he considers necessary and thereafter to return the same to the person, the company or the other body corporate, to the managing director or the manager or any other person from whose custody or power they were seized. The Investigating Authority may, before returning such books, registers, other documents and record as aforesaid, place identification marks on them or any part thereof;

(d) Every search or seizure made under this regulation should be carried out in accordance with the provisions of the Code of Criminal Procedure, relating to searches or seizures.

It would be the duty of every person in respect of whom an investigation has been ordered

(a) to produce to the Investigating Authority or any person authorised by him such books, accounts and other documents and record in his custody or control, and to furnish such statements and information as the Investigating Authority or the person so authorised by him may reasonably require for the purpose of the investigation;

(b) to appear before the Investigating Authority personally when required to do so by him to answer any question which is put to him by him in pursuance of his powers.

It would be the duty of every manager, managing director, officer and other employee of the company and every intermediary or every person associated with the securities market to preserve and to produce to the Investigating Authority or any person authorised by him in this behalf, all the books, registers, other documents and record of, or relating to, the company, or, as the case may be, of or relating to, the intermediary or such person, which are in their custody or power. Such person should

(a) allow the Investigating Authority to have access to the premises occupied by him at all reasonable times for the purpose of investigation;

(b) extend to the Investigating Authority reasonable facilities for examining any books, accounts and other documents in his custody or control (whether kept manually or in computer or in any other form) reasonably required for the purposes of the investigation;

(c) provide to such Investigating Authority any such book, accounts and records which, in the opinion of the Investigating Authority, are relevant to the investigation or, as the case may be, allow him to take out computer out-prints thereof.

The Investigating Authority would, on completion of investigation, after taking into account all relevant facts, submit a report to the appointing authority. It may also submit an interim report pending completion of investigations if he considers necessary in the interest of investors and the securities market or as directed by the appointing authority.

After consideration of the report, if satisfied that there is a violation of these regulations and after giving a reasonable opportunity of hearing to the persons concerned, the SEBI may by an order, for reasons to be recorded in writing, in the interests of investors and securities market, issue or take any of the following actions or directions, either pending investigation or enquiry or on completion of such investigation or enquiry, namely:

(a) Suspend the trading of security found to be or *prima facie* found to be involved in fraudulent and unfair trade practice in a recognised stock exchange;

(b) Restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;

(c) Suspend any office-bearer of any stock exchange or self-regulatory organisation from holding such position;

(d) Impound and retain the proceeds or securities in respect of any transaction which is in violation or *prima facie* in violation of these regulations;

(e) Direct an intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of a fraudulent and unfair transaction;

(f) Require the person concerned to call upon any of its officers, other employees or representatives to refrain from dealing in securities in any particular manner;

(g) Prohibit the person concerned from disposing of any of the securities acquired in contravention of these regulations;

(h) Direct the person concerned to dispose of any such securities acquired in contravention of these regulations, in such manner as the SEBI may deem fit, for restoring the *status quo ante;*

The SEBI would issue a press release in respect of any final order in at least two newspapers of which one should have nation-wide circulation and also put the order on its website.

The SEBI also by an order, for reasons to be recorded in writing, in the interests of investors and securities market, take the following action against an intermediary: **(a)** issue a warning or censure; **(b)** suspend the registration of the intermediary; or **(c)** cancel of the registration of the intermediary.

> **Insider**
> means a person who is **(i)** a connected person or **(ii)** in possession of/ having access to unpublished price sensitive information.

PROHIBITION OF INSIDER TRADING REGULATION 2015

The object of the regulation is to **(i)** put in place a framework for prohibition of insider trading in securities and **(ii)** strengthen the related legal framework. The main elements of the scheme of regulation, namely, restriction on communication and trading by insiders, disclosure of trading by insiders, code of fair disclosure/conduct and action for violation are discussed in this Section.

> **Connected person**
> means **(a)** an immediate relative of connected persons, **(b)** a holding/ associate/subsidiary company, **(c)** an intermediary/employee/director, **(d)** an investment/trustee/asset management company or an employee/director, **(e)** an official of a stock exchange/ clearing house/corporation, **(f)** a member of board of trustees/ asset management company of a mutual fund/an employee, **(g)** a member of board of directors/an employee of a public financial institution, **(h)** an official or an employee of a SEBI-recognised/authorised self-regulatory organisation, **(i)** a banker of the company, and **(j)** a concern firm, trust, Hindu undivided family, company or association of persons wherein a director of a company or his immediate relative or banker of the company, has more than 10 per cent of the holding or interest.

Restrictions on Communication and Trading by Insiders

The two aspects of the SEBI regulations are: **(i)** communication/procurement of unpublished price sensitive information and **(ii)** trading when in possession of such information.

Communication/Procurement of Unpublished Price Sensitive Information An **insider** means a person who is **(i)** a connected person or **(ii)** in possession of/having access to unpublished price sensitive information. A **connected person** means any person who is/has during the six months prior to the concerned act been directly/indirectly associated with a company, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or temporary or permanent business relationship between himself and the company, that directly/indirectly allows him access to unpublished price sensitive information or is reasonably expected to allow such access. The persons falling within the following categories would be deemed to be connected persons unless the contrary is established: **(a)** an immediate relative of connected persons, **(b)** a holding/associate/subsidiary company, **(c)** an intermediary/ employee/director, **(d)** an investment/trustee/asset management company or an employee/director, **(e)** an official of a stock exchange/clearing house/corporation, **(f)** a member of board of trustees/ asset management company of a mutual fund/an employee, **(g)** a member of board of directors/an employee of a public financial institution, **(h)** an official or an employee of a SEBI-recognised/authorised self-regulatory organisation, **(i)** a banker of the company, and **(j)** a concern firm, trust, Hindu undivided family, company or association of persons wherein a director of a company or his immediate relative or banker of the company, has more than 10 per cent of the holding or interest.

Immediate relative means a spouse of a person and includes parent/sibling/child any of whom is either dependent financially or consults him in taking decisions relating to trading in securities. **Trading/trade** means and includes subscribing/buying/selling/ dealing or agreeing to subscribe/buy/sell/deal in any securities.

> **Unpublished price sensitive information** means any information directly/ indirectly relating to a company/its securities that is generally not available which upon becoming generally available is likely to materially affect the price of securities

Unpublished price sensitive information means any information directly/indirectly relating to a company/its securities that is generally not available which upon becoming generally available (i.e. information that is accessible to the public on a non-discriminatory basis, for example, published on the website of a stock exchange) is likely to materially affect the price of securities, and should ordinarily including but not restricted to information relating to **(i)** financial results, **(ii)** dividends, **(iii)** change in capital structure, **(iv)** mergers/demergers/acquisitions/ delistings/diposals and expansion of business and such other transactions, **(v)** change in key managerial personnel and **(vi)** material events in accordance with the listing agreement.

An insider should not communicate/provide/allow access to any price sensitive information relating to a company, its listed/proposed to be listed securities to any person including other insiders except for furtherance of legitimate purposes/ performance of duties/discharge of legal obligations. Similar stipulations also apply to any person to procure from or cause the communication by an insider of such information. However, such information may be communicated provided access allowed to/procured in connection with a transaction that would:

- entail an obligation to make an open offer under the **SEBI Takeover Regulations (discussed in another Chapter 12**) where the Board of Directors of the company is of informed opinion that the proposed transaction is in the best interest of the company.
- not attract the obligation to make an offer but where the Board of Directors is of informed opinion that the proposed transaction is in the best interest of the company and the information that constitutes such information is disseminated to be made generally available at least two **trading days** (i.e., day on which the stock exchange is open for trading) prior to the transaction being effected in such form as it may determine.

The Board of Directors would require the parties to execute agreements to contract confidentiality and non-disclosure obligations on their part and they should keep such information confidential except for the purpose mentioned above and not otherwise trade in securities of the company when in possession of unpublished price sensitive information.

Trading When in Possession of Unpublished Price Sensitive Information No insider should trade in listed or proposed to be listed securities on a stock exchange when in possession of unpublished price sensitive information. However, he may prove his innocence by demonstrating the circumstances including the following:

(i) The transaction is an off-market *inter se* transfer between promoters who were in possession of the same unpublished price sensitive information without being in breach of the stipulation relating to the non-communication of information and both parties had made a conscious and informed trade decision;

(ii) In the case of non-individual insiders: **(a)** the individuals who were in possession of such unpublished price sensitive information were different from those taking trading decisions and were not in possession of such unpublished price sensitive information when they took the decision to trade, and **(ii)** appropriate and adequate arrangements were in place to ensure that there are no violations and no unpublished price sensitive information was communicated by the individuals to the individuals taking trading decisions and there is no evidence of such arrangements having been breached;

(iii) The trades were pursuant to a trading plan (**discussed below**):

In the case of connected people the onus of establishing that they were not in possession of unpublished price sensitive information, would be on them and in other cases on the SEBI. The SEBI may specify standards and requirements deemed necessary for the purpose.

Trading Plans An insider would be entitled to formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out on his behalf in accordance with such plan. A **compliance officer** means any designated senior officer, reporting to the Board of Directors/head of the organisation, who is financially literate and is capable of appreciating requirements for legal and regulatory compliance who would be responsible for compliance of policies, procedures, maintenance of records, monitoring adherence to the rules for the preservation of unpublished price sensitive information, monitoring of trades and the implementation of the SEBI-specified code under the overall supervision of the Board of Directors or the head of an organisation of the listed company.

The trading plan should: **(i)** not entail **(a)** commencement of trading on behalf of the insider earlier than six months from the public disclosure of the plan; **(b)** trading for the period between the twentieth trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results; **(ii)** entail trading for a period of not less than twelve months; **(iii)** not entail overlap of any period for which another trading plan is already in existence; **(iv)** set out either the value of trades to be effected or the number of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades would be effected; and **(v)** not entail trading in securities for market abuse.

The compliance officer should review the trading plan to assess whether it would have any potential for violation and would be entitled to seek such express undertakings as may be necessary to enable such assessment and to approve and monitor the implementation of the plan.

The trading plan once approved would be irrevocable and the insider would mandatorily have to implement the plan, without being entitled to either deviate from it or to execute any trade in the securities outside the scope of the trading plan. However, its implementation should not be commenced if any unpublished price sensitive information in possession of the insider at the time of formulation of the plan has not become generally available at that time and in such event he should confirm that the commencement ought to be deferred until such unpublished price sensitive information becomes generally available information. Upon approval, the compliance officer should notify the trading plan to the concerned stock exchanges.

Disclosures of Trading by Insiders

The disclosures relate to general provisions and disclosures by certain persons.

General Provisions Every public disclosure should be made in SEBI-specified form. They should include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions. The disclosures of trading should also include trading in derivatives of securities and their traded value should be taken into account. They should be maintained by the company for a minimum period of five years in the SEBI-specified form.

Disclosures by Certain Persons ***Initial Disclosures*** Every promoter, key managerial personnel and director of a listed company should disclose his holding of securities of the company. Every person on appointment as a key managerial personnel/director or upon becoming a promoter should disclose his holdings as on the date of appointment/becoming a promoter to the company within seven days.

Continual Disclosures Every promoter, employee, director should disclose to the company the number of such securities acquired or disposed of within two trading days of the transaction if the value of the securities traded, over any calendar quarter, aggregates to a traded value in excess of ₹10 lakh or a SEBI-specified value. Every company should notify the particulars of such trading to the concerned stock exchange within two trading days of receipt of the disclosure or from becoming aware of such information.

Disclosures by Other Connected Persons Any listed company may, at its discretion, require any other connected/class of connected persons to make disclosures of holdings and trading in its securities in form and frequency determined by it.

Codes of Fair Disclosure and Conduct

Code of Fair Disclosure The Board of Directors of every listed company should formulate and publish on its website, the following code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out below, without diluting the provisions of the SEBI regulations in any manner.

Principles of Fair Disclosure for Purposes of Code of Practices and Procedures for Fair Disclosure of Unpublished Price Sensitive Information

1. Prompt public disclosure of unpublished price sensitive information that would impact price discovery no sooner than credible and concrete information comes into being in order to make such information generally available.
2. Uniform and universal dissemination of unpublished price sensitive to avoid selective disclosure.
3. Designation of a senior officer as a chief investor relations officer to deal with dissemination of information and disclosure of unpublished price sensitive information.
4. Prompt dissemination of unpublished price sensitive information that gets disclosed selectively, inadvertently or otherwise to make such information generally available.
5. Appropriate and fair response to queries on news reports and requests for verification of market rumours by regulatory authorities.
6. Ensuring that information shared with analysts and research personnel is not unpublished price sensitive information.

7. Developing best practices to make transcripts or records of proceedings of meeting with analysts and other investor relations conferences on the official website to ensure official confirmation and documentation of disclosures made.
8. Handling of all unpublished price sensitive information on a need-to-know basis.

Every such code of practices and procedures for fair disclosure of unpublished price sensitive information and amendments should be promptly intimated to the concerned stock exchanges.

Code of Conduct The Board of Directors of every listed company, market intermediary and every other person who is required to handle unpublished price sensitive information in the course of business operations should formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance adopting the minimum standards set out below:

Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders

1. The compliance officer should report to the Board of Directors and in particular, to the Chairman and Audit Committee/Chairman at such frequency as may be stipulated by the Board of Directors.
2. All information should be handled within the organisation on a need-to-know basis and no unpublished price sensitive information communicated to any person except in furtherance of the insider's legitimate purposes, performance of duties or discharge of his legal obligations. The code of conduct should contain norms for appropriate Chinese Walls procedures, and processes for permitting any designated person to "cross the wall".
3. Employees and connected persons designated on the basis of their functional role ("**designated persons**") in the organisations should be governed by an internal code of conduct governing dealing in securities. The Board of Directors should in consultation with the compliance officer specify the designated persons on the basis of their role and function in the organisation. Due regard should be had to the access that such role and function would provide to unpublished price sensitive information in addition to seniority and professional designation.
4. Designated persons may execute trades subject to compliance with these regulations. Towards this end, a notional trading window should be used as an instrument of monitoring trading by them. It should be closed when the compliance officer determines that a designated persons can reasonably be expected to have possession of unpublished price sensitive information. Designated persons and their immediate relatives should not trade in securities when the trading window is closed.
5. The timing for re-opening of the trading window should be determined by the compliance officer taking into account various factors including the unpublished price sensitive information in question becoming generally available and being capable of assimilation by the market, which in any event should not be earlier than 48 hours after the information becomes generally available. The trading window should also be applicable to any person having contractual or fiduciary relation with the company, such as auditors, accountancy firms, law firms, analysts, consultants and so on, assisting or advising the company.
6. When the trading window is open, trading by designated persons should be subject to pre-clearance by the compliance officer, if the value of the proposed trades is above such thresholds as the Board of Directors may stipulate. No designated person should apply for pre-clearance of any proposed trade if he is in possession of unpublished price sensitive information even if the trading window is not closed.

7. The compliance officer should confidentially maintain a list of securities as a "restricted list" which should be used as the basis for approving or rejecting applications for pre-clearance of trades.
8. Prior to approving any trades, the compliance officer should be entitled to seek declaration to the effect that the applicant for pre-clearance is not in possession of any unpublished price sensitive information. He should also have a regard to whether any such declaration is reasonably capable of being rendered inaccurate.
9. The code of conduct should specify any reasonable timeframe, which in any event should not be more than 7 trading days, within which trades that have been pre-cleared have to be executed by the designated person, failing which fresh pre-clearance would be needed for the trades to be executed.
10. It should specify the period, which in any event should not be less than six months, within which a designated person who is permitted to trade should not execute a contra trade. The compliance officer may be empowered to grant relaxation from strict application of such restriction for reasons to be recorded in writing provided that such relaxation does not violate these regulations. Should a contra trade be executed, inadvertently or otherwise, in violation of such a restriction, the profits from such trade should be liable to be disgorged for remittance to the SEBI for credit to the Investor Protection and Education Fund administered by it under the SEBI Act.
11. It should also stipulate such formats as the board of directors deems necessary for making applications for pre-clearance, reporting of trades executed, reporting of decisions not to trade after securing pre-clearance, recording of reasons for such decisions and for reporting level of holdings in securities at such intervals as may be determined as being necessary to monitor compliance with these regulations.
12. Without prejudice to the power of the SEBI under the SEBI Act, the code of conduct should stipulate the sanctions and disciplinary actions, including wage freeze, suspension etc., that may be imposed, by the persons required to formulate a code of conduct for the contravention of the code of conduct.
13. The code of conduct should specify that in case it is observed by the persons required to formulate a code of conduct, that there has been a violation of these regulations, they should inform the SEBI promptly.

Every listed company, market intermediary and other persons formulating a code of conduct should identify and designate a compliance officer to administer the code of conduct and other requirements.

Sanction for Violations

Any contravention of these regulations would be dealt with by the SEBI in accordance with the SEBI Act.

RECAPITULATION

- The framework of operation of the primary market is prescribed by the SEBI. The SEBI's guidelines relate to: merchant bankers/lead managers; underwriters; bankers to an issue; brokers to an issue; registrar to an issue and share transfer agents; debenture trustees; portfolio managers; prohibition of fraudulent and unfair trade practices; and insider trading;

- The main elements of the SEBI's framework as applicable to merchant bankers are: registration, obligation and responsibilities, inspection/action in case of default and pre-issue and post-issue obligations.
- Merchant banking activities include managing of public issues of capital, including international offers of debt and equity (i.e. GDRs/ADRs/FCCBs and so on); private placement of securities; corporate advisory services, such as takeovers/mergers, project advisory services, loan syndication; portfolio advisory/management services and so on.
- Merchant bankers require compulsory registration with the SEBI. While granting registration, the relevant matters considered by SEBI are: the applicant is a body corporate, it has the necessary infrastructure, it has at least two experienced persons, it is not involved in any litigation, it is a fit and a proper person in terms of SEBI's fit and proper person regulations.
- The criteria for fit and proper person include financial integrity, absence of conviction/civil liability, competence, good reputation and character, efficiency and honesty, and absence of any disqualification to act as an intermediary by SEBI/other regulatory authorities such as conviction for offence involving moral turpitude, economic offence, securities laws or fraud, order for winding up, insolvency, debarred from dealings, cancellation of registration, financial unsoundness and so on.
- The obligations and responsibilities of merchant bankers include adherence to the requirements under the prescribed code of conduct, restriction on asset-based activities, maximum number of lead managers, responsibilities of lead managers, due diligence certificate, submission of documents, appointment of compliance officer and disclosures to the SEBI.
- The SEBI can undertake an inspection of the books of accounts, records, and documents of a merchant banker to ensure compliance with the provisions of the SEBI Act/rules/regulations and to investigate complaints into his affairs. Action in case of a default would be in a manner provided under the SEBI Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulations.
- Underwriters make a commitment to get the issue subscribed either by others or by themselves. They are appointed by the issuers, in consultation with the lead managers/merchant bankers.
- To act as underwriters, registration with the SEBI is mandatory. The eligibility criteria are: infrastructure, past experience, capital adequacy, non-conviction for offence involving moral turpitude/non-guilty of any economic offence, fit and proper person in terms of SEBI Criteria for Fit and Prosper Person Regulation, payment of registration fee and so on.
- The general obligations and responsibilities of underwriters are: following the prescribed code of conduct, entering into an agreement with the clients, appointment of compliance officer, provide information regarding its business to the SEBI and general responsibilities.
- The framework of inspection, disciplinary proceedings and action in case of default by the SEBI is broadly on the same pattern as applicable to lead managers.
- Bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investors in respect of issues of capital and refund of application money.
- To carry on as a banker to an issue, registration with the SEBI is necessary, which is given on the basis of eligibility criteria, such as infrastructure, non-involvement in litigation connected with the securities market/non-conviction of any economic offence, interest of the investors and payment of registration/renewal fee.
- Their obligations are furnishing of information, maintenance of accounts/records/ documents, entering into a agreement with issuing companies, subject to disciplinary action by the RBI, following the prescribed code of conduct, and appointment of compliance officer.

- The framework of inspection by the SEBI and action in case of default is broadly on the same pattern as applicable to lead managers/underwriters.
- The registrar to an issue (RI) carries on activities such as collecting applications from the investors, keeping a proper record of the applications and money received from investors/ paid to sellers, assisting the issuers in determining the basis of allotment of securities in consultation with the stock exchange(s), finalising the allotment of securities and processing/despatching allotment letters, refund orders, certificates and other related documents in respect of issues of capital.
- The share transfer agent (STA) maintains the records of holders of securities on behalf of companies and deals with all matters connected with the transfer/redemption of its securities.
- The registration procedure of RI/STAs with the SEBI, their general obligations and responsibilities, inspection by the SEBI and action in case of default is broadly on the pattern applicable to lead managers/underwriters/bankers to an issue.
- A debenture trustee is a trustee for a trust deed. He is needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed company, proposed to be listed. A trust deed means a deed executed by the body corporate in favour of the trustees, for the benefit of the debentureholders.
- Only banks/FIs/insurance companies/body corporates fulfilling the minimum capital adequacy requirement can act as trustees. The compulsory registration procedure with the SEBI is on the same pattern as applicable to lead managers/underwriters/bankers to an issue/RI/STAs.
- The responsibilities and duties of a debenture trustee are: obligation before appointment and obligations.
- The obligation before appointment is to enter into a written agreement containing the specified details, with the body corporate, before the opening of the subscription list for issue of debentures.
- The obligation of the debenture trustee is to accept the trust deed containing the following: **(i)** description of instruments, **(ii)** details of charged securities (existing/future), **(iii)** events of defaults, **(iv)** rights of debentures trustees, **(v)** obligations of body corporate and miscellaneous. The obligations of the debenture trustees also include code of conduct, maintenance of books of accounts, appointment of compliance officer and providing information to the SEBI.
- The inspection procedure and action for default to the SEBI is broadly on the same pattern as applicable to the other intermediaries.
- 'Portfolio' means the total holdings of securities of a person. Portfolio managers advise/directly undertake the management/administration of portfolio of securities/funds of clients, on their behalf. Portfolio management can be discretionary or non-discretionary. Discretionary portfolio management permits the exercise of discretion by the portfolio manager with regards to investment/management of the portfolio. Funds are invested in a non-discretionary portfolio management in accordance with the directions of the client(s).
- Portfolio management services in the country should be carried out within the framework of SEBI's regulations. According to these, merchant bankers can carry out such activities, but other categories of portfolio managers must obtain a certificate or registration from SEBI.
- While considering an application for registration, SEBI takes into account matters such as infrastructure, capital adequacy, non-involvement in any securities market-related litigation, professional qualification, non-conviction for any offence involving moral turpitude/guilty of an economic offence and so on.

- The general obligations and responsibilities of a portfolio manager include following the preseribed code of conduct, entering into contracts with clients, carrying out the general responsibilities of the discretionary portfolio manager, investing of clients, money, maintenance and audit of books of accounts, furnishing reports to clients, making the required disclosures to SEBI and appointment of they compliance officer.
- The SEBI can conduct an inspection of a portfolio manager to ensure that the books of accounts/records/documents are being maintained in the required manner, the provisions of SEBI Act/rules/regulation are being complied with and the SEBI can also investigate into complaints against him. On the basis of inspection, it can take appropriate measures in the interest of the securities market.
- Action in the case of default would be broadly on the pattern applicable to other intermediaries.
- The prohibition of fraudulent and unfair trade practices relates to **(1)** certain dealings in securities and **(2)** manipulative, fraudulent and unfair trade practices.
- Dealings in securities which are prohibited are: **(i)** buying, selling or otherwise dealing in a fraudulent manner, **(ii)** employing a manipulative/deceptive device or contrivance in contravention of the provisions of the SEBI Act/regulations and **(iii)** employing any device/artifice/scheme to defraud and (iv) engaging in any act, practice, course of business which operates/would operate as a fraud/deceit on any person, in contravention of the provisions of the SEBI Act/regulations.
- No person should indulge in a fraudulent or an unfair trade practice in securities. Dealings in securities would be deemed fraudulent/an unfair trade practice if it involves fraud.
- If there are reasonable grounds to believe that transactions in securities are being dealt with in a manner detrimental to the investors/securities market or there is violation of any provision of the SEBI Act/rules/regulation, the SEBI may conduct an investigation into the affairs of the intermediary/person associated with the securities market. On the findings, the SEBI can take action/issue a direction, such as suspension of trading of the security concerned, restraining persons from accessing the securities market, suspension of office-bearers of a stock exchange, impounding/retaining the proceeds/securities, direction not to dispose of/alienate an asset, prohibition on disposing of any security and so on. The SEBI can also suspend/cancel the registration of an intermediary.
- The main elements of the scheme of prohibition of insider trading regulation are: restriction on communication and trading by insiders, disclosure of trading by insiders, code of fair disclosure/conduct and action for violation.
- The two aspects of the restrictions on communications and trading by insiders are: **(i)** communication/procurement of unpublished price sensitive information and **(ii)** trading when in possession of such information.
- An **insider** means a person who is **(i)** a connected person or **(ii)** in possession of/having access to unpublished price sensitive information. A **connected person** means any person who is/has during the six months prior to the concerned act been directly/indirectly associated with a company, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or temporary or permanent business relationship between himself and the company, that directly/indirectly allows him access to unpublished price sensitive information or is reasonably expected to allow such access. The persons falling within the following categories would be deemed to be connected persons unless the contrary is established: **(a)** an immediate relative of connected persons, **(b)** a holding/associate/subsidiary company, **(c)** an intermediary/employee/director, **(d)** an investment/trustee/asset management company or an employee/director, **(e)** an official of a stock exchange/

clearing house/corporation, **(f)** a member of board of trustees/ asset management company of a mutual fund/an employee, **(g)** a member of board of directors/an employee of a public financial institution, **(h)** an official or an employee of a SEBI-recognised/authorised self-regulatory by the SEBI, **(i)** a banker of the company, and **(j)** a concern firm, trust, Hindu undivided family, company or association of persons wherein a director of a company or his immediate relative or banker of the company, has more than 10 per cent of the holding or interest.

Immediate relative means a spouse of a person and includes parent/sibling/child any of whom is either dependent financially or consults him in taking decisions relating to trading in securities. **Trading/trade** means and includes subscribing/buying/selling/ dealing or agreeing to subscribe/buy/sell/deal in any securities.

Unpublished price sensitive information means any information directly/indirectly relating to a company/its securities that is generally not available which upon becoming **generally available** (i.e. information that is accessible to the public on a non-discriminatory basis, for example, published on the website of a stock exchange) is likely to materially affect the price of securities, and should ordinarily including but not restricted to information relating to **(i)** financial results, **(ii)** dividends, **(iii)** change in capital structure, **(iv)** mergers/demergers/acquisitions/delistings/diposals and expansion of business and such other transactions, **(v)** change in key managerial personnel and **(vi)** material events in accordance with the listing agreement.

- An insider should not communicate/provide/allow access to any price sensitive information relating to a company, its listed/proposed to be listed securities to any person including other insiders except for furtherance of legitimate purposes/performance of duties/discharge of legal obligations. Similar stipulations also apply to any person to procure from or cause the communication by an insider of such information.
- No insider should trade in listed or proposed to be listed securities on a stock exchange when in possession of unpublished price sensitive information. In the case of connected people the onus of establishing that they were not in possession of unpublished price sensitive information, would be on them and in other cases on the SEBI. The SEBI may specify standards and requirements deemed necessary for the purpose.
- An insider would be entitled to formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out on his behalf in accordance with such plan. The trading plan should: **(i)** not entail **(a)** commencement of trading on behalf of the insider earlier than six months from the public disclosure of the plan; **(b)** trading for the period between the twentieth trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results; **(ii)** entail trading for a period of not less than twelve months; **(iii)** not entail overlap of any period for which another trading plan is already in existence; **(iv)** set out either the value of trades to be effected or the number of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades would be effected; and **(v)** not entail trading in securities for market abuse.
- The disclosures of trading by insiders relate to general provisions and disclosures by certain persons.
- The general provisions should include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions. The disclosures of trading should also include trading in derivatives of securities and their traded value should be taken into account.
- Every promoter, key managerial personnel and director of a listed company should disclose his holding of securities of the company. Every person on appointment as a key managerial personnel/director or upon becoming a promoter should disclose his holdings as on the date of appointment/becoming a promoter to the company within seven days.

- Every promoter, employee, director should disclose to the company the number of such securities acquired or disposed of within two trading days of the transaction if the value of the securities traded, over any calendar quarter, aggregates to a traded value in excess of ₹10 lakh or a SEBI-specified value. Every company should notify the particulars of such trading to the concerned stock exchange within two trading days of receipt of the disclosure or from becoming aware of such information.
- Any listed company may, at its discretion, require any other connected/class of connected persons to make disclosures of holdings and trading in its securities in form and frequency determined by it.
- The Board of Directors of every listed company should formulate and publish on its website, a code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out below, without diluting the provisions of the SEBI regulations in any manner.
- The Board of Directors of every listed company, market intermediary and every other person who is required to handle unpublished price sensitive information in the course of business operations should formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance adopting the minimum standards set out below.
- Any contravention of the regulations would be dealt with by the SEBI in accordance with the SEBI Act.

REVIEW QUESTIONS

10.1 Discuss the main features of the operational framework of merchant bankers/lead managers in the Indian primary market.

10.2 Outline the framework of operations of:
- Underwriters
- Bankers to an issue
- Brokers to an issue
- Registrar to an issue and share transfer agents.

10.3 Who is a debenture trustee? Explain briefly the responsibilities and obligations, duties and code of conduct of a debenture trustee.

10.4 Briefly discuss the registration procedure, general obligations and responsibilities and code of conduct of portfolio managers.

10.5 Outline the main features of the scheme of regulation of prohibition of fraudulent and unfair trade practices.

10.6 Define an insider trading.

10.7 Explain briefly the main elements of the regulation relating to prohibition on insider trading.

CHAPTER 11

Issue Management: Activities/Procedures

Learning Objectives

- Explain the common conditions for public and rights issues.
- Examine the eligibility requirements for public issues.
- Discuss the stipulations relating to pricing in public issues.
- Explain the provisions relating to promoters contribution in public issues.
- Analyse the restrictions on transferability (lock-in) of promoters contributions in public issues.
- Describe the provisions as to minimum offer to public, reservation and so on.
- Understand the stipulations relating to rights issues.
- Outline the manner of disclosures in the offer documents.
- Highlight the general obligations of issuers and intermediaries with respect to public and rights issues.
- Describe the framework of preferential issues of capital.
- Discuss qualified institutional placement including qualified institutional placement programme as a method to issue of capital.
- Review the framework relating to the issue of Indian depository receipts (IDRs) including rights issues in terms of IDRs rules and SEBI regulations.
- Explain the framework for issue of specified securities by small and medium enterprises.
- Understand the nature of directions issued by SEBI.
- Explain listing on institutional trading platform.
- Understand provisions for exit opportunity for dissenting shareholders.
- Examine listing of securities on stock exchange(s).
- Examine the framework for the issue and listing of debt securities.
- Examine the regulations relating to issue and listing of non-convertible redeemable preference shares.

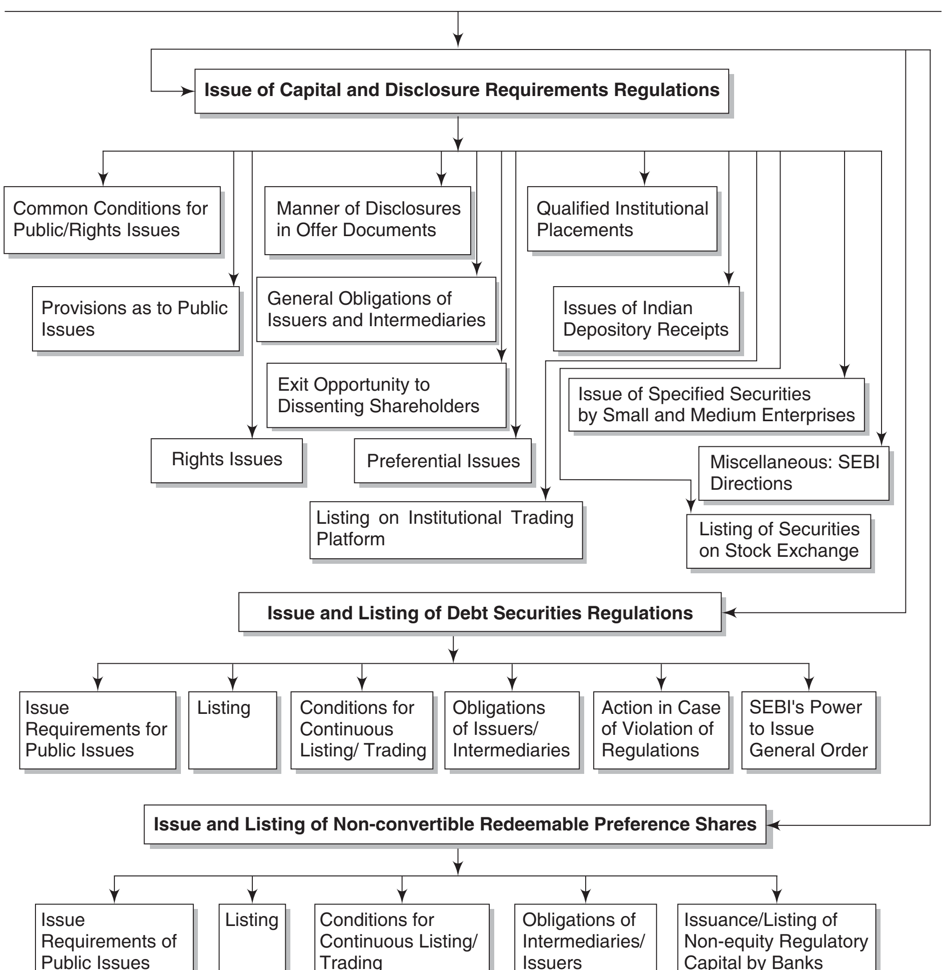
INTRODUCTION

In order to remove inadequacies and systematic deficiencies, protect the interests of investors and for the orderly growth and development of the securities market, the SEBI had put in place guidelines [Disclosure and Investor Protection (DIP) Guidelines] in 2000 as ground rules relating to new issue procedures/activities. These were rescinded in September 2009 and replaced by Issue of Capital and Disclosure Requirements (ICDR) Regulations, 2009. These are in addition to the company law requirements in relation to issues of capital/securities.[@] The SEBI has also issued Issue and Listing

[@]For a comprehensive account of company law regulations relating to capital issue activity, refer to Khan, M.Y., *Indian Financial System*, 10e, McGraw Hill Education (India), New Delhi, 2017 (Chapter 4).

of Debt Securities Regulations, 2008. The other two regulations relating to issues of capital by the SEBI are: **(i)** Listing and Issue of Capital by Small and Medium Enterprises on Institutional Trading Platform Without Initial Public Offering, 2013 and **(ii)** Issue and Listing of Non-convertible Redeemable Preference Shares, 2014. This Chapter comprehensively discusses the legal and procedural requirements of the SEBI regulations pertaining to capital issue activities. **They are portrayed in Exhibit 11.1**. They are applicable to all **(i)** Public issues, and **(ii)** Rights issues where the aggregate value of specified securities offered is ₹50 lakh and more, **(iii)** Preferential issues, **(iv)** Qualified institutional placement (QIP) by a listed issuer, and **(v)** Issues of Indian depository receipts (IDRs). The ICDR regulation is discussed in Section 1. The Chapter also discusses the SEBI Issue and listing of debt securities regulation in Section 2. Concluding observations are given in the last Section.

Exhibit 11.1 Issue Management: Procedures/Activities



ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS REGULATIONS

The issue procedure contained in the ICDR Regulation is illustrated with reference to **(a)** Common conditions for public and rights issues, **(b)** Provisions as to public issues in terms of **(i)** eligibility, **(ii)** pricing, **(iii)** promoters contribution, **(iv)** lock-in of promoters contribution, and **(v)** minimum offer to public and reservations, **(c)** Rights issue, **(d)** Disclosures in offer documents, **(e)** General obligations of issuers and intermediaries, **(f)** Preferential issues, **(g)** Qualified institutional placement, **(h)** Issue of Indian depository receipts, **(i)** Issue of specified securities by small and medium enterprises, and **(j)** SEBI directions.

> **Public issue**
> means an initial public offer (IPO) or a further public offer (FPO).

Common Conditions for Public/Rights Issues

Public issue means an initial public offer (IPO) or further public offer (FPO). An **IPO** means an offer of **specified securities** (i.e. equity shares and convertible securities) by an **unlisted issuer** (i.e. any person making an offer of specified securities whose equity shares are not listed in a recognised stock exchange) to the public for subscription including an offer for sale to the public by existing holder of the securities in an unlisted issuer. A **FPO** means an offer of specified securities by a **listed issuer** (i.e. an issuer whose equity shares are listed in a recognised stock exchange) to the public for subscription including an offer for sale of the securities to the public by existing holders in a listed issuer. A **convertible security** means a security which is convertible into/exchangeable with equity shares of the issuer at a later date with/without the option of the holder and includes convertible debts instruments (CDIs) convertible preference shares. A **CDI** is an instrument which creates/acknowledges indebtedness and is convertible into equity shares of the issuer at a later date with/without the option of the holder, whether constituting a charge on the asset of the issuer or not. **Rights** issue means an offer of specified securities by a listed issuer to its shareholders as on the record date fixed for the purpose. **The main elements of the common conditions for public/rights issues are portrayed in Exhibit 11.2.**

> **IPO**
> is an offer of shares and convertible securities by an unlisted issuer to the public for subscription including an offer for sale by existing holders of securities in an unlisted issuer.

> **FPO**
> is an offer of shares/convertible securities by a listed issuer including an offer for sale in a listed issuer.

> **CDI**
> is an instrument which creates/acknowledges indebtedness and is convertible into shares of the issuer at a later date with/without the option of the holder.

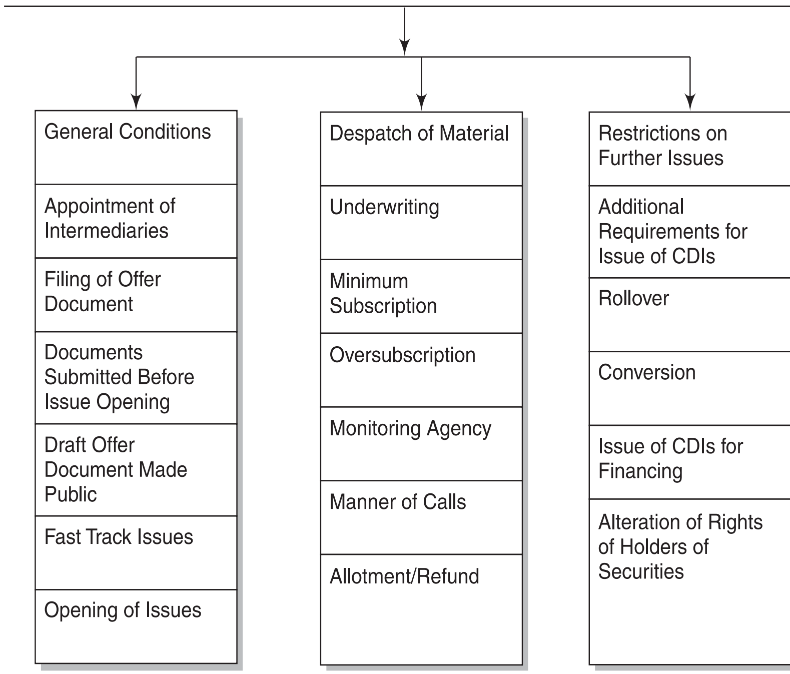
> **Rights issue**
> is an offer of shares/convertible securities by a listed issuer to its existing shareholders.

General Conditions The stipulated general condition are as discussed below.

(A) Any issuer of specified securities through a public/rights issue should satisfy the general conditions specified below at the time of **(i)** filing the draft offer document with the SEBI and **(ii)** registering/filing the final **offer document** (i.e. red-herring prospectus/prospectus/information memorandum in terms of Section 60-A of the Companies Act in case of a public issue and letter of offer in case of rights issue) with the Registrar of Companies (ROCs)/designated stock exchange (DSE). A **DSE** means a recognised stock exchange in which securities of the issuer are/proposed to be listed and which is chosen by him for the purpose of a **particular** issue out of those having nation-wide trading terminals.

> **Offer document**
> includes red-herring prospectus/information memorandum (in public issue) and letter of offer (in rights issue).

Exhibit 11.2 Common Conditions for Public/Rights Issues



(B) An issuer is prohibited from making a public issue in the following cases:

- The issuer/its promoter(s), promoter group/directors/ person(s) in control of the issuer are debarred from accessing the capital market by the SEBI. The term **promoter** includes person(s) **(i)** in control of the issuer in terms of **Regulation 2(1)(C)** of the **SEBI Substantial Acquisition of Shares and Takeover Regulation**, **(discussed in Chapter 12)** **(ii)** who are instrumental in the formulation of a plan/programme pursuant to which specified securities are offered to public; and **(iii)** named in the offer document as a promoter. However, **(a)** a director/officer of the issuer or a person acting as such in his professional capacity, **(b)** a financial institution/bank/foreign portfolio investor other than category III/mutual fund holding more than 10 per cent of capital of the issuer would not be deemed to be a promoter. These institutions would be treated as promoter for subsidiaries/companies/mutual funds promoted/sponsored by them. The term **promoter group** includes the following: **(i)** promoter(s), **(ii)** his/of his spouse immediate relative (i.e. spouse/parent/brother/sister/child), **(iii) in case of body corporate-promote, (a)** subsidiary/holding company, **(b)** any body corporate in which the promoter holds 10 per cent share capital or which holds 10 per cent of the capital of the promoter and **(c)** any body corporate in which group of individuals/companies/combination thereof holds 20 per cent of its capital also holds 20 per cent of the share capital of the issuer; **(iv)** in case of **individual-promoter, (a)** any body corporate in which 10 per cent is held by the promoter/an immediate relative, a firm/HUF in which the promoter/an immediate relative, a firm/HUF in which the promoter/an immediate relative is a member, **(b)** any body corporate in which any body corporate as provided in **(a)** above holds a minimum 10 per cent of the share capital, **(c)** any Hindu Undivided Family (HUF)/firm in which the aggregate shareholding of the promoter and his immediate relatives is at least 10 per cent, and **(d)** all persons whose shareholding is aggregated for the purpose of disclosing in the prospectus under the heading **Shareholding of the Promoter Group**. However, FIs/banks/foreign portfolio investors other than category III/mutual fund holding 10 per cent share capital of the issuer would not be deemed to be promoter group. They would be treated as such for subsidiaries/ companies or mutual funds promoted/sponsored by them.

- Any promoter/director/person in control of the issuer was/is also in a similar capacity of any other company debarred from accessing the capital market by the SEBI.
- The issuer has not **(i)** made an application for listing of specified securities on a recognised stock exchange(s) and chosen one of them as the DSE. In case of an IPO, he should make an application for listing in at least one recognised stock exchange having nation-wide trading terminals; **(ii)** entered into an agreement with a depository for dematerialisation of securities already/proposed to be issued.
- All existing partly paid-up equity shares of the issuer have been made fully paid-up or forfeited.
- Firm arrangements of finance through verifiable means towards 75 per cent of the stated means of finance, excluding the amount to be raised through the proposed issue or through existing identifiable internal accruals have been made.
- Warrants may be issued along with public/rights issues if their tenure does not exceed 18 months from the date of allotment and only one warrant is attached to one security. The price/conversion formula should be determined upfront and atleast 25 per cent of the consideration also received upfront. In case of non-exercise of option by a holder, the consideration paid should be forfeited by the issuer.
- The amount for **general corporate purposes** (i.e. such identified purposes by which no specific amount is allocated or any specified amount towards general corporate purposes in the draft offer document filed with the SEBI but would exclude issue-related expenses) should not exceed 25 per cent of the amount raised by the issuance of the securities.
- A public issue of equity securities cannot be made if the issuer/promoter(s)/director(s) is a **willful defaulter** (i.e. an issuer categorised in terms of the RBI guidelines by a bank/financial institution). Similarly, a public issue of convertible debt instruments is not permitted if: **(i)** the issuer/promoter/director is a willful defaulter or **(ii)** it is default of payment/repayment of interest/ principal for more than 6 months. The issuer of rights issues should make the specified disclosures in the offer document/abridged letter of offer if it/promoter/director is a willful defaulter. Moreover, the promoter/promoter group of the issuer should not renounce their rights.

Appointment of Merchant Bankers/Other Intermediaries The issuer should appoint merchant banker(s) at least one of whom should be lead merchant banker and other SEBI-registered intermediaries in consultation with him to carry out the issue-related obligations. The lead merchant banker should advise the issuer on their appointment only after independent assessment of their capability to carry out their obligations. The rights/obligations/responsibilities relating, *inter-alia*, to disclosures/allotment/refund and underwriting obligations of each merchant banker should be predetermined and disclosed in the offer document as specified **in Appendix 11-A on the website. The website address is http://www.mhhe.com/khanfs9e.** However, where any of the merchant bankers is an associate of the issuer, it should declare itself as a marketing lead manager and its role should be limited to marketing of the issue. The issuer should also enter into an agreement with the lead merchant banker in the format specified **in Appendix 11-B on the website** and other intermediaries as required under the regulation(s) applicable to the intermediary concerned. However, such agreements may include such other clauses as the issuer and the intermediary(ies) may deem fit without diminishing/limiting their mutual obligations under the SEBI/Companies/Securities Contracts (Regulations)/ Depositories Act(s) and the rules/regulations or any statutory modifications/enactment. In case of **ASBA (Application Supported by Blocked Amount)** process, the issuer should take cognisance of the deemed agreement of the issuer with the **Self Certified Syndicate Banks (SCBs)**. The term **ASBA** means an application for subscription to an issue along with an authorisation to **SCSB** (that is, a SEBI-registered banker to an issue which offers the facility of ASBA) to block the application money in a bank account.

ASBA is an application for subscription to an issue along with an authorisation to the self certified syndicate bank to block the application money in a bank account.

The issuer should appoint **syndicate members** (i.e. a SEBI-registered intermediary who is permitted to carry on underwriting activity) in case of issues through book building process and bankers to an issue at all mandatory collection centres specified in **Appendix 11-C on the website** and other collection centres it may deem fit. The lead merchant banker would act as the lead book runner and undertake the book building process. **Book-building** means a process undertaken to elicit demand/assess the price to determine the quantum/value of specified securities/Indian depository receipts (IDRs). The issuer should also appoint a registrar to an issue which has connectivity with all the depositories.

Syndicate member is a SEBI-registered intermediary permitted to carry on underwriting activity in a book-built issue.

Book building is a process to elicit demand/assess the price to determine the quantum/value of securities/IDRs.

Filing of Offer Document Issuers of capital through public/rights issues should file an draft offer document along with the specified fee with the SEBI through the lead merchant banker at least 30 days prior to registering the prospectus/red herring prospectus/shelf prospectus with the ROCs or filing of letter of offer with the DSE. The payable fee is related to the issue size as listed below:

Size of issue including intended oversubscription	*Amount/Rate of fee*
(A) In Case of Public Issue:	
(i) Upto ₹10 crore	A flat charge of ₹25,000
(ii) ₹10 – ₹5,000 crore	0.025 per cent of the issue size
(iii) ₹5,000 – ₹25,000 crore	₹1,25,00,000 plus 0.00625 per cent of the portion of the issue size in excess of ₹5,000 crore
(iv) More than ₹25,000 crore	A flat charge of ₹3 crore
(B) Rights Issues:	
(i) Upto ₹10 crore	A flat charge of ₹25,000
(ii) ₹10 – ₹500 crore	0.005 per cent of the issue size
(iii) More than ₹500 crore	A flat charge of ₹5,00,000

The SEBI may specify changes/issue observations on the offer document within 30 days from the later of the date of **(i)** receipt of the offer document, **(ii)** satisfactory reply on any clarification/additional information from the merchant banker(s), **(iii)** clarification/information from any regulator/agency sought by the SEBI, or **(iv)** a copy of in-principle approval letter issued by the recognised stock exchange (RSE). The issuer/merchant banker should comply with the specific changes/observations before registering them with the ROCs or filing the letter of offer with the DSE. It should simultaneously or before the issue opening file a copy with the SEBI. The lead merchant banker should also file a copy with the concerned stock exchange. The offer document should also be filed with the SEBI in a soft copy in the manner specified in **Appendix 11-D on the website**.

Security Deposit The issuer should deposit before the opening of the subscription list with the stock exchange(s) of 1 per cent of the securities offered to the public. The amount would be refunded/forfeited in the manner specified by the SEBI/stock exchange(s).

Documents to be Submitted Before Issue Opening The lead merchant banker should submit to the SEBI along with the draft offer document a **(i)** certificate confirming an agreement between the issuer and the lead merchant banker in the specified format, **(ii)** due diligence certificate in **Form A of Appendix 11-E on the website, (iii)** due diligence certificate from the debenture trustees in **Form B of Appendix 11-E on the website** in case of issue of CDIs and **(iv)** certificate in **Form C of Appendix 11-G on the website** comprising compliance of the conditions.

The lead merchant banker should also submit the following documents to the SEBI: a **(i)** statement certifying that all changes/suggestions/observations made by the SEBI have been incorporated in the offer document, **(ii)** due diligence certificate in **Form C of Appendix 11-E on the website** at the time of registering the prospectus with the ROCs **(iii)** copy of the Broad of Directors resolution of the issuer for allotment of securities to promoters against promoters' contribution before issue opening, **(iv)** certificate from a chartered accountant certifying that promoters contribution has been duly received with promoter-wise details of names/addresses/amount, **(v)** due diligence certificate in **Form D of Appendix 11-E on the website** certifying that the necessary corrective measures has been taken and **(vi)** due diligence certificate in **Form E of Appendix 11-E on the website** after issue opening but before closure of subscription. The issuer should submit the PAN/bank account/passport number of its promoters to the concerned RSE at the time of filing the offer document.

Draft Offer Document Made Public The offer document should be hosted on the website of the SEBI/concerned RSEs/associated merchant banker(s) for public comments for at least 21 days from the date of its filing. The lead merchant banker should file with the SEBI a statement containing information of public comments and the consequential changes to be made in the offer document. The issuer should on the date of filing the offer document with the SEBI or the next day make a public announcement in one English/Hindi national daily with wide circulation and one regional language paper with wide circulation at the place of its registered office inviting the public to give their comments to the SEBI in respect of these disclosures.

Fast Track Issues The above requirements relating to **(i)** filing of offer documents, **(ii)** in-principle approval from the RSEs and **(iii)** documents to be submitted before issue opening would not apply (in a fast track issue) to a public/rights issue if the issuer satisfies the following conditions:

- Its shares have been listed on a RSE having nation-wide trading terminal for at least three years immediately preceding the **reference date** [(i.e. the date of registering a red herring prospectus (in case of a book-built issue) or prospectus (in case of fixed price issue) with the ROCs for a public issue and in case of a rights issue, the date of filing of the letter of offer with the DSE)];

Reference date is the date of registering a red herring prospectus (in case of a book-built issue) or prospectus (in case of fixed price issue) with the ROCs for a public issue and in case of a rights issue, the date of filing of the letter of offer with the DSE.

- The **average market capitalisation** (i.e. the sum of the daily market capitalisation for one year upto the end of the quarter preceding the month in which the proposed issue was approved by its shareholders/ Board of Directors, divided by the number of trading days) of its public shareholding (as per the listing agreement) is at least ₹3,000 crore;
- The annualised turnover of its shares during six calendar months immediately preceding the month of the reference date has been at least 2 per cent of the weighted average number of shares listed during the last six months available as free float in case of issuers whose public shareholding is less than 15 per cent of its issued capital;
- It has **(i)** redressed at least 95 per cent of the investors grievances till the end of the quarter and **(ii)** complied with the equity listing agreement for at least three years, immediately preceding in reference date. However, in case of non-compliance relating to the composition of the Board of Directors, a compliance at the time of filing of offer document with the ROCs/DSE and adequate disclosures in the offer document about such non-compliance would be deemed as compliance with this condition;
- The imposition of only monetary penalty fines by the more exchanges on the issues would not be a ground for ineligibility for undertaking issuances;
- The impact of the auditors' qualification on the its audited accounts for the years for which they are disclosed in the offer document does not exceed 5 per cent of its net profit/loss after tax for the respective years;
- No show-cause notice(s) have been issued/prosecution proceedings initiated by the SEBI or pending against the issuer/its promoters/whole time directors as on reference date;
- The issuer/promoter/promoter group/director of the issuer has not settled any alleged violation of securities law through consent/settlement mechanism with the SEBI during 3 years immediately preceding the reference date;
- The entire shareholding of the promoter groups of the issuer is held in demat form as on the reference date.
- In case of rights issues, promoters/promoter group should mandatorily subscribe to their rights entitlements except to the extent of renunciation within the group for complying with minimum public shareholding norms prescribed by the Rule 19-A of the Securities Contracts (Regulation) Rules;
- The equity shares of the issuer have not been suspended from trading as a disciplinary measure during last 3 years immediately preceding the reference date;
- The annualised delivery-based trading turnover of the equity shares during the 6 months immediately preceding the month of reference date has been at least 10 per cent of the weighted average number of equity shares listed during the 6-month period; and
- There should be no conflict of interest between the lead merchant banker(s) and the issuer/group/associate company in accordance with the applicable regulations.

The concerned issuer should before the opening of the issue file with the SEBI a copy of the red herring prospectus/prospectus filed with the ROCs or letter of offer filed with the DSE. The lead merchant banker should also file a copy of the offer document with the RSE where the securities are proposed to be listed. The payable fee in such issues would be the same as **discussed earlier** (in respect of a normal issue).

The lead merchant banker should also submit to the SEBI the following documents along with the offer document, namely, **(i)** a due diligence certificate in **Form F of Appendix 11-E on the website, (ii)** in case of fast track issue of CDIs, due diligence certificate from the debenture trustees in **Form B of Appendix 11-E on the website.**

Opening of Issue Subject to compliance with Section 60(4) of the Companies Act, a public/rights issue may be opened within **(a)** 12 months from the date of issuance of the SEBI's observation on the offer document, **(b)** 3 months of the expiry of 30 days in case the SEBI has not issued any observation. While in case of a fast track issue, the issue should open within the period specified in Section 60(4) of the Companies Act, the first issue in case of shelf prospectus may be opened within three months of the issuance of the SEBI's observations. Before registering the red herring prospectus/prospectus with the ROCs or filing the letter of offer with the DSE, the issuer should file with the SEBI through the lead merchant banker(s) an updated offer document highlighting all the changes made in relation to matters specified in **Form F of Appendix 11-E on the website.** The updated/new offer document should be filed with the SEBI along with a fee of ₹10,000 for updation/changes per section subject to total fee not exceeding the higher of one-fourth of the filing fee at the time of filing the draft document with the SEBI or ₹50,000. An issue should be opened after at least three working days from the date of registering the red herring prospectus with the ROCs.

Despatch of Issue Material The lead merchant banker(s) should despatch the offer document and other issue material including forms for **ASBA** to the DSE/**syndicate members** (i.e. a SEBI-registered intermediary who is permitted to carry on activity as an underwriter)/ /registrar to issue and share transfer agents/depository participants/stockbrokers/underwriters/ bankers to the issue/investors' associations and **SCSBs** in advance.

Underwriting While a non-book-built public issue or rights issue can be underwritten by SEBI-registered underwriters, a public issue through the book building process should be underwritten by book runners/syndicate members. However, 75 per cent of the **net offer to the public** (i.e. offer of securities to the public excluding reservations) proposed to be compulsorily allowed to qualified institutional buyers (**QIBs**) for the purpose of compliance of the eligibility conditions relating to IPO through book building and pricing on public issues (**discussed in the next Section),** cannot be underwritten. In case the public issue is made with at least 10 per cent public offer under **Rule 19(b)(2) of the Securities Contracts (Regulation) Rule (discussed later in another Section)**, the applicable bar would be 60 per cent. A **QIB** means a SEBI-registered **(i)** mutual fund/venture capital fund alternative investment fund/foreign venture capital investor, **(ii)** SEBI-registered FII and sub-account (other than a sub-account which is a foreign corporate/individual, **(iii)** Public financial institutions (PFI), **(iv)** bank, **(v)** Multilateral/bilateral financial institutions, **(vi)** State industrial development

> **QIB**
> means a SEBI-registered mutual fund/venture capital fund, foreign venture capital invector/FII and sub-account other than a foreign corporate/individual, PFI, bank, multilateral/bilateral FIs, SIDCs, insurance companies, provident/pension fund and national investment fund.

corporation, **(vii)** IRDA-registered insurance company, **(viii)** Provident/Pension fund with a minimum corpus of ₹25 crore, **(ix)** National investment fund, and Insurance funds set up/ managed by army/navy/air force and Department of Posts of India.

The issuer should enter into an agreement with the book runner who should in turn enter into an underwriting agreement with syndicate members containing the number of securities to be subscribed by them at the predetermined price in case of under-subscription in the issue. On failure of the syndicate members, the lead book runner would fulfil the underwriting obligation. The book runners/syndicate members cannot subscribe to the issue in any other manner. The lead merchant banker/book runner must undertake a minimum underwriting obligation of the lower of 5 per cent of the total underwriting commitment or ₹25 lakh. In case of 100 per cent underwriting of an issue, the underwriting obligation would be for the entire issue and not restricted upto the minimum subscription level.

Minimum Subscription The minimum subscription in an issue should be at least 90 per cent of the offer. In the case of an IPO, however, the minimum subscription to be received would be subject to the allotment of at least 25 per cent of each class of security. In case of its non-receipt, all the application moneys received should be refunded within **(i)** 15 days and **(ii)** 7 days respectively of the closure of a non-underwritten and an underwritten issue where the minimum subscription including devolvement obligations paid by the underwriters is not received within 60 days of the closure of the issue. The offer document should contain the disclosures regarding minimum subscription as specified in **Part A of Appendix 11-G on the website.**

The above requirement are, however, not applicable to **(i)** offer for sale of securities and **(ii)** public issue by **infrastructure** companies (i.e. an enterprise wholly engaged in the business of **(a)** developing, **(b)** operating and maintaining, **(c)** developing/operating/maintaining any infrastructure facility) if disclosures regarding alternative sources of funding of the objects of the issue have been made in the offer document.

Oversubscription Allotment in excess of the specified securities offered through the offer document is prohibited. However, in case of oversubscription, upto 10 per cent of the net offer to the public may be allotted for making allotment in minimum lots.

Monitoring Agency For a issue size exceeding ₹500 crore, arrangement should be made by the issuers, excepting public financial institutions (PFIs), banks, and insurance companies for monitoring the use of the issue proceeds by a PFI or a bank named in the offer document as banker to the issue. The monitoring agency would have to submit its report to the issuer in the format specified in **Appendix 11-H on the website** on a half-yearly basis till the full utilisation of the issue proceeds.

Calls on Shares Except in cases where a monitoring agency is appointed, the outstanding subscription should be called within 12 months from the date of allotment in the issue. The equity shares, on which there are calls in arrear along with the subscription/application money, should be forfeited.

Allotment/Refund/Payment of Interest The issuer/merchant banker should ensure that the securities are allotted and/or application moneys refunded within 15 days of the failure of the issue failing which the issuer would undertake to pay interest at the rate and within the time disclosed in the offer document.

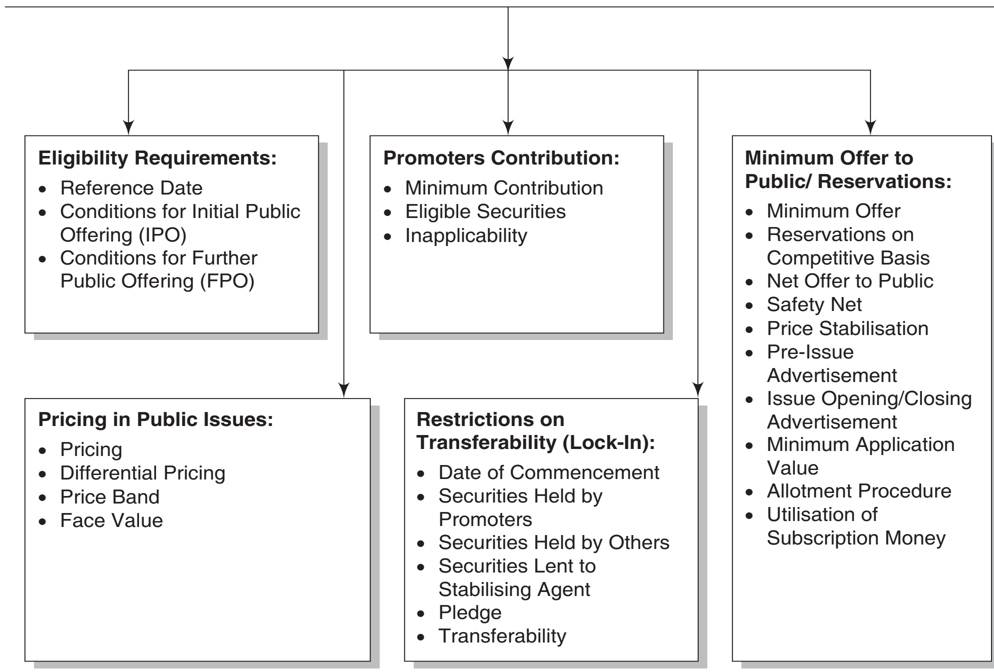
Restrictions on Further Capital Issue Unless full disclosures regarding the total number of securities and the amount proposed to be raised from further issues are made in the offer/draft offer document, issuers are prohibited from making any further issues in any manner whether by way of rights/public/preferential issues or qualified institutional placement or otherwise during the period between the **(a)** date of red herring prospectus/prospectus with the ROCs or filing the letter of offer with the DSE and the listing of the securities/refund of application money in fast track issues; and **(b)** date of filing the draft offer document with the SEBI and the listing of the securities/refund of application moneys in other issues.

Additional Requirements for Issue of Convertible Debt Instruments (CDIs) In addition to the other requirements, an issuer making a public/rights issues of CDIs should comply with the following conditions: **(i)** Obtain credit rating(s); **(ii)** Appoint debenture trustee(s); **(iii)** Crate debenture redemption reserve (DRR); **(iv)** Ensure that assets on which charge/security is proposed to be created are **(a)** sufficient to discharge the principal amount at all times and **(b)** free from encumbrances. Moreover, the consent of financial institutions/banks and lessors for a second/*pari passu* charge should be obtained and submitted to the debenture trustees before the opening of the issue where security is already created on such assets/issue of CDIs is proposed to be secured by creation of security on a leasehold land respectively. The security/asset cover should be arrived at after deduction of the liabilities having a first charge in case the CDIs are secured by a second/subsequent charge. They should be redeemed in terms of the offer document.

Rollover of Non-Convertible Portion of Partly CDIs The non-convertible portion of partly CDIs by a listed issuer amounting to more than ₹50 lakh may be rolled over without change in the rate of interest subject to compliance, in addition to the provisions of Section 121 of the Companies Act, with the following conditions: **(i)** 75 per cent of the holders have approved it through postal ballot, **(ii)** an auditors' certificate on the cash flow of the issuer and with comments on its liquidity position has been sent, along with the notice for passing the resolution, to all holders, **(iii)** the issuer has undertaken to redeem the CDIs of all holders who have not agreed to the resolution and **(iv)** credit rating from at least one SEBI-registered rating agency has been obtained and communicated to them before the rollover. If the existing trust deed/security document(s) provide for the continuance of the security till redemption, the creation of fresh security/execution of fresh trust deed would not be mandatory.

Conversion of Optionally CDIs Positive consent of the holders would be necessary for conversion of such CDIs into equity shares and non-receipt of reply to any notice by the issuer for this purpose would not be construed as consent for conversion. The holders of CDIs, where the value of the convertible portion of CDIs by a listed company exceeds ₹50 lakh and the conversion price has not been determined, should have the option not to convert them into shares. Such an option may not be given in case the upper limit on their price together with the justification was determined/disclosed to the investors at the time of the issue. If some holders who have been given the option do not exercise it, the issuer should redeem the concerned instruments within one month from the last date for exercise of option at a price not below its face value. This condition would not be applicable if redemption is in terms of the disclosures in the offer document.

Exhibit 11.3 Provision as to Public Issues



Issue of CDIs for Financing Issue of CDIs for **(i)** financing replenishment of funds, **(ii)** providing loan to or for acquiring shares of any person in the same group [in terms of Section 2(ef) or 2(g) of the Monopolies and Restrictive Trade Practice Act] or under the same management [in terms of Section 370 (1-B) of the Companies Act] are prohibited. However, fully CDIs may be issued for these purposes with a conversion period of less than 18 months from the date of their issue.

Alteration of Rights of Holders of Specified Securities The terms (including the terms of issue) of specified securities which may adversely affect the interests of the investors can be altered subject to the following conditions: with the **(i)** consent in writing of at least 75 per cent or **(ii)** sanction of a special resolution of the holders.

Provisions as to Public Issues

The provisions relating to public issues discussed below are **portrayed in Exhibit 11.3.**

Eligibility Requirements Eligibility conditions should be satisfied by an issuer on the date of **(i)** filing draft offer document with the SEBI and **(ii)** registering the offer document with the ROCs. The relate to IPOs and FPOs.

Conditions for IPO An IPO can be made by an issuer who satisfies the following conditions:

1(a) **Net tangible assets** (i.e. all net assets excluding intangible assets as defined in **AS-26 issued by the ICAI**) of at least ₹3 crore in each of the preceding three full years, not more than 50 per cent of which should be monetary assets in its business/**project** [i.e. the object for which money(ies) are proposed to be raised to cover the objects of the issue]. If the monetary assets exceed 50 per cent, the issuer should make firm commitment to utilise the excess in its business/project. The limit of 50 per cent however, would not apply in case the public offer is made entirely through an offer for sale.

1(b) Minimum average pre-tax profit of ₹15 crore calculated on a restated and consolidated basis during the three most profitable years out of the immediately preceding five years.

1(c) A **net worth** [i.e. the aggregate of paid up share capital, share premium account, and reserves/surplus (excluding revaluation reserve) reduced by the total miscellaneous expenditure to the extent not adjusted/written off and the debit balance of profit and loss account] of at least rupees one crore in each of the preceding three years (of 12 months each);

1(d) The aggregate of the proposed issue and all previous issues in the same financial year in terms of **issue size** (i.e. offer through offer document and promoters' contribution) does not exceed 5 times its pre-issue net worth as per the audited balance sheet of the last financial year;

> **Issue size**
> means offer through offer document and promoters' contribution.

1(e) In case of change of name within the last one year, at least 50 per cent of the revenue for the preceding one full year has been earned by the issuer from the activity indicated by the new name.

2. If an issuer does not satisfy any of the five conditions specified above, it can make IPO if the issue is made through book building process and the issuer undertakes to allot at least 75 per cent of the net offer to the public to QIBs and refund full subscription money(ies) if it is unable to make allotment to them.

3. An IPO of CDIs can be made without making a prior public issue/listing of the issuers' equity shares.

4. Allotments in public issues are not permitted in case the number of prospective allottees is less than 1,000.

5. An IPO cannot be made if there are outstanding convertible securities/other rights entitling any person the option to receive equity shares. However, this restriction would not be applicable to **(i)** a public issue made during the currency of CDIs issued through an earlier IPO if their conversion price was determined/disclosed in the relevant prospectus, **(ii)** outstanding options granted to employees pursuant to an employee stock option scheme framed in accordance with the Guidance Notes/Accounting Standards issued by the ICAI (Institute of Chartered Accountants of India), and **(iii)** fully paid-up outstanding securities convertible on/before the data of filing the red herring prospectus/prospectus.

6. Subject to the provisions of the Companies Act/SEBI's ICDR Regulations, equity shares may be offered for sale if held by the sellers for at least one year prior to the filing of the draft offer document with the SEBI. For computing the one-year period, the holding period of the convertible securities as well as that of the resultant equity shares together would be considered in case the shares being offered have been received on conversion/exchange of fully paid-up CDIs including depository receipts. The one-year requirement would not be applicable **(i)** in case of securities of a Government company/ statutory authority (corporation)/any SPV set up by them engaged in infrastructure sector, **(ii)** if acquired pursuant to a scheme approved by a High Court under Sections 391-394 of the Companies Act in lieu of business/invested capital which has been in existence for more than one year prior to such approval, and **(iii)** if issued under a bonus issue on securities held for at least one year prior to the filing of the offer document with the SEBI subject to the condition that they are being issued out of free resources and share premium and not by utilisation of revaluation reserve/unrealised profits of the issuer. The term **infrastructure** includes the facilities/services specified in **Appendix 11-H on the website.**

7. Every issuer may obtain grading for the IPO from at least one SEBI-registered credit rating agency as on the date of registering prospectus/red herring prospectus with the ROCs.

Conditions for Further Public Offer (FPO) A FPO can be made if the issuer satisfies the following two conditions: **(i)** the aggregate of the proposed issue and all other issues in the same financial year in terms of issue size does not exceed 5 times its pre-issue networth and **(ii)** in case of change of its name within the last one year, not less than 50 per cent of its revenue for the preceding full year has been earned from the activity indicated by the new name. If the issuer does not satisfy these conditions, it may make a FPO in terms of the stipulations listed below:

(a) **(i)** The issue is made through book building process and at least 50 per cent of the net offer to the public would be allotted to QIBs or **(ii)** At least 15 per cent of the cost of the project is contributed by banks/PFIs of which a minimum 10 per cent would come from the appraisers and at least 10 per cent of the net offer to the public would be allotted to QIBs. The full subscription money would have to be refunded on failing to make the specified allotments to the QIBs.

(b) **(i)** The minimum post-issue face value capital of the issuer is ₹10 crores or **(ii)** The issuer undertakes to provide market making for at least two-years from the date of listing of the specified securities subject to the conditions that **(1)** the buy and sell quotes are for a minimum depth of 300 securities and the bid-ask spread never exceeds 10 per cent, **(2)** the inventory of the market make as on the date of allotment of securities would be at least 5 per cent of the proposed issue.

Pricing in Public Issues The elements are pricing, differential pricing, price and price band, and the face value of equity shares.

Pricing An issuer may determine the **(i)** price of specified securities and **(ii)** coupon rate/conversion price of CDIs in consultation with the merchant banker or through the book building process. The manner of book building process is specified in **Appendix 11-J on the website.** There are two alternative methods for pricing for book-built issues. The compliance requirements in the two methods for book-built issues are listed below:

(A) Method I:

- The issuer should appoint merchant banker(s) as book runner(s) and the lead merchant banker should act as the lead book runner and be primarily responsible for the book building. There should be one lead book runner and other merchant bankers would be co-book runners/syndicate members. Their rights/obligations/responsibilities should be delineated in the *inter se* allocation of responsibility specified in **Appendix 11-A on the website**.
- The issue should be compulsorily underwritten/sub-underwritten respectively by the book/co-book runners and syndicate members. They should furnish details forthwith to the SEBI about their underwriting/sub-underwriting agreement and the details indicating actual number of shares should be disclosed/printed in the prospectus before registering with the ROCs. The fact that the book-runner(s) would have to make good the shortfall in case of undersubscription should be incorporated in the *interse* allocation of responsibility.

- The issuer should enter into an agreement with a stock exchange(s) having on-line system of offer of securities specifying, *inter-alia*, their *interse* rights/duties/responsibilities/obligations as well as a dispute resolution mechanism.
- The book runner(s)/syndicate members should appoint SEBI-registered stock brokers financially capable of honouring their commitments on defaults of clients/investors to accept bid/applications and place orders with the issuer. In case of **ASBA**, the **SCSBs** would also accept/upload the application details in electronic bidding system of the stock exchange(s). These brokers/SCSBs would be deemed as **bidding/collection centres**. The book runners/syndicate members/brokers/SCSBs would be paid by the issuer a commission/fee for their services and brokers cannot levy a service charge on the clients/investors.
- If the issue size is specified, the red-herring prospectus may not contain the price/number of securities. The draft red-herring prospectus containing all the disclosures (including total issue size) specified in **Appendix 11-G on the website** should be filed with the SEBI by the lead merchant banker except in case of a fast track issue.
- The issuer may mention the floor price/price band in the red-herring prospectus. However, in case of its non-disclosure the red-herring prospectus should contain **(i)** a statement that it would be disclosed at least one and two working days before the bid opening in an IPO and FPO respectively and the invertors may be guided in the mean-time by the secondary market prices (in FPO), and **(ii)** names of website/journals/other media/edition of the newspaper in which the announcement would be made.

  In case the issuer opts for price band and not floor price, the compliance requirement would be: **(i)** the cap of the price band would not be more than 120 per cent of the floor of the price band, **(ii)** in case of revision of the price band during the bidding period, the floor of the price band can move up/down upto 20 per cent of floor of the price band disclosed in the prospectus and the cap of the revised band will be fixed according to **(i)** above. The revision should be widely disseminated and the bidding period would be extended by three working days. The manner in which the shortfall in project financing on account of lowering of the price band by 20 per cent would be met, should be disclosed in the prospectus and allotment should not made unless the financing is tied up.
- The minimum application value of anchor investor should be ₹10 crore in a public issue. Allocation to them would be on a discretionary basis, subject to a minimum number of two and five for allocation upto ₹250 crore and more than ₹250 crore respectively. Upto 30 per cent of the portion available to QIBs can be allocated/allotted to them (i.e. anchor investor portion), one-third of which should be reserved for mutual funds. The bidding for them should open one day before the issue opening date and they should pay at least 25 per cent margin on application and the balance within two days of the closure of the issue. The allocation to the anchor investors should be completed on the day of bidding by them. They would pay the additional amount if the price for book building is higher than the one at which the allocation was made to them. Any excess payment resulting from the difference between the fixed price and the allotment price would not be refundable. The number/price of shares allocated to them should be made available in public domain by the merchant banker before issue opening. The shares allotted to them would have a 30-day lock-in. The merchant banker or any person related to the promoter/promoter group/merchant banker is not eligible to apply under the anchor investor category. The applications by the QIBs under the anchor and non-anchor categories would not be considered multiple applications.

- The margin money from non-QIB category should be uniform for each category of investors. The QIBs and anchor investors would have to pay at least 10 and 25 per cent margin money on their respective bids. The entire application money may be collected as margin money before placing of order on their behalf. Bids beyond the investment limit under any law should not be accepted by the syndicated members/brokers from any category of clients/investors. The brokers would have to pay in case clients/investors fail to pay for securities on which they had collected the margin money. The **SCSBs** should follow the procedure specified by the SEBI in regard to **ASBA**.
- The bidding process should be through an electronically-linked transparent bidding facility provided by the recognised stock exchange (RSE). While the lead book-runner should ensure the availability of adequate infrastructure with the syndicate members for data entry of the bids in a timely manner, the syndicated members should be present at the bidding centres to ensure the availability of atleast one electronically-linked computer terminal at all the centres. The public-applicants may approach the concerned brokers/SCSBs for placing an order for bidding. Whereas the brokers would accept orders for all clients/investors, the **SCSB** would accept applications only from **ASBA** investors. The QIBs can place bids only through the brokers who have the right to vet the bids. The bidding terminals would contain an online graphical display of demand and bid prices updated at periodic intervals upto 30 minutes. At the end of each day, the demand including allocations to the anchor investors should be shown graphically on the terminals of syndicate members/websites of the RSEs for information of public. All non-ASBA investors can revise their bids. The QIBs cannot withdraw their bids after the closure of bidding and their identity should not be disclosed. The RSEs should continue to display on their website the data pertaining to the issue in the specified format giving, *inter alia*, category-wise details of received bids for at least three days after the closure of bids.
- The issuer in consultation with the lead book runner should determine the issue price on the basis of the bids received and the number of securities to be offered (i.e issue size × price). All the successful bidders whose bids are above the final/cut-off price would be entitled for allotment. The retail individual investors may bid at the cut-off price. A bid by a QIB may be rejected by the lead book-runner for reasons recorded in writing at the time of its acceptance and disclosed to him. Necessary disclosures in this regard should also be made in the red-herring prospectus.
- The final prospectus containing all the specified provision including the price and the number of securities proposed to be issued should be registered with the ROCs.
- Allotment to retail individual investors, non-institutional investors and QIBs other than anchor investors should be made proportionately as illustrated below. The unsubscribed portion in any category should be allocated to the bidders as per the disclosures in the red-herring prospectus. However, undersubscription in the QIB category would not be available to any other category in case the book building process is undertaken for compliance of eligibility conditions for public issues.

Proportionate Allotment to QIBs other than Anchor Investors The proportionate allotment is shown below:

1. Issue details: (i) Issue size, 200 crore shares, **(ii)** Portion available to QIBs (50 per cent), 100 crore shares, **(iii)** Anchors investor portion, 30 crore shares, **(iv)** Portion available to non-anchor investor QIBs (100 – 30), 70 crore shares of which reserved to mutual funds (5 per cent), 3.5 crore shares; balance available for all QIBs, including mutual funds, 66.5 crore shares, **(v)** Number of QIBs, 10, **(vi)** Number of shares applied for, 500 crore shares.

2. Details of QIB Bids: (A) Non-mutual fund QIBs (A), **300** crore shares [A1, 50; A2, 20; A3, 130; A4, 50; and A5, 50], (B) Mutual fund–QIBs (MF), **200** crore shares [MF_1, 40; MF_2, 40; MF_3, 80; MF_4, 20; and MF_5, 20] = 500 crore shares.

3. Details of Proportionate Allotment of Shares to QIB Bidders/Applicants (in crores)

Type of QIB Bidder	*Shares Bid For*	*Allocation of Shares to Mutual Funds (3.5)@*	*Allocation of Shares to QIBs (66.5)@@*	*Aggregate Allocation to Mutual Funds*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
A1	50	0	6.65	0
A2	20	0	2.66	0
A3	130	0	17.29	0
A4	50	0	6.65	0
A5	50	0	6.65	0
	(A) 300	0	39.90	0
MF1	40	0.70	5.32	6.02
MF2	40	0.70	5.32	6.02
MF3	80	1.40	10.64	12.04
MF4	20	0.35	2.66	3.01
MF5	20	0.35	2.66	3.01
	(MF) 200	3.50	26.60	30.10
(A + MF)	500	3.50	66.50	30.10

@5 per cent of 70 crore shares would be allocated on proportionate basic among five mutual funds applying for 200 crore shares in the QIB category. The balance [66.5 (70 – 3.5) crore shares will be allocated on proportionate basis among 10 QIBs who have applied for 500 crore shares] including 5 mutual funds who have applied for 200 crore shares.

@@For non-mutual fund QIBs = Number of shares bid for (column 2) multiplied by (66.5 × 496.5, that is, 500 – 3.5).

For mutual funds = [Numbers of shares bid for (column 2) less shares allotted (column 3)] multiplied by (66.5 × 496.5).

(B) Alternative Method II:

In case of further public offer (FPO), an issuer may opt for an alternative method of book building in terms of the procedure outlined above excepting the requirements relating to **(i)** determination of prices and **(ii)** allocation/allotment to non-anchor investors on proportionate basis.

A floor price should be disclosed in the red-herring prospectus and the non-retail individual investors (RIIs) should bid above the floor price. The allotment would be in descending order of bids beginning with the highest price till the securities on offer are exhausted. Allotment to the non-RIIs should be on price priority basis and on proportionate basis to the RIIs. However, it should be on proportionate basis where the bid at a price exceeds the available quantity of securities. The allotment to the RIIs should be at the floor price. The issuer may place a cap **(i)** in terms of number of securities, **(ii)** percentage of its issued capital that may be allotted to a single bidder.

Differential Pricing The specified securities may be offered at different prices to different investors. In the first place, offer of securities to **retail individual investors** (i.e. an investor who applies/bids for securities upto rupees two lakh) and retail individual shareholders or employees entitled to reservation for securities for value not exceeding ₹2,00,000, may be made at a price 10 per cent lower compared to other categories of investors. A **retail individual shareholder** means a shareholder of a listed issuer who applies/bids for securities upto rupees two lakh. Secondly, the price of securities offered in the public issue component of a **composite** issue (i.e. an issue by a listed issuer on public-cum-rights basis in which allotments would be made simultaneously) may be different from the price in the rights issue but justification for the price differential should be given in the offer document. In case of the alternative method of book building, specified securities may be offered to the employees of the issuer at a price upto 10 per cent lower than the floor price.

Retail individual investor is an investor who applies/bids for securities upto rupees one lakh.

Retail individual shareholder is a shareholder of a listed issuer who **(i)** holds equity shares and **(ii)** applies/bids for securities upto rupees one lakh.

Composite issue is an issue by a listed issuers on public cum-rights basis in which allotments would be made simultaneously.

Price/Price Band An issuer may mention a price/price band in the draft prospectus and floor price/price band in the red herring prospectus and determine the price at a later stage before registering the prospectus (containing only one price/specific coupon rate on CDIs) with the ROCs. The floor price/price band may be announced by the issuer in all newspapers in which the pre-issue advertisement was released at least five (in case of IPO) and one (in case of FPO) working days before the opening of the bid. The announcement should contain relevant financial ratios computed for both upper and lower end of the price band together with a statement drawing attention of the investors to the **Section titled "Basis of Issue Price** in the prospectus. The announcement should be disclosed on the website of the concerned stock exchange(s) and pre-filled in the application form available on their website. The cap on the price band/coupon rate can be upto a maximum of 120 per cent of the floor price and the floor/final price should not be less than the face value of the securities.

Face Value of Equity Shares Subject to the provisions of the Companies/SEBI Act/regulations, an issuer (other than a Government company/statutory authority/corporation/any SPV set by them engaged in infrastructure sector) making an IPO may determine the face value of the shares in the following manner: **(i)** Issue price per share is ₹500 and more, below ₹10 but not below ₹1; **(ii)** Issue price per share is below ₹500, ₹10 per share. The disclosures about the face value of shares (including a statement about the issue price being **X times** of the face value) should be made in the advertisements/offer documents/application forms in font size identical to the issue price/price band.

Promoters Contribution The main elements are **(i)** minimum promoters contribution, **(ii)** securities ineligible for minimum promoters contribution and **(iii)** inapplicability of the requirement.

Minimum Contribution The promoters of the issuer should contribute in a public issue **(i)** at least 20 per cent of the post-issue capital in case of an IPO, **(ii)** 20 per cent of the proposed issue size/post-issue capital in case of FPO and **(iii)** 20 per cent of the proposed issue size/post-issue capital excluding the rights issue component in a composite issue. In case the post-issue shareholding of the promoters in IPO is below 20 per cent, alternative investment funds may contribute upto 10 per cent of the post-issue capital for meeting the shortfall.

The specified contribution in a public/composite issue of convertible securities should be by way of equity shares/subscription to convertible securities. If, however, the price of shares allotted on conversion is not determined/disclosed in the offer document, the contribution should be by way of subscription to the convertible securities with an undertaking in writing to subscribe to the shares on their conversion. The contribution by way of equity shares should be at the weighted average price of the shares arising out of their conversion in case of securities convertible/exchangeable on different dates of conversion price is predetermined. For computing the weighted average price, **weights** would be the number of shares arising out of conversion at various stages and **price** would be the price on conversion after taking into predetermined conversion price at various stages.

In case of an IPO of CDIs without a prior public issue of equity shares, the promoters contribution would be 20 per cent of the project cost in the form of shares and at least 20 per cent of the issue size should come from their own funds. If the project is to be implemented in stages, the contribution would be for the total equity participation till the respective stages *vis-à-vis* the debt raised/proposed to be raised through public issue.

The allotment with respect to contribution of promoters in excess of the minimum requirement should be made at the higher of the price determined in terms of the provisions relating to pricing of shares in preferential issues (**discussed later**) and the issue price.

The contribution should be brought in at least one day before the issue opening date and kept in an escrow account with a bank and released to the issuer along with the issue proceeds. If the contribution is more than ₹100 crore, at least ₹100 crore must be brought in before the issue opening date and the balance on *pro-rata* basis before calls are made to public. Where the contribution has already been brought in and utilised, the cash flow statement disclosing their use should be given in the offer document.

The contribution should be computed on the basis of the post-issue expanded capital assuming **(a)** full proposed conversion of convertible securities into shares and **(b)** exercise of all vested options where any employee stock options are outstanding at the time of the IPO in terms of conditions for initial offer (**discussed later**).

Securities Ineligible for Minimum Promoters Contribution The securities specified below acquired by/allotted to promoters would not be eligible for computing their contribution:

- Acquired during the preceding three years **(i)** for consideration other than cash and revaluation of assets/capitalisation of intangible assets is involved in the transactions, **(ii)** resulting from a bonus issue by utilisation of revaluation reserves/unrealised profits or from bonus issue against equity shares ineligible for minimum contribution. However, these would be eligible if acquired pursuant to a scheme approved under Sections 391-94 of the Companies Act.
- Acquired by the promoters/alternative investment funds during the preceding one year at a price lower than the price at which being offered to the public in the IPO. However, shares acquired would be eligible if **(i)** the difference between the two prices is paid by the promoters/alternative investment fund, **(ii)** acquired in terms of a scheme under Sections 391-94 of the Companies Act as approved by a High Court in lieu of business/invested capital in existence for more than one year prior to the approval and **(iii)** an IPO by a

Government company/statutory authority/corporation/any SPV set up by them engaged in infrastructure sector.

- Allotted to promoters during the preceding one year at prices less than the issue price against funds brought in during that period in case of an issuer formed by conversion of a partnership firm(s) where the partners are the promoters of the issuer and there is no change in management. However, specified securities allotted to promoters against capital existing in such firms for more than one year on a continuous basis would be eligible. Such securities would also be eligible if acquired pursuant to a scheme approved under Sections 391-94 of the Companies Act.
- Specified securities pledged with any creditor.

Inapplicability of Requirement The requirement of minimum promoters contribution would not apply in the following cases: **(a)** an issuer does not have any identifiable promoter; **(b)** a FPO where the shares are not infrequently traded for at least three years and the issuer has a track record of dividend payment for at least immediately preceding three years. Where, however, promoters propose to subscribe to the securities offered to the extent greater than the two options, namely, 20 per cent of **(i)** issue size and **(ii)** post-issue capital, the excess should be made at a price determined in terms of the provisions relating to preferential issues (**discussed later**) or the issue price whether is higher; **(c)** rights issue.

Restrictions on Transferability (Lock-in) of Promoters Contribution These relate to **(i)** date of commencement of lock-in, **(ii)** lock-in of securities held by promoters/others, **(iii)** lock-in of securities lent to stabilising agent under green shoe option, **(iv)** pledge of lock-in securities and **(v)** transferability of lock-in securities.

Date of Commencement of Lock-in and Inscription of Non-transferability Specified securities held by promoters/others are not transferable (*i.e.* lock-in) from the date of their allotment in a public issue for the period(s) specified below. The securities certificate should contain the inscription: **Non-transferable** and the lock-in for **demat securities** should be recorded by the depository. If the securities subject to lock-in are partly paid-up and the amount called up on them is less than the amount called up from the public, the lock-in would be three years after they have become *pari passu* with those issued to the public.

Securities Held by Promoters The lock-in of securities held by promoters in a public issue would be: **(i)** minimum contribution including by alternative investment fund, 3 years from the date of **(a) commencement of commercial production** (*i.e.* the last date of the month in which commercial production is expected to commence as stated in the offer document), **(b)** allotment in public issue whichever is earlier, **(ii)** excess contribution, one year. However, excess contribution in a FPO where the shares of the same class which are proposed to be allotted pursuant to conversion/exchange of convertible securities offered/proposed to be allotted in the offer have been listed and are not infrequently traded for at least three years and the issuer has a track record of dividend payment for at least immediately preceding three years would not be subject to lock-in.

Securities Held by Others In case of an IPO, the entire pre-issue capital held by them would be locked-in for one year. The lock-in would, however, not be applicable to equity shares **(a)** allotted to **employees** (*i.e.* permanent/full-time employees, working in India or abroad, of the **(i)** issuer or **(ii)** holding/subsidiary or **(iii)** material associate(s) of the issuer whose financial statements are consolidated as per the Accounting Standard-21 or **(iv)** whole-time or part-time director of the issuer but does not include promoters/an immediate relative of the promoter, that is, any spouse/parent/brother/sister/ child) under an employee stock option/ purchase scheme prior to the IPO if full disclosures with respect to such options/schemes are made as specified in **Part A of Appendix 11-G on the website**, **(b)** held by a VCF category I alternative investment fund/FVCI for at least one year from the date of purchase by them. In case the shares held by the VCF/FVCI have resulted from conversion of fully paid-up compulsorily convertible securities, their holding period together would be considered for computing the one-year period and the convertible securities would be deemed to be fully paid-up if the entire consideration has been paid.

Securities Lent to Stabilising Agent Under Green Shoe Option The securities lent to **stabilising agent** (*i.e.* a merchant banker resopnsibile for stabilising the price of shares under a green shoe option) under **green shoe option** (*i.e.* an option of allotting shares in excess of those offered in the public issue as a post-listing price stabilising mechanism) would not be subject to lock-in during the period starting from the date of lending and ending on the date they are returned to the lender. They would, however, be subject to lock-in for the remaining period from the date of their return to the lender.

> **Stabilising agent** is a merchant banker responsible for stabilishing the price of shares.

> **Green shoe option** is an option of allotting shares in excess of those offered in public issue as a post-listing price-stabilising mechanism.

Pledge of Lock-in Securities The lock-in securities may be pledged by the promoters with a bank/public financial institution for loan for financing the object(s) of the issue and pledge of securities is one of the terms of the sanction of the loan.

Transferability of Lock-in Securities Subject to the provisions of the SEBI Substantial Acquisition of Shares and Takeovers Regulations, the promoters can transfer the lock-in securities to another promoter/any person of the promoter group/new promoter/person in control of the issuer. Non-promoter holders of lock-in securities can transfer them to any other person holding the specified securities which are locked-in along with the securities proposed to be transferred. The lock-in on them will continue for the remaining period with the transferee who will not be eligible to transfer them till the stipulated lock-in expires.

Minimum Offer to Public and Reservations etc. The main features relate to **(i)** minimum public offer, **(ii)** reservation on competitive basis, **(iii)** allocation in net offer to public, **(iv)** safety net arrangements, **(v)** price stabilisation through green shoe option, **(vi)** subscription period, **(vii)** pre-issue advertisement for public issue, **(viii)** issue opening/closing advertisement for public issue, **(ix)** minimum application value, **(x)** allotment procedure/basis and **(xi)** utilisation of subscription money.

Minimum Offer to Public The minimum net offer to the public would be subject to the provisions of **Rule 19(2)(b) of the Securities Contracts (Regulation) Rules**, that is, at least **(i)** 25 per cent and 10 per cent of each class of issued shares/convertible debentures if the post-issue capital of the company calculated at offer price is upto ₹1,600 crore and above ₹4,000 crores respectively, **(ii)** such percentage of issued shares/convertible debentures equivalent to ₹400 crore if the port-issued capital calculated at offer price is ₹1,600 crore.

Reservation on Competitive Basis Issuers may make reservations on **competitive basis** (*i.e.* allotment of securities in proportion of the number of securities applied for in a particular reserved category to the number of securities reserved for that category) out of the issue size excluding promoters contribution and net offer to public as specified below:

> **Reservation on competitive basis** is allotment of securities in proportion of the number of securities applied for in a particular reserved category to the number of securities reserved for that category.

(a) In case of issue through the book building process: **(i)** employees in case of a **new issuer** (*i.e.* an issuer who has not completed 12 months of commercial operation and its audited operative results are not available) persons who are in permanent/full-time employment of the promoting companies excluding the promoters/his immediate relatives; and **(ii)** shareholders (other than promoters) of **(1)** listed promoting companies in case of a new issuer and **(2)** listed group companies in case of an existing issuer, upto 5 per cent of the issue size. However, shareholders of promoting companies which are designated financial institutions/state and central financial institutions would not be eligible; and **(iii)** persons who, on the date of filing the draft offer document with the SEBI, are associated with the issuer as depositors/bondholders/subscribers to the services of the issuer, upto 5 per cent of the issue size. But reservations cannot be made to the issue management team/syndicate members/their promoters, directors and employees and their group/associate companies.

> **New issuer** is an issuer who has not completed 12 months of commercial operation and its audited operative results are not available

(b) In case of an issue other than through book building process: To categories **(i)** and **(ii)** above.

(c) In case of FPO (other than a composite issue): To its retail individual shareholders.

The reservation would be subject to the following conditions: **(i)** upto a maximum of 5 per cent of the post-issue capital for employees, and **(ii)** up to 5 per cent and 10 per cent of the issue size to **(a)** shareholders and **(b)** persons who have business association as depositors bondholders/subscribers to services with the issuer respectively.

Further applications for subscription in net offer to public category may be entertained from only employees and retail individual shareholders in favour of whom reservation is made. Any unsubscribed portion in any reserved category may be added to any other reserved category and the unsubscribed portion after such *inter se* adjustment should be added to the net offer to the public category. The value of allotment to any employee should not exceed ₹2,00,000. In case of under-subscription in the net offer to the public, spill-over to the extent of under-subscription would be permitted from the reserved category to the net offer to the public category. A single applicant in the reserved category may apply for a number of specified securities exceeding the reservation.

> **Net offer to public** is an offer of securities to public excluding reservations.

Allocation in Net Offer to Public The allocation in net offer to public should be made as specified below:

- **In an issue through book building process satisfying the conditions for IPO: (a)** retail individual investors, not less than 35 per cent, **(b)** non-institutional investors, not less than 15 per cent, **(c)** QIBs, not more than 50 per cent of which 5 per cent to mutual funds. In addition, they would be eligible for allocation under the balance available for

QIBs; upto 60 per cent of the portion available to QIB to an **anchor investor** (*i.e.* a QIB who makes an application for a value of ₹10 crore or more) in accordance with the conditions specified in **Appendix 11-J on the website**. In an IPO through book building by an issuer who does not satisfy the specified eligibility conditions for IPO, at least 75 per cent should be allocated to QIBs including 5 per cent for mutual funds; upto 10 and 15 per cent to retail individual and non-institutional investors respectively.

> **Anchor investor** is a QIB making an application for a value of ₹10 crore or more.

- **In case of non-book building process: (a)** at least 50 per cent to retail individual investors. They should be allocated the higher percentage, if entitled to more than 50 per cent on proportionate basis; **(b)** remaining to other individual applicants and other investors including corporate bodies/institutions. The unsubscribed portion in either category may be allocated to the applicants in the other category(ies).

Safety-net Arrangement The **safety net arrangement** is an arrangement provided by the issuer under which a person offers to purchase the specified securities from the original resident retail individual allottee at the issue price. Subject to disclosures in **Part A of Appendix 11-G on the website**, an issuer may provide a safety-net arrangement to purchase upto a maximum of 1,000 specified securities per allottee within 6 months from the last date of despatch of security certificate/credit of demat account.

> **Safety-net** is an arrangement by the issuer to purchase securities from the original resident individual allottee at the issue price upto a maximum of 1,000 securities within 6 months

Price Stabilisation Through Green Shoe Option (GSO) An issuer may provide GSO for stabilising the post-listing price of its specified securities, subject to the following:

- The shareholders resolution approving the public issue should authorise the issuer;
- The issuer should appoint a merchant banker/book runner as a stabilising agent **(SA)** responsible for the price stabilisation process;
- Prior to filing the draft offer document with the SEBI, **(i)** the issuer and the SA should enter into an agreement stating all the terms/conditions relating to the GSO including fee charged/expenses to be incurred by the SA for discharging his responsibilities; **(ii)** the **SA** should enter into an agreement with the promoters/pre-issue shareholders or both holding more than 5 per cent of specified securities for borrowing from them. It should specify the maximum number of securities that may be borrowed for allotment/allocation in excess of the issue size (*i.e* **over-allotment**) not exceeding 15 per cent of the issue size. The lead merchant banker/book runner in consultation with the **SA** should determine the amount to be overallotted;
- The draft/final offer document should contain all material disclosures about the **GSO** specified in **Part A of Appendix 11-G on the website**;
- The securities borrowed should be in demat form and their allocation would be *pro-rata* to all successful applicants.

The **SA** should determine the relevant aspects including the timing of buying/selling of securities, quantity and the price at which to be bought from the market. The stabilisation would be available upto 30 days from the date on which trading permission is given by the recognised stock exchange in respect of these securities. The **SA** should open a **(i)** special account distinct from the issue account, with a bank to credit the money received from the applicants against the overallotment and **(ii)** depository participant account to credit the securities to be bought from the market during the stabilisation period out of the money credited in the special bank account. These securities should be returned to the promoters/pre-issue shareholders within a maximum of two working days after the end of the stabilisation period.

If, on the expiry of the stabilisation period, the **SA** has not been able to buy the securities from the market to the extent of over-allotment, the issuer should allot specified securities at the issue price in demat form to the extent of the shortfall to the special account with the depository participant within 5 days of the closure of the stabilisation period. These would be returned to the promoters/pre-issue shareholdes by the **SA** in lieu of those borrowed from them and the depository account would be closed. The issuer should make a listing application in respect of the further allotted securities to all the recognised stock exchanges where those allotted in the public issue are listed. Such allotments would not be subject to the stipulations relating to preferential issues. The **SA** should remit the monies with respect to these securities to the issuer from the special bank account. Any monies left in the special bank account after the remittance to the issuer and deduction of expenses incurred by the **SA** should be transferred to the SEBI's **Investor Protection and Education Fund** and the special bank account closed.

The **SA** should submit a report to the stock exchange on a daily basis during the stabilisation period and a final report to the SEBI in the format specified in **Appendix 11-K on the website**. He should also maintain a register for at least 3 years from the end of the stabilisation period containing **(i)** names of promoters/pre-issue shareholders from whom the securities were borrowed together with the number borrowed from each, **(ii)** price/date/time of each transaction in the course of the stabilisation process and **(iii)** allotment details by the issuer on the expiry of the process.

Period of Subscription A public issue should be kept open for a minimum of 3 and a maximum of 10 working days including the days for which it is kept open in case of revision in price band. The bidding (issue) period disclosed in the red herring prospectus should be extended for at least 3 days in case of revision of price band in a book-built public issue.

Pre-issue Advertisement Subject to the provisions of Section 66 of the Companies Act, the issuer should, after registering the red herring prospectus/prospectus with the ROCs, make a pre-issue advertisement in one **(i)** English and Hindi national daily newspaper with wide circulation and **(ii)** regional language newspaper with wide circulation at the place of the registered office of the issuer. It should be in the format and contain the disclosures specified in **Part A of Appendix 11-L on the website**. **Advertisement** includes notices, brochures, pamphalets, show cards, catalogues, hoardings, placards, posters, insertion in newspapers, cover pages of offer documents, pictures and films in any print/electronic media, radio, television programme.

Issue Opening/Closing Advertisement The advertisement should be in the format specified in **Part B of the Appendix 11-L on the website**.

Minimum Application Value The minimum application value with reference to the issue of securities is in the range of ₹10,000 to ₹15,000. The issuer should stipulate in the offer document the minimum application size in terms of number of specified securities within this range. Applications should be invited in multiples of the minimum application value. This is illustrated in **Appendix 11-M on the website**. Assuming an issue price of ₹390 per share, the minimum application size/lot can be determined within the range of 13-17 shares (in value terms between ₹5,000–₹7,500) as illustrated below.

Options	*A*	*B*	*C*	*D*	*E*
Lot size @ ₹390 per share (shares)	13	14	15	16	17
Application/bid amount for (rupees):					
1 lot	5,070	5,469	5,850	6,240	6,630
2 lots	10,140	10,920	11,700	12,480	13,260
4 lots	20,280	21,840	23,400	24,960	26,520
8 lots	40,560	43,680	46,800	49,920	—
9 lots	45,630	49,140	—	—	—

If the selected bid size is 14 (option B), necessary disclosures should be made in the offer document that an applicant should apply for 14 shares and multiples thereof.

The minimum application money should be at least 25 per cent of the issue price. In an offer for sale, however, the entire issue price should be brought in as application money.

Allotment Procedure/Basis The allotment of securities to non-anchor/retail individual investors-applicants should be on proportionate basis within the specified investor categories an the number of securities allotted rounded off to the nearest integer; the minimum allotment should be equal to the minimum application size determined/disclosed by the issuer. However, the value of securities allotted to any person under reservation category should not exceed ₹2,00,000. The allotment to each retail individual investor should not be less than the minimum bid lot subject to availability of share in this category and the remaining shares allotted on proportionate basis. The **(i)** ED/MD of the DSE, **(ii)** post-issue lead merchant banker(s) and **(iii)** registrars to the issue should ensure that the basis of allotment is finalised in a fair/proper manner in accordance with the allotment procedure specified in **Appendix 11-N on the website**. Assume **(i)** number of securities offered at ₹600 per share, 10 crore, **(ii)** offered to retail individual investors, 2.5 crore shares. **(iii)** oversubscription of issue, 4 times and in the retail individual investors category, 8.25 times, **(iv)** minimum application/bid size, 9 shares within the range of ₹5,000 – ₹7,500 **(v)** three retail individual investors A, B and C applying for 81,72 and 45 shares respectively. The allotment to them would be on proportionate basis, that is, at $1/8.25^{th}$ of the total number of shares applied for. The actual allotment would be as shown below.

Investor	*Number of Specified Securities Applied for*	*Number of Specified Securities Eligible for Allotment (Number of Securities Applied for × 8.25)*
(1)	*(2)*	*(3)*
A	81	81 ÷ 8.25 = 9.82 = 10
B	72	72 ÷ 8.25 = 8.73 = 9
C	45	45 ÷ 8.25 = 5.45 (liable to rejected as the entitlement is less than the minimum application lot of 9)

The successful applicants would be determined by draw of lots.

Utilisation of Subscription Money The post-issue lead banker should ensure that the monies received in respect of the issue are released to the issuer in compliance with the provisions of Section 73 of the Companies Act.

Annual Updation of Offer Document The disclosures made in the red herring prospectus should be updated on an annual basis by the issuer and made publicly accessible in the SEBI-specified manner.

Rights Issues

The main elements of the SEBI framework for rights issues are **(i)** record date, **(ii)** restrictions on rights issues, **(iii)** letter/abridged letter of offer, pricing and subscription period, **(iv)** pre-issue advertisement and **(v)** utilisation of funds.

Record Date To determine the eligibility of shareholders to apply for the specified securities in the rights issue, the listed issuer should announce a record date after which a rights issue cannot be withdrawn. In case of a withdrawal, the issuer is prohibited from applying for listing any of its specified securities for 12 months. It may, however, seek listing of its equity shares allotted pursuant to conversion/exchange of convertible securities issued prior to such announcement.

Restrictions An issuer can make a rights issue only after reserving shares of the same class in favour of holders of outstanding compulsorily convertible debt instruments in proportion to the convertible part. The reserved shares would be issued at the time of conversion of the CDIs on the same terms at which the rights issues were made.

Letter/Abridged Letter of Offer, Pricing and Subscription Period The abridged letter of offer, along with the application form, should be sent through registered/speed post to all existing shareholders at least 3 days before the issue opening date. Any existing shareholder can get the letter of offer from the issuer/lead merchant banker on request. Application in writing on a plain paper along with the requisite application money are permitted. Such shareholders would not be allowed to renounce their rights. Applications by shareholders on application form as well as on plain paper are liable to be rejected.

The issue price should be decided before determining the record date in consultation with the DSE. The issue should be open for a minimum of 15 days and a maximum of 30 days. The investors should have the option of either part payment on application with balance money to be paid in calls or full payment on application. The part payment should be atleast 25 per cent of the issue price.

Pre-issue Advertisement The advertisement should disclose the following:

(a) The date of completion of dispatch of abridged letter of offer and the application form;

(b) The centres other than the registered office of the issuer where the shareholders/persons entitled to receive the rights entitlements may obtain duplicate copies of the application form in case of its non-receipt within a reasonable time after the opening of the issue;

(c) A statement that if the shareholders entitled to receive the rights entitlements have neither received the original application forms nor they are in a position to obtain the duplicate forms, they may make application in writing on a plain paper to subscribe to the rights issue;

(d) A format to enable the shareholders to make the application on a plain paper specifying therein necessary particulars such as name, address, ratio of rights issue, issue price, number of equity shares held, ledger folio numbers, depository participant ID, client ID, number of equity shares entitled and applied for, additional shares if any, amount to be paid along with application, and particulars of cheque, and so on to be drawn in favour of the issuer's account;

(e) A statement that the applications can be directly sent by the shareholders through registered post together with the application moneys to the issuer's designated official address given in the advertisement;

(f) A statement to the effect that if the shareholder makes an application on plain paper and also on application form both his applications would be liable to be rejected at the option of the issuer.

The advertisement should be made in at least one **(i)** English, **(ii)** Hindi national daily newspaper and one **(iii)** regional language daily newspaper with wide circulation at the place where registered office of the issuer is situated, at least three days before the date of opening of the issue.

Utilisation of Funds Raised The issuer should utilise funds collected in rights issues after the finalisation of the basis of allotment.

Reservation for Employees Reservation for employees along with the rights issues upto ₹2,00,000 may be made by an issuer.

Manner of Disclosure in Offer Documents

The element of the SEBI framework are: **(i)** disclosures in offer document and **(ii)** abridged prospectus/letter of offer and ASBA.

Disclosure in Offer Document In general, the offer documents should contain all material disclosures which are true/adequate so as to enable the applicant to take informed investment decisions. In particular, while the red-herring prospectus/shelf prospectus/prospectus should contain the disclosures specified in **(i)** Scheudle II of the Companies Act and **(ii) Parts A, B and C of Appendix 11-G on the website**, the letter of offer should contain those specified in **Part E of Appendix 11-G on the website.** In addition, suitable reference should be made to the updated disclosures in the offer document.

Abridged Prospectus/Letter of Offer and ASBA While the abridged prospectus should contain the disclosures of the memorandum under Section 56(3) of the Companies Act and additional disclosures specified in **Part D of Appendix 11-G on the website**, the abridged letter of offer should contain the disclosures specified in **Part F of Appendix 11-G on the website.**

The abridged prospectus/letter of offer should not contain any mater extraneous to the contents of the offer document.

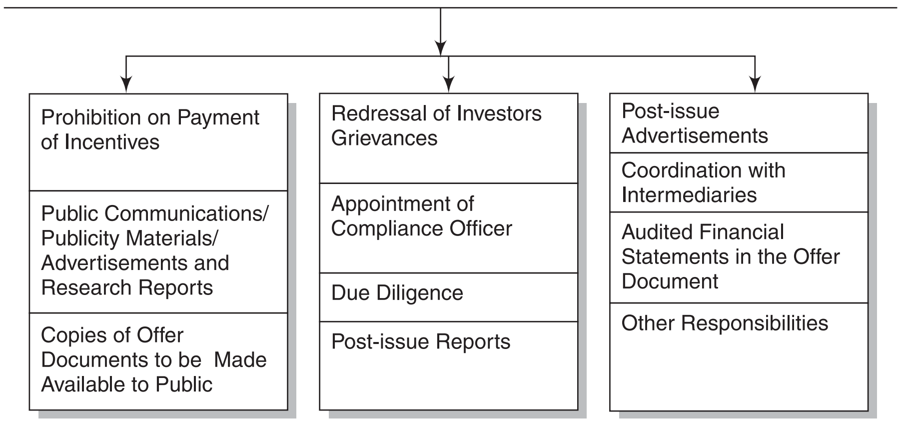
Every application form including **ASBA** form should be accompanied by a copy of the abridged prospectus/letter of offer. In all **(i)** public issues and rights issues with one payment option, the issuer should accept bids using only ASBA facility in the manner specified by the SEBI. In case of QIBs and non-institutional investors, bids should accepted using ASBA facility only.

General Obligations of Issuers/Intermediaries

The general obligations of issuers and intermediaries with respect to public/rights issues discussed in this Section are **depicted in Exhibit 11.4.**

Prohibition on Payment of Incentives Offer by any person connected with an issue including those connected with its distribution to applicants for allotment of securities of incentives in any manner, direct/indirect, in cash/kind, service/otherwise is prohibited. However, payment of fee/commission for services rendered in relation to issues is permitted.

Exhibit 11.4 General Obligations of Issuers/Intermediaries



Public Communications/Publicity Materials/Advertisements and Research Reports All public communications including advertisement and publicity materials/research reports by the issuers/intermediaries connected with the issue or their associates should contain only factual information and not projections/ estimates/conjectures or matters extraneous to the contents of the offer document. **Public communication/publicity material** includes **(i)** corporate, product and issue advertisements of the issuer, **(ii)** interviews by its promoters/directors/duly authorised employees/representatives, **(iii)** documentaries about the issuer/its promoters, and **(iv)** periodical reports and press releases.

- All public communications/publicity materials issued/published in any media during the period between the date of meeting of the Board of Directors of the issuer approving the issue and the filing of draft offer document with the SEBI should:
  (i) Be consistent with its past practices; otherwise, it should be prominently displayed/ announced that it is proposed to make an issue of specified securities in the near future and the issuer is in the process of filing a draft offer document with the SEBI,
  (ii) Prominently disclose that the **(a)** the issuer is proposing to make a public/rights issue and has filed a draft offer document with the SEBI/red herring prospectus/prospectus with the ROCs/letter of offer with the DSE, **(b)** draft offer document/red herring prospectus/final offer document is available on the website of the SEBI/lead merchant bankers (book runners). These requirements are not applicable in case of product advertisement.
- The issuer should make prompt/true/fair disclosures of all material development relating to **(i)** its business/securities and **(ii)** those of its subsidiaries/group companies, having a material effect on the issuer by issuing public notices in all newspapers in which its pre-issue advertisement was issued, during the period between the date of **(a)** registering final/red herring prospectus with the ROCs and the date of allotment of securities in public issue and **(b)** filing the letter of offer with the DSE and allotment of securities.
- The issuer should **(i)** not directly/ndirectly release during a conference/any other time any material/information which is not contained in the offer document, **(ii)** obtain approval

from the lead merchant banker(s) responsible for marketing the issue in respect of all public communications/issue advertisement/publicity materials and also make copies of all issue-related materials available with the lead merchant banker at least until the completion of the allotment.

- All advertisements/research reports by the issuer/intermediaries/associates should comply with the following:
  - **(a)** It should **(i)** be truthful/fair and not manipulative/deceptive /distorted and not contain any untrue/misleading statement/promise/forecast, **(ii)** reproduce any information contained in the offer document in full and disclose all relevant facts and not be restricted to select extracts, **(iii)** be set forth in a clear/concise/understandable language, **(iv)** not include any issue slogans/brand names except the normal commercial name of the issuer/brand of its products already in use, **(v)** include financial data for the past three years along with the particulars relating to sales/gross profit/net profit/share capital/reserves, earnings per share/dividends/book values. An issue advertisement would be considered **misleading** if it contains **(a)** statements about the performance/activities of the issuer without necessary explanatory/qualifying statements which may give an exaggerated picture of performance/activities, **(b)** an inaccurate portrayal of past performance/portrayal in a manner implying past gains/income will be repeated in future.
  - **(b)** No issue advertisement should: **(i)** use extensive technical/legal terminology, complex language and excessive details which may distract the investors, **(ii)** contain statements promising/guaranteeing rapid increase in profits, **(iii)** display models/celebrities/fictional characters/landmarks/caricatures/the likes, **(iv)** appear in the form of **crawlers** (i.e. which run simultaneously with the programme in a narrow strip at the bottom of the television screen) on television, **(v)** contain slogans/expletives/non-factual and unsubstantiated titles, **(vi)** also contain risk factors with equal importance in all respects including at least points seven print size, if it contains highlights, **(vii)** not contain information other than those specified in **Part A, B and C of Appendix 11-L on the website** in an issue advertisement displayed on a bill board, **(viii)** contain risk factors if the issue advertisement contains highlights/information other than the details contained in **Parts A and B of Appendix 11-L on the website**.
  - **(c)** In any advertisement on television screen, the risk factors should not be scrolled on the television screen and it should advise the viewers to refer to the red-herring prospectus/other offer documents for details.
- No advertisement should give the impression that the issue has been fully subscribed/oversubscribed during the period the issue is open for subscription.
- An announcement regarding closure of the issue should be made only after the lead merchant banker(s) is satisfied that at least 90 per cent of the offer has been subscribed and a certificate obtained to this effect from the Registrar to the Issue. The announcement should not be made before the date on which the issue is to be closed.
- No advertisement/distribution material should contain any offer of direct/indirect incentives in any manner in cash/kind/services/otherwise.
- No product advertisement should contain any direct/indirect reference to the performance of the issue during the period between the date of the resolution of the Board of Directors approving the issue and the allotment of securities.
- A research report may be prepared only on the basis of information disclosed to the public by updating the offer document/otherwise.
- Selective/additional information/information extraneous to the one disclosed to the public through the offer document/otherwise should not be given to the issuer/any member of

the issue management team/syndicate or to any particular section of the investors/any research analyst in any manner including at road shows/presentations, in research/sales reports/at bidding centres.

- The merchant banker should submit a compliance certificate in the specified format for the period between the date of **(i)** filing the draft offer document with the SEBI and **(ii)** closure of the issue in respect of news appearing in any: **(a)** newspapers in which public announcement was made, or **(ii)** major business magazines, or **(iii)** print/electronic media controlled by a media group having a private treaty/shareholders agreement with the issuer/promoters of the issuer.

Copies of Offer Document Available to Public The issuer/lead merchant banker(s) should ensure that the contents of the offer documents hosted on the website are the same as that of their printed versions filed with the ROCs/SEBI/stock exchanges. The lead merchant banker(s)/recognised stock exchanges should provide copies of the draft/final offer document(s) to the public on request for a reasonable charge.

Redressal of Investor Grievances The post-issue lead merchant banker(s) should be actively associated with post-issue activities such as allotment/refund/despatch, instructions to syndicate members/**SCSBs**/other intermediaries. They should also regularly monitor redressal of the associated investor grievances.

Appointment of Compliance Officer The issuer-appointed compliance officer would be responsible for redressal of investor grievances and compliance of the securities laws [i.e. Companies/ Securities Contracts (Regulation)/Depositories Act/rules/regulations and regulations/general or special orders/guidelines/circulars made/issued by the SEBI].

Due Diligence The lead merchant banker(s) should **(i)** exercise due diligence and satisfy about all the aspects of the issue including the veracity/adequacy of disclosures in the offer documents, **(ii)** call upon the issuer/its promoters/directors/the selling shareholders in offer for sale to fulfil their obligations disclosed in the offer document/required in terms of the SEBI ICDR regulations. Their responsibility would continue even after the completion of the issue process.

The post-issue merchant banker would continue to be responsible for post-issue activities till the subscribers have received the security certificates/credit to their demat account or refund of application money and the listing agreement is entered into by the issuer with the stock exchange and listing/trading permission is obtained.

Post-Issue Reports In public issues the lead merchant banker should submit final post-issue repost specifies in Part C of Appendix 11-O on the website within 7 days of the date of finalisation of basis of allotment/refund of money in case of failure of issue. In rights issues, the initial post-issue report specified in Part B of appendix 11-O on website should be submitted within 3 days of closure of the issue and the final post-issue report specified in Part D of Appendix 11-O within 15 days of the date of finalisation of basis of allotment/refund of money in case of failure of issue. The lead merchant banker should submit a due diligence certificate in the specified format along with the final post-issue report.

Post-Issue Advertisements The post-issue merchant banker should ensure that:

- Advertisement is released within 10 days from the completion of the various activities in at least one English/Hindi national daily newspaper with wide circulation and one regional language daily newspaper with wide circulation at the place of the registered office of the issuer giving details relating to **(i)** oversubscription, **(ii)** basis of allotment, **(iii)** number/value/percentage of all applications including **ASBA**/successful allottees for all applications including **ASBA**, **(iv)** date of completion of despatch of refund orders/instructions to **SCSBs** by the Registrar, and **(v)** date of despatch of certificates/filing of listing application and so on.

- Issuer/advisors/brokers any other entity connected with the issue do not publish any advertisement stating that it has been oversubscribed/indicating investors response to it during the period when the public issue is open for subscription.

Coordination With Intermediaries The post-issue merchant banker should:

(1) Maintain close coordination with the Registrar to the issue and depute its officers to the offices of the various intermediaries at regular intervals after the closure of the issue to monitor the **(i)** flow of applications from the collecting bank branches and/or **SCSBs,** **(ii)** processing of applications including those for **ASBA**/and **(iii)** other matters till the basis of allotment is finalised, despatch of security certificates/refund orders are completed and securities are listed. Any act of omission/commission on the part of any intermediary noticed during such visits should be duly reported to the SEBI.

(2) Ensure that the notice for devolvement on underwriters containing their obligations is issued within 10 days from the date of closure of the issue.

(3) Furnish information in respect of underwriters who have failed to meet their underwriting devolvements in an undersubscribed issue to the SEBI in the format specified in **Appendix 11-P on the website**.

(4) Confirm to the bankers to the issue by way of copies of listing/trading approvals that all formalities in connection with the issue have been completed and the banker is free to release the money to the issuer/for refund in case of failure of the issue.

Audited Financial Statements in the Offer Document The merchant banker should ensure that **(i)** the information contained and **(ii)** the particulars as per the audited financial statements in the offer document are not more than 6 months old from the issue opening date.

Other Responsibilities The post-issue merchant banker should ensure that:

- The despatch of refund orders/allotment letters/share certificates is by registered post/certificate of posting,
- Payment of interest to the applicants for delayed despatch of allotment letters/refund orders and so on is made as per the disclosures in the offer document,
- Transactions in securities by the promoter/promoter group between the date of registering of the offer document with the ROCs/filing the letter of offer with the DSE and the closure of the issue should be reported to the DSE within 24 hours of the transactions,
- Issue is kept open, in case of absence of definite information about subscription figures, for the required number of days to avoid any dispute at a later date by the underwriters in respect of their liability.

Dissenting shareholders mean shareholders who have voted against the resolution for change in objects/variations in terms of a contract referred to in the prospectus of the issuer.

Conditions/Manner of Providing Exit Opportunity to Dissenting Shareholders **Dissenting shareholders** mean shareholders who have voted against the resolution for change in objects/variations in terms of a contract referred to in the prospectus of the issuer. The main elements of the SEBI regulations are:

(i) conditions for exit offer, **(ii)** eligibility of shareholders for availing of the exit offer, **(iii)** exit offer price, **(iv)** manner of providing exit to dissenting shareholders and **(v)** offer not to exceed maximum permissible non-public shareholding.

Conditions The promoters/shareholders in control should make the exit offer if **(i)** 10 per cent dissenting shareholders voted in the general meeting and **(ii)** the amount to be utilised for the object for which the prospectus was issued is less than 75 per cent of the amount raised.

Eligibility Only dissenting shareholders who hold shares on the **relevant date** (i.e. date of the meeting of the Board of Directors in which the proposal for change in objects/variation in terms of a contract is approved) can avail of the offer.

Exit Offer Price The exit price payable to the dissenting shareholders would be the highest of the following:

- the volume weighted average price paid/payable for acquisition during 52 weeks immediately preceding the relevant date;
- the highest price paid/payable for any acquisition during the 26 weeks immediately preceding the relevant date;
- the volume weighted average market price for frequently traded shares for 60 trading days immediately preceding the relevant date as traded on the stock exchange where the maximum volume of trading is recorded; and
- in case of infrequently traded shares, the price determined by the promoter/shareholders having control and the merchant banker taking into valuation parameters including book value, comparable trading multiples and other customary parameters.

Exit The notice proposing the passing of special resolution changing the objects of the issue/varying the terms of the contract should also contain information about the exit offer to the dissenting shareholders. The explanatory statement to the notice should contain, in addition to other disclosures, a statement that exit opportunity would be provided. The voting results on the special resolution should be submitted to the stock exchange(s) together with a list of dissenting shareholders. A SEBI-registered merchant banker would finalise the exit offer price. The issuer should intimate the stock exchange(s) about the exit offer price which should immediately disseminate the same to public within one working day. To ensure security for performance of obligations, an interest-bearing escrow account should be created to deposit the aggregate considerations at least two working days prior to the tendering period which should start within 7 working days from the passing of the special resolution and remain open for 10 working days. The dissenting shareholders who have tendered their shares would have the option to withdraw till the closure of the tendering period. The promoter/shareholders should facilitate tendering of shares and its settlement through the SEBI-specified stock exchange mechanism for takeover/buyback/delisting. They should make payment of the consideration within 10 working days from the date of the tendering period. Within 2 days from the payment of consideration, the issuer should furnish to the stock exchange(s) disclosures detailing aggregate number of shares tendered/accepted, payment of consideration and its post-offer shareholding pattern and a report by the merchant banker that the payment has been duly made to the concerned dissenting shareholders.

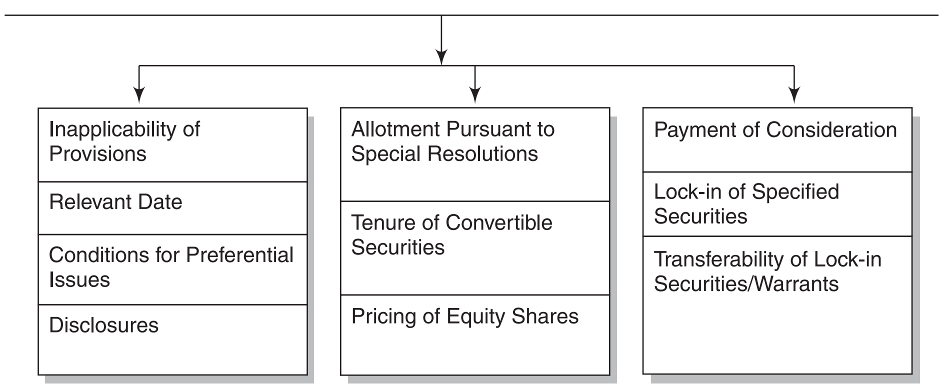
Maximum Offer The promoter/shareholders in control would have to bring down the non-public shareholding to the specified level within the permitted time under the **Securities Contract (Regulation)** Rules if the completion of the exit offer results in these shareholdings exceeding the maximum permissible non-public shareholding.

Preferential Issues

> **Preferential issue** is an issue of shares and convertible securities by a listed issuer to any select person/group of persons on a private placement basis.

A **preferential issue** means an issue of specified securities by a listed issuer to any select person/group of persons on a private placement basis. It does not include an offer of securities through public/rights/bonus issue, employee stock option/purchase scheme, qualified institutional placement, issue of sweat equity shares, depository receipts in a country outside India and foreign securities. The main elements of such issues are portrayed in Exhibit 11.5.

Exhibit 11.5 Preferential Issues



Inapplicability of Provisions The provisions relating to preferential issues would not be applicable to issue of equity shares made **(a)** pursuant to **(i)** conversion of loan/option attached to a CDI in terms of Sections 81(3)/(4) of the Companies Act, **(ii)** a scheme approved by a High Court under Sections 391-394 of the Companies Act and **(b)** in terms of a rehabilitation scheme approved by the BFIR under the Sick Industrial Companies (Special Provisions) Ac. But such issues would be subject to lock-in stipulations pertaining to preferential issues. However, the lock-in provisions would apply in this case.

The pricing and lock-in requirements would not be applicable to equity shares allotted to any financial institution in terms of Section 2(h)(ia) and **(ii)** of the Recovery of Debts Due to Banks and Financial Institutions Act. Moreover, preferential issues of equity shares and fully/partly compulsorily CDIs would be exempt from the disclosures and pricing requirements (**discussed later in this Section**) where the SEBI has granted relaxation to the issuer in terms of Regulation 29-A of the SEBI Substantial Acquisition of Shares and Takeover Regulations if adequate disclosures about the plan/process proposed to be followed for identifying the allottees are given in the explanatory statement to the notice for the general meeting of the shareholders. The provisions relating to holding shares in demat form and lock-in would not apply to a preferential issue allotted to mutual funds registered with the Board of Directors of IRDA-registered insurance company.

The provisions would also not apply where the issue is made pursuant to conversion of debt into equity under strategic debt restructuring scheme of the RBI. The conversion price should not be less than the face value of the shares. It should be certified by two independent qualified valuers. The lock-in period would be one year from the date of trading approval. The applicable provisions of the Companies Act should be complied with.

Frequently Traded Shares Such shares mean shares of an issuer in which the turnover on a stock exchange during the 12 months preceding the relevant date is at least 10 per cent of the total number of shares. The weighted average number of total shares would represent the total number where the share capital of the issuer is not identical throughout the 12-month period.

Conditions for Preferential Issues The conditions for preferential issues by a listed issue are: **(i)** a special resolution by the shareholders, **(ii)** all equity shares held by the proposed allottees are in demat form, **(iii)** the issuer is in compliance with the conditions for continuous listing specified in the listing agreement, and **(iv)** it has obtained the PAN of the proposed allottees.

Preferential issue cannot be made to person(s) who have sold equity shares of the issuer during the six months preceding the **relevant date** except where the SEBI has granted relaxation in terms of Regulation 29-A of its Substantial Acquisition of Shares and Takeover Regulation. Where any person belonging to promoter(s)/promoter group has **(i)** sold his shares during the 6 months preceding the relevant date **(ii)** previously subscribed to warrants of the issuer but failed to exercise, the promoters/group would be ineligible for one year from the date of **(1)** expiry of the tenure, **(2)** cancellation of the warrants. The **relevant** date means in case of preferential issue of **(a)** equity shares: the date 30 days prior to the date on which the shareholders meeting to consider the issue is held; however, the date of approval of the corporate debt restructuring package would be the relevant date for such issues pursuant to the RBI's CDR framework, **(b)** CDIs: a date 30 days prior to the date on which the **(i)** shareholders meeting to considers the issue is held or **(ii)** holders become entitled to apply for the shares.

Disclosures In addition to the disclosures under Section 173 of the Companies Act or other applicable laws, the issuers should disclose in the explanatory statement to the notice for the general meeting proposed for passing the special resolution the following: **(a)** objects of the issue, **(b)** proposal of the promoters/directors/**key management personnel** (i.e. officers vested executive powers/at the level immediately below the Board of Directors including any other person who is declared as a key management personnel by the issuer) of the issuer to subscribe to the offer, **(c)** shareholding pattern before/after the issue, **(d)** the time within which the issue would be completed, **(e)** identity of the natural person(s) who are the ultimate beneficial owners of the shares proposed to be allotted and/or who ultimately control the proposed allottees/percentage of post issue capital to be held by them/change in control in the issuer consequent to the issue; however, no further disclosures will be necessary if any listed company/bank/mutual fund/insurance company is in the chain of ownership of the proposed allottee, **(f)** undertaking that the **(i)** price of the securities would be recomputed where required in terms of these regulations, **(ii)** securities would continue to be locked-in till such time the amount payable on account of the recomputation of price is paid by the allottees; (g) specified disclosures if the issuer/promoter/director is a willful defaulter. The special resolution should specify the relevant date on the basis of which the price of the equity shares to be allotted on conversion/exchange of convertible securities would be calculated.

A copy of the certificate of its statutory auditors should be placed by the issuer before the general meeting of its shareholders certifying that the issue is being made in accordance with the requirements of these regulations.

The valuation of the assets in consideration for which the equity shares are being issued on a preferential basis to promoters/their relations/associates/related entities for consideration other than cash should be done by an independent qualified valuer and submitted to the concerned stock exchange. On not being satisfied with the appropriateness of the valuation, the stock exchange may get it done by another valuer by obtaining all the deemed necessary information from the issuer.

Allotment Pursuant to Special Resolution The allotment should be completed within 15 days from the date of **(i)** passing of the special resolution, **(ii)** order/approval or permission on a pending application for exemption from the applicability of the SEBI Substantial Acquisition of Shares and Takeover Regulations/approval or permission by any regulatory authority/Central Government. The 15-day limit would not apply to allotment pursuant to a scheme of corporate debt restructuring. On failure to complete the allotment within 15 days, a fresh special resolution would be necessary. The preferential issue of shares/compulsorily partly/fully CDIs should be made within the time specified by the SEBI in its order granting the relaxation to the issuer in terms of **Regulation 29-A of the SEBI Takeover Regulation**. Allotment should be made only in dematerialised form including allotment pursuant to exercise option attached to warrant or conversion of convertible securities.

Tenure of Convertible Securities The tenure should not exceed 18 months from the date of their allotment.

Pricing of Equity Shares: Frequently Traded Shares The stipulations relating to pricing of equity shares in a preferential issue are summarised below:

- **If shares have been listed for at least 26 weeks on the relevant date:** They shares should be allotted at a price higher of the average of the weekly high and low of the volume weighted average price of the related shares quoted on the stock exchange (in which the highest trading volume have been recorded) during the **(i)** 26 weeks and **(ii)** 2 weeks preceding the relevant date.
- **If listed for less than 26 weeks:** At a price higher than the following: **(a)** the average of the weekly high and low of the volume weighted average prices during the **(i)** period shares have been listed and **(ii)** 2 weeks preceding the relevant date and **(b) (i)** the price at which they were issued in the IPO or **(ii)** the value per share in a scheme of arrangement under the Companies Act pursuant to which the shares were allotted. The price should be recomputed on completion of 26 weeks with reference to the average of the weekly high and low of the volume weighted average prices during these weeks and the allottees would have to pay any difference between the (higher) recomputed price and the allotment price.
- Preferential issues to a maximum of 5 QIBs should be made not below the average of the weekly high and low of the volume weighted average prices of the related shares during the two weeks preceding the relevant date.

Pricing of Equity Shares: Infrequently Traded Shares The price should take into account valuation parameters including book value, comparable trading multiples and other customary parameters for valuation of shares of such companies. The issuer should submit a certificate of compliance from an independent merchant banker/chartered accountant having a maximum of 10 years of experience to the concerned stock exchange.

The pricing for preferential issues in respect of frequently/infrequently traded shares would be subject to appropriate adjustments if the issuer **(a)** makes **(i)** an issue of shares by way of capitalisation of profits/reserves other than by way of a dividend on shares, **(ii)** a rights issue, **(b)** consolidates its outstanding shares into a smaller number of shares, **(c)** divides them including by way of stock split, **(iii)** reclassifies them into other securities and **(iv)** is involved in similar other events/circumstances which in the opinion of the stock exchange requires adjustments.

Payment of Consideration Full consideration (price) of the specified securities other than warrants should be paid by the allottees at the time of allotment. The consideration in a preferential issue pursuant to a scheme of corporate debt restructuring (CDR) would be according to the terms of the scheme.

At least 25 per cent of the consideration should be paid against each warrant on the date of their allotment; the balance 75 per cent should be paid on allotment of shares pursuant to exercise of option. Failure on the part of the warrantholder to exercise the option would result in the forfeiture of the 25 per cent payment. The issuer should ensure that the consideration received in cash would be received from the allottees' bank accounts. A certificate of compliance from the auditors should be submitted to the stock exchange.

Lock-in of Specified Securities The specified securities allotted/shares allotted pursuant to exercise of option attached to warrants on preferential basis to promoter/promoter group, should be locked-in for 3 years from the date of **trading approval** (i.e. the latest date when trading approval has been granted by the concerned stock exchanges). However, not more than 20 per cent of the **total capital of the issuer** (i.e. equity share capital by way of public/rights issues and conversion of convertible securities and securities on preferential basis to promoter/promoter group) should be locked-in; the excess over 20 per cent would be subject to lock-in of one year.

The lock-in of securities allotted to others and those pursuant to a scheme of CDR would be one year. It would be reduced to the extent of the already lock-in of convertible securities in case of shares allotted pursuant to their conversion. Partly paid-up shares would be locked-in from the date of trading approval and would end after one year from the date they become fully paid-up. The shares would continue to be locked-in till the amount representing the difference between the **(i)** recomputed price after completion of 6 months in case of listing of shares for less than 6 months and **(ii)** allotment price is paid by the allottee. The entire pre-preferential allotment shareholding of the allottees should be lock-in from the relevant date upto 6 months from the date of trading approval.

Transferability of Lock-in Securities/Warrants Subject to the provisions of the SEBI Substantial Acquisition of Shares and Takeover Regulation, the specified securities held by promoters and lock-in may be transferred among promoters/promoter group or new promoter/persons in control of the issuer. However, the lock-in would continue for the remaining period with the transferee. The allotted securities should not be transferred by the allottees till the grant of trading approval.

QIP means allotment of shares/CDIs along with warrants and other convertible securities by a listed issuer to QIBs on private placement basis.

Qualified Institutional Placement (QIP)

The **QIP** means allotment of **eligible securities** (i.e. shares/non-convertible debt instruments along with warrants and other convertible securities) by a listed issuer to QIBs on private placement basis. The main elements of the framework relating to the QIPs are: conditions, placement document, pricing, allotment restrictions, minimum number of allottees, validity of the special resolution, tenure, and transferability of eligible securities.

Conditions for QIP A listed issuer may make a QIP of securities if it satisfies the following conditions:

- A special resolution by its shareholders for the purpose,
- Listing of shares of the same class which are proposed to be allotted/pursuant to conversion or exchange of eligible securities offered to QIP on a stock exchange having nationwide trading terminal for at least one year prior to the issue of notice to the shareholders for convening their meeting to pass the special resolution. For computing the one-year period, the period for which the shares of the same class of the issuer being a transferor company were listed in case of a transferee company in a scheme of merger/demergers/ amalgamation/ arrangement sanctioned by a High Court under Sections 391-394 of the Companies Act would also be considered.
- Is in compliance with the requirement of minimum public shareholding specified in the Securities Contracts (Regulation) Rules.
- The special resolution should, *inter-alia*, specify that the allotment would be through QIP. The relevant date should also be specified. **Relevant date** means **(i)** the date of meeting in which the Board of Directors/ its duly authorised committee decides to open the issue in case of allotment of shares, **(ii)** in case of allotment of eligible convertible securities the date **(a)** of the meeting specified in **(i)** or **(b)** on which their holders became entitled to apply for shares.

> **Relevant date** means the date **(i)** of meeting in which the Directors decide to open the issue or **(ii)** on which holders of convertible securities become entitled to apply for shares.

A SEBI-registered merchant banker(s) should manage QIP and exercise due diligence. While seeking in-principle approval for listing, he should furnish to the stock exchange(s) on which the same class of shares of the issuer are listed a due diligence certificate to the effect that the eligible securities are being issued under QIP and all the requirements have been complied with.

Placement Document The QIP should be made on the basis of a placement document containing all material information including those specified in **Appendix 11-Q on the website** and disclosures pertaining to willful defaulters. It should be serially numbered and its copies should be circulated only to select investors. While seeking in-principle approval for listing, the issuer should furnish a copy of it/a certificate confirming compliance with all the requirements along with other documents required by the stock exchange. The placement document should also be placed on the website of the stock exchange/issuer with a disclaimer that it is in connection with QIP and no offer is being made to public/any other category of investors.

Pricing The price at which a QIP is made should not be less than the average of the quoted weekly high and low of the closing prices of the shares of the same class during the two weeks preceding the relevant date. Subject to approval of shareholders, discount upto 5 per cent on this price may be offered. The price of equity shares allotted pursuant to conversion/exchange of eligible securities should be determined taking the relevant date as decided/disclosed by the issuer while passing the specified resolution.

Partly paid-up eligible securities should not be allotted. However, allottees may pay the full/ part consideration in case of allotment of non-convertible debt instruments along with warrants at the time of their allotment. Equity shares allotted on exercise of option attached to warrants should be fully paid-up.

The prices determined for a QIP would be subject to appropriate adjustments if the issuer **(a)** makes **(i)** an issue of shares by way of capitalisation of profits/reserves, **(ii)** a rights issue; **(b)** consolidates its outstanding shares into smaller number of shares; **(c)** divides them including by way of stock split; **(d)** reclassifies them into its other securities; and **(e)** is involved in similar events/circumstances which, in the opinion of the concerned stock exchange, require adjustment.

Restrictions on Allotment A minimum of 10 per cent of the eligible securities should be allotted to mutual funds. Their unsubscribed portion may be allotted to other QIBs. Driect/indirect allotment cannot be made to any QIB who is a promoter/any person related to the promoter of the issuer. A QIB would be deemed to be a person related to the promoter if has **(i)** right(s) under a shareholders/voting agreement/to appoint any nominee director and **(ii)** veto rights.

An investor can subscribe either to the combined offerings of non-CDIs with warrants or to individual securities, that is, non-convertible debt instruments or warrants. Bids by applicants in QIP cannot be withdrawn after the closure of the issue.

Minimum Number of Allottees The minimum number of allottees for each placement should be at least two and five for issue size upto and more than ₹250 crore respectively. No single allottee can be allotted more than 50 per cent of the issue size. The QIB belonging to/under the same group/control would be deemed to be a single allottee.

Validity of the Special Resolution The allotment of eligible securities should be completed with 12 months from the date of passing the resolution. A subsequent QIP can be made after 6 month of a prior QIP pursuant to a special resolution(s).

Restrictions on Amount Raised The aggregate of the proposed QIP together with all previous QIPs in the same financial year should not exceed 5 times the networth of the issuer as per its audited balance sheet of the previous year.

Tenure The maximum tenure of the convertible/exchangeable eligible securities would be 5 years from the date of allotment.

Transferability The allottees can sell the eligible securities for one year **only** on a recognised stock exchange.

Institutional Placement Programme (IPP) The provisions discussed below relate to issuance of fresh and/or offer for sale of shares in a listed issuer for achieving the minimum public shareholding in terms of Section 19(2)(b) and 19-A of the Securities Contracts (Regulation) rules.* In addition, the undermentioned provisions of the SEBI ICDR Regulations would also apply to such issues: **(i)** definitions of terms/concepts, **(ii)** debarring of promoters/directors/ persons in control from accessing the capital market, **(iii)** in-principle stock exchange approval for listing, **(iv)** dispatch of issue material, **(v)** allotment/refund and payment of interest, **(vi)** restriction on further capital issue, **(vii)** pre-issue advertisement, **(viii)** issue opening/closing advertisement, **(ix)** utilisation of subscription money, **(x)** prohibition on payment of incentives, **(xi)** public communication/ publicity material/advertisements and research reports, **(xii)** copies of offer document to public, **(xiii)** due diligence, **(xiv)** post-issue report, **(xv)** post-issue advertisement, and **(xvi)** audited financial statements in the offer document. The main elements of the SEBI regulations are discussed below.

> **IPP** is a further public offer of eligible securities, that is, equity shares of same class listed/traded in the stock exchange, by an eligible seller, that is, listed issuer, promoter/promoter group of listed issuer, in which the offer/allocation/allotment of the securities is made only to the QIBs.

***For details, refer to Khan M.Y., *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 4.**

- An **IPP** (i.e. a further public offer of eligible securities, that is, equity shares of same class listed/traded in the stock exchange, by an eligible seller, that is, listed issuer, promoter/promoter group of listed issuer, in which the offer/allocation/allotment of the securities is made only to the QIBs) requires a special resolution by the shareholders in terms of Section 81(1A) of the Companies Act. Partly-paid shares cannot be offered. In-principle approval from a stock exchange should also be obtained. A SEBI-registered merchant banker should manage the IPP and exercise due diligence.
- The offer document should contain all material information specified by the SEBI for disclosure in offer document/abridged prospectus/letter of offer. Simultaneously, with registering the offer document with the ROCs, a copy should also be filed with the SEBI/stock exchange together with the specified fee. It should also be placed on the website of the issuer/stock exchange stating that the offer is only to QIBs. A due diligence in the specified form should be submitted by the merchant banker to the SEBI that all conditions have been complied with.
- The eligible seller should announce a floor price/price band at least one day before the opening of the IPP. Allocation/allotment may be made on **(a)** proportionate/price priority basis, or **(b)** criteria mentioned in the offer document. The allotment method should be disclosed in the offer document and overseen by the stock exchange.
- The promoter/promoter group should not purchase/sell the eligible securities during the 12 weeks **(a)** prior to **(b)** after the date of the IPP. However, subject to a minimum gap of two weeks between two successive offers/programmes, they can offer the securities held by them through IPP/offer for sale through stock exchange mechanism specified by the SEBI. The allocation/allotment of the securities would be subject to the condition that **(i)** at least 25 per cent to mutual funds/insurance companies, the unsubscribed portion being offered to other QIBs, **(ii)** a QIB-promoter/any person related to the promoter (i.e. who has rights **(1)** to appoint any nominee director, **(2)** under a shareholders/visiting agreement), and **(3)** veto rights. The **ASBA** facility would be available for bidding. Bids cannot be revised downward/withdrawn.
- The minimum number of allottees would be ten and a maximum of 25 per cent of the offer size can be allotted to a single allottee. The QIBs belonging to the same group/under same control would be deemed to be a single allottee.
- The aggregate of all the tranches of the IPP of any eligible seller should not result in increase in pubic shareholding by more than 10 per cent and in case of oversubscription, allotment should be restricted to 10 per cent of the offer size.
- The issue can be kept open for a minimum of one day and a maximum of two days. The aggregate demand schedule should be displayed by the stock exchange without disclosing the price. The offer can be withdrawn in case it is not fully subscribed. The allotted securities can be sold by the allottee within one year only on a recognised stock exchange.

Bonus Issues

Subject to the provisions of the Companies Act, a listed issuer may issue bonus shares if it: **(i)** is an authorised by its articles of association, **(ii)** has not defaulted in payment of interest/principal in respect of fixed deposits/debt securities, **(iii)** has sufficient reason to believe that it has not defaulted in the payment of statutory dues of the employees such as contribution to provident fund/gratuity/bonus and **(iv)** has made partly paid-up share fully paid-up.

A bonus issue of equity shares can be made only if reservation is made of shares of the same class in favour of outstanding fully/partly CDIs at the time of the bonus issue in proportion to the convertible part. The reserved shares should be issued at the time of conversion of the CDIs on the same term/portion in which the bonus share was issued.

The bonus issue can be made only out of free reserves built out of genuine profits/securities premium collected in cash only. Bonus shares should not be issued in lieu of dividend.

The bonus issue should be implemented within 15 days from the date of its approval by the Board of Directors of the issuer. It should be implemented within 2 months from the date of the Board of Directors announcing the decision subject to shareholders approval for capitalisation of profits/reserves for bonus issue. Once announced, the decision to make a bonus issue cannot be withdrawn.

Issue of Indian Depository Receipts (IDRs)

IDR means an instrument in the form of a depository receipt created by a Domestic Depository (DD) in India against the underlying equity shares of the issuing company incorporated outside India.

OCB is a bank established outside India, acting as a custodian for the equity shares of the issuer against which IDR are being issued by having a custodial arrangement/agreement with the domestic depository or by having a place of business in India.

The issues of IDRs should conform to **(a)** Companies IDR Rules and **(b)** SEBI ICDR regulations.

Companies Issue of Indian Depository Receipts (IDRs) Rules, 2004 The main elements of the IDRs rules are: eligibility, procedure, other conditions, registration documents, condition for issue of prospectus, listing, transfer/redemption, continuous disclosures, distribution of corporate benefits, and penalty.

Eligibility An **IDR** means an instrument in the form of a depository receipt created by a Domestic Depository (DD) in India against the underlying equity shares of the issuing company incorporated outside India. The issuing company of IDRs should satisfy the following conditions: **(i)** Its pre-issued paid-up capital and free reserves are at least US $ 100 million and its has had an average turnover of US $ 500 million during the three preceding years; **(ii)** It has been making profits and declaring a minimum 10 per cent dividend for at least 5 years preceding the issue; **(iii)** Its pre-issue debt equity ratio does not exceed 2:1; and **(iv)** It would fulfill the eligibility criteria prescribed by the SEBI from time to time **(discussed subsequently)**.

Procedure Prior permission from SEBI should be obtained to raise funds in India by issuing IDRs. The application for permission from SEBI should be made at least 90 days before the opening of the issue together with a non-refundable fee of US $ 10,000. The issue fee would be 0.50 per cent of the issue value subject to a minimum of ₹10 lakh for an issue size of upto ₹100 crores and for issue size/value exceeding ₹100 crore, additional 0.25 per cent of the issue value. The issuer should obtain the necessary approvals/exemptions from the appropriate authorities from the country of its incorporation. It should appoint an **Overseas Custodian Bank (OCB)** [i.e. a bank established outside India, acting as a custodian for the equity shares of the issuer against which IDR are being issued by having a custodial arrangement/agreement with the domestic depository or by having a place of business in India], a Domestic Depository (DD) and a merchant banker for the issue of IDRs. It would deliver the underlying equity shares to the OCB who would authorise the DD to issue IDRs. It would file through a merchant banker/DD a due diligence report with the Registrar of Companies (ROCs) and SEBI in the specified form.

It would also file with the ROCs and SEBI a prospectus certified by two authorised signatories one of whom should be a whole-time director and other the Chief Accounts Officer (CAO) stating the particulars of the resolution of the Board of Directors approving the issue. The draft prospectus should be filed with the SEBI at least 21 days prior to filing of the prospectus. Any changes suggested by SEBI must be incorporated in the prospectus. The issuer may appoint SEBI-registered underwriters and should obtain in-principle listing permission from stock exchange(s) having nation-wide trading terminals in India.

Other Conditions The ceiling on IDRs by a company in any financial year is 15 per cent of paid-up capital and reserves and they would be denominated in Indian rupees only. The repatriation of the issue proceeds of IDRs would be subject to laws relating to export of foreign exchange.

Registration Documents The merchant banker to the IDR issue should deliver for registration to the SEBI and ROCs the following documents/information: **(i)** instrument constituting/defining the constitution of the issuer, **(ii)** enactments/provisions under/by which the issuer was incorporated together with an attested copy by an officer, **(iii)** address of principal office in India/an address in India where the instrument/enactments/provisions are available for inspection, **(iv)** a certified copy of the certificate of incorporation in the country in which incorporated, and **(v)** copies of agreements between issuer, OCB, DD specifying, *inter-alia*, the rights of the IDR holders. The prospectus to filed with the SEBI/ROCs should contain the prescribed particulars signed by all the whole-time directors and the CAO.

Conditions for the Issue of Prospectus/Application The application form for the securities of the issue should be accompanied by a memorandum containing the salient features of the prospectus except when it is issued in connection with invitation to enter into an underwriting agreement with respect to the IDRs. Any statement by an expert can be circulated/issued/distributed in India/abroad only if his consent to the issue appears on the prospectus.

Listing of IDRs The IDRs should be listed on a recognised stock exchange(s) and they can be purchased/possessed/freely transferred by a person resident in India.

Procedure for Transfer and Redemption A holder may transfer or may ask the DD to redeem the IRDs. In case of redemption, the DD would request the OCB to get the corresponding underlying shares released in favour of the holder of IDRs for being sold on his behalf/transferred in the book of the issuer in the name of holder of IDRs. Nomination facility for IRDs is available. The issued IDRs may be purchased/possessed and transferred by a non-resident person if the issuing company obtains specific approval from the RBI in this regard or complies with any policy/guidelines issued by the RBI on the subject-matter.

Continuous Disclosure Requirement Every issuing company should comply with such continuous disclosure requirements as may be specified by the SEBI in this behalf.

Distribution of Corporate Benefits The DD should distribute the dividends/other corporate action on the IDRs in proportion to the holdings of IDRs.

Penalty Contravention of these rules by the company/any person for which no punishment is provided in the Companies Act would be punishable with fine upto the amount of the IDR issue and a further fine upto ₹5,000 per day during which the contravention continues.

SEBI ICDR Regulations, 2009 All the provisions of the SEBI ICDR regulations are applicable in case of IDRs excepting the **(i)** disclosure requirements with respect to public/rights issues of specified securities and **(ii)** other specified provisions. The aspects of IDRs discussed here relate to: **(i)** eligibility, **(ii)** conditions for issue of IDRs, **(iii)** minimum subscription, **(iv)** fungibility, **(vi)** filing of draft prospectus/due diligence-certificates/payment of fee/issue advertisement, **(vi)** display of bid data, **(vii)** post-issue reports, **(viii)** unsubscribed issue, **(ix)** and basis of allotment.

Eligibility An issuer of IDRs should **also** satisfy the following: It **(i)** is listed in its **home country** (i.e. the country where it is incorporated/listed), **(ii)** not prohibited to issue securities by a regulatory body and **(iii)** has track record of compliance with securities market regulations in its home country.

Conditions for Issue The conditions for IDR issue are: **(i)** minimum issue size, ₹50 crore, **(ii)** procedure to be followed by each class of applicant should be mentioned in the prospectus, **(iii)** minimum application amount, ₹20,000, **(iv)** at least 50 per cent of the issue should be allotted to QIBs on proportionate basis as per illustration in **Part C of Appendix 11-J on the website**, **(v)** balance 50 per cent may be allotted among categories of non-institutional/retail individual investors including employees at the discretion of the issuer and the manner of allocation should be disclosed in the prospectus; allotment to investors within a category should be on proportionate basis; at least 30 per cent of the IDRs being offered to the public should be allocated to retail individual investors and spill over to the extent of under-subscription in this category would be permitted to others, and **(vi)** there should be only one denomination of the IDR at a time, **(vii)** the issuing company should ensure that the underlying **(1)** equity shares have been/will be listed in the home country before listing of IDRs, **(2)** shares of IDRs would rank *pari passue* with the existing shares of the same class, **(viii)** the issuing company should ensure that the underlying shares of IDRs would rank *pari passue* with the existing shares of the same class.

Minimum Subscription If the issuer does not receive in a **non-underwritten issue** the minimum subscription of 90 per cent of its offer through the offer document on the date of closure or the subscription level falls below 90 per cent after its closure on account of cheques returned unpaid/withdrawal of applications, the entire subscription money should be refunded forthwith. Failure to refund within 15 days would be liable to pay 15 per cent interest for the period of delay.

For an **underwritten issue**, the issuer should forthwith refund the entire subscription in case of under-subscription below 90 per cent including devolvement on underwriters with 60 days and with 15 per cent interest for delay beyond 60 days.

Fungibility The DIRs would not b automatically fungible into the underlying shares of the issuing company.

Filing of Offer Document/Due Diligence Certificate, Payment of Fee and Issue Advertisement The issuing company should appoint merchant banker(s) at least one of whom would be lead merchant banker and also appoint other intermediaries in consultation with the lead merchant banker and enter into an agreement with a merchant banker(s) on the lines of the format specified **in Appendix 11-B on the website**. The rights/obligations/responsibilities relating, *inter-alia*, to disclosures/allotment/refund/ underwriting obligations of each merchant banker should be determined/disclosed in the prospectus on the lines of the format specified **in Appendix 11-A on the website**.

It should also file a draft prospectus in a soft copy on the lines specified **in Appendix 11-D on the website** with the SEBI through a merchant banker with the requisite fee as prescribed in Companies Issue of IDRs Rules (**discussed earlier**). The merchant banker should **(i)** submit due diligence certificate in the format given in **Part C of Appendix 11-R on the website** to the SEBI along with the draft prospectus, **(ii)** certify that all amendments/suggestions/observations made by the SEBI have been incorporated in the prospectus, **(iii)** submit a fresh due diligence certificate specified in **Part C of Appendix 11-R on the website** while filing the prospectus with the ROCs, **(iv)** furnish a certificate specified in **Part C of Appendix 11-R on the website** immediately before the opening of the issue, certifying that no corrective action is required on its part and **(v)** furnish a certificate specified in **Part C of Appendix 11-R on the website** after the issue has been opened but before it closes for subscription.

The issuing company should **(a)** make arrangements for mandatory collection centres as specified in **Appendix 11-C on the website**, **(b)** issue an advertisement in one English/Hindi national daily newspaper with wide circulation soon after receiving final observations on the publicly-filed draft prospectus with the SEBI containing the minimum disclosures given in **Part A of Appendix 11-L on the website.**

Agreement with Other Intermediaries The issuing company should **(i)** appoint a registrar and share transfer agent which has connectivity with all depositories, **(ii)** enter into an agreement with overseas custodian bank and domestic depository.

Display of Bid Data The stock exchanges offering online bidding system for book building process should display on their website the data pertaining to the book-built IDR issue in the format specified in **Part B (II) of Appendix 11-J on the website** from the date of opening till at least 3 days after closure of the bids. The issuing company should ensure that the letter of allotment for IDRs are issued simultaneously to all allottees. On failure to issue letters of regret simultaneously, a notice should be issued in the media on the morning following the despatch of the allotment of letters.

Disclosures in Prospectus/Abridged Prospectus The prospectus should contain, in general, all material disclosures which are true/correct/adequate so as to enable the applicants to take an informed investment decision. In particular, the prospectus should contain the disclosures **(a)** specified in Companies Issue of IDR Rules and **(b)** in the manner specified in **Part A of Appendix 11-R on the website**. The abridged prospectus should contain the disclosures specified in **Part B of Appendix 11-R on the website.**

Post-issue Reports The merchant banker should submit to the SEBI **(i)** initial post-issue report on the lines of **Part A of Appendix 11-O on the website** within 3 days of closure of the issue and **(ii)** final post-issue report on the lines of **Part C and D of Appendix 11-O on the website** within 15 days of the finalisation of the basis of allotment/refund of money in case of failure of issue.

Undersubscribed Issue The merchant banker should furnish information in case of under-subscribed issues regarding underwriters who have failed to meet their underwriting devolvement to the SEBI in the format specified **in Appendix 11-P on the website.**

Finalisation of Basis of Allotment The ED/MD of the stock exchange where the IDRs are proposed to be listed along with the post-issue lead merchant banker(s) and registrar to the issue should ensure that the basis of allotment is finalised in a fair and proper manner in accordance with the allotment procedure specified **in Appendix 11-N on the website.**

Rights Issues of IDRs In addition to compliance with the requirements relating to the issue of IDRs discussed above, the listed issuer offering IDR through a rights issue should, at the time of filing the offer document, satisfy the conditions specified below. However, the conditions applicable to the issue of IDRs relating to **(i)** issue size/procedure for application/minimum application amount/reservation for QIBs, **(ii)** display of bid data and **(iii)** disclosure in prospectus/abridged prospectus would not apply in case of their rights issues. The issuer should prepare the offer document in accordance with the home country requirements along with an addendum containing disclosure specified by the SEBI and filed with the SEBI/concerned stock exchange. The applicable conditions are; **(i)** eligibility, **(ii)** renunciation, **(iii)** depository, **(iv)** record date, **(v)** disclosures, **(vi)** filing of offer document, **(vii)** fast track issue, **(viii)** dispatch of abridged letter of offer, **(ix)** period of subscription, **(x)** pre-issue advertisement and **(xi)** utilisation of funds.

- The issues should **(i)** not be in breach of ongoing material obligation under the IDR listing/deposit agreement, **(ii)** apply to the concerned stock exchange(s) for listing of issue and chose one of them as the designated stock exchange;
- Subject to the laws of the home jurisdiction of the issuer, the rights offering would be deemed to include the right of renunciation in favour of any other person and disclosed in the offer document;
- The domestic depository should take the necessary steps to enable the IRD holders to have entitlements under the rights offering and issue additional IDRs, to distribute the rights to them, arrange for their renunciation/subscription for any additional rights available due to lack of take-up of other holders.
- The issuer should announce a record date for determining the eligible shareholders. Withdrawal of the rights issue after announcing the record date should be notified to **(i)** the SEBI, **(ii)** in one **(a)** English/Hind national and **(b)** regional language daily newspaper with wide circulation at the place of the principal office of the issuer. The issuer would be eligible to apply for IDR offering on a rights basis only after 12 months from the record date.
- The offer document should contain **(i)** disclosures required under the home country regulations, **(ii)** addendum to the offer document containing SEBI-specified disclosures. It should contain all material information which are true/correct/ adequate for informed investment decision.
- A lead merchant banker(s) and other intermediaries should carry out the obligations relating to the issue. The draft offer document and the addendum should be filed with SEBI by the lead merchant banker together with the specified fee. The SEBI may specify changes or issue observations within the later of 30 days or from the following dates, namely, date of receipt of **(i)** the draft offer document/addendum, **(ii)** satisfactory reply on any clarification/additional information by the lead merchant banker, **(iii)** clarification/information sought by the SEBI from any regulator/agency, and **(iv)** a copy of in-principle approval letter from the concerned stock exchange. The revised draft offer should be filed in the light of changes/observations of the SEBI. The issuer should also submit from the overseas

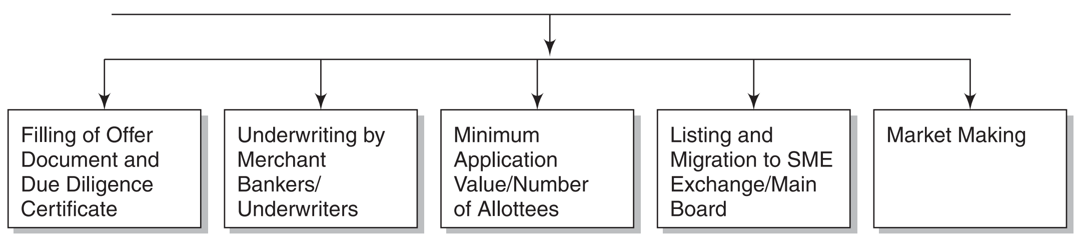
custodian/domestic depository an undertaking to comply with their obligations. He should ensure that the concerned compliance officer functions from within the territorial limits of India.

- An issuer, on satisfying the following conditions, can fast track an issue and file the offer document/addendum with the SEBI only for record purposes: **(a)** he is in compliance in all material respects with the provisions of the deposit/listing agreement for at least 3 years immediately preceding the date of its filing, **(b)** the offer document has been filed/ reviewed by the securities regulator in his home country, **(c)** there are no pending show-cause notices/prosecution proceedings against him/promoters/directors on the reference by the SEBI/regulatory authorities in the home country restricting them from accessing the capital market and, **(d)** the issuer has redressed at least 95 per cent of the IRD holders complaints before the end of 3 months immediately preceding the month of date of filing the letter of offer with the designated stock exchange.
- The abridged letter along with the application form should be dispatched through registered/speed post to all the eligible IDR holders at least 3 days before the issue opening date and made available on the website of the issuer with appropriate access restrictions. A hard copy should be made available at the principal office of the issuer/lead merchant banker to the existing IRD holders. Those who have not received the application form can apply in writing on a plain paper to the domestic depository with the requisite application money but they cannot renounce their rights. An application on an application form as well as on plain paper would be liable to be rejected. The issue price and ratio would be decided simultaneously with record date in accordance with the home country regulations.
- The subscription period would in case be less than 10 days.
- The pre-issue advertisement should be made in at least **(i)** one English/Hindi national daily newspaper with wide circulation and **(ii)** on regional language daily with wide circulation at the place of the principal office of the issuer in India at least 3 days before the issue opening. It should disclose the following: **(i)** date of completion of dispatch of the abridged letter of offer/application form, **(ii)** centres other than the principal office of the issuer in India where the eligible IDR holders may obtain duplicate copies of application form, **(iii)** statement that they can make application in writing on a plain paper to subscribe to the issue together with the format to make such application, **(iv)** statement that the application can be directly sent together with the application money to the designated official at the given address, and **(v)** statement to the effect that application made simultaneously on plain paper and application form would be rejected at the option of the issuer.
- The issuer can utilise the funds only upon completion of the allotment process.

Issue of Specified Securities by Small and Medium Enterprises (SMEs)

This Section describes the capital issue procedure of issuer whose post-issue face value capital does not exceed ₹10 crore. Issuers whose post-issue face value capital is between ₹10–25 crore may also use this procedure. The provisions of the SEBI's Issue of Capital and Disclosure Requirements (ICDR) Regulations **discussed in earlier sections of this chapter** would *mutatis mutandis* apply to such issues in respect of matters not specified by the procedure described in this Section. However, the provisions of the ICDR Regulations specified below would not apply to them: **(i)** Minimum subscription value (**Regulation 49**), **(ii)** Conditions for further public offer (**27**); **(iii)** Conditions for IPO (**26**); **(iv)** Reference date (**25**); **(v)** Fast track issues (**10**); **(vi)** Draft offer document made public (**9**); **(vii)** Documents to be submitted before opening of the issue (**8**); **(viii)** In-principle approval from recognised stock exchange (**7**); and **(ix)** Filing of offer document (**Regulation 6**). The main elements of the issue procedure by the SMEs: **(i)** filing of offer document and due diligence certificate, **(ii)** underwriting by merchant bankers and underwrites, **(iii)** minimum application value/minimum number of allottees, **(iv)** listing of specified securities, migration to SME exchange/main board and **(v)** market making are portrayed in **Exhibit 11.6**.

Exhibit 11.6 Issue of Specified Securities by Small and Medium Enterprises (SMEs)



Filing of Offer Document and Due Diligence Certificate The SME-issuer making a public/rights issue of specified securities should not file the draft offer document with the SEBI. A copy of the offer document should be filed with the SEBI through a merchant banker simultaneously with the filing of the prospectus with the **SME exchange** (i.e. a trading platform of a recognised stock exchange having nationwide trading terminals permitted by the SEBI to list the specified securities issued by SMEs and including a stock exchange granted recognition for this purpose but does not include the Main Board) and the ROCs or letter of offer with SME Exchange. **Main Board** means a recognised stock exchange having nationwide trading terminals other than SME exchange. Moreover, the SEBI would not issue any observation on the offer document. The merchant banker should submit a due diligence certificate in the prescribed format including the specified addition confirmation along with the offer document to the SEBI **in Form H of Appendix 11-E on the website**. The offer document should be displayed from the date of filing on the website of the SEBI/issuer/merchant banker/the SME exchange where the securities are proposed to be listed.

> **SME exchange** is a trading platform of a recognised stock exchange having nationwide trading terminals permitted by the SEBI to list the specified securities issued by SMEs and including a stock exchange granted recognition for this purpose but does not include the Main Board.

> **Main Board** means a recognised stock exchange having nationwide trading terminals other than SME exchange.

Underwriting by Merchant Bankers/Underwriters The **entire** issue (and not restricted to the minimum subscription level) should be underwritten. At least 15 per cent of the issue size should be underwritten by the merchant banker(s) on his/their own account(s). The issuer in consultation with the merchant banker may appoint SEBI-registered underwriters. The merchant banker may enter into an agreement with a **nominated investor** indicating the number of securities which they agree to subscribe at issue price in case of undersubscription. A **nominated investor** means a

QIB/private equity fund (i.e. a fund registered with any regulatory authority or a fund established by any person registered with any regulatory authority) who enters into an agreement with the merchant banker to subscribe to the issue in case of undersubscription or to receive/deliver the securities in the market making process. The merchant banker would fulfil the underwriting obligation in case of failure of other underwriters/nominated investors to fulfil their underwriting/subscription obligations. The underwriters/nominated investors cannot subscribe to the issue in any manner other than fulfilling their obligations under their respective agreements in this regard. All the underwriting/subscription arrangements should be disclosed in the offer document. An undertaking to the effect that the issue has been 100 per cent underwritten along with the list of underwriters/nominated investors should be filed by the merchant banker with the SEBI one day before the opening of the issue.

Minimum Application Value/Number of Allottees The minimum size would be ₹1 lakh per application and should be disclosed in the offer document. The minimum number of prospective allottees is 50.

Listing and Migration to SME Exchange/Main Board The specified securities would be listed on SME exchange. Securities of the issuer listed on any other stock exchange would have to migrate on the SME exchange. A listed issuer whose post-issue face value capital is less than ₹25 crore may migrate its securities to the SME exchange if its non-promoter shareholders approve it by a special resolution with a two-thirds majority. Similarly, such an issuer may migrate its securities from an SME exchange to the main board. Where the post-issue face value capital of an issuer listed on SME exchange is likely to exceed ₹25 crore by virtue of further issues of capital by way of rights/preferential/bonus issue(s), the issuer should migrate such listed securities to, and seek their listing on, the Main Board. He would be able to make further issues of capital only if **(i)** the non-promoter shareholders approve by a two-thirds majority in a special resolution through postal ballot and **(ii)** in-principle approval from the Main Board is obtained for listing of the entire securities.

Market Making The merchant banker should ensure compulsory market making through the SME exchange brokers in the manner specified by the SEBI for at least three years from the date of **(i)** listing of the securities on the SME exchange or **(ii)** migration from the main board. He should also enter into an agreement with nominated investors for receiving/delivering the securities in the market making subject to the SME exchange's prior approval. The details of the market making arrangement should be disclosed in the offer document. Such securities may be transferred to, or from, the concerned nominated investor. The minimum inventory of the market maker on the date of allotment should be 5 per cent of the securities proposed to be listed. The market maker should buy the entire holding in one lot of a shareholder whose holding is less than the minimum contract size for trading but he cannot sell in lots less than the minimum contract size. Moreover, he cannot buy shares from the promoter(s)/persons belonging to the promote group of the issuer or any person who has acquired shares from them during the compulsory market making period. Similarly, the promoters holding would not be eligible for offering to the market maker. However, such holding which is not locked-in can be traded with the prior permission of the SME exchange in a manner specified by the SEBI. Subject to arrangement with the issuer, the merchant banker responsible for market making may be represented on the Board of the issuer.

Directions by SEBI

Subject to the power under Sections 11, 11-A/B/D, 12(3), 24 and Chapter VI-A of the SEBI Act and Section 621 of the Companies Act, the SEBI may either *suo motu* or on receipt of information/completion/pendency of an inspection/inquiry/investigation, in the interest of investors/securities market issue directions/orders it deems fit including **(i)** directing the person concerned not to access the securities market for a specified period/to sell or divest the securities, **(ii)** any other direction which it may deem fit/proper in the circumstances of the case.

Listing on Institutional Trading Platform The provisions discussed below apply to entities which seek listing of their specified securities exclusively on the institutional trading platform either pursuant to a public issue or otherwise. The SEBI regulations in respect of the matters not specifically dealt or excluded below would apply *mutatis mutandis* to any listing of these specified securities. The **institutional trading platform** means the trading platform for listing/trading of specified securities of **(a)** an entity which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value addition and at least 25 per cent of its pre-issue capital is held by qualified institutional buyer(s), **(b)** any other entry in which at least 50 per cent of the pre-issue capital is held by qualified institutional buyers as on the date of filing of draft information/offer document with the SEBI. No person, individually/collectively with persons acting in concert, should hold 25 per cent or more of the post-issue share capital in the entity. The main elements of the SEBI regulations **(i)** listing without/with public issue, **(ii)** lock-in, **(iii)** trading lot, **(iv)** exit and **(v)** migration to main board are discussed below.

> **Institutional trading platform** means the trading platform for listing/trading of specified securities of (a) an entity which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value addition and at least 25 per cent of its pre-issue capital is held by qualified institutional buyer(s), (b) any other entry in which at least 50 per cent of the pre-issue capital is held by qualified institutional buyers.

Listing Without Public Issue The entity seeking listing of its specified securities without making a public issue should file a draft information document along with the necessary documents with the SEBI along with the specified fee. The draft information document should contain the specified disclosure. The regulations relating to the following would not be applicable in case of listing without public issue: **(i)** allotment, **(ii)** issue opening/closing, **(iii)** advertisement, **(iv)** underwriting, **(v)** the stipulation relating to initial public offer, if there are outstanding convertible securities/any other right entitling any person to receive equity shares, **(vi)** pricing, **(vii)** dispatch of issue material, and **(viii)** and other such provisions related to offer of specified securities to public. The entity should obtain in-principle approval from and list its securities on the recognised stock exchange(s) within 30 days from the **(a)** date of issuance of observations by the SEBI, **(b)** expiry of the stipulated period if the SEBI has not issued any observation. The provisions relating to minimum public shareholding would not apply to these entities. The draft and final information document should be approved by the Board of Directors of the entity and signed by all the directors, the chief executive officer, that is, the managing director/manager and the chief financial officer, that is, the whole-time finance director or any other person heading the finance function and discharging that function. The signatories should also certify that all disclosures made in the information document are true and correct. In case of mis-statement in the information document or any omission, any person who has authorised the issue of information document would be liable in accordance with the provisions of the SEBI Act/regulations.

Listing Pursuant to Public Issue An entity seeking issue and listing of its specified securities should file a draft offer document along with the necessary documents with the SEBI along with the specified fees. The minimum application size should be ₹10 lakh and the number of allottees should be more than 200. The allocation in the net offer to public category should be 75 per cent to institutional investors (without specific allocation for anchor investors), 25 per cent to non-institutional investors. **Institutional investor** means QIBs, family trust, RBI-registered systematically important NBFCs, SEBI-registered intermediaries with minimum networth of ₹500 crore. Any under-subscription in the non-institutional investor category would be available for subscription under the institutional category. The allotment to institutional investors may be on a discretionary basis whereas the allotment to non-institutional investors should be on a proportionate basis. The mode of allotment to institutional investor (whether discretionary or proportionate) should be disclosed prior to or at the time of filing of the red-herring prospectus. In case of discretionary allotment, no institutional investor should be allotted more than 10 per cent of the issue size. The offer document should disclose the broad objects of the issue. The basis of issue price may include disclosures, except projections, as deemed fit by the issuers in order to enable investors to take informed decisions and the disclosures should suitably caution the investors about the basis of valuation.

> **Institutional investor** means QIBs, family trust, RBI-registered systematically important NB-FCs, SEBI-registered intermediaries with minimum networth of ₹500 crore.

Lock-in The entire pre-issue capital of the shareholders should be locked-in for 6 months from the date of allotment in case of listing pursuant to public issue or date of listing in case of listing without public notice. The specified securities held by promoters and locked-in may be pledged with any bank/public financial institution as collateral security for loan if the pledge of the specified securities is one of the terms of sanction of the loan. The locked-in securities may be transferrable in accordance with the SEBI regulations. All specified allotted on a discretionary basis should be locked-in in accordance with the specified requirements for lock-in by anchor investor on the main board of the stock exchange.

Trading Lot The minimum trading log would be ₹10 lakh.

Exit of Entities Listed Without Making a Public Issue The entity whose specified securities are listed on the institutional trading platform without making a public issue may exit from that platform, if **(a)** it is approved by its shareholders by passing a special resolution through postal ballot where 90 per cent of the total votes and the majority of non-promoter votes have been cast in favour of such proposal and **(b)** the recognised stock exchange approves of such an exit. The recognised stock exchange may delist the specified securities upon non-compliance of the conditions of listing and in the specified manner. No delisted entity promoted by promoters and directors would be permitted to list on institutional trading platform for 5 years from the date of delisting.

Migration to Main Board An entity that has listed its specified securities on institutional trading platform may at its option migrate to the main board after three years from the date of listing subject to compliance with the eligibility requirements of the concerned stock exchange.

Listing of Securities on Stock Exchanges The main elements of the regulation are: in-principle approval, application for listing, listing agreement and obligation of stock exchanges.

In-principle Approval of Recognised Stock Exchange(s) The issuer/issuing company should obtain in-principle approval **(a)** in case of an initial public offer/an issue of IDRs from all the recognised stock exchange(s) on which the specified securities are proposed to be listed and **(b)** in case of other issues, before issuance of further securities where they are **(i)** listed only on recognised stock exchange(s) having nationwide trading terminals, from all such stock exchange(s), **(ii)** not listed on any recognised stock exchange having nationwide trading terminals, from all the stock exchange(s) on which they are proposed to be listed, **(iii)** listed on recognised stock exchange(s) having nationwide trading terminals as well as on the recognised stock exchange(s) not having nationwide trading terminals, from all recognised stock exchange(s) having nationwide trading terminals.

Application for Listing The issuer/issuing company should complete the pre-listing formalities within the SEBI-specified time lines. It should make an application for listing within 20 days from the date of allotment, to recognised stock exchange(s) along with the documents specified by them, failing which it should pay penal interest to allottees for each day of delay at the rate of atleast 10 per cent per annum from the expiry of 30 days from date of allotment till the listing of securities to the allottees. In the event of non-receipt of listing permission from the stock exchange(s), or withdrawal of observation letter issued by the SEBI, the securities would not be eligible for listing and the issuer/issuing company would be liable to refund the subscription monies, to the respective allottees immediately alongwith interest at the rate of 10 per cent per annum from the date of allotment.

Listing Agreement Every issuer/issuing company desirous of listing its securities should execute a listing agreement with the recognised stock exchange.

Obligation of Stock Exchange(s) The stock exchange(s) should grant in-principle approval/list the securities or reject the application for in-principle approval/listing by the issuer/issuing company within 30 days from the later of the date of receipt of **(i)** application for in-principle approval/listing, **(ii)** satisfactory reply from the issuer/issuing company, in cases where the stock exchange(s) has sought any clarification from them.

Directions by the SEBI The SEBI may either *suo moto* or on receipt of information or on completion of any inspection, inquiry or investigation, in the interest of investors or the securities market, issue such directions or orders as it deems fit including any or all of the following: directing the persons concerned not to **(a)** access the securities market for a specified period, **(b)** to sell or divest the securities, **(c)** any other direction which it deems fit and proper in the circumstances of the case.

SEBI ISSUE AND LISTING OF DEBT SECURITIES REGULATION 2008

> **Debt securities** means non-convertible securities which create/acknowledge indebtedness and include debentures/bonds and other securities of a body corporate/any statutory body.

These regulations are applicable to **(i)** public issues of debt securities and **(ii)** listing of debt securities through public offer or on private placement basis on a recognised stock exchange. **Debt securities** means non-convertible securities which create/acknowledge indebtedness and include debentures/bonds and other securities of a body corporate/any statutory body constituted by virtue of a legislation, whether constituting a charge on its assets but excludes **(i)** bonds issued by Government/other bodies specified by the SEBI, **(ii)** security receipts and **(iii)** securitised debt instruments.

Public issue means an offer/invitation by a issuer to public to subscribe to debt securities. **Private placement** is an offer/invitation to less than 50 persons to subscribe to debt securities. **Recognised stock exchange** means a stock exchange which is recognised by the SEBI under the provisions of the Securities Contracts (Regulation) Act. The main elements of the regulations **(i)** issue requirements for public issues, **(ii)** listing of debt instruments, **(iii)** conditions for continuous listing and trading, **(iv)** obligations of intermediaries and issuers, **(v)** procedure for action for violation and **(vi)** miscellaneous are discussed in this Section.

> **Private placement** is an offer/invitation to less than 50 persons to subscribe to debt securities.

> **Issuer**
> means a company/public sector undertaking/statutory corporation which **(i)** makes/proposes to make an issue of debt securities, **(ii)** has listed/seeks to list its securities on a recognised stock exchange.

Issue Requirements for Public Issues

Any **issuer** (i.e., a company/public sector undertaking/statutory corporation which **(i)** makes/proposes to make an issue of debt securities, **(ii)** has listed/seeks to list its securities on a recognised stock exchange) cannot make public issue of debt securities if on the date of filing of draft/final offer document, the issuer/persons in control of the issuer/its promoter **(a)** has been restrained/prohibited/debarred by the SEBI from accessing the securities market/dealing in securities, **(b)** is a willful defaulter/is in default of payment of interest/repayment of principal in respect of debt securities issued to public for more than 6 months. **Offer document** means prospectus and includes any such document/**advertisement** (i.e. notices/brochures/ pamphlets/circulars/ show cards/catalogues/hoardings/placards/ postcards/ insertions in newspaper/pictures/ films/cover pages of offer documents or any other print media/radio/television programme through any electronic medium), whereby subscription to debt securities are invited from the public. To make a public issue of such securities, the following condition must be satisfied on the date of filing of draft/final offer document. It has: **(a)** made an application to a recognised stock exchange(s) for their listing, one of which would be chosen as the designated stock exchange for the particular issue; **(b)** obtained in-principle approval for their listing; **(c)** obtained credit rating from at least one SEBI-registered credit agency which should be disclosed in the offer document. All the ratings including the unaccepted ratings must also be disclosed in the offer document; and **(d)** entered into an arrangement with a SEBI-registered depository for their dematerialisation.

> **Offer document**
> means prospectus and includes any such document/advertisement whereby subscription to debt securities are invited from the public.

The issuer should appoint **(1)** SEBI-registered merchant bankers at least one of whom would be the lead manager, **(2)** debenture trustees, and **(3)** not issue debt securities to provide loan to, acquisition of shares of, any person who is part of the same group/under the same management.

Disclosures in/Filing of Offer Document The offer document should contain all **material** (i.e. anything likely to impact investors investment decision) disclosures necessary for subscribers to take an informed investment decision. The issuer/lead merchant banker should ensure that it contains the following:

- Disclosures specified in Schedule II of the Companies Act;
- Disclosures/additional disclosures specified by the SEBI.

A draft offer document should be filed with the designated stock exchange (DSE) through the lead merchant banker. It should be made public by posting on the website of the DSE for public comments for 7 days. It may also be displayed on the website of the issuer/merchant banker/stock exchange(s) where the securities are proposed to be listed. The lead merchant banker should ensure that **(i)** it clearly specifies the names and contact particulars of the compliance officer of the merchant banker/issuer, **(ii**) all comments received are suitably addressed prior to its filing with the Registrar of Companies (ROCs). A copy of the draft/final offer document should also be forwarded to the SEBI for its records. Prior to filing the offer document with the ROCs, the merchant banker should furnish to the SEBI a due diligence certificate. The debenture trustees should, prior to the opening of the issue, furnish to the SEBI a due diligence certificate. The draft/final offer document should be displayed on the website of stock exchanges. It should be filed with the designated stock exchange, and the ROCs simultaneously for dissemination on the website before the opening of the issue. If required, a physical copy of the offer document should be made available to any person.

Advertisement for Public Issues The issuer should make an advertisement in a national daily with wide circulation on/before the issue opening date containing the specified disclosures. The advertisement should **(i)** not be misleading in material particular/contain information in a distorted manner or which is manipulative/deceptive, **(ii)** be truthful/fair/clean and not contain an untrue/misleading statement/promise/forecast, **(iii)** not contain any extraneous matters to the contents of the offer document, and **(iv)** urge the investors to invest only on the basis of the information contained in the offer document. Any corporate/product advertisement during the subscription period should not make any reference to the issue or be used for solicitation.

Abridged Prospectus/Application Forms The issuer/lead merchant banker should ensure that **(1)** every application form is accompanied by a copy of the abridged prospectus which should not contain extraneous mattes and **(2)** adequate space would be provided in the application form to enable the investors to fill in various details. The facility for subscription of application in electronic mode may be provided. The issue through the on-line system of the DSE should comply with the relevant applicable requirements as may be specified by the SEBI.

Price Discovery Through Book Building The issuer may determine the price of the securities in consultation with the lead merchant banker. It may be a fixed price or may be determined through book building process in accordance with procedure specified by the SEBI. **Book building** means a process undertaken prior to filing of prospectus with the ROCs by means of circulation of a notice/circulars/advertisement/other document by which the demand for the securities proposed to be issued is elicited and their price and quantity is assessed.

> **Book building** means a process undertaken prior to filing of prospectus with the ROCs by means of circulation of a notice/circulars/advertisement/other document by which the demand for the securities proposed to be issued is elicited and their price and quantity is assessed.

Minimum Subscription The amount of minimum subscription sought to be raised should be disclosed in the offer document. If the minimum subscription is not received, all application money received should be refunded forthwith to the applicants.

Allotment of Securities/Payment of Interest The debt securities offered to the public should be allotted/application money refunded within 30 days of the closure of the issue failing which the issuer should undertake to pay 15 per cent interest per annum. The demat account of allottees should be credited within two working days from the date of allotment.

Underwriting The issue may be undertaken by SEBI-registered underwriter(s). Adequate disclosures regarding the underwriting arrangement should be made in the offer document.

Prohibition of Mis-Statement The offer document should not omit disclosure of any material facts which may make the statement misleading. The offer document/abridged prospectus/any advertisement should not contain any false/misleading statement.

Trust Deed A trust deed securing the issue of debt securities should be executed in favour of the debenture trustees within 3 months of the closure of the issue. It should contain the clauses prescribed under Section 117-A of the Companies Act and those mentioned in the SEBI Debenture Trustees Regulation (**discussed in Chapter 6**). Moreover, it should not contain clauses which have the effect of **(i)** limiting/extinguishing the obligations/liabilities of trustees/issuer(s) in relation to right(s)/interest(s) of the investors, **(ii)** limiting/restricting/waiving the provisions of the SEBI Act/these regulations and circulars/guidelines issued by the SEBI, **(iii)** indemnifying the trustees/issuer(s) for loss/damage caused by their act of negligence/commission/omission.

Debenture Redemption Reserve (DRR) The issuer should create a DRR in accordance with the provisions of the Companies Act and circulars issued by the Government. Any distribution of dividend would require the approval of the trustees if the issue has defaulted in payment of **(i)** interest, **(ii)** redemption, **(iii)** creation of security.

Creation of Security The proposal to create a charge/security in respect of the debt securities should be disclosed in the offer document along with its implications. The issuer should give an undertaking that the assets in which charge is created are free from any encumbrances and if they are already charged to secure a debt, the permission/ consent to create second or ***pari passu*** charge on the assets have been obtained from the earlier creditor(s). The issue proceeds should be kept in an escrow account until the documents for creation of security are executed.

Right to Recall/Redeem Prior to Maturity The issuer may **(i)** recall the debt securities at his call option, **(ii)** provide right of (put) redemption to all/**retail investors** (i.e. holders of securities upto ₹ 2 lakh) at their option prior to maturity date. The right to recall/redeem should be exercised in terms of the issue and detailed disclosures in the offer document including date, period of exercise (at least 3 working days), and redemption amount including premium/discount. These rights may be exercised with respect to all/a part of the securities held/issued. The partial exercise should be done on proportionate basis only. The rights would be exercisable after 24 months from date of their issue. The issuer should **(i)** send a notice to all eligible holders at least 21 days before the exercise date, **(ii)** provide a copy of the notice to the concerned stock exchange for wider dissemination and advertise in a national daily having wide circulation indicating details of the rights and eligibility of the entitled holders, **(iii)** pay the redemption proceeds to the investors with interest due within 15 days from the last date within which the right can be exercised and **(iv)** pay 15 per cent interest for the period of delay. After the completion of the exercise, the issuer should submit a detailed report to the stock exchange regarding the redeemed securities and their redemption.

Redemption and Roll-Over The securities should be redeemed in terms of the offer document. Their rollover would require a special resolution of their holders and 21-days notice to them. The notice should contain disclosures with regard to credit rating and rationale for the roll-over. The issuer should, prior to sending the notice to the securityholders, file a copy of it and proposed resolution with the concerned stock exchange for dissemination to the public on its website. The roll-over would be subject to the following: **(i)** approval by a special resolution passed through postal ballot having consent of at least 75 per cent of the secuirtyholders, **(ii)** at least one rating within 6 months prior to the date of redemption, **(iii)** execution of a fresh trust deed at the time of the roll-over or the existing trust deed may continue if it has provision to this effect and **(iv)** creation/maintenance of adequate security in respect of securities to be rolled-over. The securities of all the securityholders who have not given their positive consent should be redeemed.

Listing of Debt Securities

The SEBI requirements relating to listing of debt securities are as follows:

Mandatory Listing The issuer of debt securities to the public should make an application for listing to a recognised stock exchange(s). It should comply with the conditions of listing as specified in the listing agreement with the concerned stock exchange. For listing of debt securities issued on private basis, the issuer should forward the listing application along with the specified disclosures to the concerned stock exchange within 15 days from the date of their allotment. The issuer should execute an agreement with the stock exchange. The conditions of listing of securities issued on a private placement basis on a recognised stock exchange are as follows: The issues is in compliance with the provisions of the Companies Act/rules and other applicable laws; credit rating has been obtained from at least one SEBI registered agency; the securities are listed in demat form; and the specified disclosures have been made.

The issuer should comply with the conditions of listing as specified in the listing agreement with the concerned stock exchange.

Consolidation/Re-issue An issuer may carry out consolidation/re-issuance of its debt securities if **(i)** the articles contain and enabling provision, **(ii)** the issue is through private placement, **(iii)** fresh credit has been obtained for re-issuance to be revalidated periodically disclosing any changes and **(iv)** appropriate disclosures are made in the term sheet.

Disclosures in Respect of Private Placements The issuer should make the specified disclosures in a disclosure document. These should be made on the website of the concerned stock exchange. The issuer may file a shelf disclosure document containing the specified disclosures. While making subsequent private placement within 180 days from its filing, filing disclosure document would not be required.

Relaxation of Rule 19 Securities Contracts (Regulation) Rules The SEBI has relaxed the strict enforcement of the rules relating to **(i)** the documents to be forwarded along with the application to the stock exchange for listing and the conditions precedent to listing relating to listing of debt securities by way of public issue/private placement [Rules 19 **(1) and (3)**] and **(ii)** minimum amount of public offer **[Rule (19)(b)]** in relation to listing of debt securities **(a)** by way of private placement and, **(b)** issued to public by an infrastructure company/ Government company/a statutory authority/corporation/any special purpose vehicles set up by any of the them which is engaged in infrastructure sector.

Conditions for Continuous Listing/Trading of Debt Securities

The conditions are listed below.

Continuous Listing All the issuers making public issue of debt securities/seeking their listing issued on a private placement basis should comply with the conditions of listing specified in the respective listing agreement(s).

Trading The debt securities issued to public or on a private placement basis should be traded and such trades should be cleared/settled in recognised stock exchanges subject to conditions specified by the SEBI. In case of securities made over-the-counter, the trades should be reported on a recognised stock exchange having a nationwide trading terminal/other platform specified by the SEBI. The SEBI may specify conditions for reporting of all such trades.

Obligations of Intermediaries/Issuers

The obligations of the debenture trustees/issuers/lead merchant bankers are listed below:

Debenture Trustee They should

- Be vested with the requisite powers for protecting the interests of the securityholders including the right of a nominee director on the Board of Directors of the issuer in consultation with the institutional secuirtyholders;
- Carry out their duties and perform their functions under the regulations/the SEBI Debenture Trustee Regulations/trust deed/offer document with due care, diligence and loyalty;
- Ensure disclosure of all material events on an ongoing basis; and
- Supervise the implementation of the conditions regarding creation of security and debenture redemption reserve.

Issuer/Lead Merchant Banker The issuer should disclose all the material facts in the offer document and ensure that all the disclosures are true, fair and adequate and there is no misleading/untrue statement/misstatement. The merchant banker should verify and confirm that such disclosures are true, fair, adequate and ensure that the issuer is in compliance with the regulations as well as transactions specific required disclosures and the Companies Act. The issuer should treat the applicants in a fair and equitable manner as per the SEBI-specified procedures. The intermediaries would be responsible for the due diligence in respect of assignments undertaken by them in respect of the issue, offer and distribution of securities to the public. No person should employ any device/scheme/artifice to defraud in connection with the issue/subscription/distribution of securities which are listed/proposed to be listed. The issuer and the merchant banker should ensure that the security created is adequate to ensure 100 per cent asset cover for the debt securities.

Action in Case of Violation of Regulations

Inspection by SEBI The SEBI may *suo moto* or upon information received by it, appoint a person(s) to undertake the inspection of books of account/records/documents of the issuer/merchant banker/other intermediary associated with the issue/disclosure/listing of securities for any of the following purposes:

- To verify where the **(i)** provisions of the SEBI Act/Securities Contracts (Regulation) Act/Depositories Act and the rules/regulations, **(ii)** requirement specified in these regulations in respect of issue of securities, and **(iii)** requirement of listing conditions and continuous disclosure has been complied with;

- To inquire into **(i)** the complaints received from the investors/other market participants/ any other person on any matter of issue/transfer of securities, **(ii)** the affairs of the issuer in the interest of the investor protection or the integrity of the market, **(iii)** whether any direction issued by the SEBI has been complied with.

While undertaking an inspection, the inspecting authority/SEBI should follow the SEBI specified procedure for inspection of intermediaries.

Directions by SEBI The SEBI may *suo moto* on receipt of information on completion or pendency of inspection, in the interests of the securities market, issue/pass such directions as it may deem fit including the following:

- Direct the issuer to refund the application money,
- Direct the person concerned not to **(i)** further deal in securities in any particular manner, **(ii)** access the securities market for a particular period,
- Restraint the issuer/promoters/directors from making further issues of capital,
- Direct the person concerned to sell/divest the securities,
- Direct the issuer/depository not to give effect/transfer or further freeze of transfer of securities.
- Any other direction which the SEBI may deem fit and proper in the circumstances of the case.

Appeal Any person aggrieved by an order of the SEBI/Adjudicating Officer under the SEBI Act/ these regulations may prefer an appeal to the Securities Appellate Tribunal (SAT).

Power of SEBI to Issue General Order/Circular

The SEBI may by a general/specific order/circular specify any conditions/requirements in respect of issue of debt securities. In particular, they may provide for the following matters: **(i)** Electronic issuances and other procedures including the procedure for price discovery, **(ii)** Conditions governing trading/reporting/clearing and settlement of trade and **(iii)** Listing conditions. In case of a special order, the affected person should be given an opportunity to represent his case.

ISSUE AND LISTING OF NON-CONVERTIBLE REDEEMABLE PREFERENCE SHARES (NCRPSs) 2013

These regulations apply to **(i)** public issue of NCRPSs, **(ii)** listing of NCRPSs issued by public companies through public issue/on private placement basis and **(iii)** issue/listing of perpetual non-cumulative preference shares (PNPSs) and perpetual debt instruments (PDIs) issued by banks on private placement basis in compliance with the RBI guidelines. The main elements of the regulations are: issue requirements for public issues, listing of NCRPSs, conditions for their continuous listing/trading, obligations of intermediaries/issuers, issue/listing of non-equity regulatory capital instruments by banks and miscellaneous.

Issue Requirements for Public Issues

The issue requirements for public issue are: general conditions, disclosures in the offer document, filing of draft offer document, mode of disclosure, advertisements, electronics issuances, price discovery through book building, redemption, minimum subscription, underwriting and prohibition of mis-statements in offer document.

General Conditions No issuer can make any public issue of NCRPSs if as on date of filing of draft/final offer document, the issuer/promoter **(i)** has been restrained/ prohibited/debarred by the SEBI from accessing the securities market/dealing in securities, **(ii)** is a willful defaulter or is in default of payment of interest/repayment of principal for more than 6 months and the following conditions are satisfied: It has **(a)** made an application to one/more stock exchange for listing of securities. Where the application is made to more than one stock exchange, the issuer should choose one of them as the designated stock exchange. Where any of such stock exchanges have notionwide trading terminals, the issuer should choose one of them as the designated stock exchange; **(b)** obtained in-principle approval for listing; **(c)** obtained a credit rating from at least one SEBI-registered credit rating agency and disclosed in the offer document. Where credit ratings are obtained from more than one credit rating agency, all the ratings, including the unaccepted ratings, should be disclosed; **(d)** entered into an arrangement with a SEBI-registered depository for dematerialisation of the NCRPSs proposed to be issued to the public; **(e)** the minimum tenure of the NCRPSs should not be less than three years; and **(f)** the issue has been assigned a rating of not less than "**AA**" or equivalent.

The issuer should create a capital redemption reserve in accordance with the provisions of the Companies Act. The issue should not be for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management other than to subsidiaries of the issuer. The issuer should appoint merchant bankers at least one of whom should be a lead merchant banker.

Disclosures in the Offer Document The offer document should contain all **material disclosures** (i.e. **Material disclosures** anything which is likely to impact an investor's investment decision), which are necessary for the subscribers to take an informed investment decision. The issuer and the lead merchant banker should ensure that it contains the specified disclosures in the Companies Act and SEBI regulations.

Material disclosures includes anything which is likely to impact an investor's investment decision

Filing of Draft Offer Document A draft offer document should be filed with the designated stock exchange through the lead merchant banker and made public by posting the same on its website for seeking public comments for 7 working days from the date of its filing. It may also be displayed on the website of the issuer, merchant banker and the concerned stock exchanges.

The lead merchant banker should ensure that the draft offer document clearly specifies the names and contact particulars of its compliance officer and the issuer including the postal and *e-mail* address, telephone and fax numbers and all comments received on the draft offer document are suitably addressed prior to the filing of the offer document with the Registrar of Companies (ROCs). A copy of draft and final offer document should also be forwarded to the SEBI for its records along with specified fee simultaneously with filing of these documents with stock exchange. The non-refundable fee for public issues and private placements is 0.0025 per cent and 0.00025 per cent respectively of the issue size. The lead merchant banker should, prior to filing of the offer document with the ROCs furnish to the SEBI a due diligence certificate.

Mode of Disclosure of Offer Document The draft and final offer document should be displayed on the websites of stock exchange simultaneously with filing with the ROCs, for dissemination on its website prior to the opening of the issue. A physical copy of the offer document should be provided to any person on request by the issuer/lead merchant banker.

Advertisement for Public Issue The issuer should make an advertisement in one English national daily newspaper and one Hindi national daily newspaper with wide circulation at the place where the registered office of the issuer is situated, on or before the issue opening date containing, among others, the SEBI- specified disclosures. No issuer should issue an advertisement which is misleading in material particulars or which contains any information in a distorted manner or which is manipulative or deceptive. The advertisement should be truthful, fair and clear and not contain a statement, promise or forecast which is untrue or misleading. The credit rating should be prominently displayed in the advertisement. It should not contain any matters which are extraneous to the contents of the offer document and urge the investors only on the basis of information contained in the offer document. Any corporate or product advertisement issued by the issuer during the subscription period should not make any reference to the issue of NCRPSs or be used for solicitation.

Abridged Prospectus and Application Forms The issuer and lead merchant banker should ensure that: **(a)** every application form issued by the issuer is accompanied by a copy of the abridged prospectus. It should not contain matters which are extraneous to the contents of the prospectus. Adequate space should be provided in the application form to enable the investors to fill the in various details like name, address, etc. The issuer may provide the facility for subscription of application in electronic mode.

Price Discovery Through Book Building The issuer may determine the price of NCRPSs in consultation with the lead merchant bankers and the issue may be at fixed price or the price may be determined throughout book building process.

Redemption The issuer should redeem the NCRPSs in terms of the offer document.

Minimum Subscription The issuer may decide the amount of minimum subscription which it seeks to raise by public issue of NCRPSs in accordance with the provisions of Companies Act, and disclose the same in the offer document. In the event of non-receipt of minimum subscription, all application moneys received should be refunded forthwithstanding to the applicants. In the event of the application monies are refunded beyond eight days from the last day of the offer, such amount should be refunded together with interest at such rate as may be set out in the offer document but in no case be less than 15 per cent per annum.

Underwriting A public issue of NCRPSs may be underwritten and adequate disclosures regarding underwriting arrangements should be made in the offer document.

Prohibition of Mis-statements in the Offer Document The offer document should not omit disclosure of any material fact which may make the statement misleading. The offer document or abridged prospectus or any advertisement issued in connection with a public should not contain any false or misleading statement.

Mandatory Listing of Non-Convertible Redeemable Preference Shares (NCRPSs)

An issuer of NCRPSs to the public should make an application for listing and comply with conditions of listing as specified in the listing agreement with the concerned stock exchange.

An issuer of NCRPSs on private placement basis should forward the SEBI-specified disclosures to the recognised stock exchange within fifteen days from the date of their allotment. The listing of NCRPSs issued by way of private placement would be subject to the following conditions:

(a) the issue is in compliance with the provisions of the Companies Act/rules and other applicable laws; **(b)** credit rating has been obtained from at least one SEBI-registered credit rating agency. Where credit ratings are obtained from more than one credit trading agencies, all the ratings should be disclosed in the offer document; **(c)** the NCRPSs are in dematerialised form; **(d)** the specified disclosure (**discussed later**) have been made; **(e)** the minimum application size for each investor is not less than ₹10 lakh; **(f)** the issue is in compliance with requirements pertaining to creation of capital redemption reserve and prohibition on loan to/acquisition of shares of a group entity (**discussed earlier**), and **(g)** where the application is made in more than one stock exchange, the issuer should choose one of them as the designated stock exchange.

The issuer should comply with conditions of the listing as specified in the listing agreement with the concerned stock exchange. The designated stock exchange should collect a regulatory fee from the issuer at the time of listing of NCRPSs issued on private placement basis. The issuer making a private placement of NCRPSs should also make the specified disclosures accompanied by the latest annual report. They should be made on the websites of the concerned stock exchanges.

The requirement of Rule 19(1) and (3) of the Securities Contracts (Regulations) Rules relating to submission of documents and allotments are not applicable to the listing of NCRPSs.

Conditions for Continuous Listing and Trading of Non-Convertible Redeemable Preference Shares

Continuous Listing Conditions The issuers should comply with the conditions of listing specified in the respective listing agreement for non-convertible redeemable preference shares. It should also be promptly disseminated to investors and prospective investors in such manner as the concerned stock exchange may determine. The issuer and stock exchange should disseminate all information and reports including compliance reports filed by the issuer to the investors and the general public by placing them on their websites.

Trading of Non-Convertible Redeemable Preference Shares The listed non-convertible preference shares issued to the public or on a private placement basis should be traded/cleared and settled subject to conditions specified by the SEBI. Trades of NCRPSs made over-the-counter should be reported on a recognised stock exchange having a nation-wide trading terminal or such other platform specified by the SEBI.

Obligations of Intermediaries and Issuers

The issuer should disclose all the material facts in the offer documents issued or distributed to the public and ensure that they are true, fair and adequate and there is no mis-leading or untrue statements or mis-statement in the offer document.

The merchant banker should verify and confirm that the disclosures are true, fair and adequate and ensure that the issuer is in compliance with the SEBI regulations as well as all transaction specific disclosures required in these and the Companies Act.

The issuer should treat the applicant in a public issue in a fair and equitable manner as per the SEBI-specified procedure. The intermediaries would be responsible for diligence in respect of assignments undertaken by them in respect of issue, offer document and distribution of securities to the public.

No person should employ any device, scheme or artifice to defraud in connected with their listed/proposed to be listed issue or subscription or distribution.

Issuance and Listing of Non-Equity Regulatory Capital Instruments by Banks

The above provisions would apply to the issuance and listing of perpetual debt instruments by banks subject to the prior approval and in compliance with the guidelines issued by the RBI.

If a bank is incorporated as a company under Companies Act, it should, in addition, comply with the provisions of Companies Act and/or other applicable statutes. It should also comply with the terms and conditions specified by the SEBI and make adequate disclosures in the offer document regarding the features of these instruments and relevant risk factors and if such instruments are listed comply with the listing requirements.

Miscellaneous

Inspection by the Board Without prejudice to the provision of Section 11 and 11-C of the SEBI Act and Section 209-A of the Companies Act, the SEBI may *suo moto* or upon information received by it, appoint one or more persons to undertake the inspection of the books of account, records and documents of the issuer or merchant banker or any other intermediary associated with the public issue, disclosure or listing of non-convertible redeemable preference shares for any of the purposes specified below:

- To verify whether **(a)** the provisions of the SEBI/Companies/Securities Contracts (Regulation)/Depositories Act/rules and regulations in respect of issue of securities; **(b)** the requirement in respect of issue of securities as specified in these regulations; **(c)** the requirements of listing conditions and continuous disclosure requirement have been complied with;
- To inquire into **(i)** the complaints received from investors, other market participants or any other persons on any matter of issue and transfer of securities; **(ii)** the affairs of the issuer in the interest of investor protection or the integrity of the market governed; **(iii)** whether any direction issued by the SEBI has been complied with.

Power to Issue Directions Without prejudice to its powers under Chapter VI-A and Section 24 of the SEBI Act, the SEBI may, in the interest of investors in securities market, issue such directions as it deems fit under Section 11, 11-A, 11-B, 11-D of the SEBI Act including: **(a)** Directing the **(i)** issuer to refund the application money, **(ii)** persons concerned not to further deal in securities in any particular manner/not to access the securities market for a particular period; **(iii)** persons concerned to sell/direct securities, **(iv)** issue/depository not to give effect transfer/directing further freeze of transfer of securities, **(b)** Restraining the issuer/promoter(s)/directors from making further issues of securities. The SEBI may also issue any other direction which it may deem fit and proper in the circumstances of the case.

Power of the SEBI to Issue General Order or Circular The SEBI may by a general or special order or circular specify any condition or requirement in respect of issue of non-convertible redeemable preference shares to provide for all or any of the following matters: **(a)** electronic issuances and other issue procedures including the procedure for price discovery; **(b)** conditions governing trading, reporting, clearing and settlement of trade; **(c)** listing conditions.

Recapitulation

- The activities in/procedures of the issue management in India have to conform to the SEBI regulatory framework. The framework currently applicable has two main elements: **(i)** Issue of Capital and Disclosure Requirements (ICDR) Regulation 2009 and **(ii)** Issue and Listing of Debt Securities (ILDS) Regulations, 2008.
- The ICDR regulations relate to **(i)** common conditions for public and rights issues, **(ii)** provisions as to public issues, **(iii)** rights issues, **(iv)** manner of disclosures in offer documents, **(v)** general obligations of issuers/ intermediaries, **(vi)** preferential issues, **(vii)** qualified institutional placement, **(viii)** issue of Indian depository receipts, **(ix)** issue of securities by small and medium enterprises and (**x**) SEBI directions.
- While public issue means an initial public offer (IPO) or a further public offer (FPO), a rights issue means an offer of equity shares and convertible securities by a listed issuer to its shareholders as on the record date. The common conditions for public/rights issues are: general conditions, appointment of intermediaries, filing of offer document, documents submitted before issue opening, draft offer documents made public, issue pricing, draft offer documents made public, fast track issues, issue opening, despatch of material, underwriting, minimum subscription, oversubscription, monitoring agency, manner of calls, allotment/refund, restrictions on further issues, additional requirements for issue of convertible debt instruments (CDIs), rollover, conversion, issue of CDIs for financing and alteration of rights of holders of securities.
- The general conditions to be satisfied by an issuer at the time of filing/registering the draft/final offer documents (in case of public issue) and letter of offer (in case of rights issue) with the SEBI/ROCs/DSE are: **(i)** The issuer/its promoters/promoter group/person(s) in control are not debarred from accessing the capital market, **(ii)** The issuer of CDIs is not in the list of RBI's willful defaulters/in default for more than 6 months; has made an application for listing on a RSE; and has entered into an agreement with a depository for demat of securities; **(iii)** All existing partly paid-up shares are fully paid up/forfeited, **(iv)** Firm arrangements for 75 per cent of the stated means of finance excluding the amount from the proposed issue/internal accruals have been made.
- The issuer should appoint (lead) merchant banker(s)/intermediaries to carry out the issue-related obligations. It should also appoint syndicate members in book-built issues, bankers to an issue at all mandatory collection centres and registrars to an issue who have connectivity with all the depositories. Book building is the process to elicit demand/assess the price to determine quantum/value of securities/IDRs.
- An offer document together with the specified fee should be filed with the SEBI not less than 30 days before registering the prospectus/red herring prospectus/shelf prospectus with the ROCs or letter of offer with the DSE. Any changes/observations by the SEBI should be complied with before filing them with the ROCs/DSE/SEBI.
- Issues must obtain in-principle approval for listing of the securities from the concerned RSEs having nation-wide trading terminals.
- The lead merchant banker should submit to the SEBI along with the offer document **(i)** copy of the agreement with the issuer, **(ii)** *inter se* allocation of responsibilities of each merchant banker, **(iii)** due diligence certificates from the concerned lead merchant banker/debenture trustees, **(iv)** statements certifying all changes/observations by SEBI have been incorporated in the offer document/certificate from a Chartered Accountant in respect of promoters contribution and Board of Directors resolution for allotment of securities to promoters. The issuer should submit PAN/bank account/passport number of its promoters.

- The offer document should be hosted on the website of the SEBI/concerned RSEs/merchant bankers for public comment for not less than 21 days. A public announcement should also be made in English/Hindi regional newspapers.
- The above requirements relating to filing of offer documents, in-principle approval for listing and submission of documents before issue opening would not apply if the **(i)** issuers (**fast track issue**) shares have been listed for at least 3 years, **(ii)** the average market capitalisation of its public shareholding is at least ₹10,000 crore, (**(iii)** the annualised turnover of its shares has been at least 2 per cent of weighted average number of shares listed during the last 6 months, **(iv)** it has redressed at least 95 per cent of its investors grievances/complied with the equity listing agreement for at least 3 years, **(v)** the impact of the auditor's qualification on its accounts does not exceed 5 per cent of its net profits/loss after tax, **(vi)** no show cause notice has been issued/proceedings initiated/pending against it/promoters/whole time directors and **(vii)** the entire promoters holding is in demat form.
- An issue should open within **(a)** 12 months from the date of the SEBI's observations on the offer document, **(b)** 3 months after 30 days in case of no observation from the SEBI.
- The offer document/other issue material should be despatched to the DSE/syndicate members/underwriters/banker to an issue/investors association/ **SCSBs** in case of **ASBA** in advance.
- Issues can be underwritten only by SEBI-registered underwriters/book runners (syndicate members). But securities compulsorily allotted to QIBs cannot be underwritten. The lead merchant banker/book runner must undertake a minimum underwriting of the lower of the 5 per cent of the total commitment or ₹25 lakh.
- The minimum subscription in an issue should be 90 per cent of the offer. In case of its on-receipt the entire application money received should be refunded within 15 days and seven days from the date of closure of the issue in non-underwritten and underwritten issues respectively.
- For issue size exceeding ₹500 crore, a PFI/bank should be appointed to monitor the use of the issue proceeds. Where a monitoring agency is not appointed, the outstanding subscription must be called within 12 months of allotment. Shares with calls in arrear should be forfeited. Within 15 days of the failure of an issue, the application money must be refunded failing which the specified interest would have to be paid.
- In addition to the other requirements, an issuer of CDIs should comply with the following conditions: **(i)** obtain credit rating, **(ii)** appoint debenture trustees, **(iii)** create debenture redemption fund, **(iv)** assets on which charge is proposed are sufficient to discharge the liability and free from encumbrances. They should be redeemed in terms of the offer document.
- The non-convertible portion of the partly CDIs can be rolled over without change in the interest rate if 75 per cent of the holders approve it; an auditors certificate on its liquidity position has been sent to them; the holding of all holders who have not agreed would be redeemed; credit rating has been obtained and communicated to them before rollover.
- Positive consent of the holders would be necessary for conversion of optionally CDIs into shares. The holders should be given the option not to convert them if the conversion price was not determined/disclosed to the investors at the time of the issue.
- The terms of issue of securities adversely affecting the investors can be altered with the consent/sanction in writing of at least 75 per cent/special resolution of the holders.
- The provisions as to public issues are: eligibility requirements, pricing, promoters contribution, lock-in and minimum offer to public/reservations.
- The eligibility conditions relate to IPOs and FPOs. An IPO can be made by an issuer who has **(i)** net tangible assets of at least ₹3 crore in the preceding 3 years not more than 50 per cent

of which should be monetary assets, **(ii)** a track record of distributable profits for at least 3 out of immediately preceding five years; in case of a partnership converted into a company/ company formed out of a diversion, their track record would be considered only if their financial statements fro the respective years are revised to conform to the format prescribed by the Companies Act and certified by a chartered accountant to that effect, **(iii)** net wroth of at least rupees one crore in the preceding 3 years, **(iv)** the aggregate of all issues in one financial year does not exceed 5 times of its pre-issue networth and **(v)** at least 50 per cent of the revenue of the preceding year has been earned from the activity indicated by the new name in case of change of its name within the last one year.

An issuer who does not satisfy any of the above five conditions can make an IPO if it alternatively satisfies the following two conditions: **(a)** it is through book building with at least 50 per cent of the net offer to the public allotted to QIBs or at least 15 per cent of the project cost is contributed by PFIs/banks of which a minimum 10 per cent is from appraisers and 10 per cent of the net offer to the public is allotted to QIBs, **(b)** its minimum post-issue face value of capital is ₹10 crore or there would be compulsorily market making for at least 2 years from the date of listing of the securities provided the minimum depth of securities for buy and sell quotes is 300, the bid-ask spread never exceeds 10 per cent and the inventory of the market is not less than 5 per cent of the issue.

An IPO of CDIs can be made without a prior issue/listing of shares. The minimum number of allottees in a public issue is 1,000. An IPO cannot be made if there are outstanding convertible securities/rights entitling a person the option to receive shares after the IPO. Shares held for at least one year prior to the filing of the draft offer document with the SEBI may be offered for sale. An IPO grading from a SEBI-registered rating agency is mandatory.

- A FPO can be made if the issuer satisfies the two requirements of an IPO, namely, the aggregate of the issue size in one year (i.e. 5 times its pre-issue net worth) and the minimum revenue (i.e. 50 per cent) from the activity indicated by the new name in case of change within the last one year. If these two conditions are not satisfied, a FPO can be made in a manner similar to an IPO when the issuer does not satisfy the five conditions.
- The price of specified securities/coupon rate/conversion price of CDIs should be determined by the issuer in consultation with the merchant banker(s) or through the book building process.
- The lead merchant banker would act as the lead book runner and be primarily responsible for book building. Other merchant bankers would act as co-book runners/syndicate members. The issue should be compulsorily underwritten by the book runner(s) and sub-underwritten by the syndicate members. The book runners/syndicate members should appoint SEBI-registered brokers and the self certified syndicate banks in case of **ASBA** would act as bidding, collection centres.

If the issue size is issued, the red-herring prospectus may not contain the price/number of securities but the floor price/price band may be mentioned. In case of its non-disclosure, the price should be disclosed at least one/two working days before the bid opening in an IPO and FPO respectively. In case of opting price band by the issuer, the cap should not be more than 120 per cent of the floor. In case of revision of price, the bidding period should be extended by three days.

The minimum application value of an anchor investor should be ₹10 crore in a public issue. Upto 30 per cent available to QIBs may be allocated them, one-third of which to mutual funds. The bidding for them should open one day before the issue opening date and they should pay at least 25 per cent margin on application and the balance within two days of the closure of the issue. The margin money from non-QIB category should be uniform for each category. The QIBs would have to pay 10 per cent.

The bidding should be through an electronically-linked transparent facility of a RSE. All non-ASBA investors can revise their bids and the QIBs cannot withdraw their bids after the closure of the issue.

The issue price should be fixed on the basis of the bids received and the number of securities to be offered. All the successful bidders whose bids are above the final/cut-off price would be entitled for allotment. The retail individual investor may bid at the cut-off rate.

The allotments to categories except anchor investors should be made proportionately and the unsubscribed portion in any category should be allocated as per the disclosures in the red-herring prospectus.

- The securities maybe offered at differential prices **(i)** to retail individual investors/shareholders and **(ii)** in a composite issue on public-cum-rights basis. A price/price band (in draft prospectus) and floor price/price band (in red herring prospectus) may be mentioned and the (one) price/specific coupon rate on CDIs may be determined at a later stage. The cap on the price band/coupon rate can be upto 120 per cent of the floor price/rate. The floor/final price should not be less than the face value. The face value of shares should be between ₹10 and 1 and ₹10 per share in case of issue prices being ₹500 and above and below ₹500 respectively.
- The minimum promoters contribution in a public issue should be at least 20 per cent of the post-issue capital (in IPO)/proposed issue size/post issue capital (in FPO) and composite issue excluding the rights component. It should be by way of shares/subscription to convertible securities. In case of an IPO of CDIs without a prior public issue, it should be 20 per cent of the project cost in the form of shares and at least 20 per cent of the issue size should be from their own funds. Any excess contribution should be at the higher of the price applicable to preferential issues (**discussed later**) and the issue price. The contribution should be brought in at least one day before the issue opening date.
- The specified securities held by promoters and others are not transferable. The lock-in of securities held by promoters in a public issue would be **(i)** 3 years from the date of commencement of commercial production and allotment in public issue whichever is earlier in respect of minimum contribution and one year in case of excess contribution. In case of an IPO, the entire pre-issue capital held by other investors would be locked-in for one year. Securities lent to a stabilising agent under green shoe option would be subject to lock-in for the remaining period from the date of their return to the lender. The lock-in securities may be pledged by the promoters with a bank/PFI for loan for financing the object(s) of the issue. Promoters as well non-promoter holders of lock-in securities can transfer them respectively to another promoter/person. The lock-in will continue till the remaining period with the transferee till its expiry.
- The minimum/net offer to public should be 10 and 25 per cent of the post-issue capital (in an IPO) and issue size (in FPO). Reservations on competitive proportionate basis out of the issue size (excluding promoters contribution and net offer to public) can be made: **(a)** in a book-built issue, to employees, shareholders and persons associated with the issuer as depositors/bondholders/subscribers to its services upto 5 per cent of the issue size; **(b)** in a non-book-built issue to employees and shareholders; and **(c)** in case of FPO (other than a composite issue) to retail individual shareholders. The unsubscribed portion in a reserved category may be added to the other and the unsubscribed portion after the *inter se* adjustment should be added to the net offer to the public category. The allocation to the net offer to the public would be: **(a)** in a book-built issue, **(i)** retail individual investors, at least 35 per cent **(ii)** non-institutional investors, at least 15 per cent **(iii)** QIBs, not more than 50 per cent of which 5 per cent to

mutual funds who would also be eligible for allocation under the balance available for QIBs; upto 35 per cent of the QIB share to an anchor investor making an application for at least ₹10 crore **(iv)** issuer who does not satisfy the five eligibility conditions, at least 50 per cent to QIBs **(v)** where the issuer is required to allocate 60 per cent to the QIBs, to retail individual investors, 30 per cent and non-institutional investors, 10 per cent; **(b)** in a non-bank built issue, at least 50 per cent to retail individual investors, the balance to other individual/institutional investors. An issuer may provide a safety net to purchase upto a maximum of 1,000 securities at the issue price per allottee within six months from the date of dispatch of security certificates/ credit of demat amount.

An issuer may provide green shoe option for stabilisation of the post-listing price of its securities by allotting excess shares. Upto 15 per cent of the issue size may be borrowed by the stabilising agent from the promoters/pre-issue shareholders holding more than 5 per cent of the securities. The stabilisation would be available upto 30 days from the date on which permission for trading is given by the RSE. The securities should be returned within two working days after the stabilisation period. If the stabilising agent is unable to buy the securities from the market to the extent of the overallotment, the issuer would allot securities at the issue price to the extent of the shortfall within 5 days of the stabilisation period. These would be returned to the promoters/pre-issue shareholders in lieu of those borrowed from them.

A public issue should be open for a minimum of 3 and a maximum of 10 days. The pre-issue advertisement should be made in one English/Hindi national daily and one regional language newspaper. The minimum application value is in the range of ₹5,000 – ₹7,500. Applicants should be invited in multiples of this value. The minimum application should be 25 per cent of the issue price. The entire issue price in an offer for sale should be brought in as application money. The allotment of securities to non-anchor investors should be on proportionate basis within the specified categories.

- The main elements of the framework of rights issues are record date, restrictions, letter/ abridged letter of offer, pricing and subscription period, pre-issue advertisement and utilisation of funds.
- To determine the eligibility of the shareholders, a record date should be announced after which a rights issue cannot be withdrawn. Rights issue can be made only after reserving shares of the same class in favour of holders of outstanding fully/partly CDIs in proportion to the convertible part. The abridged letter of offer together with the application form should be sent to the all the existing shareholders at least three days before the opening of the issue. Applications can also be made on plain offer. Such applicants cannot renounce their rights. Applications by shareholders on application form as well as on plain paper would be rejected. The issue price should be determined before the record date and the issue should be open for a minimum of 15 days and a maximum of 30 days. The pre-issue advertisement in one English/Hindi/regional newspaper should be made at least 3 days before the date of opening of the issue. The funds collected can be utilised after the finalisation of the basis of allotment.
- The general obligations of issuers/intermediaries with respect to public/rights issues are: prohibition on payment of incentive; public communications, publicity materials, advertise-ments and research reports; copies of offer document made available to public; redressal of investors grievances, appointment of compliance officer; due diligence; post-issue reports; post-issue advertisement; coordination with intermediaries; audited financial statements in the offer document and; other responsibilities.
- All public communications including advertisements/publicity materials/research reports should contain only factual information and not projections/conjectures/ matters extraneous

to the offer document. They should be consistent with the past practices. They should also be truthful/fair and not **(i)** manipulative/deceptive distorted, **(ii)** contain any untrue/misleading statements/promises/forecasts.

The issuer should **(i)** make prompt/true/fair disclosures of all material developments relating to its business/securities and those of its subsidiaries/group companies and **(ii)** not release any information which is not contained in the offer document, **(iii)** not use extensive technical/legal terminology, complex language and excessive details/display models/celebrities/fictional characters/landmarks etc, **(iv)** not use crawlers on televisions or contain slogans/expletives/non-factual and unsubstantial titles, and **(v)** highlight risk factors prominently.

The advertisement should not **(i)** give the impression that the issue has been fully subscribed/oversubscribed during the period it is open for subscription and an announcement regarding closure should be made only after 90 per cent of the offer has been subscribed, **(ii)** contain any offer of direct/indirect incentives in cash/kind/services and so on.

- The contents of the offer document hosted on the website should be the same as the printed version filed with the ROCs/SEBI/DSE. Copies of the offer documents should be made available to the public on request for a reasonable charge. The post-issue lead merchant banker should be actively associated with the post-issue activities and regularly monitor redressal of the associated investor grievances. The compliance officer would be responsible for redressal of investor grievances and compliance with the securities laws.
- The lead merchant banker should exercise due diligence and satisfy about all the aspects of the issue and call upon the issuer (s) to fulfil their obligations. He should submit to the SEBI the initial post-issue report within 3 days of the closure of the issue and final report within 15 days of finalisation of basis of allotment/refund of money in case of failure of issue. The post-issue merchant banker would continue to be responsible for post-issue activities till the subscribers receive the security certificate/created to their demat account or refund of application money and the listing/trading permission is obtained.

  He should ensure that post-issue advertisement is released within 10 days from the completion of the various activities giving details relating to over-subscription, basis of allotment and so on. He should also **(i)** maintain close coordination with the various intermediaries after the closure of the issue, **(ii)** ensure that notice for devolvement on underwriters is issued within 10 days from the date of closure, **(iii)** furnish information to the SEBI in respect of underwriters who have failed to meet their devolvements and **(iv)** confirm to the bankers to the issue that all formalities have been completed and the banker is free to release the money to the issuer/for refund in case of failure of the issue.
- The merchant banker should ensure that **(i)** all the information contained in the offer document is not more than 6 months old, **(ii)** payment of interest to the applicants for delayed despatch of allotment letters/refund orders is made as per the disclosures in the offer document, **(iii)** the issue is kept open for the required number of days to avoid any dispute by the underwriters in respect of their liability.
- Dissenting shareholders mean shareholders who have voted against the resolution for change in objects/variations in terms of a contract referred to in the prospectus of the issuer. The main elements of the SEBI regulations are: **(i)** conditions for exit offer, **(ii)** eligibility of shareholders for availing of the exit offer, **(iii)** exit offer price, **(iv)** manner of providing exit to dissenting shareholders and **(v)** offer not to exceed maximum permissible non-public shareholding.

  The promoters/shareholders in control should make the exit offer if **(i)** 10 per cent dissenting shareholders voted in the general meeting and **(ii)** the amount to be utilised for the object for which the prospectus was issued is less than 75 per cent of the amount raised.

Only dissenting shareholders who hold shares on the **relevant date** (i.e. date of the meeting of the Board of Directors in which the proposal for change in objects/variation in terms of a contract is approved) can avail of the offer.

The exit price payable to the dissenting shareholders would be the highest of the following: the volume weighted average price paid/payable for acquisition during 52 weeks immediately preceding the relevant date; the highest price paid/payable for any acquisition during the 26 weeks immediately preceding the relevant date; the volume weighted average market price for frequently traded shares for 60 trading days immediately preceding the relevant date as traded on the stock exchange where the maximum volume of trading are recorded; and in case of infrequently traded shares, the price determined by the promoter/shareholders having control and the merchant banker taking into valuation parameters including book value, comparable trading multiples and other customary parameters.

The promoter/shareholders in control would have to bring down the non-public shareholding to the specified level within the permitted time under the **Securities Contract (Regulation)** Rules if the completion of the exit offer results in these shareholdings exceeding the maximum permissible non-public shareholding.

- Preferential issue is an issue of specified securities by a listed issuer to any select group/group of persons on a private placement basis. The main elements of such issues are: conditions, disclosures, allotments, tenure of convertible securities, pricing of shares payment of consideration, lock-in and transferability of lock-in securities/warrants.
- The conditions for preferential issues are a special resolution by the shareholders, all shares held by the proposed allottees are in demat form and the issuer **(i)** is in compliance with the conditions for continuous listing and **(ii)** has obtained the PAN of the allottees.
- The issuer should disclose in the explanatory statement to the notice for the special resolution **(i)** objects of the issue, **(ii)** shareholding pattern before/after issue, **(iii)** the time-frame for the issue, **(iv)** identity of the proposed allottees, **(v)** undertaking relating to recomputation of prices of the securities and lock-in till the payment of the recomputed prices by the allottees. The resolution should specify the relevant date to calculate the share prices. A copy of the certificate of the statutory auditors should also be placed before the general body meeting. The valuation of the assets other than cash in consideration for which shares are being issued should be done by an independent qualified valuer.
- The allotment should be completed within 15 days from the date of passing the resolution failing which a fresh special resolution would be necessary.
- The tenure of convertible securities should not exceed 18 months from the date of their allotment.
- If shares have been listed for 6 months and more, they should be allotted at a price higher of the average of the weekly high and low of the quoted closing prices of the related shares during the **(i)** 6 months, **(ii)** 2 weeks preceding the relevant date. If listed for less than 6 months, the shares should be allotted at a price higher than **(a)** the average of the weekly high and low of the closing prices during **(i)** the shares have been listed and **(ii)** 2 weeks preceding the relevant date and **(b)** the price at which they were issued in the IPO. On completion of the 6 months, the price should be recomputed with reference to the average of the weekly high and low of the closing prices during those months and the allottees would have to pay the difference between the recomputed price and the allotment price. Preferential issues to the QIBs should be made not below the average of the weekly high and low of the closing prices of the related shares during the two weeks preceding the relevant date.

- Full price of the securities other than warrants should be paid by the allottees at the time of allotment. At least 25 per cent of the price should be paid against each warrant on the date of their allotment and the balance 75 per cent on allotment of shares pursuant to exercise of option.
- The allotted securities to promoters and others should be locked-in for three and one year(s) respectively. Partly-paid shares would be locked-in for one year of becoming fully paid-up. The entire pre-preferential allotment shareholding of allottees would be lock-in from the relevant date upto 6 months from the date of such allotment.
- The lock-in securities held by promoters may be transferred among them or new promoters/ persons in control of the issuer. The lock-in would continue for the remaining period with the transferee.
- The qualified institutional placement (QIP) is the allotment of shares/CDIs/warrants and other convertible securities by a listed issuer to QIBs on private placement basis. The main elements of QIP are: conditions, placement document, pricing, allotment restrictions, minimum number of allottees, validity of the special resolution, tenure and transferability.
- The QIP should satisfy the following conditions: **(i)** a special shareholders resolution, **(ii)** listing of shares of the same class on a stock exchange for at least one year and **(iii)** is in compliance with the requirement of minimum public shareholding. It should be made on the basis of a placement document containing all the specified material information.
- The QIP should be made at a price not below the average of the quoted weekly high and low of the closing prices of shares of the same class during the two weeks preceding the relevant date. Partly paid-up eligible securities should not be allotted. Equity shares allotted on exercise of option attached to a warrant should be fully paid-up.
- A minimum of 10 per cent of the eligible securities should be allotted to mutual funds. Direct/ indirect allotment cannot be made to a promoter-QIB/a person related to the promoter. Bids by applicants cannot be withdrawn after the closure of the issue.
- The minimum number of allottees for each placement should be a least two for issue size upto ₹250 crore and five for more than ₹250 crore. No single allottee can be allotted more than 50 per cent of the issue size.
- The allotment of securities should be completed within 12 months from the date of the resolution. There should be a gap of at least six months between each placement in case of multiple placements. The aggregate of the QIP together with all the QIPs in one financial year should not exceed 5 times the networth of the issuer. The maximum tenure of convertible/exchangeable securities would be five years. The allottees can sell the securities for one year **only** on a recognised stock exchange.
- The provisions discussed below relate to issuance of fresh and/or offer for sale of shares in a listed issuer for achieving the minimum public shareholding in terms of Section 19(2)(b) and 19-A of the Securities Contracts (Regulation) rules.

  An **IPP** (i.e. a further public offer of eligible securities, that is, equity shares of same class listed/traded in the stock exchange, by an eligible seller, that is, listed issuer, promoter/promoter group of listed issuer, in which the offer/allocation/allotment of the securities is made only to the QIBs) requires a special resolution by the shareholders in terms of Section 81(1A) of the Companies Act. Partly-paid shares cannot be offered. In-principle approval from a stock exchange should also be obtained. A SEBI-registered merchant banker should manage the IPP and exercise due diligence.

  The eligible seller should announce a floor price/price band at least one day before the opening of the IPP.

The promoter/promoter group should not purchase/sell the eligible securities during the 12 weeks **(a)** prior to **(b)** after the date of the IPP. The allocation/allotment of the securities would be subject to the condition that **(i)** at least 25 per cent to mutual funds/insurance companies, the unsubscribed portion being offered to other QIBs, **(ii)** a QIB-promoter/any person related to the promoter (i.e. who has rights **(1)** to appoint any nominee director, **(2)** under a shareholders/visiting agreement), and **(3)** veto rights.

The minimum number of allottees would be ten and a maximum of 25 per cent of the offer size can be allotted to a single allottee. The QIBs belonging to the same group/under same control would be deemed to be a single allottee.

The aggregate of all the tranches of the IPP of any eligible seller should not result in increase in pubic shareholding by more than 10 per cent and in case of oversubscription, allotment should be restricted to 10 per cent of the offer size.

- An IDR means an instrument in the form of a depository receipt created by a domestic depository in India against the underlying equity shares of the issuing company incorporated outside India. The issue of IDRs should conform to **(a)** Companies IDR Rules and **(b)** SEBI ICDR regulations.
- The main elements of the IDR rules are: eligibility, procedure, other conditions, registration documents, conditions for issue of prospectus, listing, transfer/redemption, continuous disclosures, distribution of corporate benefits and penalty.
- The eligibility conditions for the issuing company are a specified minimum pre-issue capital and reserves/dividend payment record, debt-equity ratio and fulfilment of SEBI-prescribed criteria. Prior permission from the SEBI would be necessary to raise funds. There is a ceiling on IDRs of 15 per cent of the paid-up capital and reserves of the issuer in a financial year. The IDRs should be denominated in Indian rupees. The merchant banker to the IDR issue should deliver for registration to the SEBI/ROCs the specified documents. The IDRs should be listed and can be purchased/possessed/freely transferred by a person resident in India. The issuer should comply with the continuous disclosure requirements specified by the SEBI. Contravention of these rules by the company/any other person for which no punishment is provided in the Companies Act would be punishable with a fine upto the IDR amount and a further fine of ₹5,000 per day during the period of the contravention.
- All the provisions of the SEBI ICDR regulations are applicable in case of IDRs excepting the disclosure requirements with respect to public/rights issues and other specified provisions. The elements of the SEBI framework of issue of IDRs are: eligibility, conditions for issue, minimum subscription, fungibility, filing of draft prospectus/due diligence certificate/payment of fee and issue advertisement, display of bid data, post-issue reports, unsubscribed reports and basis of allotment.
- The issuer should be **(i)** listed in its home country, **(ii)** not prohibited to issue securities by a regulatory body and **(iii)** has track record of compliance with securities market regulations, in its home country.

  The issue conditions are: minimum issue size, ₹50 crore; minimum application amount, ₹20,000; at least 50 per cent of the issue allotted to QIBs and the balance allotted to non-institutional/retail individual investors on a proportionate basis and; only one denomination of IDRs at a time

  If the issuer does not receive 90 per cent of subscription money, the entire subscription money should be refunded within 15 days failing which 15 per cent penal interest for the period of delay would have to be paid.

The issuing company should enter into a agreement with a merchant banker and the mutual rights/obligations/responsibilities should be disclosed in the prospectus. It should also file a draft prospectus with the SEBI with the requisite fee and submit all the due diligence and other certificates. It should also make arrangements for mandatory collection centres and issue an advertisement in one English/Hindi national daily. The prospectus should contain all material disclosures prescribed by the IDR rules and the SEBI.

The merchant banker should submit to the SEBI the initial post-issue report within 3 days of the closure of the issue and the final report within 15 days of the finalisation of the basis of allotment/refund of money. The basis of allotment should be fair and proper.

- The listed issuer offering IDR through a rights issue should, at the time of filing the offer document, satisfy the conditions specified below.

  The issues should **(i)** not be in breach of ongoing material obligation under the IDR listing/deposit agreement, **(ii)** apply to the concerned stock exchange(s) for listing of issue and chose one of them as the designated stock exchange;

  The domestic depository should take the necessary steps to enable the IRD holders to have entitlements under the rights offering and issue additional IDRs, to distribute the rights to them, arrange for their renunciation/subscription for any additional rights available due to lack of take-up of other holders.

  The issuer should announce a record date for determining the eligible shareholders. Withdrawal of the rights issue after announcing the record date should be notified to **(i)** the SEBI, **(ii)** in one **(a)** English/Hind national and **(b)** regional language daily newspaper with wide circulation at the place of the principal office of the issuer. The issuer would be eligible to apply for IDR offering on a rights basis only after 12 months from the record date.

  An issuer, on satisfying the following conditions, can fast track an issue and file the offer document/addendum with the SEBI only for record purposes: **(a)** he is in compliance in all material respects with the provisions of the deposit/listing agreement for at least 3 years immediately preceding the date of its filing, **(b)** the offer document has been filed/reviewed by the securities regulator in his home country, **(c)** there are no pending show-cause notices/prosecution proceedings against him/promoters/directors on the reference by the SEBI/regulatory authorities in the home country restricting them from accessing the capital market and, **(d)** the issuer has redressed at least 95 per cent of the IRD holders complaints before the end of 3 months immediately preceding the month of date of filing the letter of offer with the designated stock exchange.

  The subscription period would in no case be less than 10 days.

  The pre-issue advertisement should be made in at least **(i)** one English/Hindi national daily newspaper with wide circulation and **(ii)** on regional language daily with wide circulation at the place of the principal office of the issuer in India at least 3 days before the issue opening.

  The issuer can utilise the funds only upon completion of the allotment process.

- The main elements of the issue procedure by the SMEs (i.e. issuers whose post-issue face value capital is between ₹10–25 crore) are: **(i)** filing of offer document and due diligence certificate, **(ii)** underwriting by merchant bankers/underwriters, **(iii)** minimum application value/number of allottees, **(iv)** listing of securities, migration to SME exchange/main board, and **(v)** market making.
- A copy of the offer document should be filed with the SEBI through a merchant banker simultaneously with the filing of the prospectus with the SME exchange/ROCs or letter of offer to the SME exchange. The SEBI would not issue any observations on the offer document and a due diligence in the prescribed format should be filed by the merchant banker.

- The entire issue must be underwritten of which 15 per cent by the merchant banker. In case of undersubscription, a nominated investor, that is, a QIB/private equity fund, may agree to subscribe at the issue/deliver or receive securities in the market making process. Any shortfall would devolve on the merchant banker. The fact of 100 per cent underwriting should be filed with the SEBI one day before issue opening.
- The minimum application value is ₹1 lakh per application and the minimum number of allottees is 50.
- The specified securities should be listed on the SME exchange. Securities of the issue listed on any other exchange would have to migrate on the SME exchange with the approval of two-thirds of the non-promoter shareholders and *vice versa*.
- The merchant banker should ensure compulsory market making through the SME exchange brokers for at least 3 years. The securities may be transferred to, or from, the concerned nominated investor(s). The inventory of the market maker on the date of allotment should be 5 per cent of the securities proposed to be listed. The market maker cannot buy shares from the promoter/persons belonging to the promoter group/any person who has acquired shares from them during the compulsory market making period. However, promoter holdings which are not locked-in can be traded with the approval of the SME exchange in a manner specified by the SEBI. The market maker may seek representation on the Board of the SME-issuer.
- The **institutional trading platform** means the trading platform for listing/trading of specified securities of **(a)** an entity which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value addition and at least 25 per cent of its pre-issue capital is held by qualified institutional buyer(s), **(b)** any other entry in which at least 50 per cent of the pre-issue capital is held by qualified institutional buyers as on the date of filing of draft information/offer document with the SEBI. No person, individually/collectively with persons acting in concert, should hold 25 per cent or more of the post-issue share capital in the entity. The main elements of the SEBI regulations **(i)** listing without/with public issue, **(ii)** lock-in, **(iii)** trading lot, **(iv)** exit and **(v)** migration to main board are discussed below.
- The entity seeking listing of its specified securities without making a public issue should file a draft information document along with the necessary documents with the SEBI along with the specified fee. The regulations relating to the following would not be applicable in case of listing without public issue: **(i)** allotment, **(ii)** issue opening/closing, **(iii)** advertisement, **(iv)** underwriting, **(v)** the stipulation relating to initial public offer, if there are outstanding convertible securities/any other right entitling any person to receive equity shares, **(vi)** pricing, **(vii)** dispatch of issue material, and **(viii)** and other such provisions related to offer of specified securities to public. The entity should obtain in-principle approval from and list its securities on the recognised stock exchange(s) within 30 days from the **(a)** date of issuance of observations by the SEBI, **(b)** expiry of the stipulated period if the SEBI has not issued any observation. The provisions relating to minimum public shareholding would also not apply to these entities.
- An entity seeking issue and listing of its specified securities should file a draft offer document along with the necessary documents with the SEBI along with the specified fees. The minimum application size should be ₹10 lakh and the number of allottees should be more than 200. The allocation in the net offer to public category should be 75 per cent to institutional investors (without specific allocation for anchor investors), 25 per cent to non-institutional investors. **Institutional investor** means QIBs, family trust, RBI-registered systematically important NBFCs, SEBI-registered intermediaries with minimum networth of ₹500 crore. Any undersubscription in the non-institutional investor category would be available for subscription under the institutional category. The allotment to institutional investors may be on a discretionary

basis whereas the allotment to non-institutional investors should be on a proportionate basis.

- The entire pre-issue capital of the shareholders should be locked-in for 6 months from the date of allotment in case of listing pursuant to public issue or date of listing in case of listing without public notice. The minimum trading log would be ₹10 lakh.
- The entity whose specified securities are listed on the institutional trading platform without making a public issue may exit from that platform, if **(a)** it is approved by its shareholders by passing a special resolution through postal ballot where 90 per cent of the total votes and the majority of non-promoter votes have been cast in favour of such proposal and **(b)** the recognised stock exchange approves of such an exit.
- An entity that has listed its specified securities on institutional trading platform may at its option migrate to the main board after three years from the date of listing subject to compliance with the eligibility requirements of the concerned stock exchange.
- The main elements of the regulation pertaining to listing of securities on stock exchanges are: in-principle approval, application for listing, listing agreement and obligation of stock exchanges.

  The issuer/issuing company should obtain in-principle approval **(a)** in case of an initial public offer/an issue of IDRs from all the recognised stock exchange(s) on which the specified securities are proposed to be listed and **(b)** in case of other issues, before issuance of further securities where they **(i)** are listed only on recognised stock exchange(s) having nationwide trading terminals, from all such stock exchange(s), **(ii)** are not listed on any recognised stock exchange having nationwide trading terminals, from all the stock exchange(s) on which they are proposed to be listed, **(iii)** are listed on recognised stock exchange(s) having nationwide trading terminals as well as on the recognised stock exchange(s) not having nationwide trading terminals, from all recognised stock exchange(s) having nationwide trading terminals. It should make an application for listing within 20 days from the date of allotment, to recognised stock exchange(s) along with the documents specified by them, failing which it should pay penal interest to allottees for each day of delay at the rate of atleast 10 per cent per annum from the expiry of 30 days from date of allotment till the listing of securities to the allottees.

  Every issuer/issuing company desirous of listing its securities should execute a listing agreement with the recognised stock exchange.

  The stock exchange(s) should grant in-principle approval/list the securities or reject the application for in-principle approval/listing by the issuer/issuing company within 30 days from the later of the date of receipt of **(i)** application for in-principle approval/listing, **(ii)** satisfactory reply from the issuer/issuing company, in cases where the stock exchange(s) has sought any clarification from them.
- Debt securities mean non-convertible securities which create/acknowledge indebtedness including bonds/debentures and other securities of a body corporate/any statutory body but excluding bonds issued by Government/other bodies specified by the SEBI, security receipts and securitised debt instruments. Private placement is an offer to less than 50 persons, while public issue is an offer/ invitation to public to subscribe to debt securities. The main element of the SEBI regulations relating to issue and listing of debt securities are: issue requirements; listing; conditions for continuous listing and trading; obligations of intermediaries/issuers; procedure for action for violation; and powers of the SEBI to issue general order.
- Any issuer who has been restrained/prohibited/debarred by the SEBI from accessing the

securities market/dealing in securities cannot make public issue of debt securities. To make such an issue the conditions to be satisfied on the date of filing of draft/final offer document are in-principle approval for their listing, credit rating from at least one SEBI-registered rating agency and agreement with a SEBI-registered depository for their dematieralisation. The issuer should appoint merchant bankers/trustees and not issue such securities to provide loan to, acquisition of shares of, any person who is a part of the same group/under the same management. The issuer should make an advertisement in a national daily with wide circulation on/before the issue opening date. The application forms should be accompanied by a copy of the abridged prospectus. The issue could be fixed-price or book-built. The minimum subscription and underwriting arrangement should be disclosed in the offer document and it should not certain any false/misleading statement. A trust deed must be executed and debenture redemption reserve should be created. The creation of security should be disclosed in the offer document.

- The listing of debt securities is mandatory. The issuer should comply with the conditions of listing specified in the listing agreement.
- The debt securities issued to public or on private placement basis should be traded/cleared/settled in a recognised stock exchange subject to conditions specified by the SEBI including conditions for reporting of all such trades.
- The debenture trustees, issuers and merchants should comply with their obligations specified by the SEBI.
- In case of violation of any regulation(s), the SEBI may carry out inspection of books of accounts/ records/documents of the issuers/intermediaries. It can issue such directions as it may deem fit. An aggrieved party may prefer an appeal with the SAT.
- The main elements of the SEBI regulations relating to issue and listing of non-convertible redeemable preference share regulations are: issue requirements for public issues, listing of NCRPSs, conditions for their continuous listing/trading, obligations of intermediaries/issuers, issue/listing of non-equity regulatory capital instruments by banks and miscellaneous.
- The issue requirements for public issue are: general conditions, disclosures in the offer document, filing of draft offer document, mode of disclosure, advertisements, electronics issuances, price discovery through book building, redemption, minimum subscription, underwriting and prohibition of mis-statements in offer document.
- No issuer can make any public issue of NCRPSs if as on date of filing of draft/final offer document, the issuer/promoter has been restrained/ prohibited/debarred by the SEBI from accessing the securities market/dealing in securities and such direction or order is in force.
- The offer document should contain all **material disclosures** (i.e. **Material disclosures** anything which is likely to impact an investor's investment decision), which are necessary for the subscribers to take an informed investment decision. The issuer and the lead merchant banker should ensure that it contains the specified disclosures in the Companies Act and SEBI regulations.
- The draft and final offer document should be displayed on the websites of stock exchange simultaneously with filing with the ROCs, for dissemination on its website prior to the opening of the issue. A physical copy of the offer document should be provided to any person on request by the issuer/lead merchant banker.
- The issuer should make an advertisement in one English national daily newspaper and one

Hindi national daily newspaper with wide circulation at the place where the registered office of the issuer is situated, on or before the issue opening date containing, among others, the SEBI- specified disclosures.

- The issuer may determine the price of NCRPSs in consultation with the lead merchant bankers and the issue may be at fixed price or the price may be determined throughout book building process.
- The issuer may decide the amount of minimum subscription which it seeks to raise by public issue of NCRPSs in accordance with the provisions of Companies Act, and disclose the same in the offer document.
- A public issue of NCRPSs may be underwritten and adequate disclosures regarding underwriting arrangements should be made in the offer document.
- The offer document should not omit disclosure of any material fact which may make the statement misleading. The offer document or abridged prospectus or any advertisement issued in connection with a public should not contain any false or misleading statement.
- An issuer of NCRPSs to the public should make an application for listing and comply with conditions of listing as specified in the listing agreement with the concerned stock exchange.
- The issuers should comply with the conditions of listing specified in the respective listing agreement for non-convertible redeemable preference shares. Each rating obtained by an issuer should be reviewed by the registered credit rating agency atleast once a year and any revision promptly disclosed by the issuer to the concerned stock exchange(s). It should also be promptly disseminated to investors and prospective investors in such manner as the concerned stock exchange may determine. The issuer and stock exchange should disseminate all information and reports including compliance reports filed by the issuer to the investors and the general public by placing them on their websites.
- The listed non-convertible preference shares issued to the public or on a private placement basis should be traded/cleared and settled subject to conditions specified by the SEBI.
- The issuer should disclose all the material facts in the offer documents issued or distributed to the public and ensure that they are true, fair and adequate and there is no mis-leading or untrue statements or mis-statement in the offer document.

  The merchant banker should verify and confirm that the disclosures are true, fair and adequate and ensure that the issuer is in compliance with the SEBI regulations as well as all transaction specific disclosures required in these and the Companies Act.

  The issuer should treat the applicant in a public issue in a fair and equitable manner as per the SEBI-specified procedure. The intermediaries would be responsible for diligence in respect of assignments undertaken by them in respect of issue, offer document and distribution of securities to the public.

  No person should employ any device, scheme or artifice to defraud in connected with their listed/proposed to be listed issue or subscription or distribution.

REVIEW QUESTIONS

11.1 Explain briefly the common conditions for public and rights issues.
11.2 Discuss the eligibility requirements for public issues.
11.3 Examine the stipulations relating to pricing in public issues.

11.4 What are the provisions relating to promoters contribution in public issues?
11.5 What are the restrictions on transferability of promoters contribution in public issues?
11.6 Describe the provisions as to reservations in public issues.
11.7 Write a brief note on rights issue by listed issuers.
11.8 Outline briefly the general obligations of issuers/intermediaries in respect of public and rights issues.
11.9 Describe the framework of preferential issues of capital.
11.10 Discuss qualified institutional placement as a method of capital issue.
11.11 Outline the framework relating to the issue of IDRs.
11.12 Discuss the main elements of the framework relating to issue of capital by SMEs.
11.13 Examine the framework for the issue and listing of debt securities.
11.14 Describe the features of the SEBI regulations relating to issue and listing of non-convertible redeemable preference shares.
11.15 Write brief notes on:
- Book building process of issues of capital
- Green shoe option
- QIBs
- Infrastructure projects

CHAPTER 12

Corporate Restructuring

Learning Objectives

- Explain the meaning, types, economics and limitations of merger/amalgamation/acquisition/takeover.
- Describe and illustrate how to determine the firm's value, financing techniques in merger and the evaluation of merger as a capital budgeting decision.
- Understand the relevant tax provisions applicable to mergers and demergers.
- Describe the Company law provisions relating to combination.
- Explain the pre-scrutiny of combination by the Competition Commission of India.
- Examine the SEBI Substantial Acquisition of Shares and Takeover Code.
- Discuss and illustrate financial restructuring.
- Analyse demerger/divestiture.

INTRODUCTION

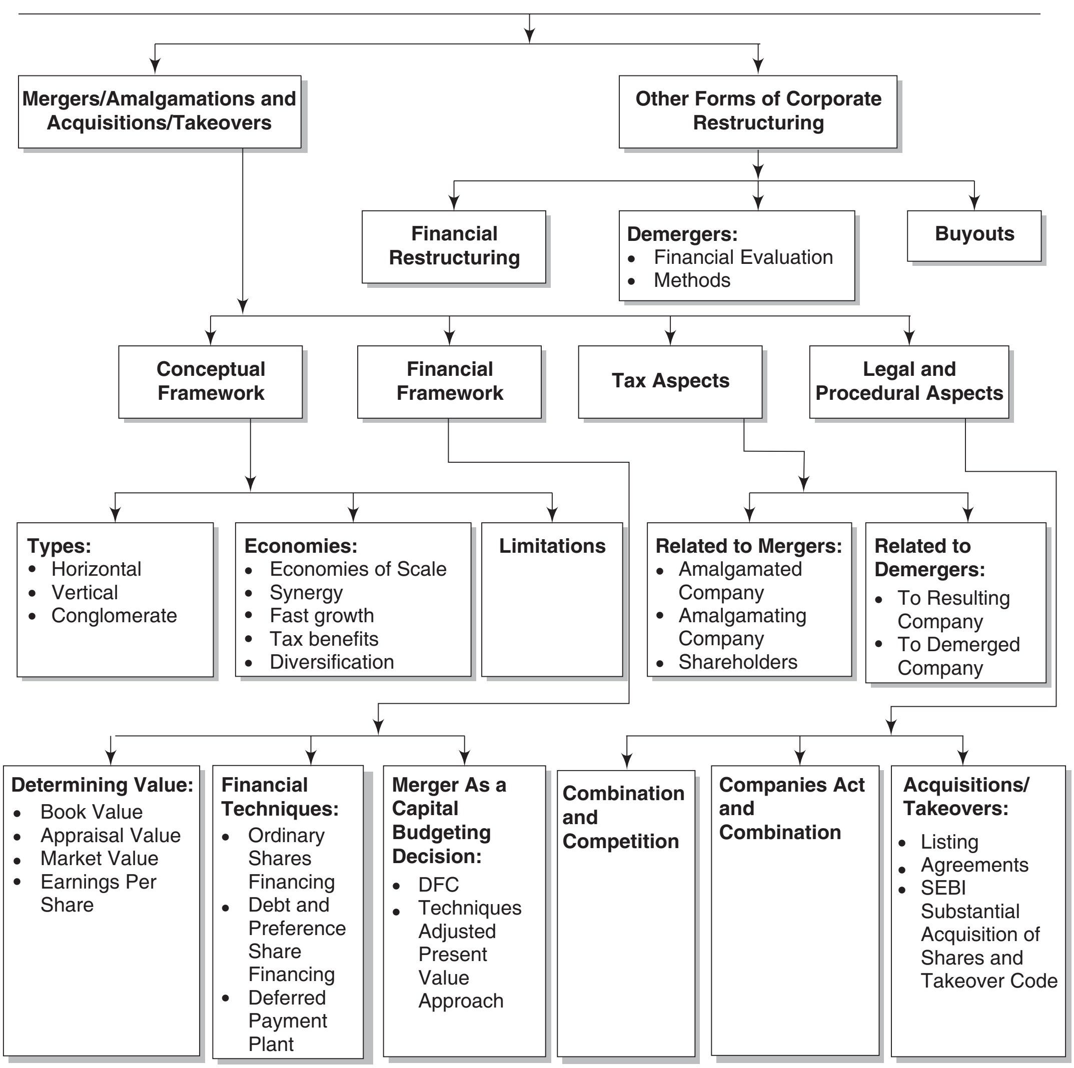
> **Corporate restructuring** implies activities related to expansion/contraction of a firm's operations or changes in its assets or financial or ownership structure.

Activities related to expansion or contraction of a firm's operations or changes in its assets or financial or ownership structure are referred to as corporate restructuring[1]. The most common forms of corporate restructuring are mergers/amalgamations and acquisitions/takeovers, financial restructuring, divestitures/demergers and buyouts. The focus of this chapter is on mergers and acquisitions. Sections 1—4 cover different aspects of mergers and acquisitions, namely, conceptual framework, financial framework, taxation and legal and procedural compliances. Other forms of corporate restructuring, that is, financial restructuring, demerger and buyouts are discussed in Section 5. **These are portrayed in Exhibit 12.1.** The main points are summarised in Section 6.

CONCEPTUAL FRAMEWORK

Profitable growth constitutes one of the prime objectives of most of the business firms. It can be achieved 'internally' either through the process of introducing/developing new products or by expanding/enlarging the capacity of existing product(s). Alternatively, the growth process can

Exhibit 12.1 Corporate Restructuring



be facilitated 'externally' by acquisitions of existing business firms. This acquisition may be in the form of *mergers, acquisitions, amalgamations, takeovers, absorption, consolidation,* and so on. Although the legal procedure involved in these are different, in view of the perspective of economic considerations (motives and effect) these terms are used interchangeably here.

There are strengths and weaknesses of both the processes of promoting growth. For instance, internal expansion apart from enabling the firm to retain control with itself also provides flexibility in terms of choosing equipment, mode of technology, location, and the like which are compatible with its existing operations. However, internal expansion usually involves a longer implementation period and also entails greater uncertainties particularly associated with developing new product(s). Above all, there may be sometimes an added problem of raising adequate funds to execute the required capital budgeting projects involving expansion. Acquisition/merger obviates, in most of the situations, financing problems as substantial/full payments are normally made in the form of shares of the purchasing company. Further, it also expedites the pace of growth as the acquired firm already has the facilities or products (acceptable to the market) and, therefore, obviously, saves the time otherwise required in building up the new facilities from scratch in the case of internal expansion programme.

A growing firm may, therefore, be in constant search for identifying potential firms which may be merged. The finance manager's job is to evaluate such merger decisions. These decisions, in a way, are analogous to capital budgeting decisions in that the cost of present investment (purchase consideration paid for acquisition of an enterprise either through issuance of shares and/or cash) is to be compared with expected future benefits accruing to the merging firm. The firm will opt for merger if it adds to the wealth of shareholders, otherwise merger will not be a financially viable proposition.

However, merger evaluations are relatively more difficult *vis-a-vis* capital budgeting decisions, the two chief reasons being: **(i)** all benefits from merger are not easily quantifiable and so also all costs, for instance, benefits of less competition and economies of scale (technical, managerial, financial) are not easily measurable attributes; and **(ii)** buying a company is more complicated than buying a new machine in that the firm is to address itself to many tax, legal and accounting issues.

This section describes the conceptual aspects of mergers, acquisitions, amalgamations, takeovers, absorption and so on, in terms of their types, economics and limitations. Although the terms mergers, amalgamations and acquisitions are different, their economic impact is the same as far as the business firms involved are concerned. For this reason, these terms are used interchangeably in this Section. The differences in these terms are explained later in this chapter.

Types of Mergers

Notwithstanding terminological differences mergers can be usefully distinguished into the fol lowing three types: **(i)** horizontal, **(ii)** vertical and **(iii)** conglomerate.

> **Horizontal merger** is a merger when two or more firms dealing in similar lines of activity combine together.

Horizontal Merger Horizontal merger takes place when two or more corporate firms dealing in similar lines of activity combine together. Elimination or reduction in competition, putting an end to price-cutting, economies of scale in production, research and development, marketing and management are often motives underlying such mergers.

> **Vertical merger** is a merger that involves two or more stages of production/distribution that are usually separate.

Vertical Merger Vertical merger occurs when a firm acquires firms 'upstream' from it and/or firms 'downstream' from it. In the case of an 'upstream' merger, it extends to the firms supplying raw materials and to those firms that sell eventually to the consumer in the event of a 'downstream' merger. Thus, the combination involves two or more stages of production or distribution that are usually separate[1]. Lower buying cost of materials, lower distribution costs, assured supplies and market, increasing or creating barriers to entry for potential competitors or placing them at a cost disadvantage are the chief gains accruing from such mergers.

Conglomerate merger is a merger in which firms engaged in different unrelated activities combine together.

Conglomerate merger is a combination in which a firm established in one industry combines with a firm from an unrelated industry. In other words, firms engaged in two different/unrelated economic/business activities combine together. Diversification of risk constitutes the rationale for such mergers.

Economics of Mergers

The major economic advantages of a merger are: **(i)** economies of scale, **(ii)** synergy, **(iii)** fast growth, **(iv)** tax benefits and **(v)** diversification.

Economies of Scale The operating cost advantage in terms of economies of scale is considered to be the primary motive for mergers, in particular, for horizontal and vertical mergers. They result in lower average cost of production and sales due to a higher level of operations. For instance, overhead costs can be substantially reduced on account of sharing central services such as accounting and finance, office, executive and top level management, legal, sales promotion and advertisement and so on.

Koutsoyiannis classifies these economies into two groups, namely, real and pecuniary. **Real economies** arise from a reduction in the factor inputs per unit of output, while **pecuniary economies** are realised from paying lower prices for factor inputs due to bulk transactions.[2]

In operational terms, real economies may arise from **(i)** the production activity of the firm, **(ii)** the research and development/technological activities, **(iii)** the synergy effects, **(iv)** marketing and distribution activities, **(v)** transport, storage, inventories, and **(vi)** managerial economies.

Cheaper finance is the most vital ingredient of pecuniary economies. A post-merger large firm is likely to raise finance at cheaper/lower rates either of the pre-merger units could have. The reason is that the larger the size of the firm, the more secured the investors consider their funds, resulting in lower risk of default/financial risk. Besides, the flotation cost (in making new issues) per unit decreases with the increase in the size of shares and debentures. Above all, the merger may bring about optimal debt capacity, in that, before the merger both firms may have had lop-sided capital structures–one overextended and another underextended by debt. Both these firms will be undervalued firms.

Synergy results from complementary activities.

Synergy Synergy results from complementary activities. For instance, one firm may have a substantial amount of financial resources while the other has profitable investment opportunities. Likewise, one firm may have a strong research and development (R & D) team whereas the other may have a very efficiently organised production department. Similarly, one firm may have well established brands of its products but lacks marketing organisation and another firm may have a very strong marketing organisation. The merged business unit in all these cases will be more efficient than the individual firms. And, hence, the combined value of the merged firms is likely to be greater than the sum of the individual entities (units). Symbolically,

Combined value = Stand alone value of acquiring firm, V_A + Stand alone value of acquired/target firm,

$$V_T + \text{Value of synergy, } \Delta V_{AT} \quad \textbf{(12.1)}$$

Normally, the value of synergy is positive and this constitutes the rationale for the merger. In valuing synergy, costs attached with acquisitions should also be taken into account. These costs primarily consist of costs of integration and payment made for the acquisition of the target firm, in excess of its value, V_T. Therefore, the *net gain* from the merger is equal to the difference between the value of synergy and costs (Equation 12.2)

$$\text{Net gain} = \text{Value of synergy, } \Delta V_{AT} - \text{Costs} \tag{12.2}$$

Illustration 12.1

Assume Firm A has a pre-merger value of ₹320 lakh and Firm T has a pre-merger value of ₹90 lakh. It is estimated that the merger would yield cost savings with a present value of ₹40 lakh. For acquisition of Firm T, Firm A will be required to make payment of ₹100 lakh (consisting of issue of shares worth ₹80 lakh and cash of ₹20 lakh). Besides, it is to incur acquisition costs of ₹5 lakh. Determine the value of gain, costs and net gain from merger.

Solution

Gain = Value of synergy (in terms of present value of cost savings), ΔV_{AT} = ₹40 lakh
Costs = Value of cash and shares paid + Other acquisition costs – Pre-merger value of Firm T
= ₹100 lakh + ₹5 lakh – ₹90 lakh = ₹15 lakh
Net gain = ΔV_{AT} – Costs = ₹40 lakh – ₹15 lakh = ₹25 lakh.

In practice, the value of synergy, in well thought out mergers, is likely to be of higher value than the costs involved, yielding net gain.

Fast Growth A merger often enables the amalgamating firm to grow at a rate faster than is possible under the internal expansion route, via its own capital budgeting proposals, because the acquiring company enters a new market quickly, avoiding the delay associated with building a new plant and establishing a new line of products. 'Internal growth is time consuming, requiring research and development, organisation of the product, market penetration and in general a smoothly working organisation[3]. Above all, there may sometimes be an added problem of raising adequate funds to execute the required/profitable capital budgeting projects. A merger obviates all these obstacles and, thus, steps up the pace of corporate growth.

Tax Benefits Under certain conditions, tax benefits may turn out to be the underlying motive for a merger. These conditions relate to the tax laws allowing set off and carry forward of losses. It may be beneficial to merge a firm saddled with large tax carry forward losses with a firm having sufficient current earnings. The argument is that this tax loss carry forward will reduce the taxable income of the newly merged firm, with its obvious impact on the reduction of tax liability. The merged firm is taxed as if the two firms (acquiring and target) had always been together. In operational terms, the losses of target firm will be allowed to be set off against the profits of the acquiring firm.

Illustration 12.2

Firm A acquires Firm T. As of date Firm T has accumulated losses of ₹1,000 lakh. Firm A is a well managed company with a good profit record. The projected profits before taxes, of Firm A, for the next 3 years are given in the table:

Year 1	₹350
2	500
3	700

Assuming corporate tax rate of 35 per cent and discount rate of 12 per cent, determine the present value of tax gains likely to accrue on account of merger to A.

Solution

Table 12.1 Present Value (PV) of Tax Shield

(₹ lakh)

Particulars	*Years*		
	1	*2*	*3*
(a) Profit before tax	₹350	₹500	₹700
(b) *Less:* Adjustment against loss of firm T/Reduction in taxable income	350	500	150*
(c) Reduction in tax payments ($b \times 0.35$)	122.5	175	52.5
(d) Multiple by PV factor at 12%	0.893	0.797	0.712
(e) Total PV of tax shield is ₹286.24 lakh [(c) $\times$ PV factor)]	109.39	139.47	37.38

*(₹1,000 lakh accumulated loss of Firm T–₹350 lakh and ₹500 lakh adjusted in years 1 and 2 respectively).

Firm A gains ₹286.24 lakh in terms of tax savings on acquisition of Firm T.

Diversification Diversification is yet another major advantage, especially in a conglomerate merger. The argument is that a merger between two unrelated firms would tend to reduce business risk, which, in turn, reduces the discount rate/required rate of return (k_e) of the firm's earnings (as investors are risk averse) and, thus, increases the market value. In other words, such mergers help stabilise or smoothen overall corporate income, which would otherwise fluctuate due to seasonal or economic cycles. In operational terms, the greater the combination of statistically independent, or negatively correlated income streams of the merged companies, the higher will be the reduction in the business risk factor and the greater will be the benefit of diversification or *vice versa*.

However, such diversification can also be attained by individual shareholders on their own. Therefore, the financial managers should ensure that the merger should not be at a cost higher than the one at which shareholders would have attained the same risk reduction by diversifying their individual investment portfolios; corporate diversification should be less expensive than personal diversification.

Limitations

However, merger suffers from certain weaknesses. First, a merger may not turn out to be a financially profitable proposition in view of non-realisation of potential economies in terms of cost reduction. Second, the management of the two companies may not go along because of friction. Third, dissenting minority shareholders may cause problems. Finally, it may attract government antitrust action in terms of the Competition Act.

FINANCIAL FRAMEWORK

This section discusses the financial framework of a merger decision. It covers three inter-related aspects: **(i)** determining the firm's value, **(ii)** financing techniques in merger and **(iii)** analysis of the merger as a capital budgeting decision.

Determining the Firm's Value

One of the first problems in analysing a potential merger involves determining the value of the acquired firm. The value of a firm depends not only upon its earnings but also upon the operating and financial characteristics of the acquiring firm. It is, therefore, not possible to place a single value for the acquired firm. Instead, a range of values is determined, which would be economically justifiable to the prospective acquirer. The final price within this range is negotiated by the two firms. To determine an acceptable price for a firm, a number of factors, quantitative as well as qualitative, are relevant. However, placing a value on qualitative factors, such as managerial talent, strong sales staff, excellent production department and so on, is difficult. Therefore, the focus of determining the firm's value is on several quantitative variables. The quantitative factors relate to **(i)** the value of the assets and **(ii)** the earnings of the firm. Based on the assets' values and earnings, these factors include book value, appraisal value, market value and earnings per share.

Book value
is the value of owner's equity determined dividing net worth by the equity shares outstanding.

Book Value The book value of a firm is based on the balance sheet value of the owner's equity. It is determined dividing net worth by the number of equity shares outstanding. The book value, as the basis of determining a firm's value, suffers from a serious limitation as it is based on the historical costs of the assets of the firm. Historical costs do not bear a relationship either to the value of the firm or to its ability to generate earnings. Nevertheless, it is relevant to the determination of a firm's value for several reasons: **(i)** it can be used as a starting point to be compared and complemented by other analyses, **(ii)** in industries where the ability to generate earnings requires large investments in fixed assets, the book value could be a critical factor where especially plant and equipment are relatively new, **(iii)** a study of the firm's working capital is particularly appropriate and necessary in mergers involving businesses consisting primarily of liquid assets, for example, financial institutions.

Appraisal value
is the value acquired from an independent appraisal agency.

Appraisal Value Appraisal value is another measure of determining a firm's value. Such a value is acquired from an **independent appraisal agency**. This value is normally based on the replacement cost of assets. The appraisal value has several merits. In the first place, it is an important factor in special situations such as in financial companies, natural resource enterprises or organisations that have been operating at a loss. For instance, the assets of a financial company largely consist of securities. The value of the individual securities has a direct bearing on the firm's earning capacity. Similarly, a company operating at a loss may only be worth its liquidation value, which would approximate the appraisal value. Secondly, appraisal by independent appraisers may permit reduction in accounting goodwill by increasing the recognised worth of specific assets. Goodwill results when the purchase price of a firm exceeds the value of the individual assets. Third, appraisal by an independent agency provides a test of the reasonableness of result obtained through methods based upon the going-concern concept. Further, the appraiser may identify strengths and weaknesses that otherwise might not be recognised, such as in the valuation of patents and partially completed research and development expenditure. On the other hand, this method of analysis is not adequate by itself since the value of individual assets may have little relation to the firm's overall ability to generate earnings and, thus, the going-concern value of the firm. In brief, the appraisal value procedure is useful if carried out in conjunction with other evaluation processes. In specific cases, it is an important instrument for valuing a firm.

Market Value The market value, as reflected in the stock market quotations, comprises yet another approach for estimating the value of a business. The justification of market value as an approximation of true worth of a firm is derived from the fact that market quotations by and large indicate the consensus of investors as to the firm's earning potentials and the corresponding risk. The market value approach is one of the most widely used in determining value, specially of large listed firms. The market value of a firm is determined by investment as well as speculative factors. This value can change abruptly as a result of change not only in analytical factors but also due to purely speculative influences and is subject to market sentiments and personal decisions. Nevertheless, the market value provides a close approximation of the true value of a firm. In actual practice, a certain percentage premium above the market price is often offered as an inducement for the current owners to sell their shares.

Earnings Per Share According to this approach, the value of a prospective acquisition is considered to be a function of the impact of the merger on the earnings per share (EPS). In other words, the analysis could focus on whether the acquisition will have a positive impact on the EPS after the merger or if it will have the effect of diluting the EPS. The future EPS will affect the firm's share prices, which is a function of price-earnings (P/E) ratio and EPS. The effect of acquisition on the EPS is illustrated in Illustration 12.3.

Illustration 12.3

Company A is contemplating the purchase of Company B. Company A has 2,00,000 shares outstanding with ₹25 market value per share while Company B has 1,00,000 shares selling at ₹18.75. The EPS are ₹3.125 for Company A and ₹2.5 for Company B. Assuming that the two managements have agreed that the shareholders of Company B are to receive Company A's shares in exchange for their shares **(i)** in proportion to the relative earnings per share of the two firms or **(ii)** 0.9 share of Company A for one share of Company B (share exchange ratio of 0.9: 1), illustrate the impact of merger on the EPSc (earnings per share of the combined firm). Also, compute the EPS after merger on the assumption that the anticipated growth rate in earnings is 8 per cent for Company A and 14 per cent for Company B.

Solution

Table 12.2 Merger Effect on EPS (Exchange Ratio in Proportion to Relative Earnings Per Share, 0.8 that is ₹2.5/₹3.125)

Company	*Original number of shares*	*EPS*	*Total earnings after taxes Col. 2 × Col. 3*
1	*2*	*3*	*4*
A 2,00,000	₹3.125	₹6,25,000	
B	1,00,000	2.50	2,50,000
Total post-merger earnings			8,75,000
Number of shares after the merger: 2,00,000 + 80,000 i.e. (1,00,000 × 0.8)			2,80,000
Earnings per share for Company A:			
1. Equivalent before the merger			3.125

(*Contd.*)

(*Contd.*)

2. After the merger (₹8,75,000/2,80,000)	3.125
Earnings per share for Company B:	
1. Before the merger	2.50
2. Equivalent EPS after the merger: (EPS after the merger × Share exchange ratio) i.e ₹3.125 × 0.8	2.50

Table 12.3 Merger Effect on EPS (Exchange ratio, 0.9 : 1)

(1)	Total post-merger earnings (EPSc)	₹8,75,000
(2)	Number of shares after the merger: (2,00,000 + 90,000 i.e (0.9 × 1,00,000)	2,90,000
(3)	Earnings per share: (₹8,75,000 ÷ ₹2,90,000)	3.017
(4)	Company A's shareholders	
	EPS before the merger	3.125
	EPS after the merger	3.017
	Dilution in EPS	(0.108)
(5)	Company B's shareholders	
	EPS before the merger	2.50
	Equivalent EPS after the merger (EPS after the merger × share exchange ratio), i.e (₹3.017 × 0.9)	2.715
	Accretion in EPS	0.215

Table 12.4 Projections of Earnings Per Share

Year	*Post-merger earnings*			*Post-merger EPS in EPS*			*Accretion (Dilution)*	
	Company A (8% growth)	*Company B (14% growth)*	*Total earnings (A + B)*	*Combined EPS Col. 4 ÷ 2,90,000*[a]	*Company A Col.2 ÷ 2,00,000*	*Company B Col.3 ÷ 90,000*[b]	*Company A*	*Company B*
1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
1	₹6,25,000	₹2,50,000	₹8,75,000	₹3.02	₹3.13	₹2.78	₹ (0.11)	₹0.24
2	6,75,000	2,85,000	9,60,000	3.31	3.38	3.17	(0.01)	0.20
3	7,29,000	3,24,900	10,53,900	3.63	3.65	3.61	(0.02)	0.02
4	7,87,320	3,70,386	11,57,706	3.99	3.94	4.11	0.05	(0.12)
5	8,50,306	4,22,240	12,72,546	4.39	4.25	4.69	0.14	(0.30)
6	9,18,330	4,81,354	13,99,684	4.83	4.59	5.34	0.24	(0.51)

[a] 2,00,000 shares of Company A + 90,000 of Company B i.e. (1,00,000 × 0.9, exchange ratio).

[b] 0.9 × 1,00,000 shares of Company B = 90,000 equivalent shares in Company A.

To summarise the discussion relating to earnings per share approach to determine the value of a firm, when the share exchange ratio is in proportion to the EPS, there is no affect on the EPS of the acquiring/surviving firm as well as on the acquired firm (Table 12.2). When, however, the share exchange ratio is different, it may result in dilution in the EPS of the acquiring firm and accretion in the EPS of the acquired firm (Table 12.3). For management of a firm considering acquiring another firm, a merger that results in dilution in EPS should be avoided. However, the fact that the merger immediately dilutes a firm's current EPS need not necessarily make the transaction undesirable. Such a criterion places undue emphasis upon the immediate effect of the prospective merger on the EPS. In examining the consequences of the merger upon the surviving concern's EPS, the analysis should be extended into future periods and the effect of the expected future growth rate in earnings should also be included in the analysis (Table 12.4) The dilution in the EPS of company A is more than offset by accretion in the EPS, with effect from year 4.

Financing Techniques in Mergers

After the value of firm has been determined on the basis of the preceding analysis, the next step is the choice of the method of payment of the acquired firm. The choice of financial instruments and techniques of acquiring a firm usually have an effect on the purchasing agreement. The payment may take the form of either cash or securities, that is, ordinary shares, convertible securities, deferred payment plans and tender offers.

Ordinary Share Financing When a company is considering the use of common (ordinary) shares to finance a merger, the relative price-earnings (P/E) ratios of two firms are an important consideration. For instance, for a firm having a high P/E ratio, ordinary shares represent an ideal method for financing mergers and acquisitions. Similarly, ordinary shares are more advantageous for both companies when the firm to be acquired has a low P/E ratio. This fact is illustrated in Table 12.5.

Table 12.5 Effect of Merger on Firm A's EPS and MPS

(a) **Pre-merger Situation:**		
	Firm A	*Firm B*
Earnings after taxes (EAT) (₹)	5,00,000	2,50,000
Number of shares outstanding (N)	1,00,000	50,000
EPS (EAT ÷ N) (₹)	5	5
Price-earnings (P/E) ratio (times)	10	4
Market price per share, MPS (EPS × P/E ratio) (₹)	50	20
Total market value of the firm (N × MPS) or (EAT × P/E ratio) (₹)	50,00,000	10,00,000
(b) **Post-merger Situation:**		
	Assuming share exchange ratio as	
	1: 2.5*	1:1
EATc of combined firm (₹)	7,50,000	7,50,000
Number of shares outstanding after additional shares issued	1,20,000	1,50,000
EPSc (EATc ÷ N) (₹)	6.25	5
P/Ec ratio (times)	10	10
MPSc (₹)	62.50	50
Total market value (₹)	75,00,000	75,00,000

* Based on current market price per share.

From a perusal of Table 12.5 certain facts stand out. The exchange ratio of 1:2.5 is based on the exchange of shares between the acquiring and acquired firm on their relative current market prices. This ratio implies that Firm A will issue 1 share for every 2.5 shares of Firm B. The EPS has increased from ₹5 (pre-merger) to ₹6.25 (post-merger). The post-merger market price of the share would be higher at ₹6.25 × 10 (P/E ratio) = ₹62.50.

When the exchange ratio is 1: 1 it implies that the shareholders of the Firm B demand a heavy premium per share ₹30 in this case i.e., (₹50 worth of share obtained in post-merger situation — ₹20 worth of equity share in pre-merger situation).

As shown in Table 12.6, at such an exchange ratio, the entire merger gain (of ₹15 lakh) accrues to the shareholders of Firm B. Evidently, this is the most favourable exchange ratio for shareholders of Firm B; the management of Firm A, in general, is not likely to agree to a more favourable exchange ratio (as it will cause decrease in shareholders' wealth of Firm A). This is the tolerable exchange ratio from the perspective of Firm A. Likewise, the management of Firm B is not likely to agree to a share exchange ratio that is detrimental to the wealth of its shareholders. Such an exchange ratio is 1: 3.25 (Table 12.7). At this ratio, the total gains accruing from the merger rests with the shareholders of Firm A. This is another set of tolerable exchange ratio from the viewpoint of Firm B. Thus, it may be generalised that *the maximum and the minimum exchange ratio should be between these two sets of tolerable exchange ratio.*

The exchange ratio eventually negotiated/agreed upon would determine the extent of merger gains to be shared between the shareholders of the two firms. This ratio would depend on the relative bargaining position of the two firms and the market reaction of the merger move.

Table 12.6 Apportionment of Merger Gains Between the Shareholders of Firms A and B

(1) Total market value of the merged firm		₹75,00,000
Less: Market value of the pre-merged firms:		
Firm A	₹50,00,000	
Firm B	10,00,000	60,00,000
Total merger gains 15,00,000		
(2) (a) Apportionment of gains (assuming share exchange ratio of 2.5:1)		
Firm A:		
Post-merger market value (1,00,000 shares × ₹62.50)		62,50,000
Less: Pre-merger market value		50,00,000
Gains for shareholders of Firm A12,50,000		
Firm B:		
Post-merger market value (20,000 shares × ₹62.50)		12,50,000
Less: Pre-merger market value		10,00,000
Gains for shareholders of Firm B2,50,000		
(b) Assuming share exchange ratio of 1:1		
Firm A:		
Post-merger market value (1,00,000 shares × ₹50)		50,00,000
Less: Pre-merger market value		50,00,000
Gains for shareholders of Firm A		NIL
Firm B:		
Post-merger market value (50,000 shares × ₹50)		25,00,000
Less: Pre-merger market value		10,00,000
Gains for shareholders of Firm B		15,00,000

Table 12.7 Determination of Tolerable Share Exchange Ratio for shareholders of Firms, Based on Total Gain Accruing to Shareholders of Firm A

(a)	Total market value of the merged firm (Combined earnings, ₹7,50,000 × P/E ratio, 10 times)	₹75,00,000
(b)	*Less:* Pre-merger or minimum post-merger value acceptable to shareholders of Firm B	10,00,000
(c)	Post-merger market value of Firm A (a – b)	65,00,000
(d)	Divided by the Number of equity shares outstanding in Firm A	1,00,000
(e)	Desired post-merger MPS (₹65 lakh/1 lakh shares)	₹65
(f)	Number of equity issues required to be issued in Firm A to have MPS of ₹65 and to have post-merger value of ₹10 lakh of Firm B, that is, (₹10 lakh/₹65)	15,385
(g)	Existing number of equity shares outstanding of Firm B	50,000
(h)	Share exchange ratio (g)/(h) i.e. 50,000/15,385 For every 3.25 shares of Firm B, 1 share in Firm A will be issued	1 : 3.25

Note: Share exchange ratio of 1:1 (shown in Table 12.6) can also be determined on the basis of procedure shown in Table 12.7.

Debt and Preference Shares Financing From the foregoing discussion it is clear that financing of mergers and acquisitions with equity shares is advantageous both to the acquiring firm and the acquired firm when the P/E ratio is high. However, since some firms may have a relatively lower P/E ratio as also the requirement of some investors might be different, other types of securities, in conjunction with/in lieu of equity shares, may be used for the purpose.

In an attempt to tailor a security to the requirements of investors who seek dividend/ interest income in contrast to capital appreciation/growth, convertible debentures and preference shares might be used to finance mergers. The use of such sources of financing has several advantages. **(i)** Potential earning dilution may be partially minimised by issuing a convertible security. For example, assume that the current market price of the shares of an acquiring company is ₹50 and the value of the acquired firm is ₹50,00,000. If the merger proposal is to be financed with equity, 1,00,000 additional shares will be required to be issued. Alternatively, convertible debentures of the face value of ₹100 with conversion ratio of 1.8, which would imply a conversion value of ₹90 (₹50 × 1.8), may be issued. To raise the required ₹50,00,000, 50,000 debentures convertible into 90,000 equity shares would be issued. Thus, the number of shares to be issued would be reduced by 10,000, thereby reducing the dilution in EPS, which could ultimately result, if convertible security was not resorted to in place of equity shares. **(ii)** A convertible issue might serve the income objectives of the shareholders of the target firm without changing the dividend policy of the acquiring firm. **(iii)** Convertible security represents a possible way of lowering the voting power of the target company. **(iv)** Convertible security may appear more attractive to the acquired firm as it combines the protection of fixed security with the growth potential of ordinary shares.

In brief, fixed income securities are compatible with the needs and purposes of mergers and acquisitions. The need for changing the financing leverage and the need for a variety of securi ties is partly resolved by the use of senior securities.

Earn-out plan is a plan for payment to shareholders of target firm in merger that is linked to the earnings of the firm.

Deferred Payment Plan Under this method, the acquiring firm, besides making an initial payment, also undertakes to make additional payments in future years to the target firm in the event of the former being able to increase earnings consequent to the merger. Since the future payment is linked to the firm's earnings, this plan is also known as **earn-out plan**. Adopting such a plan ensures several advantages to the acquiring firm: **(i)** It emerges to be an appropriate outlet for adjusting the differences between the amount of shares the acquiring firm is willing to issue and the amount the target firm is agreeable to accept for the business; **(ii)** In view of the fact that fewer number of shares will be issued at the time of acquisition, the acquiring firm will be able to report higher EPS immediately; **(iii)** There is a built-in cushion/protection to the acquiring firm as the total payment is not made at the time of acquisition; it is contingent on the realisation of the projected earnings after merger.

Notwithstanding the above benefits, there are certain problems in this mode of payment, the important ones being: **(i)** The target firm must be capable of being operated as an autonomous business entity so that its contribution to the total projects may be determined; **(ii)** There must be freedom of operation to the management of the newly acquired firm; **(iii)** On the part of the management of the acquiring firm, there must be willing cooperation to work towards the success and growth of the target firm, realising that only by this way the two firms can gain from the merger.

There could be various types of deferred payments plans. The arrangement eventually agreed upon would depend on the imagination of the management of the two firms involved. One of the often used plans, for this purpose is the **base-period earnout**. Under this plan, the shareholders of the target firm are to receive additional shares for a specified number of future years, if the firm is able to improve its earnings *vis-à-vis* the earnings of the base period (the earnings in the previous year before the acquisition). The amount becoming due for payment, in shares, in the future years will primarily be a function of excess earnings, price-earnings ratio and the market price of the shares of the acquiring firm. The basis for determining the required number of shares to be issued is as per Equation 12.3.

> **Base-period earnout** is the payment to shareholders of target firm in shares related to increase in firm's earnings in future years over the base period earnings.

(Excess earnings × *P/E* ratio)/ Share price of Acquiring firm **(12.3)**

Illustration 12.4

Company A has purchased Company B in the current year. Company B had its base year earnings of ₹3,00,000. At the time of merger, its shareholders received an initial payment of 75,000 shares of Company A. The market value of the Company A's shares is ₹30 per share and the P/E ratio is 8. The projected post-merger earnings of Company B for the next three years are ₹3,30,000, ₹3,90,000 and ₹4,14,000. Assuming no changes in share prices and P/E ratio of Company A, determine the number of shares required to be issued to the shareholders of Company B during these three years. As per the agreement with Company B, they will receive shares for 3 years only.

$$\text{Year 1: } \frac{₹30{,}000 \times 8}{₹30} = 8{,}000 \text{ shares}$$

$$\text{Year 2: } \frac{₹90{,}000 \times 8}{₹30} = 24{,}000 \text{ shares}$$

$$\text{Year 3: } \frac{₹1{,}14{,}000 \times 8}{₹30} = 30{,}400 \text{ shares}$$

Thus, the shareholders of Company B will receive a total of 1,37,400 shares (75,000 initially + 62,400 in the subsequent three years). In financial terms, they have received Company A shares worth ₹41.22 lakh (1,37,400 shares × ₹30). This sum is higher than the shareholders would have received initially. Assuming the *P/E* ratio of Company B is 7 times (the assumption is reasonable in that the P/E ratio of Company A is 8 times; the *P/E* multiple of the acquiring firm is normally higher than that of the acquired firm), its valuation/purchase consideration would have been ₹21 lakh only (₹3 lakh × 7 times). Clearly, there is a substantial gain to the shareholders of Company B and this gain is not at the cost of the wealth of the shareholders of Company A. Evidently, the method is fair and equitable.

To conclude, the deferred plan technique provides a useful means by which the acquiring firm can eliminate part of the guesswork involved in purchasing a firm. In essence, it allows the merging management the privilege of hindsight.

Tender offer is a method to acquire control in another firm through bidding.

Tender Offer An alternative approach to acquire another firm is the tender offer. A tender offer, as a method of acquiring a firm, involves a bid by the acquiring firm for controlling interest in the acquired firm. The essence of this approach is that the purchaser approaches the shareholders of the firm rather than the management to encourage them to sell their shares generally at a premium over the current market price.

Since the tender offer is a direct appeal to the shareholders, prior approval of the management of the target firm is not required.

As a form of acquiring firms, the tender offer has certain advantages and disadvantages. The disadvantages are: **(i)** If the target firm's management attempts to block it, the cost of executing the offer may increase substantially and **(ii)** the purchasing company may fail to acquire a sufficient number of shares to meet the objective of controlling the firm.

The major advantages of acquisition through tender offer include: **(i)** If the offer is not blocked, say in 'friendly' takeover, it may be less expensive than the normal route of acquiring a company. This is so because it permits control by purchasing a smaller proportion of the firm's shares and **(ii)** The fairness of the purchase price is not questionable as each shareholder individually agrees to part with his shares at the negotiated price.

Merger as a Capital Budgeting Decision

Free cashflows are after-tax operating earnings from acquisition plus non-cash expenses applicable to the target firm less expected additional investments in long-term assets and working capital.

As a normative financial framework, the merger should be evaluated as a capital budgeting decision. The target firm should be valued in terms of its potential to generate incremental future cash inflows. Such cash flows should be incremental ***future free cash flows*** likely to accrue due to the acquisition of the target firm. Free cash flows, in the context of a merger, are equal to after-tax operating earnings (expected from acquisition) plus non-cash expenses, such as depreciation and amortisation (applicable to the target firm), less additional investments expected to be made in the long-term assets and working capital of the acquired firm. These cash flows are then to be discounted at an appropriate rate that reflects the riskiness of target firm's business.

Like the capital budgeting decision, the present value of the expected benefits from the merger are to be compared with the cost of the acquisition of the target firm. Acquisition costs include the payment made to the target firm's shareholders and debenture-holders, the payment made to discharge the external liabilities, estimated value of the obligations assumed, liquidation expenses to be met by the acquiring firm and so on less cash proceeds expected to be realised by the acquiring firm from the sale of certain asset(s) of the target firm (not intended to be used in business subsequent to merger). The decision criterion is to 'go for the merger' if the net present value, NPV, is positive; the decision would be 'against the merger' in the event of the NPV being negative. Being a comprehensive measure of evaluation, it is not surprising to note that most of the merger decisions in America are evaluated in the capital budgeting framework[4].

The following are the steps used to evaluate merger decisions as per the capital budgeting approach.

(i) Determination of Incremental Projected Free Cash Flows to The Firm (FCFF) These FCFF should be attributable to the acquisition of the business of the target firm. Format 12.1 contains constituent items of such cash flows.

Format 12.1 Determination of FCFF

After-tax operating earnings
Plus: Non-cash expenses, such as depreciation and amortisation
Less: Investment in long-term assets
Less: Investment in net working capital

Note: All the financial inputs should be on incremental basis.

(ii) Determination of Terminal Value The firm is normally acquired as a going concern. The projected FCFF in such situations are made in two segments, namely, during the explicit forecast period and after the forecast period. Terminal value, TV, is the present value of FCFF, after the forecast period. Its value can be determined as per Equations 12.3 to 12.5.

(a) When FCFF are likely to be *constant till infinity*:

$$TV = \text{FCFF}_{T+1}/K_0 \tag{12.4}$$

Where FCFF_{T+1} refers to the expected FCFF in the first year after the explicit forecast period.

(b) When FCFF are likely to *grow (g)* at a constant rate:

$$TV = \text{FCFF}_T\ (1 + g)/\ (K_0 - g) \tag{12.5}$$

(c) When FCFF are likely to *decline* at a constant rate:

$$TV = \text{FCFF}_T\ (1 - g)/\ (K_0 + g) \tag{12.6}$$

(iii) Determination of Appropriate Discount Rate/Cost of Capital In the event of the risk complexion of the target firm matching with the acquired firm (say in the case of horizontal merger and firms having virtually identical debt-equity ratio), the acquiring firm can use its own weighted average cost of capital (k_0) as discount rate. In case the risk complexion of the acquired firm is different, the appropriate discount rate is to be computed reflecting the riskiness of the projected FCFF of the target firm.

(iv) Determination of Present Value of FCFF The present value of FCFF during the explicit forecast period [as per step **(i)**] and of terminal value [as per step **(ii)**] is determined by using appropriate discount rate [as per step **(iii)**].

(v) Determination of Cost of Acquisition The cost of acquisition is determined as per Format 12.2.

Format 12.2 Cost of Acquisition

Payment to equity shareholders (Number of equity shares issued in acquiring company × Market price of equity share)

Plus: Payment to preference shareholders
Plus: Payment to debenture-holders
Plus: Payment of other external liabilities (say creditors)
Plus: Obligations assumed to be paid in future
Plus: Dissolution expenses (to be paid by acquiring firm)
Plus: Unrecorded/contingent liability
Less: Cash proceeds from sale of assets of target firm (not to be used in business after acquisition)

Illustration 12.5 illustrates the application of capital budgeting approach to merger decision.

Illustration 12.5

The Hypothetical Limited wants to acquire Target Ltd. The balance sheet of Target Ltd. as on March 31 (current year) has the following assets and liabilities:

(₹ lakh)

Liabilities	*Amount*	*Assets*	*Amount*
Equity share capital			
(4 lakh shares of ₹100 each)	₹400	Cash	₹10
Retained earnings	100	Debtors	65
10.50% Debentures	200	Inventories	135
Creditors and other liabilities	160	Plant and Equipment	650
	860		860

Additional information:

(i) The shareholders of Target Ltd. will get 1.5 share in Hypothetical Ltd. for every 2 shares; the shares of the Hypothetical Ltd. would be issued at its current market price of ₹180 per share. The debenture-holders will get 11% debentures of the same amount. The external liabilities are expected to be settled at ₹150 lakh. Dissolution expenses of ₹15 lakh are to be met by the acquiring company.

(ii) The following are projected incremental free cash flows (FCFF) expected from acquisition for 6 years (₹ lakh):

Year-end 1	₹150
2	200
3	260
4	300
5	220
6	120

(iii) The free cash-flow of Target limited is expected to grow at 3 per cent per annum, after 6 years.

(iv) Given the risk complexion of Target limited, cost of capital relevant for Target limited cash flows has been decided at 13 per cent.

(v) There is unrecorded liability of ₹20 lakh.

Advise the company regarding financial feasibility of the acquisition.

Solution

Table 12.8 Financial Evaluation of Merger Decision

(i) Cost of Acquisition (t = 0)

(₹ lakh)

Share capital (3,00,000 shares × ₹180)	₹540
11% Debentures	200
Settlement of external liabilities	150
Unrecorded liability	20
Dissolution expenses of Target firm	15
	925

(ii) PV of Free Cash Inflows (years = 1 – 6)

(₹ lakh)

Year-end	*FCFF*	*PV factor (0.13)*	*Total PV*
1	₹150	0.885	₹132.75
2	200	0.783	156.60
3	260	0.693	180.18
4	300	0.613	183.90
5	220	0.543	119.46
6	120	0.480	57.60
			830.49

(iii) PV of FCFF After the Forecast Period (Referred to as Terminal Value, TV)

$$\text{TV6} = \text{FCFF}_6\,(1 + g)/(k_0 - g)$$

$$= ₹120 \text{ lakh } (1.03)/(0.13 - 0.03) = ₹123.6/0.1 = ₹1{,}236 \text{ lakh}$$

$$\text{PV of TV} = ₹1{,}236 \text{ lakh} \times 0.480 = ₹593.28 \text{ lakh}$$

(iv) Determination of Net Present Value

PV of Free cash flows (years 1 – 6)	₹830.49 lakh
PV of Free cash flows subsequent to year 6	593.28
Total PV of benefits/FCFF	1,423.77
Less: Cost of acquisition	925.00
Net present value	498.77

Recommendation As the NPV is positive, acquisition of Target limited is financially viable.

Illustration 12.6

Would your decision for acquiring Target limited **(in Illustration 12.6)** change, if FCFF after the forecast period are assumed to be **(a)** constant and **(b)** decline by 10 per cent per annum after 6 years?

Solution

Table 12.9 Determination of NPV, When FCFF are Constant after year-6

(₹ lakh)

PV of FCFF (years 1 – 6)	₹830.49
PV of FCFF (subsequent to year 6)	443.08*
Total PV of benefits	1,273.57
Less: Cost of acquisition	925.00
Net present value	348.57

*Determination of PV related to TV:

$$TV = FCFF_6/k_0 = ₹120 \text{ lakh}/0.13 = ₹923.08 \text{ lakh}$$

$$PV = ₹923.08 \text{ lakh} \times 0.480 = 443.08 \text{ lakh}$$

Table 12.10 Determination of NPV when FCFF are Expected to Decline at 10 per cent after year 6

(₹ lakh)

PV of FCFF (years 1 – 6)	₹830.49
PV of FCFF (subsequent to year 6)	225.39*
Total PV of benefits	1,055.88
Less: Cost of acquisition	925.00
Net present value	130.88

*Determination of PV related to TV:

$$TV = FCFF6(1 - g)/(k_0 + g) = ₹108 \text{ lakh}/(0.13 + 0.10) = ₹469.57 \text{ lakh}$$

$$PV = ₹469.57 \text{ lakh} \times 0.480 = ₹225.39$$

Recommendation Since the NPV is positive in both the situations, the merger proposal continues to be financially viable.

The finance manager can use *sensitivity analysis* to have a range of NPV values within which acquisition price may vary. Sensitivity analysis can be carried out by making changes in the target firm's key financial parameters such as growth rate in FCFF (during the explicit forecast period as well as in subsequent years), sales, profit margins, investment in plant and machinery, investment in working capital and the period of growth itself[5].

> **Adjusted present value**
> a variant of DCF, is value of the target company if it were entirely financed by equity plus the value of the impact of debt financing in terms of the tax benefits as well as bankruptcy cost.

Adjusted Present Value (APV) Approach The APV approach is a variant of the DCF approach used to value the target firm. This approach is very appropriate for valuing companies with changing capital structures (such as leveraged buyout targets[6]) and for valuing target companies which are having capital structures substantially different from those of acquiring companies. The approach values FCFF of target firm in two components: **(i)** the value of the target company if it were entirely equity financed and **(ii)** value the impact of debt financing both in terms of the tax benefit and bankruptcy costs.

The APV based valuation has its genesis in the Modigliani-Miller (MM) propositions on capital structure, according to which in a world of no taxes, the valuation of the firm (the sum of equity and debt) is independent of capital structure (change in debt/equity proportion). In other words, the capital structure can affect the valuation only through taxes and other market imperfections and distortions[7].

The APV approach uses these concepts of MM to show the impact of debt financing in terms of tax shield on valuation. The approach, as stated earlier, first values the company as if it were wholly equity financed by discounting future FCFF at a discount rate referred to as *unlevered cost of equity*. Since interest is a deductible item of expense to determine taxable income, it provides tax savings (assuming the firm has taxable income). The value of these tax savings are then added. Finally, to have the full impact of debt financing reflected in the valuation of the Target, adjustment is required to be made for incremental bankruptcy costs; the adjustment value may be determined subjectively or may be based on some suitable financial surrogate. Consider Illustration 12.7.

Illustration 12.7

For the facts in **Illustration 12.6,** compute the value of Target Limited based on the APV approach, given the cost of unlevered equity as 16 per cent, perpetual debentures and a corporate tax rate of 35 per cent. Ignore bankruptcy costs. Also estimate the NPV.

Solution

Table 12.11 (i) PV of FCFF, Discounted at Unlevered Cost of Equity (k_u)

(₹ lakh)

Year-end	*FCFF*	*PV factor (0.16)*	*Total PV*
1	₹150	0.862	₹129.30
2	200	0.743	148.60
3	260	0.641	166.66
4	300	0.552	165.60
5	220	0.476	104.72
6	120	0.410	49.20
			764.08

(ii) PV of FCFF After the Forecast Period/Terminal Value

(₹ lakh)

$$TV6 = FCFF6\ (1 + g)/(k_u - g)$$

$$= ₹120 \text{ lakh } (1.03)/(0.16 - 0.03) = ₹950.77 \text{ lakh}$$

$$\text{PV of TV} = ₹950.77 \text{ lakh} \times 0.410 = ₹389.82 \text{ lakh}$$

(iii) PV of Tax Savings Due to Interest

(₹ lakh)

Amount of Debt (11% Debentures)	₹200
Amount of interest (₹200 lakh × 0.11)	22
Tax savings (₹22 lakh per year × 0.35 tax rate)	7.7
Present value of tax shield (₹7.7 lakh/0.11)	70.0

Table 12.12 (iv) Adjusted Present Value and NPV of Target Limited

(₹ *lakh)*

(i)	PV of FCFF (years 1 – 6)	₹764.08
(ii)	PV of terminal value	389.82
(iii)	PV of tax shield	70.00
	Total adjusted present value	1223.90
	Less: Cost of acquisition	925.00
	Net present value	298.90

The acquisition of Target limited is financially profitable according to the APV approach. However, the approach brings to fore the fact that the tax advantage of debt may not be sizable, particularly when viewed along with bankruptcy costs.

In valuing the present value of a tax shield, the cost of debt is used as a discount rate. One argument for using the cost of debt as discount rate is that the tax benefits are likely to be realised and are, therefore, subject to low risk. Another argument is that uncertainty about company's ability to realise the tax shield is best measured by the rate at which the lenders are willing to lend to the company, that is, cost of debt[8].

However, there is a counter argument for using higher discount rates (say, weighted average cost of capital or unlevered cost of equity) to value the tax shield. Tax shields are not certain in nature; future tax shields are tied to the business operations in future, that is, future profits. In other words, there will be a high correlation between the profits and cash flows and the interest tax shield. Hence, the risk will be similar. With similar risk, the interest tax shields should also be discounted at the same rate as the operations of the target firm, that is, the unlevered cost of equity[9].

To sum up it may be said that the discount rate to value the tax shield will depend on the circumstances of each case. When the firm has a low target debt ratio and business prospects are very promising, there is a greater probability of realising tax shields in the future. Therefore, in such a situation, the cost of debt can be used as the discount rate. On the contrary, if the target debt ratio of the firm as well as its business risk is high, there is obviously a greater uncertainty in realising potential tax shields and, hence, they should be subject to a higher discount rate. Finally, the finance manager may also consider (say, in undecisive situations) a discount rate lying somewhere between the cost of debt and the weighted average cost of capital or unlevered cost of equity.

TAX ASPECTS OF AMALGAMATION, MERGER AND DEMERGERS

This section summarises the important and relevant tax provisions applicable to amalgamations, acquisitions, mergers and demergers.

Tax Aspects Related to Amalgamation/Mergers

Amalgamation for the purposes of income tax is recognised only if the conditions given under Section 2 (1B) of the Income Tax Act, 1961 (ITA) are fulfilled. According to Section 2 (1B) 'amalgamation', in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies that so merge are referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger is the amalgamated company) in such a manner that:

(i) all the property/liabilities of the amalgamating company(ies) immediately before the amalgamation, becomes the property/liabilities of the amalgamated company by virtue of the amalgamation;

(ii) Shareholders holding not less than three-fourths (in value) of the shares in the amalgamating company(ies) (other than shares already held therein immediately before the amalgamation by the amalgamated company, its subsidiary or by a nominee of the said company) become shareholders of the amalgamated company by virtue of the amalgamation.

Tax Concessions to Amalgamated Company The following are the major tax benefits available to the amalgamated company.

1. Carry Forward and Set off of Business Losses and Unabsorbed Depreciation According to Section 72 A, the amalgamated company is entitled to carry forward accumulated losses as well as unabsorbed depreciation of the amalgamating company, provided the following conditions are fulfilled:

(i) The amalgamated company continuously holds, for a minimum period of 5 years, from the date of amalgamation at least three-fourths of the above value of fixed assets of the amalgamating company, acquired in the scheme of amalgamation.

(ii) The amalgamated company continues the business of the amalgamating company for a minimum period of 5 years from the date of amalgamation.

(iii) The amalgamated company fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purposes.

(iv) The amalgamation should be of a company owning an industrial undertaking or ship. Industrial undertaking, in this context, means an undertaking that is engaged in

- the manufacture or processing of goods; or
- the manufacture of computer software; or
- the business of generation or distribution of electricity or any other form of power; or
- the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services; or
- mining or
- the construction of ships, aircrafts or rail systems.

In case where any of the above conditions (i–iv) are not complied with, the set off of loss or allowance of depreciation made in any previous year in the books of the amalgamated company would be deemed to be the income of the amalgamated company and chargeable to tax for the year in which such conditions are not complied with.

2. Expenditure on Scientific Research Where an amalgamating company transfers any asset represented by capital expenditure on scientific research to the amalgamated Indian company, unabsorbed capital expenditure in the books of the amalgamating company would be eligible to be carried forward and set off in the hands of the amalgamated company.

3. Expenditure on Acquisition of Patent Rights or Copy Rights The expenditure on patents and copyrights not yet written off in the books of amalgamating company would be allowed to be written off by the amalgamated company in the same number of balance instalments.

Where such rights are later on sold by the amalgamated company, the profit/loss on such sales would be treated in the hands of the amalgamated company, in the same manner as it would have been allowed to be treated by the amalgamating company.

In case such expenditure has been incurred by the amalgamating company after March 31, 1998, such an expenditure would be eligible for depreciation, as intangible asset and provisions of depreciation would apply.

4. Expenditure on Know-how Regarding the expenditure incurred on know-how, the amalgamated company would be entitled to claim deduction with respect to the transferred undertaking, to the same extent and for the same residual period as otherwise would have been allowed to the amalgamating company, had such an amalgamation not taken place. Like patent rights, in case such an expenditure is incurred by the amalgamating company after March 31, 1998, such an expenditure will be eligible for depreciation as intangible asset and provisions of depreciation would apply.

5. Expenditure for Obtaining Licence to Operate Telecommunication Services When the amalgamating company transfers licence to the Indian amalgamated company, the expenditure on acquisition of licence, not yet written off, is allowed to the amalgamated company in the same number of balance instalments. When such licence is sold by the amalgamated company, the treatment of surplus/deficiency would be the same as would have been in the case of the amalgamating company.

6. Preliminary Expenses Deduction of preliminary expenses (to the extent not amortised) would be made in the books of the amalgamated company in the same manner as would have been allowed to the amalgamating company.

7. Expenditure on Prospecting of Certain Minerals Where an amalgamating company merges with the amalgamated company, the amount of expenditure on prospecting, etc, of certain minerals of the amalgamating company that are not yet written off, would be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.

8. Capital Expenditure on Family Planning The capital expenditure on family planning not yet written off would be allowed to the amalgamated company in the same number of balance instalments.

9. Bad Debts When the debts of amalgamating company have been taken over by the amalgamated company and subsequently such debt or part of debt becomes bad, they would be allowed as a deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.

In brief, the Income tax Act for all types of business reorganisations/amalgamations/mergers has become **fully tax neutral**. Virtually all fiscal concessions/incentives/deductions (in respect of fixed assets, capital expenditures, intangible assets, deferred revenue expenditure and so on) that would otherwise have been available to the amalgamating company are made available to the amalgamated company as well. In other words, the unwritten off amount, with respect to all these items, is treated in the hands of the amalgamated company in the same manner as would have been treated by the amalgamating company. Thus, the amalgamated company is not put to any disadvantage as far as the income tax concessions and incentives are concerned. The present generous/favourable fiscal provisions are indicative/reflective of Government policy to facilitate, promote and create opportunities for more amalgamations and mergers.

Tax Concessions to Amalgamating Company The tax concessions to the amalgamating are summarised below.

(i) Free of Capital Gains Tax According to Section 47 (vi), where there is a transfer of any capital asset by an amalgamating company to any Indian amalgamated company, such transfer will not be considered as a transfer for the purpose of capital gain.

(ii) Free of Gift-Tax According to Section 45 **(b)** of the Gift Tax Act, where there is a transfer of any asset by an Indian amalgamating company, gift tax will not be attracted.

Tax Concessions to the Shareholders of an Amalgamating Company According to Section 47 (vii), where a shareholder of an Indian amalgamating company transfers his shares, such transaction will be disregarded for capital gain purposes, provided the transfer of shares is made in consideration of the allotment of any share to him or shares in the amalgamated company.

Further, for computing the period of holding of such shares, the period for which such shares were held in the amalgamating company would also be included so that the shareholders of the amalgamating company are not put to disadvantage.

Tax Aspects Related to Demergers

Demerger is the transfer by a company one or more of its undertakings to another company.

Meaning of Demerger Pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, a demerger means the transfer, by the demerged company, of one or more of its undertakings to any resulting company in such a manner that:

(i) all the property/liabilities of the undertaking, being transferred by the demerged company, immediately before the merger becomes the property/liabilities of the resulting company by virtue of the demerger;
(ii) the property and the liabilities of the undertaking(s) being transferred by the demerged company immediately before the demerger are transferred at values appearing in its books of account;
(iii) the resulting company issues, in consideration of the demerger, its shares on a proportionate basis to the shareholders of the demerged company;
(iv) shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger;
(v) the transfer of the undertaking is on a going concern basis;
(vi) the demerger is in accordance with the conditions, if any, notified in this behalf under Section 72 A (5) by the Central Government.

The undertaking, in the present context, means any part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

Meaning of Demerged Company Demerged company means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.

Meaning of Resulting Company Resulting company means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and the resulting company, in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and may include any authority or body/local authority/public sector company/company established, constituted or formed as a result of demerger.

Tax Concessions to Resulting Company The resulting company is entitled virtually to all the tax concessions as are available to the amalgamated company. These are listed on the next page.

(i) Carry Forward and Set off of Business Losses and Unabsorbed Depreciation of the Demerged Company The accumulated loss and unabsorbed depreciation 'in a demerger' should be allowed to be carried forward by the resulting company, if these are directly related to the undertaking proposed to be transferred. Where it is not plausible to relate these to the undertaking, such loss and depreciation would be apportioned between the demerged company and the resulting company in proportion of the assets coming to the share of each as a result of the demerger.

(ii) Expenditure on Acquisition of Patent Rights or Copyrights Where the patent or copyrights acquired by the demerged company is transferred to the resulting Indian company, the expenditure on patents or copyrights not written off would be allowed to be written off in the hands of the resulting company in the same number of balance instalments. On their subsequent sales, the treatment of deficiency/surplus in the resulting company would be the same as would have been in the case of the demerged company.

(iii) Expenditure on Know How

(iv) Expenditure for Obtaining Licence to Operate Telecommunication Services

(v) Expenditure on Prospecting, etc. of Certain Minerals Where there is a transfer of items listed (iii to v) above by the demerged company to the resulting Indian company, the amount of expenditure not yet written off would be allowed to the resulting company in the same number of balance instalments. In the case of sales of any of these items, the treatment of the deficiency/surplus in the books of the resulting company would be the same as would have been in the case of a demerged company.

(vi) Preliminary Expenses Where the undertaking of an Indian company is transferred before the expiry of 10/5 years, to another company, the preliminary expenses of such an undertaking that are not yet written off would be allowed as deduction in the same manner as would have been allowed to the demerged company.

(vii) Bad Debts Where due to demerger, the debts of the demerged company have been taken over by the resulting company and subsequently such debt or part of debt becomes bad, such bad debts would be allowed as a deduction to the resulting company.

(viii) Expenditure Related to Demerger In the case of expenditures that are incurred after the April 1, 1999, wholly and exclusively for the purpose of the demerger of an undertaking, the resulting Indian company incurring such an expenditure would be allowed a deduction of an amount equal to one-fifth of such expenditure for five successive previous years beginning with the previous year in which the demerger takes place.

Tax Concessions for the Demerged Company The concessions for the demerged company are as follows.

(i) Free of Capital Gains Tax Where there is a transfer of any capital asset in a demerger, such transfer would not be regarded as a transfer for the purpose of capital gain.

(ii) Reserves for Shipping Business Where a ship acquired out of the reserve is transferred even within the period of eight years of acquisition, there would be no deemed profits to the demerged company.

Tax Concessions to the Shareholders

Any transfer or issue of shares by the resulting company to the shareholders of the demerged company would not be regarded as transfer if the transfer or issue is made in consideration of the demerger of the undertaking. In the case of demerger, the existing shareholders of the demerged company would hold shares in the resulting company as well as shares in the demerged company.

Further, for computing the period of holding of such shares in the resulting company, the period for which such shares were held in the demerged company would also be included.

LEGAL AND PROCEDURAL ASPECTS OF MERGERS/AMALGAMATIONS AND ACQUISITIONS/TAKEOVERS

Following the economic reforms in India in the post-1991 period, there is a discernible trend among promoters and established corporate groups towards consolidation of market share and diversification into new areas through acquisition/takeover of companies, and in a more pronounced manner through mergers/amalgamations. Although the financial evaluation and the economic considerations, in terms of motive and effect, of the above mentioned are similar, the legal procedures involved are different. The merger and amalgamation of corporates constitutes the subject matter of the Companies Act, the courts and law and pre-security of combination by the Competition Commission of India and there are well laid down procedures for valuation of shares and rights of investors. The acquisition/takeover bids fall under the purview of the SEBI. We first cover the framework of pre-security and mergers/amalgamations. The regulatory framework governing acquisition/takeovers is described subsequently.

Combination and Competition Act

Prior to 1991, pre-entry scrutiny of mergers/combinations in India was conducted by the Monopolies and Restrictive Practices (MRTP) Commission under the MRTP Act, 1969. Since 2003, the Competition Commission of India (CCI) is empowered under the Competition Act 2002 to scrutinise and clear combinations that may give rise to monopoly situations. The CCI is mandated, upon its own knowledge or information, to enquire within one year of its happening whether an acquisition/acquisition of control/amalgamation or merger has caused/is likely to cause an appreciable adverse effect on competition in India. The CCI has issued regulations (2011) in respect of procedures regarding transactions of business relating to combinations. The main features of the regulation of combination by the CCI are discussed below.

Regulation of Combination Any combination entered into by any **person** (i.e. individual/Hindu Undivided Family/company/firm/association of person(s) incorporated in India or abroad/ corporation or Government company/body corporate/cooperative society/local authority/every other artificial judicial person) or **enterprise** which causes or is likely to cause an **appreciable adverse effect** on competition within the **relevant market** in India would be void. Whether a combination would have the effect of/is likely to have appreciable adverse effect on competition in the relevant market, the CCI would have due regard to all/any of the factors listed below:

- Actual/potential level of competition through imports in the market;
- Extent of barriers to entry to the market;
- Degree of countervailing power in the market;
- Likelihood of the combination resulting in the concerned parties being able to significantly and sustainably increase price/profit margin;
- Extent of effective competition likely to sustain the market;
- Market share in the relevant market of the concerned person/enterprise individually/jointly;
- Likelihood of the combination resulting in the removal of a vigorous/effective competitor(s) in the market;
- Nature/extent of vertical integration in the market;
- Possibility of a failing business;
- Nature/extent of innovation;
- Relative advantage by way of contribution to economic development by any combination having/likely to have appreciable adverse effect on competition;
- The benefits of combination outweigh the adverse impact of combination.

The term **enterprise** means a person/department of Government who/which is/has been engaged in any activity relating to production/storage/supply/ distribution/acquisition/control of articles/goods or the provision of any kind of services or **investment or in the business of acquiring/holding/underwriting/ dealing with shares/debentures/other securities of any other body corporate directly/indirectly through one of its units/divisions/subsidiaries**.

Relevant market means the market determined by the CCI with reference to the relevant **(i)** product, **(ii)** geographic market or both.

Relevant market means the market determined by the CCI with reference to the relevant **(i)** product, **(ii)** geographic market or both. While the geographic market refers to the area in which the conditions of competition are homogeneous distinct from the neighbouring area, product market comprises all interchangeable/ substitute products/services.

Any person/enterprise proposing to enter into combination should give notice to the CCI containing the details of the proposal within 30 days of **(a)** approval of the mergers/amalgamation by the Board of Directors, (i.e. the individual himself/herself including sole proprietor, Karta in a HUF, Board of Directors of a company, body/person empowered in Government company/corporation, association of persons, body of individuals whether incorporated or not, body corporate incorporated in India/abroad, cooperative society, local authority, partners of a firm and person(s) competent to act in case of any other judicial person), **(b)** execution of any agreement/other documents for acquisition/acquiring control. The combination would be effective after 210 days from the date of the notice.

Combination The acquisition of an enterprise(s) by a person(s) or merger or amalgamation of enterprises would constitute their combination subject to the conditions **discussed later. Acquisition** means directly/indirectly acquiring/agreeing to acquire **(i)** share/voting rights/assets or **(ii)** control over management/assets of an enterprise. Included in **control** is controlling the affairs/management by an enterprise(s)/group(s) either jointly or singly over another enterprise/group. **Group** means two/more enterprises which directly/indirectly are in a position to **(i)** exercise at least 26 per cent of the voting rights or **(ii)** appoint more than 51 per cent of the Board of Directors or **(iii)** control the management/affairs of the other enterprise. The value of assets would be determined on the basis of their audited book value less depreciation in the financial year immediately preceding the financial year in which the date of merger falls. Such value will include the brand value, value of goodwill/copyrights/patents/permitted use/collective work/registered proprietor/trade mark/user/homogenous geographical indication/geographical indication/design/layout design/similar other commercial rights and so on.

Combination
is the acquisition of an enterprise(s) by a person(s) or merger or amalgamation of enterprises.

Acquisition
means directly/indirectly acquiring/agreeing to acquire **(i)** share/voting rights/assets or **(ii)** control over management/assets of an enterprise.

Control
is controlling the affairs/management by an enterprise(s)/group(s) either jointly or singly over another enterprise/group.

Group
means two/more enterprises which directly/indirectly are in a position to **(i)** exercise at least 26 per cent of the voting rights or **(ii)** appoint more than 51 per cent of the Board of Directors or **(iii)** control the management/affairs of the other enterprise.

The conditions for pre-combination scrutiny by the CCI pertain to the value of assets and turnover, that is, value of goods and services. **Goods** include **(i)** product manufactured/proceed/mined, **(ii)** debentures/stocks/shares after allotment and **(iii)** goods incorporated into India. **Service** means service of any description made available to potential users, including services in connection with business of any industrial/commercial matters such as banking/communication/education/financing/ insurance/chit funds/real estate/transport/storage/material treatment/processing/supply of electrical or other energy/boarding, lodging, entertainment, amusement/ construction/repair/conveying of news or information and advertising.

Conditions To constitute combination, the following conditions must be satisfied in regard to **(i)** acquisition, **(ii)** acquiring control and **(iii)** merger/amalgamation:

The acquirer and the concerned enterprise jointly have in **(a)** India assets and turnover exceeding ₹1,000 crore and ₹3,000 crore, respectively, **(b)** India/outside India, the respective amounts are more than 500 million US dollars (including at least ₹500 crore in India), and 1,500 million US dollars (including at least ₹1,500 crore in India). The stipulations for the group to which the concerned enterprise belongs are that their joint holdings in India are/would be ₹4,000 crores (assets) and ₹12,000 crores (turnover). Such holdings in India/outside India should aggregate more than two billion US dollars (of which at least ₹500 crore in India) in terms of assets and six billion US dollars (including at least ₹1,500 crore in India) in terms of turnover.

Procedure for Investigation Where the CCI is of the *prima facie* opinion that a combination is likely to cause/has caused an appreciable adverse effect on competition within the relevant market in India or any person/enterprise has given a notice to the CCI proposing to enter into a combination, it would issue a show cause notice to the parties to the combination to respond within 30 days as to why an investigation should not be conducted. After receipt of their response, the CCI may call for a report from its Directors General within specified time. Within 7 days from the receipt of the response of the parties concerned or the report from the Director General whichever is later, the CCI would direct the parties to publish details of the combination within 10 days in a manner appropriate for bringing to the knowledge/information of the public/persons affected/ likely to be affected by the combination. The CCI may invite any person/member of the public affected/likely to be affected to file written objections within 15 days of the publication of the details of the combination. Within 15 days of the expiry of the period for filing objection, additional/other information deemed fit by the CCI may be sought from the parties concerned to be furnished within the next 15 days. After receipt of all information, the CCI would proceed within 45 days to deal with the case in the manner specified below.

Orders of CCI On the basis of its assessment of the appreciable adverse effect of combination on competition, the CCI would **(i)** approve, **(ii)** disapprove, **(iii)** propose appropriate/suitable modification to eliminate the adverse effect within the specified period. In case of failure of parties who accept the suggested modification to carry it out, the combination would be deemed to have an appreciable adverse effect on competition and the CCI would deal with it according to the provisions of the Competition Act.

The parties concerned can within 30 days of the proposed modification submit an amendment to the modification and the CCI, if satisfied, would approve the combination. If, however, the CCI does not accept the amendment, the parties would have to accept the CCI-proposed modifications failing which the combination would be deemed to have an appreciable adverse effect on competition and deal with in accordance with the provisions of the Competition Act. The proposed acquisition/acquiring of control/merger or amalgamation by the parties concerned, without prejudice to the imposition of any penalty or initiation of any prosecution under the Competition Act, would not be given effect to after the CCI's direction/the combination being deemed to have an appreciable adverse effect or competition. The CCI can also frame a scheme to implement its order.

If, however, the CCI does not pass an order/issue direction on the expiry of the 210-day period from the date of the original notice by the parties, the combination would be deemed to have been approved by it. The limits of 210 days would not include the 60 days given to the parties to file an amendment to the modification proposed by the Commission (30 days) and accept the modification after rejection of their amendment (30 days). Similarly, any extension of time sought/granted by the parties/CCI would be deducted for reckoning the 210 day-period. Where a combination is ordered by the CCI to be void, the acquisition/acquiring of control/ merger or amalgamation would be dealt with under any other law as if the combination had not taken place and the parties concerned dealt with accordingly.

Penalties The CCI may cause an inquiry into compliance of its orders/directions. Failure, without reasonable cause, to comply with its orders/directions would be punishable with a fine upto rupees one lakh for each day of non-compliance subject to a maximum of ₹10 crore. If any person fails to pay any monetary penalty imposed on him, the CCI would proceed to recover it in the specified manner, including under the Income Tax Act as assessee in default. Non-compliance with CCI's orders/directions or failure to pay the fine would be punishable with imprisonment up to 3 years or with fine up to ₹25 crore or with both. Any person can approach the Appellate Tribunal for recovery of compensation from any enterprise for any loss/damage suffered by him as a result of violation of CCI's directions or contravention without reasonable ground, of any decision/order of the CCI or any condition/restrictions subject to which any approval/sanction/direction/exemption in relation to any matter has been accorded/given/made/granted under the Competition Act or delay in carrying out such orders/directions of the CCI. Penalty for **(i)** failure to comply with directions of the CCI/Director General, fine up to Rupees one lakh for each day of failure subject to a maximum of ₹1 crore; **(ii)** non-furnishing of information on combination, up to 1 per cent of the highest of the total turnover or assets; **(iii)** making of false statements/omission to furnish material information, not less than ₹50 lakh and upto ₹1 crore, **(iv)** offences relating to furnishing of information, fine up to ₹1 crore and any other order deemed fit by the CCI. Included in these offences are **(1)** making of a statement/furnishing of a document knowing or having reasons to believe to be false in any material particular, **(2)** omission to state any material fact knowing it to be material, and **(3)** willfully altering/suppressing/destroying any document required to be furnished.

In case of contravention of provision(s) of the Competition Act/rules/regulations/order/direction by a company, the company as well as every person incharge of, and responsible for the conduct of its business would be deemed to be guilty of the contravention. In case of contravention with the consent/connivance of, or attributable to any neglect on the part of any director/manager/secretary/other officer, they would also be deemed to be guilty.

Combination and Companies Act

The provisions of the Companies Act, 2013 relating to combination contained in Sections 230–32 are summarised below.

(1) Merger can be by **(i)** absorption or **(ii)** formation of a new company. Merger by absorption involves the transfer of the undertaking, property and liabilities of the companies to another existing company. Their transfer to a new company is merger by formation of a new company. While absorption relates to the transferor and transferee companies, merger by formation of a new company is in relation to the transferor companies. Any proposal/scheme/arrangement for reconstruction of a company (or companies) involving merger/amalgamation under which the whole/part of the undertaking, property (includes assets/rights and interest of every description)/liabilities (includes debts and obligations of every description) of the transferor company are required to the transferred to the transferee company or are proposed to be divided among and transferred to two/more companies would require sanction by the National Company Law Tribunal (NCLT). On receipt of the application of the company, any creditor or member, the NCLT would order a meeting of the creditors/members to be called/held/conducted in a manner directed by it. The notice for the meeting should be sent to all the creditors/members and debentureholders individually at their registered address accompanied by a statement disclosing, *inter-alia*, the details of the arrangement/scheme, a copy of the valuation report and explaining their effect on creditors, key managerial personnel, promoters/non-promoter members, debentureholders and any material interest of the directors/debenture trustees. The notice and other documents should also be **(i)** placed on the website of the company, **(ii)** sent to the SEBI/concerned stock exchanges for placing on their websites, and **(iii)** published in newspapers in the prescribed manner. The notice for the meeting issued by way of an advertisement should indicate the time within which copies of the scheme would be made available to the concerned persons free of charge from the registered office of the company.

The notice should, moreover, provide that the person to whom it is sent may vote in the meeting either themselves or through proxies or by postal ballot to the adoption of the proposal within one month only. Persons **(i)** holding at least 10 per cent of the shareholding or **(ii)** having a minimum 5 per cent of the total outstanding debt can make objections to the scheme.

Further, the notice with all the documents in the prescribed form should also be sent to the **(i)** Central Government, **(ii)** Income Tax authorities, **(iii)** RBI, **(iv)** SEBI, **(v)** Registrar of Companies, **(vi)** Respective stock exchanges, **(vii)** Official liquidator, **(viii)** Competition Commission of India and **(ix)** other sectoral regulators/authorities likely to be affected by the arrangement. Any representation by them should be made within 30 days from the receipt of the notice failing which it would be presumed that they have no representations to make on the proposal.

The scheme approved by three-fourths in value of creditors/members and sanctioned by the NCLT would be binding on the company/all creditors/members.

(2) The merging companies would have to circulate in the meeting ordered by the NCLT the following: **(i)** Draft of the proposed terms of the scheme drawn up and adopted by its directors, **(ii)** Confirmation that a copy of the draft scheme has been filed with the Registrar of Companies, **(iii)** A report adopted by its directors explaining the effect on each class of shareholders, key managerial personnel, promoter/non-promoter shareholders, laying out in particular the share exchange ratio, specifying any special valuation difficulties, **(iv)** Expert valuation report and **(v)** A supplementary accounting of the last annual accounts of any merging company related to the financial year ending more than six months before the first meeting of the company summoned for approving the scheme.

(3) On being satisfied that the above procedures have been complied with, the NCLT would sanction the scheme /arrangement. It would also make provision for the matters specified below:

(a) Transfer to the transferee company of the whole/any part of the undertaking, property/liabilities of the transferor company from a date to be determined by the parties;

- **(b)** Allotment/appropriation by the transferee company of any shares/debentures, policies/ other like instruments in the company which under the scheme are to be allotted/appropriated by the company to/or for any person. However, the transferee company cannot hold any shares in its own name/in the name of any trust on its behalf/on behalf of any subsidiary/associate companies and such shares should be cancelled/extinguished.
- **(c)** Continuation by/against the transferee company of any legal proceedings pending by/ against transferor company on the date of the transfer;
- **(d)** Dissolution, without winding up, of transferor company;
- **(e)** Provision to be made for any person who dissents from the arrangement;
- **(f)** Allotment of shares of the transferee company to a non-resident shareholder;
- **(g)** Transfer of employees of the transferor to the transferee company;
- **(h)** In case the transferor company is a listed company and the transferee company is an unlisted company, **(i)** the transferee company would remain an unlisted company until it becomes a listed one, **(ii)** provision for payment of the value of shares held by shareholders of the transferor company who decide to opt of the transferee company and their other benefits according to a pre-determined price formula or after a valuation. However, the amount can in no case be less than what has been specified by any SEBI regulation;
- **(i)** Set-off any dissolution fee paid by the transferor company against any similar fee paid by the transferee company subsequent to the amalgamation; and
- **(j)** Such incidental/consequential/supplemental matters as deemed necessary to secure that the merger/amalgamation is fully/effectively carried out. However, the NCLT would sanction any scheme only if the auditors certify that the accounting treatment proposed in the scheme is in conformity with the accounting standards prescribed by the Government.

(4) The property/liabilities of the transferor company would be by virtue of the sanction order of the NCLT transferred to the transferee company.

(5) Every concerned company should file a certified copy of the order with the Registrar of the Companies (ROCs) within 30 days of its receipt.

(6) The merger/amalgamation scheme should clearly indicate an appointed date from which it would be effective.

(7) The company concerned should, until the completion of the scheme, file a statement in the prescribed form/within prescribed time with the ROCs every year duly certified by a practicing Chartered/Cost Accountant /Company Secretary that the scheme is being complied with the orders of NCLT.

(8) Contravention of the above provisions by the transferor/transferee company would be punishable with a minimum fine of one lakh rupees which may extend to 25 lakh rupees. Every defaulting officer would be punishable with imprisonment upto one year or fine between 1-3 lakh rupees or with both.

Annexure 1 below contains the gist of the scheme of merger of Reliance Pertrochemicals Ltd with Reliance Industries Ltd. The demerger scheme of DCM Ltd is outlined in Annexure 2.

Annexure 1 Merger of Reliance Pertrochemicals Ltd (RPL) with Reliance Industries Ltd (RIL)

The merger of RPL with RIL in March 1992 was the biggest ever merger till date and resulted in the creation of the largest Indian corporate. RIL was engaged in the manufacture and sale of textiles, fibre and fibre intermediates and petrochemicals. In particular, it was engaged in the manufacture of polyester staple fibre (PSF), polyester filament yearn (PFY), purified teraphtalic acid (PTA), linear alkyl benzene (LAB) and other products. Its paid-up capital (₹157.94 crore) consisted of **(i)** equity capital, ₹152.14 crore (15.21 crore shares of ₹10 each) **(ii)** 11 per cent cumulative redeemable preference shares of ₹100 each, ₹30 lakh; and 15 per cent cumulative redeemable preference shares of ₹100 each, ₹5.5 crore.

The RPL was incorporated in November 1988 with the main objective of manufacturing poly vinyl chloride (PVC), mono ethylene glycol (MEG) and high density poly ethylene (HDPE). Its paid-up equity capital stood at ₹749.30 crore consisting of 74.93 crore shares of ₹10 each.

In terms of a scheme of amalgamation approved by the shareholders of the two companies and Mumbai and Gujarat High Courts in July/August 1992, the RPL was merged with the RIL with effect from March 2, 1992. The merger was aimed to enhance shareholders' value by realising significant synergies of both the companies. Liberalisation of government policy and the accompanying economic reforms created this opportunity for the RIL's shareholders.

As per the scheme of amalgamation, the expected benefits of merger to the amalgamated entity, *inter-alia,* were:

- Benefit from diversification as the risks involved in the operation of different units would be minimised
- Business synergy due to economies of scale and integrated operations
- Higher retailed earning leading to enhanced intrinsic values of shareholding to investors. The capital requirement would also be at manageable levels
- Strong fundamentals which would enhance its credit rating and resource raising ability in financial markets, both national and international

The exchange ratio was one equity share of ₹10 each in RIL for every 10 equity shares of RPL with a par value of ₹10 each. The exchange ratio was based on the expert valuation made by three reputed firms of chartered accountants, namely, S.B. Billimoria & Co, Choksi & Co and Heribhakthi & Co. Pursuant to the above, 7,49,26,428 equity shares of ₹10 each were issued as fully paid-up to the shareholders of RIL without payment being received in cash.

All the assets, liabilities and obligations of RPL were taken over by the merged entity–RIL. The excess of assets over liabilities takenover by RIL consequent on the amalgamation less the face value of the equity shares issued to the shareholders of the RPL represented amalgamation reserve. All the employees of RPL on the date immediately preceding the effective date became the employees of the RIL.

The post-merger scenario of the RIL is reflected in the increase in its capital, turnover, net profit and equity dividend. Compared to the pre-merger capital of ₹157.94 crore, the post-merger capital rose to ₹358.74 crore. The turnover increased from ₹2,298 crore in 1991–92 to ₹7,019 crore in 1994–95. Net profit of RIL stood at ₹10,651 crore in 1994–95 compared to ₹163 crore in 1991–92. The equity dividend rose phenomenally to 55 per cent (1994–95) from 30 per cent (1991–92). The RIL emerged post-merger as a mega corporation and became a global player. Its foreign exchange earnings in 1994–95 aggregated ₹174 crore.

Annexure 2 Demerger of DCM Ltd

DCM Ltd, promoted by Late Shri Ram in 1889, has become a conglomerate of 13 units with multifarious manufacturing activities in sugar, textile, chemicals, ryon tyre cord, fertilisers and so on. These units on their own being of the size of independent companies, the directors felt that greater focus on the operation of the various units of the company would result in substantial improvement in the results of their operations. The post-reorganisation slogan would be: "**The Trimmer We Are, The Faster We Are**".

On the basis of the various discussions, meetings, consultations between the members of the Board of Directors, financial institutions and consultants, it was decided to take appropriate steps to carry on the business of various units more effectively and efficiently in the larger interest of shareholders, debentureholders, creditors, employees and in the general public interest. To achieve the objective of carrying the business of DCM Ltd more smoothly and profitably, DCM Ltd was reorganised by dividing its business among four companies having shareholders with the same interest *inter-se* in DCM but to be managed and operated independently (Exhibit 1).

Exhibit 1 Division of DCM Ltd.

(i) **DCM Ltd** comprising DCM Mills (DCM Estate) DCM Engineering Products, DCM Data Products, Hissar Textiles Mills, Shri Ram Fibres Ltd, and DCM Toyota Ltd.

(ii) **DCM Shri Ram Industries Ltd** comprising Shri Ram Rayons, Daurala Sugar Works, and Hindon River Mills.

(iii) **DCM Shri Ram Consolidated Ltd** comprising Shri Ram Fertilises and Chemicals Industries Ltd, Shri Ram Cement Works Ltd, Swatantra Bharat Mills Ltd, and DCM Silk Mils Ltd.

(iv) **Shri Ram Industrial Enterprises Ltd** comprising Shri Ram Food and Fertilisers Ltd, and Mawana Sugar Works Ltd.

The division of DCM Ltd took place through the scheme of arrangement approved by the Delhi High Court on April 16, 1990 according to which three new companies were formed. The scheme of arrangement became effective from April 1, 1990. The four companies thereafter started operating independently, each with their respective Boards of Directors.

Some of the notable features of the scheme of reorganisation of the erstwhile DCM Ltd into four companies were:

- The total paid-up capital of ₹23 crore was divided equally.
- The allocation of various assets and liabilities among them was done as under:

	DCM Shri Ram Industries Ltd	*DCM Shri Ram Consolidated Ltd*	*Shri Ram Industrial Enterprises Ltd*	*DCM Ltd*
Fixed deposits	16%	33%	36%	15%
Debentures	16%	12%	36%	36%
Common assets/ liabilities/income/benefit	16.66%	16.66%	33.33%	33.33%
Expenses and cost of arrangement	16.66%	16.66%	33.33%	33.33%
Specific assets	(All at book value as on 1.4.1990 unit-wise)			

- Though the liability for debentures was divided, the debentures were physically retained in DCM Ltd. The mortgage of assets of various units already created with the trustees for debentureholders were modified to the effect that each group's assets would stand charged only for the liability allocated to it.
- For payment of interest and principal amount to debentureholders, Indian Bank, which was the debenture trustees was appointed a Registrar by all the four companies and they remitted their share of liabilities to the Registrar on due dates for onward payment to debentureholders. The cost of Registrar would be shared by all the companies.
- The fixed deposit receipts were split into four new receipts in the proportion in which the fixed deposits appeared in the books of account as on the effective date.
- Upon transfer of the undertakings to them, the new companies allotted one equity share each to the holders of four equity shares in DCM Ltd. The paid-up value of DCM equity share was thereupon reduced for ₹10 each to ₹2.5 each. Thereafter, the DCM equity shares were consolidated into equity shares of the face value of ₹10 each. Any fraction arising on allotment/consolidation of shares was disposed of and sales proceed distributed *pro rata* to the eligible shareholders.
- The equity shares of the four companies were subsequently listed in the stock exchange(s).
- Disputes with respect to the provisions of the scheme of arrangement were to be settled by two arbitrators and an umpire appointed by the arbitrators.

Thus, the demerger of DCM Ltd was completed with lots of innovation and practical solutions to the complex problem of reorganising a century-old company. After reorganisation, all the DCM Group companies have grown tremendously. From a non-dividend position prior to the demerger, all the companies have grown manifold adding value both to the shares as well as to the new entities.

Acquisition/Takeovers

Takeover implies acquisition of controlling interest in a company by another company/group.

Takeover implies acquisition of controlling interest in a company by another company. It does not lead to the dissolution of the company whose shares are being/have been acquired. It simply means a change of controlling interest in a company through the acquisition of its shares by another group. Takeovers can assume three forms: **(i)** negotiated/friendly, **(ii)** open market/hostile and **(iii)** bail out. The first type of takeover is organised by the incumbent management with a view to parting with the control of management to another group, through negotiation. The terms and conditions of the takeover are mutually settled by both the groups. Hostile takeovers are also referred to as raid on the company. In order to takeover the management of, or acquire controlling interest in, the target company, a person/group of persons acquire shares from the open market/financial institutions/mutual funds/willing shareholders at a price higher than the prevailing market price. Such takeovers are hostile to the existing management. When a profit earning company takes over a financially sick company to bail it out, it is known as **bail out takeover**. Normally, such takeovers are in pursuance of a scheme of rehabilitation approved by public financial institutions/scheduled banks. The takeover bids, in respect of purchase price, track record of the acquirer

Bail out takeover is the takeover of a financially weak company by a profitable company.

and his financial position, are evaluated by a leading financial institution. Corporate takeovers in the country are governed by the listing agreement with stock exchanges and the SEBI Substantial Acquisition of Shares and Takeover (SEBI Code) Code. The main elements of the regulatory framework for takeovers are briefly described below.

Listing Agreement The takeover of companies listed on the stock exchanges is regulated by Clause 40-A and 40-B of the listing agreement. While Clause 40-A deals with minimum level of public shareholding, Clause 40-B contains the requirements to be met when a takeover offer is made.

Minimum Level of Public Shareholding In order to ensure availability of floating stock, every listed company should maintain, on a continuous basis, public shareholding of atleast 25 per cent of the total number of issued shares of a class/kind of its listed shares. Public shareholding exclude shares held by **(1)** promoters/promoter group and **(2)** custodians against which depository receipts are issued overseas. The minimum level of public shareholding in a company **(a)** which offers/had offered in the past a particular class/kind of shares to the public under Rule 19**(2)(b)** of the Securities Contracts (Regulation) Rules or **(b)** which has atleast two crore shares outstanding with a market capatalisation of atleast ₹1,000 crore, should be 10 per cent of the total number of issued shares. Market capitalisation means the average capitalisation for the previous financial year. The average should be computed as the sum of the daily market capitalisation over one year divided by the number of trading days. The market capitalisation would be considered for the succeeding four quarters.

Takeover Offer The company also agrees that it is a condition for continuous listing that whenever the takeover offer is made or there is any change in the control of the management of the company, the person who secures the control and the company whose shares have been acquired would comply with the relevant provisions of the SEBI Takeover Code.

> **Acquisition**
> means directly/indirectly acquiring/agreeing to acquire shares/voting rights in, or control over, a target company.

The SEBI Substantial Acquisition of Shares and Takeover Code (SEBI Takeover Code) A takeover bid is generally understood to imply the acquisition of shares carrying voting rights in a company, in a direct or indirect manner, with a view to gaining control over the management of the company. Such takeovers could take place through a process of friendly negotiation or in a hostile manner, in which the existing management resists the change in control. Both the substantial acquisition of shares and change in the control of a listed company are covered by takeover bids. The main elements of the SEBI Code are: **(i)** Substantial Acquisition of Shares, Voting Rights/Control, **(ii)** Open Offer Process, **(iii)** Other Obligations, **(iv)** Disclosures of Shareholding and Control, and **(v)** Miscellaneous. However, these regulations do not apply to direct/indirect acquisition of shares/voting rights in, or control over a company, listed on the institutional trading platform of a stock exchange.

> **Control**
> includes the right to appoint majority of directors or to control the management or policy decisions exercisable by a person(s) acting individually or in concert, directly/indirectly, including by virtue of their shareholding/management rights/shareholders agreement/voting agreements or in any other manner.

Substantial Acquisition of Shares, Voting Rights or Control **Acquisition** means directly/indirectly acquire/agree to acquire shares voting rights in, or control over, a target company. **Control** includes the right to appoint majority of directors or to control the management or policy decisions exercisable by a person(s) acting individually or in concert, directly/indirectly, including by virtue of their shareholding/management rights/shareholders agreement/

voting agreements or in any other manner. **Shares** means shares/security carrying voting rights including depository receipts carrying an entitlement to exercise voting rights. **Target company** means a company listed on a stock exchange. **Person acting in concert** means persons who, with a common objective/purpose of acquisition of shares/voting rights in, or exercising control, over a target company, pursuant to a formal/informal agreement/understanding, directly/indirectly co-operate for acquisition of shares/voting rights in, or exercise of control over, the target company. The persons falling within the following categories would be deemed to be persons acting in concert with other persons within the same category, unless the contrary is established: **(i)** a company, its holding company, subsidiary company and any company under the same management/control; **(ii)** a company, its directors, and any person entrusted with the management of the company; **(iii)** directors of companies referred to above and associates of such directors. **Associate** of a person means **(a)** any immediate relative, **(b)** trust of which the person/immediate relative is a trustee, **(c)** firm in which he/immediate relative is a partner, and **(d)** member of a Hindu Undivided Family of which he is a coparcener. **Immediate relative** means his spouse including parents/brothers/ sisters/children or of the spouse; **(iv)** promoters and members of the promoter group; **(v)** immediate relatives; **(vi)** a mutual fund, its sponsor, trustee, trustee company, and asset management company; **(vii)** a collective investment scheme and its collective investment management company, trustees and trustee company; **(viii)** a venture capital fund and its sponsor, trustees, trustee company and asset management company; **(ix)** an alternate investment fund and its sponsor/trustee/manager; **(x)** a merchant banker and its client, who is an acquirer; **(xi)** a portfolio manager and its client, who is an acquirer; **(xii)** banks, financial advisors and stock brokers of the acquirer, or of the company which is a holding company or subsidiary of the acquirer, and where the acquirer is an individual, of the immediate relative of such individual. However, a bank whose sole role is that of providing normal commercial banking services or activities in relation to an open offer under these regulations would be excluded; **(xiii)** an investment company or fund and any person who has an interest in such investment company or fund as a shareholder or unitholder having not less than 10 per cent of the paid-up capital of the investment company or unit capital of the fund, and any other investment company or fund in which such person or his associate holds not less than 10 per cent of the paid-up capital of that investment company or unit capital of that fund. However, holding of units of mutual funds registered with the SEBI would be excluded.

> **Person(s) acting in concert** means persons who, with a common objective/purpose of acquisition of shares/voting rights in, or exercising control, over a target company, pursuant to a formal/informal agreement/under-standing, directly/indirectly co-operate for acquisition of shares/voting rights in, or exercise of con-trol over, the target company.

> **Associate** means **(a)** any im-mediate relative, **(b)** trust of which the person/immediate relative is a trustee, **(c)** firm in which he/immediate relative is a partner, and **(d)** member of a Hindu Undivided Family of which he is a copar-cener.

The main elements of the SEBI code relating to substantial acquisition of shares/voting rights/control: **(i)** substantial acquisition of shares/voting rights, **(ii)** acquisition of control, **(iii)** indirect acquisition of shares/control, **(iv)** voluntary offer, **(v)** offer size, **(vi)** offer price, **(vii)** mode of payment, **(viii)** general exemptions, and **(ix)** exemptions by the SEBI.

> **Acquirer** is a person who directly/indirectly acquire/agrees to acquire by himself/through or with person(s) acting in concert with him shares/voting rights in or control over a target company.

Substantial Acquisition of Shares/Voting Rights To acquire shares/voting rights in a target company which together with shares/voting rights already held by him and by persons acting in concert with him entitle them to exercise 25 per cent./more of the voting rights in the target company, an **acquirer** (i.e.

person who directly/indirectly acquire/agrees to acquire by himself/through or with person(s) acting in concert with him shares/voting rights in or control over a target company), would have to make a public announcement of an open offer for acquiring the shares. Similar announcement would be required by an acquirer, who has already acquired/holds shares/voting rights entitling him to exercise 25 per cent/more of the voting rights but less than the permissible non-public shareholding, to acquire within any financial year additional shares/voting rights entitling him to exercise more than 5 per cent of the voting rights, subject to a ceiling of the maximum permissible non-public shareholding under the Securities Contracts (Regulation) Rules, namely, 75 per cent. For determining the quantum of acquisition of additional voting rights, only gross acquisition would be taken into account. In case of acquisition by way of issue of new shares by the target company or where it has issued new shares in any financial year, the difference between the pro- and post-allotment percentage voting rights would be regarded as the additional acquisition.

The acquisition of shares/voting rights of a company by the promoter/shareholders in control in terms of the SEBI ICDR regulations pertaining to conditions/manner of providing exit opportunity to dissenting shareholders **(discussed in Chapter 11 of this book)** should be exempt from these requirements.

Acquisition of Control Irrespective of acquisition/holding of shares/voting rights in a target company, no acquirer would directly/indirectly acquire, control over the target company unless he makes a public announcement of an open offer.

Indirect Acquisition of Shares/Voting Rights/Control Acquisition of shares/voting rights in/control over, any company/other entity, that would enable any person(s) acting in concert with him to exercise/direct the exercise of such percentage of voting rights in/control over, the acquisition of which would otherwise attract the obligation to make a public announcement of an open offer for acquiring shares, would be considered as an **indirect acquisition** of shares/voting rights in/control over the target company. In the case of an indirect acquisition where **(a)** the proportionate net asset value of the target company as a percentage of the consolidated net asset value of the entity or business being acquired, **(b)** the proportionate sales turnover of the target company as a percentage of the consolidated sales turnover of the entity or business being acquired, or **(c)** the proportionate market capitalisation of the target company as a percentage of the **enterprise value** for the entity or business being acquired, is in exercise of 80 per cent, on the basis of the most recent audited annual financial statements, such indirect acquisition would be regarded as a direct acquisition of the target company for all purposes including without limitation, the obligations relating to timing, pricing and other compliance requirements for the open offer. **Enterprise value** means market capitalisation of the company **plus** debt, minority interest and preference shares **minus** total cash and cash equivalents.

> **Indirect acquisition** is acquisition by a person enabling him to exercise/direct the exercise of such percentage of voting rights the acquisition of which would otherwise attract the obligation to make public announcement.

> **Enterprise value** means market capitalistaion of the company plus debt, minority interest and preference shares minus total cash and cash equivalents.

Delisting Offer The acquirer who makes a public announcement of an open offer for acquiring shares of a target company can delist the company in terms of the SEBI delisting of shares regulations. He should declare upfront his intention to do so at the time of the detailed public statement. Failure to delist should be announced within two working days in all the concerned newspapers. Within five working days from the date of the announcement of failure, the acquirer through the manager of the open should offer file with the SEBI a draft of the letter of offer and comply with all other applicable provisions. Moreover, the offer price should be enhanced by 10 per cent per annum for the period between the scheduled date and the actual date of payment of consideration to the shareholders.

In case of completing offer (**discussed** later), the acquirer would **(i)** not be entitled to delist the company, **(ii)** not be liable to pay interest to the shareholders on account of delay due to the competing offer and **(iii)** comply with all the applicable provisions and make an announcement within two working days from the date of public announcement regarding competing offer in all the newspapers in which the detailed public statement was made.

The shareholders who have tendered shares in acceptance of the unsuccessful offer can withdraw them within 10 working days from the date of its announcement. Those who have not tendered their shares would be entitled to tender their shares in acceptance of the offer made to them.

Voluntary Offer An acquirer, who holds shares or voting rights in a target company (**shares in brief**) entitling them to exercise 25 per cent or more but less than the maximum permissible non-public (75 per cent) shareholding, would be entitled to voluntarily make a public announcement of an open offer for acquiring shares subject to their aggregate shareholding after completion of the open offer not exceeding the maximum permissible non-public shareholding. However, where an acquirer has acquired shares of the target company in the preceding 52 weeks without attracting the obligation to make a public announcement, he would not be eligible to voluntarily make a public announcement of an open offer. Moreover, during the offer period he would not be entitled to acquire any shares otherwise than under the open offer.

An acquirer who has made a public announcement to acquire shares would not be entitled to acquire any shares of the target company for a period of six months after completion of the open offer except pursuant to another voluntary open offer. However, such restriction would not prohibit him from making a competing offer upon any other person making an open. Shares acquired through bonus issue or stock splits would not be considered for purposes of this dis-entitlement. A **willful defaulter** (i.e. a [person/director/promoter/partner categorised by a bank/financial institution/their consortium in accordance with the RBI guidelines) cannot make a public announcement of an offer for acquiring shares/enter into any transaction that would attract the obligation to make an announcement of an open offer. He can make a competing offer.

> **Tendering period** is the period within which shareholders may tender their shares in acceptance of an open offer.

> **Offer period** is period between the date of entering into a formal/informal agreement to acquire shares/voting right in, or control over, a target company requiring public announcement or the date of public announcement and the date on which the payment of consideration to shareholders who have accepted the open offer is made or the date on which open offer is withdrawn.

Offer Size The open offer for acquiring shares to be made by the acquirer should be for at least 26 per cent of total shares of the target company, as of the tenth working day from the closure of the **tendering** period (i.e. period within which shareholders may tender their shares in acceptance of an open offer).

The total shares of the target company as of the tenth working day from the closure of the tendering period would take into account all potential increases in the number of outstanding shares during the **offer period** (i.e. period between the date of entering into a formal/informal agreement to acquire shares/voting right in, or control over, a target company requiring public announcement or the date of public announcement and the date on which the payment of consideration to shareholders who have accepted the open offer is made or the date on which open offer is withdrawn) contemplated as of the date of the public announcement. The offer size should also be proportionately increased in case of an increase in total number of shares, after the public announcement, which is not contemplated on the date of the public announcement.

The voluntary open offer should be for acquisition of at least such number of shares as would entitle their holder(s) to exercise an additional 10 per cent of the total shares of the target company, and would not exceed such number of shares as would result in the post-acquisition holding of the acquirer exceeding the maximum permissible non-public shareholding applicable to the target company. However, in the event of a competing offer, the acquirer who has voluntarily made a public announcement of an open offer would be entitled to increase the number of shares to such number as he deems fit. The increase in offer size be made within 15 working days from the public announcement, failing which the acquirer would not be entitled to increase the offer size. Upon an acquirer opting to increase the offer size, the such open offer would be deemed to be a voluntary offer. In the event of the shares accepted in the open offer were such that the shareholding of the acquirer(s) pursuant to completion of the open offer results in their shareholding exceeding the maximum permissible non-public shareholding, he would be required to bring down the non-public shareholding to the level specified and within the time permitted under Securities Contract (Regulation) Rules.[@@] The acquirer whose shareholding exceeds the maximum permissible non-public shareholding, pursuant to an open offer, would not be eligible to make a voluntary delisting offer under the SEBI Delisting of Equity Shares Regulations, within 12 months from the date of the completion of the offer period. Any open offer should be made to all shareholders of the target company, other than the acquirer and the parties to any underlying agreement for the sale of shares of the target company.

Offer Price The open offer for acquiring shares should be made at a price not lower than the price determined in the manner specified below:

1. Direct Acquisition In the case of direct acquisition and indirect **acquisition deemed to be direct acquisition** of shares, the offer price should be the highest of: **(a)** the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement of an open offer; **(b)** the **volume-weighted average price** (i.e. product of number of equity shares bought and price of each share divided by the number of shares bought) paid/payable for acquisitions, by the acquirer during the 52 two weeks immediately preceding the date of the public announcement; **(c)** the highest price paid/payable for any acquisition by the acquirer during the 26 weeks immediately preceding the date of the public announcement; **(d)** the **volume-weighted average market price** (i.e. product of number of shares traded on a stock exchange and price of each share divided by the total number of shares traded) of such shares for a period of 60 trading days immediately preceding the date of the public announcement as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during

Volume-weighted average price is a product of number of equity shares bought and price of each share divided by the number of shares bought.

Volume-weighted average market price is a product of number of shares traded on a stock exchange and price of each share divided by the total number of shares traded.

[@@]**For an account refer to Khan, M.Y., *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 4** such period, provided such shares are **frequently traded**. Frequently traded shares mean shares in which the traded turnover on any stock exchange during 12-calendar months preceding the calendar month in which the public announcement is made is at least 10 per cent of the total shares of the target company; **(e)** where the shares are not frequently traded, the price determined by the acquirer and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies; and **(f)** the per share value computed in case of indirect acquisition (**discussed later**).

2. Indirect Acquisition Deemed Direct Acquisition In the case of an indirect acquisition of shares, the offer price would be the highest of: **(a)** the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement; **(b)** the volume-weighted average price paid/payable for any acquisition, during the 52 weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain; **(c)** the highest price paid/payable for any acquisition by the acquirer during the 26 weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain; **(d)** the highest price paid/payable for any acquisition between the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, and the date of the public announcement of the open offer for shares of the target company; **(e)** the volume-weighted average market price of the shares for a period of 60 days earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, provided such shares are frequently traded; and **(f)** the per share value in case of indirect acquisition (**discussed later**).
3. In case the offer price is incapable of being determined under any of the parameters above, the offer price should be the fair price of shares of the target company to be determined by the acquire and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies.

4. Indirect Acquisition In the case of an indirect acquisition and open offers, where the proportionate **(a)** net asset value of the target company as a percentage of the consolidated net asset value; **(b)** sales turnover of the target company as a percentage of the consolidated sales turnover; or **(c)** market capitalisation of the target company as a percentage of the enterprise value for the entity or business being acquired is in excess of 15 per cent, the acquirer would be required to compute and disclose, in the letter of offer, the per share value of the target company taken into account for the acquisition, along with a detailed description of the methodology adopted for such computation. The **market capitalisation** of the target company would be taken into account on the basis of the volume-weighted average market price of the shares on the stock exchange for a period of 60 trading days preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period.

5. In respect of direct and indirect deemed direct acquisition, where the acquirer has any outstanding convertible instruments convertible into shares of the target company at a specific price, the price at which such instruments are to be converted into shares, would also be considered as a parameter. The price paid for shares of target company would include any price paid/agreed to be paid for the shares in the target company, in any form whatsoever, whether stated in the agreement for acquisition of shares or in any incidental, contemporaneous or collateral agreement, whether termed as control premium or as non-compete fees or otherwise.

6. Where the acquirer has acquired/agreed to acquire any shares in the target company during the **offer period** (i.e. period between the date of entering into formal/informal agreement to acquire shares/voting rights/control of a target company requiring public announcement and the date of public announcement and the date on which the payment of consideration to shareholders who have accepted the open offer is made or the date on which open offer is withdrawn) by subscription/purchase, at a price higher than the offer price, the offer price would stand revised to the highest price for any acquisition. However, no acquisition would be made after the third working day prior to the commencement and until the expiry of the tendering period.

7. The price parameters outlined above may be adjusted by the acquirer in consultation with the manager to the offer, for corporate actions such as issuances pursuant to rights issue, bonus issue, stock consolidations, stock splits, payment of dividend, de-mergers and reduction of capital, where the record date for effecting such corporate actions falls prior to three working days before the commencement of the tendering period. However, adjustment should be made for dividend declared if the per share dividend is more than 50 per cent higher than the average paid during the three financial years preceding the date of the public announcement.

8. Where the acquirer acquires shares of the target company during the period of 26 weeks after the tendering period at a price higher than the offer price, he would pay the difference between the highest acquisition price and the offer price, to all the shareholders whose shares were accepted in the open offer, within 60 days from the date of such acquisition.

9. Where the open offer is subject to a minimum level of acceptances, the acquirer may indicate a lower price, but not be less than the price determined under this regulation, for acquiring all the acceptances despite the acceptance falling short of the indicated minimum level of acceptance, in the event the open offer does not receive the minimum acceptance.

10. In the case of any indirect acquisition, the offer price would stand enhanced by an amount equal to a sum determined at the rate of 10 per cent per annum for the period between the earlier of the date on which the primary acquisition is contracted or the date on which the intention or the decision to make the primary acquisition is announced in the public domain, and the date of the detailed public statement, provided such period is more than five working days.

11. The offer price for partly-paid-up shares should be computed as the difference between the offer price and the amount due towards calls-in-arrears including calls remaining unpaid with interest.

12. The offer price for equity shares carrying differential voting rights should be determined by the acquirer and the manager to the open offer with full disclosure of justification for the price so determined, being set out in the detailed public statement and the letter of offer. However, the price should not be lower than the amount determined by applying the percentage rate of premium that the offer price for the equity shares carrying full voting rights represents to the price parameter computed above to the volume-weighted average market price of the shares carrying differential voting rights in the aforesaid provisions, subject to shares carrying full voting rights and the shares carrying differential voting rights, both being frequently traded shares.

13. In the event of any of the price parameters not being available or denominated in Indian rupees, the conversion of such amount into Indian rupees would be effected at the exchange rate as prevailing on the date preceding the date of public announcement and the acquirer should set out the source of such exchange rate in the public announcement, the detailed public statement and the letter of offer.

14. The SEBI may, at the expense of the acquirer, require valuation of the shares by an independent merchant banker other than the manager to the open offer or an independent practicing chartered accountant having a minimum experience of 10 years.

Mode of Payment The offer price may be paid **(a)** in cash; **(b)** by issue/exchange/transfer of listed shares **(i)** shares, **(ii)** secured debt instruments with a rating not below investment grade as rated by a SEBI-registered agency, **(iii)** convertible debt securities; **(c)** a combination of the mode of payment of consideration stated in Clauses **(a)** and **(b)**. However, where any shares have been acquired/agreed to be acquired by the acquirer and persons acting in concert with him during the 52 weeks immediately preceding the date of public announcement constitute more than ten per cent of the voting rights in the target company and has been paid for in cash, the open offer would entail an option to the shareholders to require payment of the offer price in cash, and a shareholder who has not exercised an option in his acceptance would be deemed to have opted for receiving the offer price in cash. In case of revision in offer price, the mode of payment of consideration may be altered subject to the condition that the component of the offer to be paid in cash prior to such revision is not reduced.

The shares sought to be **(i)** issued/exchanged/transferred or **(ii)** upon conversion of other securities, towards payment of the offer price, should conform to the following requirements: **(a)** they are listed for at least two years on a stock exchange preceding the date of public announcement and frequently traded at the time of the public announcement; **(b)** the issuer has redressed at least 95 per cent of the complaints received from investors by the end of the calendar quarter immediately preceding the calendar month in which the public announcement is made; **(c)** the issuer has been in material compliance with the listing agreement for at least two years immediately preceding the date of the public announcement. In case where the SEBI is of the view that a company has not been materially compliant with the provisions of the listing agreement, the offer price should be paid in cash only; **(d)** the impact of auditors' qualifications on the audited accounts of the issuer for three immediately preceding financial years does not exceed 5 per cent of the net profit or loss after tax for the respective years; and **(e)** the SEBI has not issued any direction against the issuer to access the capital market/to issue fresh shares.

Where the shareholders have been provided with options to accept payment in cash or by way of securities, or a combination, the pricing for the open offer may be different for each option subject to compliance with minimum offer price requirements. The detailed public statement and the letter of offer should contain justification for such differential pricing.

In the event the offer price consists of consideration to be paid by issuance of securities, which requires compliance with any applicable law, the acquirer should ensure that compliance before the commencement of the tendering period failing which the entire consideration should be paid in cash.

Where listed securities are offered as consideration, their value should be the higher of: **(a)** the average of the weekly high and low of their closing prices quoted on the stock exchange during **(i)** the six months **(ii)** 2 weeks preceding the **relevant** date (i.e. 30th day prior to the date on which the meeting of shareholders is held to consider the proposed issues of shares); **(b)** the volume-weighted average market price for a period of 60 trading days preceding the date of the public announcement, on the stock exchange where the maximum volume of trading in the shares of the company are recorded during the six-month period prior to the relevant date and the ratio of exchange of shares should be duly certified by an independent merchant banker (other than the manager to the open offer)/chartered accountant having a minimum experience of ten years.

General Exemptions

(1) The following acquisitions would be exempt from the obligation to make an open offer:

(a) Acquisition pursuant to *inter se* transfer of shares amongst qualifying persons, being **(i)** immediate relatives; **(ii)** persons named as promoters in the shareholding pattern for at least three years prior to the proposed acquisition; **(iii)** a company, its subsidiaries/ holding company/ their other subsidiaries of such holding company, persons holding not less than 50 per cent of the equity shares of the company, other companies in which such persons hold not less than 50 per cent of the equity shares, and their subsidiaries subject to control over such qualifying persons being exclusively held by the same persons; **(iv)** persons acting in concert for not less than three years prior to the proposed acquisition, and disclosed under the listing agreement; **(v)** shareholders of a target company who have been persons acting in concert for a period of not less than three years prior to the proposed acquisition and are disclosed under the listing agreement, and any company in which the entire equity share capital is owned by such shareholders in the same proportion as their holdings in the target company without any differential entitlement to exercise voting rights in such company. For purposes of availing of the exemption, **(i)** If the shares of the target company are frequently traded, the acquisition price per share should not be higher by more than 25 per cent of the volume-weighted average market price for a period of 60 trading days preceding the date of issuance of notice for the proposed *inter se* transfer on the stock exchange where the maximum volume of trading in these shares are recorded; and **(ii)** the transferor and the transferee should have complied with the applicable disclosure requirements (**discussed later in this Chapter**).

(b) Acquisition in the ordinary course of business by SEBI-registered **(i)** underwriter by way of allotment pursuant to an underwriting agreement of; **(ii)** stock broker on behalf of his client in exercise of lien over the shares purchased on behalf his client under the bye-laws of concerned the stock exchange; **(iii)** merchant banker/a nominated investor in the process of market making/subscription to the unsubscribed portion of an issue; **(iv)** any person acquiring shares pursuant to a scheme of safety net; **(v)** a merchant banker acting as a stabilising agent or by the promoter or pre-issue shareholder; **(vi)** by a market-maker of a stock exchange during the course of market making; **(vii)** a bank, acting as a escrow agent; and **(viii)** invocation of pledge by banks or public financial institution as a pledgee.

- **(c)** Acquisition at subsequent stages, by an acquirer who has made a public announcement of an open offer for acquiring shares pursuant to an agreement of disinvestment provided: **(i)** both the acquirer and the seller are the same at all the stages of acquisition; and **(ii)** full disclosures of all the subsequent stages of acquisition have been made in the public announcement of the open offer/the letter of offer.
- **(d)** Acquisition pursuant to a scheme: **(i)** made under the Sick Industrial Companies (Special Provisions) Act; **(ii)** of arrangement involving the target company as a transferor/a transferee company, or reconstruction of the target company, including amalgamation, merger/demerger, pursuant to an order of a court/competent authority under any law/regulation, Indian or foreign; or **(iii)** of arrangement not directly involving the target company as a transferor/transferee company, or reconstruction not involving the target company's undertaking, including amalgamation, merger/demerger, pursuant to an order of a court/competent authority under any law/regulation, Indian or foreign, subject to: **(1)** the component of cash and cash equivalents in the consideration paid being less than 25 per cent of the consideration paid under the scheme; and **(2)** where after implementation of the scheme of arrangement, persons directly/indirectly holding at least 33 per cent of the voting rights in the combined entity are the same as the persons who held the entire voting rights before the implementation of the scheme.
- **(e)** Acquisition pursuant to the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESA);
- **(f)** Acquisition pursuant to the provision of the SEBI Delisting of Equity Shares Regulations.
- **(g)** Acquisition by way of transmission/succession/inheritance.
- **(h)** Acquisition of voting rights/preference shares carrying voting rights arising out of the operation of Section 87(2) of the Companies Act.
- **(i)** Acquisition of shares by the consortium of banks/financial institutions/other secured lenders on conversionof debt under strategic debt restructuring scheme in accordance with the RBI specified guidelines.
- **(j)** Increase in voting rights/pursuant to forfeiture of shares by the target company in compliance with the provisions of the Companies Act.

(2) The acquisition of shares not involving a change of control over the target company, pursuant to a scheme of corporate debt restructuring authorised by the shareholders by way of special resolution passed by postal ballot.

(3) An increase in voting rights in a target company of any shareholder beyond the limit attracting an obligation to make an open offer pursuant to buy-back of shares by the target company provided he reduces his shareholding such that his voting rights fall below the threshold within 90 days from the date of the closure of the buy-back offer.

(4) The following acquisition would be exempt from the obligation to make an open offer:

- **(a)** Acquisition of shares by any shareholder of a target company, up to his entitlement, pursuant to a rights issue;
- **(b)** Acquisition of shares by any shareholder of a target company, beyond his entitlement, pursuant to a right issue, subject to the fulfilment of the following conditions the: **(i)** acquirer has not renounced any of his entitlement; and **(ii)** price at which the rights issue is made is not higher than the *ex-rights* price of the shares of the target company, being the sum of: **(1)** the volume weighted average market price of the

shares of the target company during a period of 60 trading days ending on the day prior to the date of determination of the rights issue price, multiplied by the number of shares outstanding prior to the rights issue, divided by the total number of shares outstanding after allotment under the rights issue. The volume weighted average market price should be determined on the basis of trading on the stock exchange where the maximum volume of trading in the shares is recorded during the period; and **(2)** the price at which the shares are offered in the rights issue, multiplied by the number of shares offered in the rights issue divided by the total number of shares outstanding after allotment under the rights issue.

(c) Increase in voting rights in a target company of any shareholder pursuant to buy-back of shares provided that: **(i)** the shareholder has not voted in favour of the resolution authorising the buy-back; **(ii)** in the case of a shareholder resolution, voting is by way of postal ballot; **(iii)** where a resolution of shareholders is not required for the buy-back, the shareholder, in his capacity as a director, or any other interested director has not voted in favour of the resolution of the Board of Directors authorising the buy-back; and **(iv)** the increase in voting rights does not result in an acquisition of control by the shareholder over the target company. Where, however, the aforesaid conditions are not met, in case the shareholder reduces his shareholding such that his voting rights fall below the level at which the obligation to make an open offer would be attracted within 90 days from the date of closure of the buy-back offer by the target company, the shareholder would be exempt from the obligation to make an open offer;

(d) Acquisition of shares in a target company by any person in exchange for shares of another target company tendered pursuant to an open offer for acquiring shares;

(e) Acquisition of shares from State-level financial institutions/their subsidiaries/companies promoted by them, by promoters of the target company pursuant to an agreement between the transferors and the promoter;

(f) Acquisition of shares in a target company from a SEBI-registered venture capital fund/category I alternative investment fund/foreign venture capital investor by promoters of the target company pursuant to an agreement between them.

(5) In respect of acquisition **(i)** pursuant to *inter se* transfer of shares among qualifying persons, **(ii)** from state-level financial institutions and venture capital funds/foreign venture capital investor, the acquirer should intimate the stock exchanges the details of the proposed acquisition in the specified form at least four working days prior to the proposed acquisition, and the stock exchange should forthwith disseminate the information to the public.

(6) In respect of any acquisition made pursuant to exemption under these regualtions, the acquirer should file a report with the stock exchanges where the shares of the target company are listed, in the specified form within four working days from the acquisition, and the stock exchange should forthwith disseminate such information to the public.

(7) In respect of any acquisition of or increase in voting rights pursuant to exemption pursuant to **(i)** *inter se* transfer, **(ii)** court order, **(iii)** operation of the Companies Act, **(iv)** corporate debt restructuring, **(v)** buy-back and **(vi)** rights issue, the acquirer should, within 21 working days of the date of the acquisition, submit a report in the specified form along with supporting documents to the SEBI giving all details in respect of acquisitions, along with a non-refundable fee of ₹1,50,000.

Exemption by the SEBI The SEBI may, for reasons recorded in writing, grant **(i)** exemption from the obligation to make an open offer for acquiring shares, **(ii)** relaxation from strict compliance with any procedural requirement relating to open offer process and other obligations (**discussed later**) deemed fit in the interests of investors in securities/securities market on being satisfied that: **(a)** the Central/State Government/other regulatory authority has superseded the Board of Directors of the target company and has appointed new directors if the **(i)** Board of Directors has formulated a plan which provides for transparent, open, and competitive process for acquisition of shares/voting rights in, or control over, the target company to secure its smooth and continued operation in the interests of all its stakeholders and the plan does not further the interests of any particular acquirer; **(ii)** conditions and requirements of the competitive process are reasonable and fair and; **(iii)** process provides for details including the time when the open offer for acquiring shares would be made/completed and the manner in which the change in control would be effected; and **(b)** the provisions relating to open offer process and other obligations are likely to act as impediment to the implementation of the plan of the target company and exemption from strict compliance with one/more such provisions is in **(1)** public interest, **(2)** the interests of investors in securities/securities market. For seeking exemption/relaxation, the acquirer/target company should apply to the SEBI together with the non-refundable fee of ₹3,00,000 supported by an affidavit detailing the proposed acquisition and the grounds for the exemption.

Open Offer Process The main elements of the open offer process are: **(i)** manager to the offer, **(ii)** timing, **(iii)** publication, **(iv)** contents, **(v)** filing of letter with SEBI, **(vi)** provision of escrow, **(vii)** other procedures, **(viii)** conditional offer, **(ix)** competing offer, **(x)** payment of consideration, **(xi)** completion of acquisition, and **(xii)** withdrawal of open offer.

Manager to the Open Offer Prior to making a public announcement, the acquirer should appoint a SEBI-registered merchant banker, other than an associate, as the manager to the open offer who should make the public announcement.

Timing The public announcement in terms of its publication and contents should be made on the date of agreeing to acquire shares/voting rights in, or control over the target company. It should be made: **(a)** in the case of market purchases, prior to the placement of the purchase order with the stock broker to acquire the shares, that would take the entitlement to voting rights beyond the stipulated thresholds; **(b)** upon conversion of convertible securities without a fixed date of conversion/depository receipts for the underlying shares of the target company on the same days as the date of exercise of the option to convert such securities into shares; **(c)** upon conversion of convertible securities with a fixed date of conversion on the second working day preceding the scheduled date of conversion of the securities into shares; **(d)** pursuant to a disinvestment on the same day as the date of executing the agreement for acquisition of shares/voting rights in, or control over the target company; **(e)** in the case of indirect acquisition of shares/voting rights in, or control over the target company at any time within four working days from the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain; **(f)** under preferential issue on the date on which the Board of Directors of the target company authorises the preferential issue; **(g)** the public announcement pursuant to an increase in voting rights consequential to a buy-back not qualifying for exemption not later than the ninetieth day from the date of closure of the buy-back offer by the target company; **(h)** pursuant to any acquisition of shares or voting rights in or control over the target company where the specific date on which the title to such shares, voting rights or control is acquired is beyond the control of the acquirer, not later than two working days from the date of receipt of intimation of having acquired the title.

The announcement should be made on the date of the first acquisition if the acquirer discloses in the public announcement the details of the proposed subsequent acquisitions.

The public announcement relating to voluntary offer should be made on the same day on which the acquirer takes the decision to voluntarily make a public announcement of an open offer. A detailed public statement should be published by the acquirer through the manager to the open offer, within five working days of the public announcement and in case of a public announcement relating to indirect acquisition within five working days of the completion of the primary acquisition. In the event the acquirer does not succeed in acquiring the ability to exercise or direct the exercise of voting rights in, or control over, the target company, a detailed public statement of an open offer for acquiring shares would not be required.

Publication The public announcement should be sent to all the concerned stock exchanges, who should forthwith disseminate the information to the public. A copy should be sent to the SEBI and the target company at its registered office within one working day of the date of the public announcement. The detailed public statement should also be published in all editions of any one English national daily with wide circulation, any one Hindi national daily with wide circulation, and any one regional language daily with wide circulation at the place where the registered office of the target company is situated and one regional language daily at the place of the stock exchange where the maximum volume of trading in the shares of the target company are recorded during the 60 trading days preceding the date of the public announcement. Simultaneously, with publication of such detailed public statement in the newspapers, a copy of the same should be sent to: **(i)** the SEBI through the manager to the open offer, **(ii)** all the stock exchange on which the shares of the target company are listed, who should forthwith disseminate the information to the public, and **(iii)** the target company at its registered office to be forthwith circulated to the members of its Board of Directors.

Contents The public announcement should contain the specified information including the following: **(a)** name and identity of the acquirer; **(b)** name and identity of the seller; **(c)** nature of the proposed acquisition such as purchase/allotment of shares, any other means of acquisition of shares/voting rights; **(d)** consideration for the proposed acquisition that attracted the obligation to make an open offer and the price per share; **(e)** the offer price, and mode of payment of consideration; and **(f)** offer size, and conditions as to minimum level of acceptance. The detailed public statement pursuant to public announcement should contain the specified information in order to enable shareholders to make an informed decision with reference to the open offer. The public announcement of the open offer, the detailed public statement, and any other statement, advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares should not omit any relevant information, or contain any misleading information.

Filing of Letter of Offer with the SEBI Within five working days from the date of the detailed public statement, the acquirer should, through the manager to the open offer, file with the SEBI, a draft of the letter of offer, containing the specified information along with a non-refundable fee, as per the following scale:

Consideration payable under the open offer	*Amount*
Up to ten crore rupees	₹1,25,000
More than ten crore rupees, but less than or equal to one thousand crore rupees	₹1,25,000 *plus* 0.025 per cent of the portion of the offer size in excess of ten crore rupees
More than one thousand crore rupees, but less than or equal to five thousand crore rupees	₹1,25,00,000 *plus* 0.03125 per cent of the portion of the offer size in excess of one thousand crore rupees
More than five thousand crore rupees	₹2,50,00,000 *plus* 0.01 per cent of the portion of the offer size in excess of five thousand crore rupees subject to a maximum of three crore rupees

The consideration payable under the open offer should be calculated at the offer price, assuming full acceptance of the open offer, and in the event the open offer is subject to differential pricing, at the highest offer price, irrespective of mode of payment of the consideration. However, in the event of consideration being enhanced owing to a revision to the offer price/size, the payable fees would stand revised accordingly, and paid within five working days from the date of the revision. The manager to the open offer should provide soft copies of the public announcement, the detailed public statement and the draft letter of offer in accordance with the specified specifications and the SEBI would upload the same on its website.

The SEBI should give its comments on the draft letter of offer as expeditiously as possible but not later than fifteen working days of its receipt and in the event of no comments being issued within this period, it would be deemed that the SEBI does not have comments to offer. However, in the event the SEBI has sought clarifications/additional information, the period for issuance of comments would be extended to the fifth working days from the date of receipt of satisfactory reply. If SEBI specifies any changes, the manager to the open offer and the acquirer should carry them out in the letter of offer before dispatch to the shareholders. In the case of competing offers, the SEBI should provide its comments on the draft letter of offer in respect of each competing offer on the same day. In case the disclosures in the draft letter of offer are inadequate, the SEBI may call for a revised letter of offer.

Provision of Escrow Within two working days prior to the date of the detailed public statement of the open offer, the acquirer should create an escrow account towards security for performance of his obligations and deposit amount as per the following scale: **(a)** on the first 500 crore rupees, 25 per cent of the consideration, **(b)** an additional amount equal to 10 per cent of the balance consideration.

Where, however, an offer is made conditional upon minimum level of acceptance, the higher of 100 per cent of the consideration payable in respect of the minimum level of acceptance or 50 per cent under the open offer should be deposited in cash in the escrow account. In case of an upward revision of the offer price/size, the value of the escrow amount should be computed on the revised consideration calculated at the revised offer price, and the additional amount brought into the escrow account prior to effecting the revision. The escrow account may be in the form of **(a)** cash at any bank; **(b)** bank guarantee issued in favour of the manager to the open offer; **(c)** deposit of frequently traded and freely transferable securities with appropriate margin. In case of escrow account by way of a bank guarantee/deposit of securities, the acquirer should also ensure that at least one per cent of the total payable consideration is in cash with a bank as a part of the escrow account. For the escrow account in the form of a cash deposit, the acquirer should empower the manager to the open offer to instruct the bank to issue a banker's cheque/demand draft/make payment of the amounts lying to the credit of the escrow account.

The escrow account in the form of a bank guarantee should be in favour of the manager to the open offer and kept valid throughout the offer period and for an additional period of 30 days after completion of payment of consideration to shareholders who have tendered their shares in acceptance of the open offer. Similarly, the acquirer should empower the manager to the open offer to realise the value of escrow account in the form of securities by sale or otherwise, and if there is any shortfall in the escrow account, he would be liable to make good such shortfall. The manager should not release the escrow account until the expiry of 30 days from the completion of payment of consideration to the concerned shareholders. In case of non-fulfilment of obligations by the acquirer, the SEBI may direct the manager to forfeit in full/part the escrow account/any amounts lying in the special escrow account.

The escrow account deposited with the bank in cash should be released only in the following manner: **(a)** the entire amount to the acquirer upon withdrawal of offer as certified by the manager to the open offer; **(b)** for transfer of an amount not exceeding 90 per cent of the escrow account to special escrow account (**discussed later**); **(c)** to the acquirer, the balance of the escrow account after transfer of cash to the special escrow account, on the expiry of 30 days from the completion of payment of consideration to the concerned shareholders; **(d)** the entire amount to the acquirer upon the expiry of 30 days from the completion of payment of consideration to the concerned shareholders, where the open offer is for exchange of shares/other secured instruments; **(e)** the entire amount to the manager to the open offer, in the event of forfeiture for non-fulfilment of any of the obligations, for distribution after deduction of expenses, if any, of registered market intermediaries associated with the open offer in the following manner: **(i)** one-third to the target company; **(ii)** one-third to the Investor Protection and Education Fund, and **(iii)** one-third to be distributed *pro rata* among the shareholders who have accepted the open offer.

Other Procedures Simultaneously with the filing of the draft letter of offer with the SEBI, the acquirer should send a copy to the target company at its registered office and to all the concerned stock exchanges. It should be dispatched to the shareholders whose names appear on the register of members of the target company as of the **identified date** (i.e. date falling on the tenth working prior to the commencement of the tendering period for the purpose of determining the shareholders to whom letter of offer would be sent), not later than seven working days from the receipt of comments from the SEBI or where no comments are offered within seven working days from the expiry of the period. However, where local laws/regulations of any jurisdiction outside India may expose the acquirer/the target company to material risk of civil, regulatory/criminal liabilities in the event the letter of offer in its final form were to be sent without material amendments or modifications into such jurisdiction, and the shareholders resident in such jurisdiction hold shares entitling them to less than 5 per cent of the voting rights of the target company, the acquirer may refrain from dispatch of the letter of offer into such jurisdiction. Moreover, every person holding shares, regardless of whether he held shares on the identified date or has not received the letter of offer, would be entitled to tender such shares in acceptance of the open offer. Simultaneously, the acquirer should send the letter of offer to the custodian of shares underlying depository receipts, if any, of the target company. Irrespective of whether a competing offer has been made, an acquirer may make upward revisions to the offer price/the number of shares sought to be acquired under the open offer, at any time prior to the commencement of the last three working days before the commencement of the tendering period. In case of any revision of the open offer (i.e. offer price/size), the acquirer should: **(a)** make corresponding increases to the amount kept in escrow account and make an announcement in respect of the revisions in all the newspapers in which the detailed public statement was made; and **(b)** simultaneously inform the SEBI, all the concerned stock exchanges and the target company at its registered office.

The acquirer should disclose during the offer period every acquisition made by him of any shares of the target company in the specified form to each of the concerned stock exchanges/ the target company at it registered office within 24 hours of the acquisition, and the stock exchanges should forthwith disseminate the information to the public. He should facilitate tendering of shares by the shareholders and its settlement through the SEBI specified stock exchange mechanism.

However, he would not acquire/sell any shares of the target company during the period between three working days prior to the commencement of, and until the expiry of, the tendering period.

The acquirer should issue an advertisement in the specified form one working day before the commencement of the tendering period, announcing the schedule of activities for the open offer, the status of statutory and other approvals, if any, whether for the acquisition attracting the obligation to make an open offer or for the open offer, unfulfilled conditions, if any, and their status, the procedure for tendering acceptances and such other specified material detail. The advertisement should be: **(a)** published in all the newspapers in which the detailed public statement was made; and **(b)** simultaneously sent to the SEBI, all the concerned stock exchanges and the target company at its registered office.

The tendering period should start within 12 working days from date of receipt of comments from the SEBI and remain open for 10 working days. Shareholders who have tendered shares in acceptance of the open offer would not be entitled to withdraw their acceptance during the tendering period.

The acquirer should, within 10 working days from the last date of the tendering period, complete all the legal requirements relating to the open offer including payment of consideration to the concerned shareholders. He would be responsible to pursue all required statutory approvals in order to complete the open offer without any default/neglect/delay. Where, however, the acquirer is unable to make the payment to the concerned shareholders within such period owing to non-receipt of statutory approvals, the SEBI may, where it is satisfied that such non-receipt was not attributable to any wilful default failure/neglect on the part of the acquirer to diligently pursue such approvals, grant extension of time for making payments, together with interest to the shareholders for the delay at the specified rate. Where the statutory approval extends to some but not all shareholders, the acquirer would have the option to make payment to shareholders in respect of whom no statutory approvals are required in order to complete the open offer.

The acquirer should issue a post-offer advertisement in the specified form within 5 working days after the offer period, giving details including aggregate number of shares tendered/accepted, date of payment of consideration. The advertisement should be: **(i)** published in all the newspapers in which the detailed public statement was made; and **(ii)** simultaneously sent to the SEB, all the concerned stock exchanges and the target company at its registered office.

Conditional Offer An acquirer may make an open offer conditional as to the minimum level of acceptance. Where, however, the open offer is pursuant to an agreement, the agreement should contain a condition to the effect that in the event the desired level of acceptance of the open offer is not received, the acquirer would not acquire any shares and the agreement attracting the obligation to make the open offer stand rescinded. In case

Conditional Offer is an open offer conditional as to the minimum level of acceptance.

of conditional offer, the acquirer should not acquire, during the offer period, any shares in the target company except under the open offer and any underlying agreement pursuant to which the open offer is made.

Competing Offers Upon a public announcement of an open offer, any person would be entitled to a make a public announcement of an open offer within 15 working days of the date of the detailed public statement made by the acquirer. The open offer should be for such number of shares which when taken together with shares held by such acquirer would be at least equal to the holding of the acquirer who has made the first public announcement. Such open offer would not be regarded as a voluntary open offer. Every open offer and open offer first made would be regarded as competing offers.

> **Competing offers** every open offer and open offer first made would be regarded as competing offers.

No person would be entitled to make a public announcement of an open offer enter into any transaction that would attract the obligation to make a public announcement of an open offer after 15 working days of the date of the detailed public announcement and until the expiry of the offer period for such open offer. Unless the open offer first made is conditional, an acquirer cannot make a competing offer conditional as to the minimum level of acceptances. A public announcement of an open offer to acquire shares, or enter into any transaction that would attract the obligation to make a public announcement of an open offer cannot be made until the expiry of the offer period where the open offer is **(a)** for acquisition of shares pursuant to disinvestment, **(b)** pursuant to a relaxation from strict compliance with the open offer process and other obligations granted by the SEBI. The schedule of activities and the tendering period for all competing offers should be carried out with identical timelines and the last date for tendering shares in acceptance of the every competing offer should stand revised to the last date for tendering shares in acceptance of the competing offer last made.

Upon the public announcement of the competing offers, an acquirer who had made a preceding competing offer would be entitled to revise his open offer with more favourable terms to the shareholders of the target company. The acquirers making the competing offers would be entitled to make upward revisions of the offer price at any time up to 3 working days prior to the commencement of the tendering period. Except for these variations, all the provisions of the SEBI code would apply to every competing offer.

Payment of Consideration In case of consideration payable in cash, the acquirer should open a special escrow account with a SEBI-registered banker to an issue and deposit therein, such sum as would, together with cash transferred to the escrow account, make up the entire sum due and payable to the shareholders as consideration payable under the open offer, and empower the manager to the offer to operate the special escrow account on his behalf. The acquirer should complete payment of consideration whether in the form of cash or by issue, exchange or transfer of securities, to the concerned shareholders, within 10 working days of the expiry of the tendering period. Unclaimed balances, if any, lying to the credit of the special escrow account at the end of 7 years from the date of deposit would be transferred to the Investor Protection and Education Fund.

Completion of Acquisition The acquirer should not complete the acquisition of shares or voting rights in, or control over, the target company, whether by way of subscription to shares or a purchase of shares attracting the obligation to make an open offer for acquiring shares, until the expiry of the offer period. In case of an offer made pursuant to a preferential allotment, the offer should be completed within 15 days from the date of passing of the resolution for preferential allotment. In case of delisting offer, the acquirer should complete the acquisition of shares only after making the public announcement regarding the success of the delisting proposal. Subject to the acquirer depositing in the escrow account, cash of an amount equal to 100 per cent of the consideration payable under the open offer assuming full acceptance of the open offer, the parties to such agreement may after the expiry of 21 working days from the date of detailed public statement, act upon the agreement and the acquirer may complete the acquisition of shares/voting rights in, or control over, the target company as contemplated.

The acquirer should complete the acquisition contracted under any agreement attracting the obligation to make an open offer not later than 26 weeks from the expiry of the offer period. In the event of any extraordinary and supervening circumstances rendering it impossible to complete the acquisition within this period, the SEBI may, for reasons to be published, may grant an extension of time by such period as it may deem fit in the interests of investors in securities/securities market.

Withdrawal of Open Offer An open offer once made can not be withdrawn except under any of the following circumstances: **(a)** Refusal of statutory approvals required for the open offer to acquire shares or for effecting the acquisitions attracting the obligation to make an open offer; **(b)** the acquirer, being a natural person, has died; **(c)** any condition stipulated in the agreement for acquisition attracting the obligation to make the open offer is not met for reasons outside the reasonable control of the acquirer, and such agreement is rescinded provided such conditions were specifically disclosed in the detailed public statement and the letter of offer. However, the acquirer cannot withdraw the open offer even if the proposed acquisition through the preferential issue is not successful; and **(d)** such circumstances, as in the opinion of the SEBI, merit withdrawal.

In case of withdrawal of the open offer, the acquirer should through the manager to the open offer, within two working days: **(a)** make an announcement in the same newspapers in which the public announcement was published, providing the grounds and reasons for withdrawal of the open offer; and **(b)** simultaneously inform in writing: **(i)** the SEBI, **(ii)** all the concerned stock exchanges, who should forthwith disseminate the information to the public, and **(iii)** the target company at its registered office.

Other Obligations The other obligations relate to: **(i)** directors of the target company, **(ii)** acquirer, **(iii)** target company, and **(iv)** manager to the offer.

Directors of the Target Company During the offer period, no person representing the acquirer should be appointed as director on the board of directors of the target company. After an initial period of 15 working days from the date of detailed public statement, appointment of persons representing him on the Board of Directors may, however, be effected in case the acquirer deposits in the escrow account, 100 per cent of the consideration payable under the open offer in cash. Where the acquirer has made conditional offer, no director representing him may be appointed to the Board of Directors of the target company during the offer period unless he has waived/attained such conditions and complies with the requirement of deposits cash in the escrow account.

In case of conditional offer, the acquirer, regardless of the size of the cash deposited in the escrow account, would not be entitled to appoint any director representing during the offer period. During the pendency of competing offers, regardless of the size of the cash deposited by an acquirer in the escrow account, there would be no induction of any new director to the Board of Directors of the target company. In case of death or incapacitation of any director, the vacancy may be filled by any person subject to approval by shareholders of the target company by way of a postal ballot. In the event the acquirer is already represented by a director, he would not participate in any deliberation of the Board of Directors of the target company/vote on any matter in relation to the open offer.

Obligations of the Acquirer Prior to making the public announcement, the acquirer should ensure that **(i)** firm financial arrangements have been made for fulfilling the payment obligations under the open offer and **(ii)** he is able to implement the open offer, subject to the necessary statutory approvals. In case he has not declared an intention in the detailed public statement and the letter of offer to alienate any material assets of the target company/its subsidiaries whether by way of sale, lease, encumbrance or otherwise outside the ordinary course of business, he would be debarred from causing such alienation after acquiring control for two years after the offer period. In the event the target company/its subsidiary(ies) is required to alienate the assets despite not expressing the intention to alienate by the acquirer, the alienation would require a special resolution passed by shareholders of the target company, by way of postal ballot and the notice for which should, *inter alia*, contain reasons as to why the alienation is necessary.

The acquirer should ensure that the contents of the public announcement, the detailed public statement, the letter of offer and the post-offer advertisement are true, fair and adequate in all material aspects and not misleading in any material particular, and are based on reliable sources, and state the source wherever necessary. He should not sell shares of the target company held by them, during the offer period. He would be jointly and severally responsible for fulfillment of applicable obligations.

Obligations of the Target Company Upon a public announcement of an open offer for acquiring shares of a target company being made, the Board of Directors of the target company should ensure that during the offer period, its business is conducted in the ordinary course consistent with past practice. Unless the approval of shareholders of the target company by way of a special resolution by postal ballot is obtained, the Board of Directors of the target company/any of its subsidiaries during the offer period would not **(A) (i)** alienate any material assets whether by way of sale, lease, encumbrance or otherwise or enter into any agreement; **(ii)** effect any material borrowings outside the ordinary course of business; **(B)** issue/allot any authorised but unissued securities entitling the holder to voting rights. However, the target company/its subsidiaries may issue/allot shares **(i) (a)** upon conversion of convertible securities issued prior to the public announcement of the open offer, in accordance with pre-determined terms of conversions, **(b)** pursuant to any public issue in respect of which the red herring prospectus has been filed with the Registrar of Companies prior to the public announcement of the open offer or **(c)** pursuant to any rights issue in respect of which the record date has been announced prior to the public announcement of the open offer **(C)** implement any buy-back of shares/ effect any other change in the capital structure of the target company; **(D)** enter into, amend/ terminate any material contracts to which the target company or any of its subsidiaries is a party, outside the ordinary course of business, whether such contract is with a related party, within the meaning of the term under applicable accounting principles, or with any other persons; and **(E)** accelerate any contingent vesting of a right of any person to whom the target company or any of its subsidiaries may have an obligation to acquire shares of the target company by way of employee stock options or otherwise.

In any general meeting of a subsidiary of the target company in respect of the above matters, the target company/its subsidiaries should vote in a manner consistent with the special resolution passed by the shareholders of the target company. The target company would be prohibited from fixing any record date for a corporate action on or after the third working day prior to the announcement of, and until the expiry of, the tendering period. It should furnish to the acquirer within two working days from the identified date, a list of shareholders as per the register of its members containing names, addresses, shareholding and folio number, in electric form and a list of persons whose applications for registration of transfer of shares are pending. The acquirer should, however, reimburse reasonable costs payable by the target company to external agencies in order to furnish such information.

Upon receipt of the detailed public statement, the Board of Directors of the target company should constitute a committee of independent directors to provide reasoned recommendations on the open offer, and the target company should publish them. The committee would be entitled to seek external professional advice at the expense of the target company. The committee should provide its written reasoned recommendations on the open offer to the shareholders of the target company which should be published in the specified form, at least two working days before the commencement of the tendering period, in the same newspaper where the public announcement of the open offer was published, and simultaneously, a copy of the same should be sent to: **(i)** the SEBI, **(ii)** all the concerned stock exchanges, who should forthwith disseminate the information to the public, and **(iii)** to the manger to the open offer, and where there are competing offers, to the manager to the open offer for every competing offer.

The Board of Directors of the target company should **(i)** facilitate the acquirer in verification of shares tendered in acceptance of the open offer, **(ii)** make available to all acquirers making competing offers, any information and co-operation provided to any acquirer who has made a competing offer.

Upon fulfilment by the acquirer of the required conditions, the Board of Directors of the target company should without any delay register the transfer of shares acquired by him in physical form, whether under the agreement or from open market purchases, or pursuant to the open offer.

Obligations of the Manager to the Open Offer Prior to public announcement being made, the manager to the open offer should ensure that **(a)** the acquirer is able to implement the open offer; and **(b)** firm arrangements for funds through verifiable means have been made by him to meet the payment obligations under the open offer. He should also ensure that the contents of the public announcement, the detailed public statement, the letter of offer and the post-offer advertisement are true, fair and adequate in all material aspects, not misleading in any material particular, are based on reliable sources, state the source wherever necessary, and are in compliance with the requirements under these regulations. Further, he should **(i)** furnish to the SEBI a due diligence certificate along with the draft letter of offer, **(ii)** ensure that market intermediaries engaged for the purposes of the open offer are SEBI-registered, **(iii)** exercise diligence, care and professional judgment to ensure compliance with these regulations, **(iv)** not deal on his own account in the shares of the target company during the offer period, **(v)** file a report with the SEBI within 15 working days from the expiry of the tendering period, in the specified form, confirming status of completion of various open offer requirements.

Disclosure of Shareholding and Control These relate to **(i)** disclosure related provisions, **(ii)** continual disclosures and **(iii)** disclosure of encumbered shares.

Disclosure-related Provisions The disclosures should be of the aggregate shareholding/voting rights of the acquirer/promoter of the target company/every person acting in concert with him. The acquisition/holding of any convertible security should also be regarded as shares and disclosed accordingly. Upon receipt of these disclosures, the stock exchange(s) should forthwith disseminate them.

Disclosure of Acquisition and Disposal The acquirers should disclose their aggregate shareholding and voting rights in the target company in the specified form. He should disclose in the specified form the number of shares/voting rights held and changes in shareholding/voting rights even if the change results in shareholding falling below 5 per cent if the change exceeds 2 per cent of the total in the target company. These disclosures should be made within two working days of the receipt of intimation of allotment of shares/the acquisition of shares/voting rights in the target company to **(a)** every concerned stock exchange; and **(b)** the target company at its registered office.

Shares taken by way of encumbrance including pledge/lien or any such transaction should be treated as an acquisition while shares given upon release of encumbrance should be treated as a disposal, and disclosures should be made accordingly in the specified form. However, such requirement would not apply to a bank/public financial institution as pledgee in connection with a pledge of shares for securing indebtedness in the ordinary course of business.

Continual Disclosures Every person, who together with persons acting in concert with him, holds shares or voting rights entitling him to exercise 25 per cent or more of the voting rights, should disclose their aggregate shareholding and voting rights as of the thirty-first day of March, in such target company in the specified form. The promoter of should together with persons acting in concert with him, disclose their aggregate shareholding and voting rights as of the thirty-first of March, in such target company in the specified form. These disclosure should be made within seven working days from the end of each financial year to **(a)** every concerned stock exchange; and **(b)** the target company at its registered office.

Disclosure of Encumbered Shares The promoter of every target company should disclose details of their shares encumbered by him/persons acting in concert with him in the specified form. He should also disclose details of any invocation/release of encumbrance of share in the specified form. These disclosures should be made within seven working days from the creation/invocation/release of encumbrance to, **(a)** every concerned stock exchange; and **(b)** the target company at its registered office.

Miscellaneous *Power to Issue Direction* The SEBI may, in interest of investors in securities/securities market, issue such directions for violation of these regulations as it deems fit including: **(a)** Disinvestment of shares acquired; **(b)** Transfer of the shares, or any proceeds of a directed sale of shares, to the Investor Protection and Education Fund; **(c)** The target company/any depository not to give effect to any transfer of shares acquired; **(d)** The acquirer/any person acting in concert/any nominee or proxy not to exercise any voting or other rights attached to the shares acquired; **(e)** Debarring any person from accessing the capital market or dealing in securities for such period as may be directed, having regard to the nature and gravity of the violations; **(f)** The acquirer to make an open offer for acquiring shares of the target company at such offer price as determined by the SEBI; **(g)** The acquirer not to cause, and the target company not to effect, any disposal of assets of the target company or any of its subsidiaries contrary to the contents of the letter of offer, where the conditions set out are not met; **(h)** The acquirer who has failed to make an open offer or has delayed making of an open offer, to make the open offer and to pay interest at such rate as considered appropriate by the SEBI along with the offer price; **(i)** The acquirer who has failed to make payment of the open offer consideration to shareholders, not to make any open offer or enter into any transaction that would attract the obligation to make an open offer in respect of shares of any target company for such period as the SEBI may deem fit; **(j)** The acquirer who has made an open offer but has delayed making payment of the consideration to shareholders, to pay interest at such rate as considered appropriate by the SEBI for the delayed period; **(k)** Any person to cease and desist from exercising control acquired over any target company without complying with the specified requirements; **(l)** Divestiture of such number of shares as would result in the shareholding of an acquirer and persons acting in concert with him being limited to the maximum permissible non-public shareholding or below.

In any proceedings, the SEBI would comply with the principles of natural justice before issuing directions to any person. It may, for failure to carry out the requirements of these regulations by any registered intermediary, initiate appropriate proceedings in accordance with the applicable regulations.

Hostile Takeover

Strategies The acquirer company can use any of the following techniques aimed at taking over the target company.

Street Sweep This technique requires that the acquirer should accumulate large amounts of stock in a company before making an open offer. The advantage is that the target firm is left with no choice but to give in.

Bear Hug In this case, the acquirer puts pressure on the management of the target company by threatening to make an open offer. The board capitulates straightaway and agrees to a settlement with the acquirer for change of control.

Strategic Alliance This strategy involves disarming the opposition by offering a partnership rather than a buyout. The acquirer should assert control from within and takeover the target company.

Brand Power This implies entering into an alliance with powerful brands to displace the partner's brands and, as a result, buy out the weakened company.

Defensive Strategies The target company can also use one of the following strategies to defend itself against the attack mounted by the acquiring company in its bid for open market takeover.

Poison Pill This strategy involves issue of low price preferential shares to existing shareholders to enlarge the capital base. This would make hostile takeover too expensive.

Poison Put In this case, the target company can issue bonds that encourage holders to cash in at high prices. The resultant cash drainage would make the target unattractive.

Greenmail In this strategy, the target company should repurchase the shares cornered by the raider. The profits made by the raider are after all akin to blackmail and this would keep the raider at a distance from the target.

Pac-man Defence This strategy aims at the target company making a counter bid for the raider's company. This would force the raider to defend himself and consequently call off his raid.

White Knight In order to repel the move of the raider, the target company can make an appeal to a friendly company to buy the whole, or part, of the company. The understanding is that the friendly buyer promises not to dislodge the management of the target company.

White Squire This strategy is essentially the same as White Knight and involves sell out of shares to a company that is not interested in the takeover. As a consequence, the management of the target company retains its control over the company.

Evidently, hostile takeovers, as far as possible, should be avoided as they are more difficult to consummate; in other words, friendly takeovers are better forms of corporate restructuring.

OTHER FORMS OF CORPORATE RESTRUCTURING

Financial restructuring, divestitures/demergers and buyouts are some of the other common forms used by firms for corporate restructuring. These forms of corporate restructuring are explained in this Section.

Financial Restructuring

In the case of mergers/acquisitions/takeover and amalgamation types of corporate restructuring, the potential acquiring firm has to deal with the management and/or shareholders of the other firm(s). **Financial restructuring,** on the other hand, is carried out internally in the firm with the consent of its various stakeholders. This form of corporate restructuring is relatively more easy to put to ground.

Financial restructuring is carried out internally with the consent of the various stakeholders by corporates which have accumulated substantial losses.

Financial restructuring is a suitable mode of restructuring of corporate firms that have incurred accumulated sizable losses for/over a number of years. As a sequel, the share capital of such firms, in many cases, gets substantially eroded/lost; in fact, in some cases, accumulated losses over the years may be more than share capital, causing negative net worth. Given such a dismal state of financial affairs, a vast majority of such firms are likely to have a dubious potential for liquidation. Can some of these firms be revived? Financial restructuring is one such a measure for the revival of only those firms that hold promise/prospects for better financial performance in the years to come. To achieve the desired objective, such firms warrant/merit a restart with a fresh balance sheet, which does not contain past accumulated losses and fictitious assets and shows share capital at its real/true worth.

Restructuring Scheme Financial restructuring is achieved by formulating an appropriate restructuring scheme involving a number of legal formalities (including consent of the court and consent of the affected stakeholders, say, creditors, lenders and shareholders). It is normal for equity shareholders to make the maximum sacrifice, followed by preference shares and debentureholders/lenders and creditors, respectively. The sacrifice is in terms of waiver of a part of the sum payable to various liability-holders. The sacrifice may be also be in terms of acceptance of new securities with a lower coupon rate, with a view to reduce the future financial burden on the firm. The arrangement may also take the form of conversion of debt into equity; sometimes, creditors, apart from reducing their claim, may also agree to convert their dues into securities to avert pressure of payment. As a result of all these measures, the firm may have better liquidity to work with. Thus, financial restructuring implies a significant change in the financial/capital structure of firms, leading to a change in the payment of fixed financial charges and change in the pattern of ownership and control.

In brief, financial restructuring (also referred to as internal reconstruction) aims at reducing the debt/payment burden of the firm. The aggregate sum resulting **(a)** from the reduction/waiver in the claims from various liability-holders and **(b)** profit accruing from the appreciation of assets such as land and buildings is then utilised to write off accumulated losses and fictitious assets (such as preliminary expenses and cost of issue of shares and debentures) and create provision for bad and doubtful debts and downward revaluation of certain assets, say, plant and machinery, if they are overstated. In practice, the financial restructuring scheme is drawn in such a way so that all the above requirements of write-off are duly met. The financial restructuring scheme is illustrated in Illustration 12.8.

Illustration 12.8

Following is the balance sheet of Weak Limited as on March 31, current year

(₹ lakh)

Liabilities	*Amount*	*Assets*	*Amount*
Equity capital (5,00,000 shares)	500	Land and building	180
13% Preference shares (₹100 each)	100	Plant and machinery	220
12.5% Debentures	200	Furniture	30
Debenture interest payable	25	Stock	120
Bank loan	75	Sundry debtors	50
Trade creditors	300	Cash at bank	5
		Preliminary expenses	10
		Cost of issue of debentures	5
		Profit and loss account	580
	1,200		1,200

The company suffered heavy losses and was not getting on well. Now, it feels that the worst is over and that it holds the potential of earning profits in the future. To ensure better future functioning, the company adopts the following scheme of reconstruction:

(i) Equity shares are to be reduced to ₹25 per share, fully paid up.

(ii) Preference shares are to be reduced (with coupon rate of 11%) to equal number of shares of ₹50 each, fully paid up.

(iii) Debentureholders agree to forgo outstanding interest. They have also agreed to accept new debentures carrying 10 per cent interest.

(iv) Trade creditors have agreed to forgo 25 per cent of their existing claims.

(v) To make payment of the bank loan and augment the working capital, the company issues 5 lakh equity shares at ₹25 each; payable on application. The existing shareholders have agreed to subscribe to the new issue.

(vi) While land and building is to be revalued at ₹300 lakh, plant and machinery is to be written down to ₹175 lakh. A provision amounting to ₹5 lakh is to be made for bad and doubtful debts.

You are required to show the impact of financial restructuring/reconstruction. Also draw the new balance sheet assuming the scheme of reconstruction is executed.

Solution

Impact of Financial Restructuring (₹ *lakh)*

(I) Benefits to Weak Limited	
(a) Reduction of liabilities payable	
Reduction in equity share capital (5 lakh shares × ₹75 per share)	₹375
Reduction in preference share capital (1 lakh shares × ₹50 per share)	50
Waiver of outstanding debenture interest	25
Waiver from trade creditors (₹300 lakh × 0.25)	75
	525
(b) Revaluation of assets	
Appreciation of land and building (₹300 lakh – ₹180 lakh)	120
(c) Total sum available to write off fictitious assets and over-valued assets	645
(II) Amount (₹645 lakh) Utilised to Write off Losses, Fictitious Assets and Over-valued Assets	
Writing off profit and loss account	₹580
Cost of issue of debentures	5
Preliminary expenses	10
Provision for bad and doubtful debts	5
Revaluation of plant and machinery (₹220 lakh-₹175 lakh)	45
	645

Balance Sheet of Weak Limited as at … (After Reconstruction) **(**₹ *lakh)*

Liabilities	Amount	Assets		Amount
Equity capital (₹25 each)	250	Land and building		300
11% Preference shares (₹50 each)	50	Plant and machinery		175
10% Debentures	200	Furniture		30
Trade creditors	225	Stock		120
		Sundry debtors	₹50	
		Less: Provision	5	45
		Cash at bank		55*
	725			725

*Opening balance, ₹5 lakh + Sale proceeds from issue of new equity shares, ₹125 lakh – Payment of bank loan, ₹75 lakh.

In sum, financial restructuring is unique in nature and company specific. It is carried out, in practice, when all the stakeholders are prepared to sacrifice and are convinced that the restructured firm (reflecting true value of assets, capital and other significant financial parameters) can now be put back on the profit track. This type of corporate restructuring helps in the revival of firms that otherwise would have faced closure/liquidation.

Divestitures/Demergers

Demerger (divestiture) is a form of corporate restructuring which involves sale of only some assets of the firm.

Unlike the merger in which all assets are sold, a **divestiture/demerger** involves selling of some of the assets only. These assets may be in the form of a plant, division, product line, subsidiary and so on. Although divestiture causes contraction from the perspective of selling firm, it may not, however, entail decrease in its profits. On the contrary, it is believed by the selling firm that its value will be enhanced by parting/divesting/demerging some of its assets/divisions/operating units (as they are either causing losses or yielding very low returns). By selling such unproductive/non-performing assets and utilising cash proceeds in expanding/rejuvenating other leftover assets/operating units, the firm is likely to augment the profits of the demerged/divesting firm. Evidently, the motive for demerger or divestiture is often positive. As Gitman aptly states, the motives for divestiture is to generate cash for the expansion of other product lines, to get rid of a poorly performing operation, to streamline the corporate firm, or to restructure the company's business consistent with its strategic goals[10].

Reverse synergy implies that the assets/units which are demerged are of more worth to other firms than the firm itself.

Evidently, divestiture enables the selling firm to have a more lean and focussed operation. This, in turn, is likely to augment its efficiency as well as profitability and help in creating more value for its shareholders. In other words, it implies that the operating units are worth much more to other firms than to the firm itself. In technical terms, it is aptly referred to as **reverse synergy** in that the value of the parts is greater than the whole.

Reverse capital budgeting is the capital budgeting in which cash inflows on account of demerger occur at time zero and the cash outflows are in terms of sacrifice associated with the transfer of the division/asset.

Financial Evaluation For the purpose of financial evaluation, the divestiture/demerger decision can be considered akin to **reverse capital budgeting** decision in that the selling firm receives cash by divesting an asset, say a division of the firm, and these cash inflows received are then compared with the present value of the CFAT sacrificed on account of parting of a division/asset. In other words, it has cash inflows in time zero period. For future years, it has been deprived of cash inflows after taxes (CFAT), which the division would have generated. Given the basic conceptual framework of capital budgeting, Format 12.3 contains the steps involved in assessing whether the divestiture decision is profitable for the selling firm or not.

Format 12.3 Financial Evaluating of Divestiture/Demerger Decision

(a)	Decrease in CFAT due to sale of division (for years 1, 2…… n)	________
(b)	Multiply by appropriate cost of capital relevant to division (given its risk level)	________
(c)	Decrease in present value of the selling firm ($a \times b$)	________
(d)	*Less:* Present value of obligations related to the liabilities of the division (assuming liabilities are also transferred with the sale of a division which is normal)	________
(e)	Present value lost due to sale of division ($c - d$)	________

The decision criterion is that the selling firm should go for divestiture/demerger, if its divestiture proceeds received from selling the division are more than the present value the demerged division otherwise would have provided; in case the present value lost due to sale of division is greater than the sale proceeds obtained from it, the firm should not go for divestiture/demerger.

Spin-off is a method for demerger through creation of a separate firm.

Methods of Demerger/Divestiture Demerger/divestiture is normally accomplished either by an outright sale of an operating unit/division/asset to another firm or through a **spin-off**. A spin-off requires creation of a new, separate, corporate firm; the shares of the newly created legal entity are distributed on a *pro rata* basis to existing shareholders of the parent company; such a distribution enables the existing shareholders to maintain the same proportion of ownership in the newly created firm as they had in the original firm[11]. As a sequel, the newly created entity becomes an independent company, taking its own decisions and developing its own policies and strategies, which need not necessarily be the same as those of the parent company. In brief, the firm acts as a separate business entity. However, spin-off, like outright sale, does not bring any cash to the parent company.

A variation of spin-off is the **split-up**. In broad terms, the split-up involves the breaking up of the entire firm in a series of spin-offs (in terms of newly created separate legal entities) so that the parent firm no longer exists and only the new offspring survive[12]. For instance, a corporate firm has 4 divisions, namely, A, B, C and D; a decision to split-up implies that four new corporate firms (with autonomous and separate legal status) are to be formed to takeover, say, one division each and the original corporate firm is to be wound up. Since demerged units are relatively smaller in size, they are logistically more conveniently managed. Therefore, it is expected that spin-offs and split-ups are likely to enhance efficiency and may prove instrumental in achieving better performance.

> **Split-up**
> is a method for demerger through breaking-up of the firm in a series of spin-offs.

Annexure 3 below contains the salient features of the scheme of reverse merger of ICICI Ltd with ICICI Bank Ltd.

Annexure 3 Reverse Merger of ICICI Ltd with ICICI Bank Ltd

The ICICI Ltd was one of the leading development/public financial institutions [D/P FIs]. It had sponsored a large number of subsidiaries including the ICICI Bank Ltd. The RBI permitted D/P FIs to transform themselves into banks in 2002. As a bank, ICICI Ltd would have access to low-cost (demand) deposits and could offer a wide range of products and services and greater opportunities for earning non-fund-based income in the form of fee/commission. The ICICI Bank Ltd also considered various strategic alternatives in the context of the emerging competitive scenario in Indian banking. It identified a large capital base and size and scale of operations as key success factors. The ICICI Ltd and its two other subsidiaries, namely, ICICI Capital Services Ltd (ICICI Capital) and ICICI Personnel Financial Services Ltd (ICICI PFs) amalgamated in reserve merger with the ICICI Bank in view of its significant shareholding and the strong business synergies between them. As a financial institution, ICICI Ltd was offering a wide range of products and services to corporate and retail customers in India through a number of business operations, subsidiaries and affiliates. The ICICI PFs, a subsidiary of ICICI, was acting as a focal point for marketing, distribution and servicing the retail product portfolio of ICICI including auto/commercial vehicle loans, credit cards, consumer loans and so on. The ICICI Capital was engaged in sale and distribution of various financial and investment products like bonds, fixed deposits, Demat services, mutual funds and so on. The appointed date for the merger was March 30, 2002. The effective date of merger was May 3, 2002.

The (reverse) merger of ICICI Ltd and two of its subsidiaries with ICICI Bank has combined two organisations with complementary strengths and products and similar processes and operating structure. The merger has combined the large capital base of ICICI Ltd with strong deposit raising capacity of ICICI Bank, giving ICICI Bank improved ability to increase its market share in banking fee and commission while lowering the overall cost of funding through access to lower-cost retail deposits. The ICICI Bank would now be able to fully leverage the strong corporate relationship that ICICI has built seamlessly, providing the whole range of financial products and services to corporate clients. The merger has also resulted in the integration of the retail financial operations of the ICICI and its two merging subsidiaries and ICICI Banks into one entity, creating an optimum structure for the retail business and allowing the full range of assets and liability products to be offered to retail customers.

As per the scheme of amalgamation (reverse merger) approved by the High Court of Gujarat and the High Court of Mumbai in March/April 2002, the (consideration) exchange ratio for the merger was one fully paid-up equity share of ₹10 of ICICI Bank for two fully paid-up equity shares of the ICICI Ltd of the face value of ₹10 each. No shares were issued pursuant to the amalgamation of ICICI PFS and ICICI Capital. The exchange ratio was determined on the basis of a comprehensive valuation process incorporating international best practices, carried out by two separate financial advisors (JM Morgan Stanley and DSP Merril Lynch) and an independent accounting firm (Deloitte, Haskins and Sells).

The equity shares of the ICICI Bank held by ICICI Ltd were transferred to a trust, to be divested by appropriate placement. The proceeds of such divestment would accrue to the merged entity.

The ICICI Bank has issued to the holders of preference shares of ₹1 crore each of ICICI, one preference share of ₹1 crore fully-paid up on the same terms and conditions.

With respect to stock options issued by the ICICI to its Directors/employees, which have not been exercised/are outstanding, the options in ICICI Bank in the ratio of one equity share of ₹10 each for every two equity shares of ₹10 each granted in ICICI Ltd would be issued. The exercise price would be twice the price paid by the directors/employees for the exercise of ICICI stock options.

As both ICICI Ltd and ICICI Bank were listed in India and U.S. markets, effective communication to a wide range of investors was a critical part of the merger process. It was equally important to communicate the rationale for the merger to domestic and international institutional lenders and to rating agencies. The merger process was required to satisfy legal and regulatory procedures in India, as well as to comply with the U.S. Securities and Exchange Commission requirements under U.S. securities laws.

The merger also involved significant accounting complexities. In accordance with the best practices in accounting, the merger has been accounted for under the purchase method of accounting under the Indian GAAPs. Consequently, ICICI's assets have been fair-valued for their incorporation in the books of accounts. The fair value of ICICI's loan portfolio was determined by an independent valuer while its equity and related investment portfolio was fair-valued by determining its mark-to-market value. The total additional provisions and write-offs required to reflect the fair value of the ICICI's assets have de-risked the loan and investment portfolios and created a significant cushion in the balance sheet while maintaining healthy levels of capital adequacy.

The merger was approved by the shareholders of both companies in January 2002, by the Gujarat and Mumbai High Courts in March/April 2002.

Management buyout is sale of the existing firm to the management.

Buyouts

Buyouts constitute yet another form of corporate restructuring. In the corporate world, **Management buyouts** (MBOs) are the more usual modes of acquisition. The MBO involves the sale of the existing firm to the management.

The management may be from the same firm or may be form outside (entrepreneurs) or may assume a hybrid form (i.e., the management may be of the existing firm as well as from outside).

In general, when the potential acquiring management team may not/does not have adequate financial resources of its own to pay the acquisition price, it seeks financial support from other sources, say, investors, institutions, venture funds, banks and so on. When finance is made/arranged by outside investors, it is normal for them to secure representation on the board of the corporate. In cases when debt forms a substantial part of the total financing from outsiders, the buyout transaction is appropriately referred to as a leveraged buyout (LBO). According to Emery and Finnerty, a **leveraged buyout** is an acquisition that is financed principally, sometime more than 90 per cent, by borrowing on a secured basis[13].

> **Leveraged buyout** implies acquisition of a firm that is financed principally by borrowing on a secured basis.

Since LBOs cause substantial financial risk, it is desired that LBO acquisitions/firms should have a relatively low degree of operating/business risk. LBOs will not be a suitable form of corporate restructuring if the acquired firm already has a high degree of business risk. Further, to ensure the success of LBO, it is imperative that the acquiring management/firm should carry out the exercise to determine the maximum level of debt it should go for, based on its cash generating capacity to service the debt in future. This exercise would enable the firm to determine the maximum degree of financial leverage it can employ in a buyout.

RECAPITULATION

- The growth of a firm can be achieved 'internally' either by developing new products and/or expanding the capacity of existing products or 'externally' by acquisitions, mergers, amalgamations, absorption and so on.
- While a merger is a combination of two or more firms in which the resulting firm maintains the identity of one of the firms only, an amalgamation involves the combination of two or more firms to form a new firm. In the case of merger/absorption, the firm that has been acquired/absorbed is known as the target firm and the firm that acquires is known as the acquiring firm.
- There are three types of mergers: (i) horizontal, (ii) vertical and (iii) conglomerate. Horizontal merger takes place when two or more firms dealing in similar lines of activity/business combine together. Vertical merger involves combination of two or more firms engaged in the various stages of production or distribution in the same business activity. Conglomerate merger is a combination of firms engaged in different/unrelated business activities.
- The major economic advantages of a merger are: (i) economies of scale, (ii) synergy, (iii) fast growth, (iv) tax benefits and (v) diversification.
- Synergy takes place as the combined value of the merged firm is likely to be greater than the sum of individual business entities. The combined value = value of acquiring firm, V_A + value of target firm, V_t + value of synergy, DV_{AT}.
- In ascertaining the gains from the merger, costs associated with acquisition should be taken into account. Therefore, the net gain from the merger is equal to the difference between the value of synergy and costs: Net gain = DV_{AT} – costs.
- Set-off and carry forward of losses of an acquiring firm with the firm having profits reduce the taxable income of the newly merged firm and, hence, the reduction of tax liability. Thus, a merger can provide tax benefits.

- Merger suffers from certain weaknesses also, the major ones being: (i) the management of the two firms may not go along because of friction and (ii) the dissenting minority shareholders may cause problems.
- The financial framework of merger covers three inter-related aspects: (i) determining the firm's value, (ii) financing techniques in merger and (iii) analysis of the merger as a capital budgeting decision.
- The alternative approaches to value a firm are (i) book value, (ii) appraisal value, (iii) market value and (iv) earnings per share (EPS).
- The alternative methods of financing mergers/payment to the acquired company are: (i) ordinary share financing, (ii) debt and preference share financing, (iii) convertible securities, (iv) deferred payment plan and (v) tender offers.
- The extent of merger gains to be shared between the shareholders of the acquiring firm and the target firm depends on the exchange ratio. The ratio depends on the relative bargaining position of the two firms and the market reaction of the merger move. Normally, the exchange ratio is such in which the merger gains accrue to the shareholders of both firms.
- Merger as a capital budgeting decision involves the valuation of the target firm in terms of its potentials to generate incremental future free cash flows (FCFF) to the acquiring firm. These cash flows are then to be discounted at an appropriate rate that reflects the riskiness of the target firm's business. The cost of acquisition is deducted from the present value of FCFF. The merger proposal is financially viable in case the NPV is positive. The finance manager can use sensitivity analysis to have a range of NPV values within which the acquisition price may vary.
- Alternatively, the target firm can be valued according to the adjusted present value (APV) approach. The APV approach to value FCFF of target firm has two components: (i) the value of the target company if it were entirely equity financed discounting the FCFFs using the unlevered cost of equity and (ii) the value of impact of debt financing both in terms of tax shield and bankruptcy costs. The present value of tax shield is determined, discounting tax savings by pre-tax cost of debt. The incremental bankruptcy costs (due to debt financing) are subtracted. The proposal is financially viable in case the NPV is positive.
- Activities related to expansion or contraction of a firm's operations or changes in its assets or financial or ownership structure are referred to as corporate restructuring. Its major forms other than mergers/amalgamation and takeovers/acquisitions are: (i) financial restructuring, (ii) divestitures/demergers and buyouts.
- Financial restructuring is carried out internally in the firm with the consent of its various stake-holders. It is suitable mode of restructuring for corporate firms that have accumulated sizable losses over a number of years but hold prospects for better financial performance in future. An appropriate financial restructuring scheme is formulated which enables the corporate to write-off past accumulated losses and fictitious assets and restart with a fresh balance sheet which shows its share capital as well as its assets at their real/true worth.
- Divestitures/demergers involves selling of some segments of a business only in the form of a plant, division, product line, subsidiary and so on as they are either incurring losses or yielding

very low returns. This enables the firm to have a more lean and focused operation. Besides, by selling the unproductive assets and utilising cash proceeds in expanding/rejuvenating other leftover assets/operating units, the firm is likely to augment the profits of the demerged firm/wealth for its shareholders. The concept of demerger is also known as reverse synergy in that the value of the parts is greater than that of the whole.

- Divesture can take the following forms: (i) outright sale of an operating unit, (ii) spin-off, that is, creation of a new separate firm and (iii) split-up which involves the breaking-up of the entire firm in a number of new created separate legal entities.
- The management buyouts (MBO) involves the sale of a existing firm to the management (from the same firm/from outside/hybrid form). The leveraged buyouts (LBO) takes place when debt forms a substantial part of total financing from outsiders. The LBO should be used by corporates which have a low degree of operating /business risk.
- The following are the major tax benefits available to the amalgamated/resulting company: (i) carry forward and set-off of business losses, unabsorbed depreciation, unabsorbed capital expenditure on scientific research and (ii) the expenditure on patents and copyrights, know how, family planning, preliminary expenses and so on not yet written off in the books of amalgamating/demerged company to be written off by the amalgamated/resulting company in the same number of balance instalments. Virtually all fiscal concessions/incentives/deductions available to the amalgamating/demerged company are also available to the amalgamated/resulting company.
- The tax concessions are also available to the amalgamating company. Several tax concessions are also available to the shareholders of the amalgamating as well as the demerged company.
- Although the economic considerations of mergers, amalgamations and acquisitions are similar, the legal procedures involved are different. While the mergers and amalgamations are governed by the Companies Act, the courts and law, the takeovers and acquisitions are regulated by the SEBI. The pre-security of combination is done by the CCI.
- The merger of corporates in India is governed by the provisions of the Company Act 2013 (Sections 230-32).
- The pre-entry scrutiny of combinations in India is conducted by the CCI under the Competition Act 2002. It is mandated upon its own knowledge or information to enquire within one year of its happening whether an acquisition/acquiring of control/amalgamation or merger has caused/is likely to cause an appreciable adverse effect on competition in India. It has issued regulation (2011) in respect of procedure regarding transactions of business relating to combinations. The main features of the regulation of combination under the Competition Act are: (i) regulation of combination, (ii) combination, (iii) conditions and (iv) procedure.
  - Any combination entered into by any person/enterprise which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India are void. Whether a combination would have the effect of/is likely to have appreciable adverse effect on competition in the relevant market, the CCI would have due regard to all/any of the factors listed below: (i) Actual/potential level of competition through imports in the market;

(ii) Extent of barriers to entry to the market; (iii) Degree of countervailing power in the market; (iv) Likelihood of the combination resulting in the concerned parties being able to significantly and sustainably increase price/profit margin; (v) Extent of effective competition likely to sustain the market; (vi) Extent to which substitutes are/likely to be available in the market; (vii) Market share in the relevant market of the concerned person/enterprise individually/jointly; (viii) Likelihood of the combination resulting in the removal of a vigours/effective competitor(s) in the market; (ix) Nature/extent of vertical integration in the market; (x) Possibility of a failing business; (xi) Nature/extent of innovation; (xii) Relative advantage by way of contribution to economic development by any combination having/likely to have appreciable adverse effect on competition; (xiii)The benefits of combination outweigh the adverse impact of combination.

- The parties to combination should give notice to the CCI containing details of the proposed within 30 days of (a) approval of the merger/amalgamation by the Board of Directors, (b) execution of any agreement/other documents for acquisition/acquiring control. The combination would be effective after 210 days from the date of notice.
- The conditions for pre-combination scrutiny by the CCI pertain to the value of assets and turnover. The acquirer and the concerned enterprise jointly have in (a) India assets and turnover exceeding ₹1,000 crore and ₹3,000 crore respectively, (b) India/outside India, the respective amounts are more than 500 million US dollars (including at least ₹500 crore in India0, and 1,500 million US dollars (including at least ₹1,500 crore in India). The stipulations for the group to which the concerned enterprise belongs are that their joint holdings in India are/would be ₹4,000 crores (assets) and ₹12,000 crores (turnover). Such holdings in India/outside India should aggregate more than two billion US dollars (of which at least ₹500 crore in India) in terms of assets and six billion US dollars (including at least ₹1,500 crore in India0 in terms of turnover.
- Takeovers imply acquisition of controlling interest in a company by another company. They can take three forms: (i) negotiated/friendly, (ii) open market/hostile and (iii) bail-out.
- In the case of hostile takeover, the target company can use the following strategies to defend itself: (i) Poison Pill, (ii) Poison Put, (iii) Greenmail, (iv) Pac-man defence, (v) White Knight and (vi) White Squire.
- The corporate takeovers in India are governed by the Companies Act, listing agreements and SEBI code. The provisions of the Companies Act relate to acquisition of shares, restriction on acquisition and transfer of shares and so on. The takeover of companies listed on stock exchange is regulated by Clause 40–A and 40–B of the listing agreement. While Clause 40–A deals with conditions for continued listing, Clause 40–B contains the requirements to be met when a takeover offer is made.
- The SEBI takeover code provides for the following: **(i)** Substantial Acquisition of Shares, Voting Rights/Control, **(ii)** Open Offer Process, **(iii)** Other Obligations, **(iv)** Disclosures of Shareholding and Control, and **(v)** Miscellaneous.
- Acquisition means directly/indirectly acquire/agree to acquire shares voting rights in, or control over, a target company. **Control** includes the right to appoint majority of directors or to control the management or policy decisions exercisable by a person(s) acting individually or in concert, directly/indirectly, including by virtue of their shareholding/management rights/shareholders agreement/voting agreements or in any other manner. **Shares** means shares/

security carrying voting rights including depository receipts carrying an entitlement to exercise voting rights. **Target company** means a company listed on a stock exchange. **Person acting in concert** means persons who, with a common objective/purpose of acquisition of shares/voting rights in, or exercising control, over a target company, pursuant to a formal/informal agreement/understanding, directly/indirectly co-operate for acquisition of shares/voting rights in, or exercise of control over, the target company. The persons falling within the following categories would be deemed to be persons acting in concert with other persons within the same category, unless the contrary is established: **(i)** a company, its holding company, subsidiary company and any company under the same management/control; **(ii)** a company, its directors, and any person entrusted with the management of the company; **(iii)** directors of companies referred to above and associates of such directors. **Associate** of a person means **(a)** any immediate relative, **(b)** trust of which the person/immediate relative is a trustee, **(c)** firm in which he/immediate relative is a partner, and **(d)** member of a Hindu Undivided Family of which he is a coparcener. **Immediate relative** means his spouse including parents/brothers/ sisters/children or of the spouse; **(iv)** promoters and members of the promoter group; **(v)** immediate relatives; **(vi)** a mutual fund, its sponsor, trustee, trustee company, and asset management company; **(vii)** a collective investment scheme and its collective investment management company, trustees and trustee company; **(viii)** a venture capital fund and its sponsor, trustees, trustee company and asset management company; **(viii-a)** an alternate investment fund and its sponsor/trustee/manager; **(ix)** a foreign institutional investor and its sub-accounts; **(x)** a merchant banker and its client, who is an acquirer; **(xi)** a portfolio manager and its client, who is an acquirer; **(xii)** banks, financial advisors and stock brokers of the acquirer, or of the company which is a holding company or subsidiary of the acquirer, and where the acquirer is an individual, of the immediate relative of such individual. However, a bank whose sole role is that of providing normal commercial banking services or activities in relation to an open offer under these regulations would be excluded; **(xiii)** an investment company or fund and any person who has an interest in such investment company or fund as a shareholder or unitholder having not less than 10 per cent of the paid-up capital of the investment company or unit capital of the fund, and any other investment company or fund in which such person or his associate holds not less than 10 per cent of the paid-up capital of that investment company or unit capital of that fund.

- The main elements of the SEBI code relating to substantial acquisition of shares/voting rights/control are: **(i)** substantial acquisition of shares/voting rights, **(ii)** acquisition of control, **(iii)** indirect acquisition of shares/control, **(iv)** voluntary offer, **(v)** offer size, **(vi)** offer price, **(vii)** mode of payment, **(viii)** general exemptions, and **(ix)** exemptions by the SEBI.
- The open offer for acquiring shares should be made at a price not lower than the price determined in the manner specified below:
  1. **Direct Acquisition** In the case of direct acquisition and indirect **acquisition deemed to be direct acquisition** of shares, the offer price should be the highest of: **(a)** the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement of an open offer; **(b)** the **volume-weighted average** price (i.e. product of number of equity shares bought and price of each share divided by the number of shares bought) paid/payable for acquisitions, by the acquirer during the 52 two weeks immediately preceding the date of the public announcement; **(c)** the highest price paid/payable for any acquisition by the acquirer

during the 26 weeks immediately preceding the date of the public announcement; **(d)** the **volume-weighted average market price** (i.e. product of number of shares traded on a stock exchange and price of each share divided by the total number of shares traded) of such shares for a period of 60 trading days immediately preceding the date of the public announcement as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, provided such shares are **frequently traded**. Frequently traded shares mean shares in which the traded turnover on any stock exchange during 12-calendar months preceding the calendar month in which the public announcement is made is at least 10 per cent of the total shares of the target company; **(e)** where the shares are not frequently traded, the price determined by the acquirer and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies; and **(f)** the per share value computed in case of indirect acquisition (**discussed later**).

2. **Indirect Acquisition Deemed Direct Acquisition** In the case of an indirect acquisition of shares, the offer price would be the highest of: **(a)** the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement; **(b)** the volume-weighted average price paid/payable for any acquisition, during the 52 weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain; **(c)** the highest price paid/payable for any acquisition by the acquirer during the 26 weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain; **(d)** the highest price paid/payable for any acquisition between the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, and the date of the public announcement of the open offer for shares of the target company; **(e)** the volume-weighted average market price of the shares for a period of 60 days earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, provided such shares are frequently traded; and **(f)** the per share value in case of indirect acquisition (**discussed later**).
3. In case the offer price is incapable of being determined under any of the parameters above, the offer price should be the fair price of shares of the target company to be determined by the acquire and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies.
4. **Indirect Acquisition** In the case of an indirect acquisition and open offers, where the proportionate **(a)** net asset value of the target company as a percentage of the consolidated net asset value; **(b)** sales turnover of the target company as a percentage of the consolidated sales turnover; or **(c)** market capitalisation of the target company as a percentage of the enterprise value for the entity or business being acquired is in excess

of 15 per cent, the acquirer would be required to compute and disclose, in the letter of offer, the per share value of the target company taken into account for the acquisition, along with a detailed description of the methodology adopted for such computation. The **market capitalisation** of the target company would be taken into account on the basis of the volume-weighted average market price of the shares on the stock exchange for a period of 60 trading days preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period.

5. In respect of direct and indirect deemed direct acquisition, where the acquirer has any outstanding convertible instruments convertible into shares of the target company at a specific price, the price at which such instruments are to be converted into shares, would also be considered as a parameter. The price paid for shares of target company would include any price paid/agreed to be paid for the shares in the target company, in any form whatsoever, whether stated in the agreement for acquisition of shares or in any incidental, contemporaneous or collateral agreement, whether termed as control premium or as non-compete fees or otherwise.
6. Where the acquirer has acquired/agreed to acquire any shares in the target company during the **offer period** (i.e. period between the date of entering into formal/informal agreement to acquire shares/voting rights/control of a target company requiring public announcement and the date of public announcement and the date on which the payment of consideration to shareholders who have accepted the open offer is made or the date on which open offer is withdrawn) by subscription/purchase, at a price higher than the offer price, the offer price would stand revised to the highest price for any acquisition. However, no acquisition would be made after the third working day prior to the commencement and until the expiry of the tendering period.
7. The price parameters outlined above may be adjusted by the acquirer in consultation with the manager to the offer, for corporate actions such as issuances pursuant to rights issue, bonus issue, stock consolidations, stock splits, payment of dividend, de-mergers and reduction of capital, where the record date for effecting such corporate actions falls prior to three working days before the commencement of the tendering period. However, adjustment should be made for dividend declared if the per share dividend is more than 50 per cent higher than the average paid during the three financial years preceding the date of the public announcement.
8. Where the acquirer acquirers shares of the target company during the period of 26 weeks after the tendering period at a price higher than the offer price, he would pay the difference between the highest acquisition price and the offer price, to all the shareholders whose shares were accepted in the open offer, within 60 days from the date of such acquisition.
9. Where the open offer is subject to a minimum level of acceptances, the acquirer may indicate a lower price, but not be less than the price determined under this regulation, for acquiring all the acceptances despite the acceptance falling short of the indicated minimum level of acceptance, in the event the open offer does not receive the minimum acceptance.

10. In the case of any indirect acquisition, the offer price would stand enhanced by an amount equal to a sum determined at the rate of 10 per cent per annum for the period between the earlier of the date on which the primary acquisition is contracted or the date on which the intention or the decision to make the primary acquisition is announced in the public domain, and the date of the detailed public statement, provided such period is more than five working days.

11. The offer price for partly-paid-up shares should be computed as the difference between the offer price and the amount due towards calls-in-arrears including calls remaining unpaid with interest.

12. The offer price for equity shares carrying differential voting rights should be determined by the acquirer and the manager to the open offer with full disclosure of justification for the price so determined, being set out in the detailed public statement and the letter of offer. However, the price should not be lower than the amount determined by applying the percentage rate of premium that the offer price for the equity shares carrying full voting rights represents to the price parameter computed above to the volume-weighted average market price of the shares carrying differential voting rights in the aforesaid provisions, subject to shares carrying full voting rights and the shares carrying differential voting rights, both being frequently traded shares.

13. In the event of any of the price parameters not being available or denominated in Indian rupees, the conversion of such amount into Indian rupees would be effected at the exchange rate as prevailing on the date preceding the date of public announcement and the acquirer should set out the source of such exchange rate in the public announcement, the detailed public statement and the letter of offer.

14. The SEBI may, at the expense of the acquirer, require valuation of the shares by an independent merchant banker other than the manager to the open offer or an independent practicing chartered accountant having a minimum experience of 10 years.

- The main elements of the open offer process are: **(i)** manager to the offer, **(ii)** timing, **(iii)** publication, **(iv)** contents, **(v)** filing of letter with SEBI, **(vi)** provision of escrow, **(vii)** other procedures, **(viii)** conditional offer, **(ix)** competing offer, **(x)** payment of consideration, **(xi)** completion of acquisition, and **(xii)** withdrawal of open offer.
- The other obligations relate to: **(i)** directors of the target company, **(ii)** acquirer, **(iii)** target company, and **(iv)** manager to the offer.
- These relate to **(i)** disclosure related provisions, **(ii)** continual disclosures and **(iii)** disclosure of encumbered shares.
- The SEBI may, in interest of investors in securities/securities market, issue such directions for violation of these regulations as it deems fit.

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SOLVED PROBLEMS

P.12.1 The XYZ Ltd wants to acquire ABC Ltd by exchanging its 1.6 shares for every share of ABC Ltd. It anticipates to maintain the existing P/E ratio subsequent to the merger also. The relevant financial data are furnished below:

	XYZ Ltd	*ABC Ltd*
Earnings after taxes (EAT) (₹)	15,00,000	4,50,000
Number of equity shares outstanding (N)	3,00,000	75,000
Market price per share (MPS) (₹)	35	40

(a) What is the exchange ratio based on market prices?
(b) What is pre-merger EPS and the P/E ratio for each company?
(c) What was the P/E ratio used in acquiring ABC Ltd.?
(d) What is EPS of XYZ Company after the acquisition?
(e) What is the expected market price per share of the merged company?

Solution

(a) Exchange ratio based on market prices: $\dfrac{1.6 \times ₹35}{₹40}$

(b) EPS and P/E ratio

Particulars	*XYZ Ltd*	*ABC Ltd*
(a) EAT (₹)	15,00,000	4,50,000
(b) N	3,00,000	75,000
(c) EPS (a) ÷ (b) (₹)	5	6
(d) P/E ratio (MPS ÷ EPS) (times)	7.00 (₹35/5)	6.67 (₹40/6)

(c) Implied P/E ratio in the acquisition of ABC Ltd:

$$\frac{\text{Market price of shares offered to XYZ}}{\text{Current EPS of ABC Ltd}} = \frac{₹56}{6} = 9.33 \text{ times}$$

(d) EPS of XYZ Company after merger: $\dfrac{₹15,00,000 + ₹4,50,000}{3,00,000 + 1,20,000} = ₹4.64$

(e) Expected market price after merger: ₹4.64 × 7 times = ₹32.48.

P.12.2 A Ltd wants to acquire T Ltd by exchanging 0.5 of its shares for each share of *T* Ltd. The relevant financial data are as follows:

Particulars	*A Ltd*	*T Ltd*
EAT (₹)	18,00,000	3,60,000
Equity share outstanding	6,00,000	1,80,000
EPS (₹)	3	2
P/E ratio (times)	10	7
Market price per share (₹)	30	14

Required:

(a) What is the number of equity shares required to be issued by A Ltd for acquisition of T Ltd?

(b) What is the EPS of A Ltd after the acquisition?

(c) Determine the equivalent earnings per share of T Ltd.

(d) What is the expected market price per share of A Ltd after the acquisition, assuming its P/E multiple remains unchanged?

(e) Determine the market value of the merged firm.

Solution

(a) Number of shares = 1,80,000 × 0.5 = 90,000.

(b) EPS = $\dfrac{₹18,00,000 + ₹3,60,000}{6,00,000 + 90,000} = ₹3.13$

(c) Equivalent EPS = ₹3.13 × 0.5 = ₹1.565.

(d) Expected Market price = ₹3.13 × 10 times = ₹31.30.

(e) Market value = ₹31.30 × 6,90,000 shares = ₹2,15,97,000

P.12.3 The following data concern companies *A* and *T*:

Particulars	*Company A*	*Company B*
Earnings after taxes (₹)	1,40,000	37,500
Equity shares outstanding	20,000	7,500
EPS (₹)	7	5
P/E ratio (times)	10	8
Market price (₹)	70	40

Company A is the acquiring company, exchanging its one share for every 1.5 shares of B Ltd. Assume that company A expects to have the same earnings and P/E ratio after the merger as before (no synergy effect), show the extent of gain accruing to the shareholders of the two companies as a result of the merger. Are they better or worse off than they were before the merger?

Solution

$$\text{EPS after the merger} = \frac{₹1,40,000 + ₹37,500}{20,000 + 5,000} = ₹7.1.$$

Market price after the merger = ₹7.1 × 10 times = ₹71

Total market value = ₹71 × 25,000 = ₹17,75,000

Gains from the merger

Post-merger market value of the firm		₹17,75,000
Less: Pre-merger market value:		
Company A (20,000 ´ ₹70)	₹14,00,000	
Company T (7,500 ´ ₹40)	3,00,000	17,00,000
		75,000

Apportionment of gains among shareholders

Particulars	*Post-merger value*	*Pre-merger value*	*Difference*
Firm A	₹14,20,000*	₹14,00,000	₹20,000
Firm B	3,55,000**	3,00,000	55,000

*(20,000 × ₹71)

**(5,000 × ₹71)

Thus, the shareholders are better off after the merger.

P.12.4 Assume every thing to be the same as provided in P.12.3. Determine the range of the minimum and maximum share exchange ratio between the two firms. Also provide confirmation of your answer.

Solution

(i) Determination of tolerable exchange ratio for shareholders of Firm A based on total gains accruing to shareholders of Firm B

(a)	Total market value of the merged firm	₹17,75,000
(b)	*Less:* Pre-merger value/minimum post-merger value acceptable to shareholders of firm A	14,00,000
(c)	Maximum acceptable post-merger market value of Firm B	3,75,000
(d)	To maintain post-merger value of ₹14,00,000 of Firm A, pre-merger MPS of Firm A has to be	70
(e)	Number of equity issued required to be issued in firm A to have MPS of ₹70 and to have post-merger value of firm B at ₹3,75,000 (₹3,75,000/₹70)	5,357 app.
(f)	Existing number of equity shares outstanding of Firm B	7,500
(g)	Share exchange ratio (5,357/7,500)	0.714:1

For every 1 share of Firm B, 0.714 share will be issued in Firm A

Confirmation

Combined earnings of the merged firm	₹1,77,500
Divided by the total number of shares after the merger (20,000 + 5,357)	25,357
Combined EPS after the merger (1,77,500/25,357)	7.00

(*Contd*)

(*Contd*)

MPS after the merger (₹7 × 10 P/E ratio)	70
Total value of the post-merger firm (₹70 × ₹25,357)	17,74,990*
Market value of shares for shareholders of Firm A (20,000 × ₹70) after the merger	14,00,000
Market value of shares for shareholders of Firm A before the merger	14,00,000
Gain to the shareholders of Firm A (₹14 lakh – ₹14 lakh)	Nil
Market value of shares for shareholders of Firm B (5,357 × ₹70) after the merger	3,74,990
Market value of shares for shareholders of Firm B before the merger	3,00,000
Gain to the shareholders of Firm B (₹3,74,990 – ₹3,00,000)	74,990*
Total gain from merger	75,000*

*Difference of ₹10 in two sets of figures (₹75,000 – ₹74,990) and (₹17,75,000 – ₹17,74,990) is due to approximation in the number of shares determined (5,357).

(ii) Determination of tolerable exchange ratio for shareholders of Firm B based on total gains accruing to shareholders of Firm A

(a) Total market value of the merged firm	₹17,75,000
(b) *Less:* Pre-merger value/minimum post-merger value acceptable to shareholders of firm B	3,00,000
(c) Maximum acceptable post-merger market value of Firm A	14,75,000
(d) Divided by the number of existing equity shares of Firm A	20,000
(e) Desired post-merger MPS (₹14,75,000/20,000 shares)	73.75
(f) Number of equity issues required to be issued in Firm A to have MPS of ₹73.75 (given P/E ratio of 10 times) and to have postmerger value of ₹3,00,000 of Firm B (₹3,00,000/₹73.75)	4,068 shares app.
(g) Existing number of equity shares outstanding of Firm B	5,000
(h) Share exchange ratio (4,068/7,500) 0.5424:1	
For every 1 share in firm B, 0.5424 share will be issued in firm A	

Confirmation

Combined earnings of the merged firm	₹1,77,500
Divided by the total number of shares after the merger (20,000 + 4,068)	24,068
Combined EPS after the merger (₹1,77,500/24,068)	7.375
MPS after the merger (₹7.375 × 10)	73.75
Total value of the post-merger firm (24,068 shares × ₹73.75)	17,75,015*
Market value of shares for shareholders of Firm *A* (20,000 shares × ₹73.75)	14,75,000
Market value of shares for shareholders of Firm *A* before the merger	14,00,000
Gain to the shareholders of Firm *A* (₹14,75,000 – ₹14,00,000)	75,000
Market value of shares for shareholders of Firm *B* (4,068 shares × ₹73.75)	₹3,00,015*
Market value of shares for shareholders of Firm *B* before the merger	3,00,000
Gain to the shareholders of Firm *B*	Nil/₹15*
Total gain from merger	

*Difference of ₹15 in two sets of figures (₹17,75,015 and ₹17,75,000) and (₹3,00,015 and ₹3,00,000) is due to approximation in the number of shares determined 4,068.

Acceptable exchange ratios: Thus, the minimum and maximum shares exchange ratio are 0.5424:1 and 0.714 between the shares of Firm A and Firm B.

P.12.5 Sound Industries Limited (SI) is planning to purchase Not so sound Industries Ltd. (NSS). SI has 5 lakh shares outstanding of ₹100 each, having the current market price per share (MPS) of ₹250. NSS has 2 lakh shares of ₹100 each, currently selling in the market at ₹170 per share. EPS are ₹32 and ₹24 for SI and NSS, respectively.

Required

(a) Illustrate the impact of a merger on the EPS, assuming that the share exchange ratio is to be in the relative proportion of EPS of the two firms. Also determine the equivalent EPS after the merger with Firm NSS.

(b) The management of NSS has quoted a share exchange ratio of 1:1 for the merger to take place. Should SI accept this ratio, even through the price-earning ratio of SI Ltd. will remain unchanged after merger and no synergy accrues due to the merger. If not, what is the maximum ratio it should accept.

Solution

(a) Impact of merger on EPS (based on exchange ratio of ₹24/₹32 = 0.75)

Company	*Number of shares*	*EPS*	*Total EAT*
SI	5,00,000	₹32	₹1,60,00,000
NSS	2,00,000	24	48,00,000
Total post-merger earnings			2,08,00,000
Divided by the number of shares after the merger (5,00,000 + 1,50,000 i.e., 2,00,000 × 0.75)			6,50,000
Combined earnings per share			₹32
Shareholders of SI:			
EPS before the merger			32
EPS after the merger			32
Shareholders of NSS:			
EPS before the merger			24
Equivalent EPS after the merger (EPS after the merger ´ share exchange ratio) i.e., (₹32 × 0.75)			24

Thus, there is no change in effective EPS for shareholders of either of the firms.

(b) Effect of share exchange ratio of 1:1 on valuation of the firms *(in lakh)*

Pre-merger situation:	*Firm SI*	*Firm NSS*
EAT (₹)	160	48
Number of shares outstanding (N)	5	2
EPS (₹)	32	24
Market price per share (₹)	250	170
P/E ratio implicit (MPS/EPS) (times)	7.8125	7.0833
Total market value (N × MPS) (₹)	1,250	340

(*Contd*)

(*Contd*)

Post-merger situation:		
Combined EAT (₹)		208
Number of shares outstanding after additional shares of 2 lakh issued as shares exchange ratio is 1:1 (N)	7	
EPSc (combined EAT/N) (₹)	208/7	
P/E ratio (times)		7.8125
MPS (₹)		232.143
Total market value, MPS × Number of shares of merged firm		1,625
Gain from merger (₹1,625 lakh – ₹1,250 lakh – ₹340 lakh)		35
Gain to shareholders of firms		
Firm SI		
Pre-merger market value		1,250
Less: Post-merger market value (5 lakh shares × ₹232.143)		1,160.715
Loss to the shareholders		89.285
Firm NSS		
Post-merger market value (2 lakh shares × ₹232.143)		464.286
Less: Pre-merger market value		340.000
Gain to the shareholders		124.286

Evidently, the management of SI will not accept a share exchange ratio of 1: 1 as it reduces the wealth of its shareholders by ₹89.285 lakh. The maximum ratio likely to be acceptable to its management is (0.75 : 1) as calculated on the next page.

Determination of acceptable share exchange ratio to Firm SI
(based on total gains of ₹35 lakh accruing to Firm NSS) *(₹ lakh)*

Total market value of the merged firm	1,625
Less: Minimum post-merger value acceptable to SI	1,250
Post-merger market value of Firm NSS	375
Since post-merger value of Firm SI remains unchanged, it implies MPS of ₹250 is to remain intact. Therefore, the number of equity shares required to be issued in Firm SI to have a MPS of ₹250 and to have a post-merger value of ₹375 lakh for Firm NSS will be (₹375 lakh/₹250)	1,50,000
Existing number of equity shares outstanding in Firm NSS	2,00,000
Share exchange ratio (1,50,000/2,00,000)	0.75:1
For every 1 share in Firm NSS, 0.75 share will be issued in Firm SI. This is the maximum exchange ratio that may be acceptable to management of SI	

P.12.6 Prospective Limited is contemplating taking over the business of Target Limited. The summarised balance sheet of Target Limited as on 31st March was as follows:

(₹ lakh)

Liabilities	*Amount*	*Assets*	*Amount*
Equity share capital (50 lakh @ ₹10)	500	Fixed assets:	
General reserve	250	Land and buildings	300
Profit and loss account	120	Plant and machinery	580
13% Debentures	100	Current assets:	
Current liabilities	30	Inventories	70
		Debtors	35
		Bank	15
	1,000		1,000

Additional information:

1. Prospective Limited agrees to takeover all the current assets at their book value but the fixed assets were to be revalued as under:
   Land and buildings: ₹500 lakh
   Plant and machinery: ₹500 lakh
   These sums apart, Prospective Limited is required to pay ₹50 lakh for goodwill.
2. Purchase consideration is to be paid as ₹130 lakh, in cash, to pay for 13% debentures and other liabilities, and the balance is to be paid in terms of shares of Prospective Limited.
3. Expected benefits (FCFF) accruing to Prospective limited are as follows:

(₹ lakh)

Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
₹200	₹300	₹260	₹200	₹100

   Further, it is estimated that the FCFF are expected to grow at 5 per cent per annum after 5 years.
4. Cost of capital for the purpose of analysis is to be 15 per cent.
   Suggest whether Prospective Limited is likely to benefit taking over Target Limited.

Solution

Financial evaluation of merger decision *(₹ lakh)*

(i) Cost of acquisition		
Fixed assets:		
Land and buildings	500	
Plant and machinery	500	
Goodwill	50	₹1,050

(*Contd*)

(*Contd*)

Current assets:		
Inventories	70	
Debtors	35	
Bank	15	120
		1,170
(ii) ₹1,170 lakh is payable as follows:		
Cash payment to pay 13% Debentures and current liabilities		130
Shares of Prospective Limited (₹1,170 lakh – ₹130 lakh)		1,040

(iii) Present value of FCFF (years 1 = 5)

(₹ lakh)

Year-end	*FCFF*	*PV factor (0.15)*	*Total PV*
1	₹200	0.870	₹174.00
2	300	0.756	226.80
3	260	0.658	171.08
4	200	0.572	114.40
5	100	0.497	49.70
			735.98

(iv) PV of FCFF after the forecast period

$$\text{TV5} = \text{FCFF5 } (1 + g)/(K_e - g)$$

$$= ₹100\ (1.05)/(0.15 - 0.05) = ₹1{,}050 \text{ lakh}$$

$$\text{Present value} = ₹1{,}050 \text{ lakh} \times 0.497 = ₹521.85 \text{ lakh}$$

(v) Determination of net present value *(₹ lakh)*

Present value of FCFF (years 1 – 5)	₹735.98
Present value of FCFF subsequent to year 5	521.85
Total present value of benefits/FCFF	1,257.83
Less: Cost of acquisition	1,170.00
Net present value	87.83

P.12.7 Excellent Limited, acquiring company, is interested in the acquisition of Pathetic Limited, target company. The management of Excellent Limited wants you to compute the maximum price it should be willing to pay to acquire Pathetic Limited as per adjusted present value approach. For the purpose, you have been provided with the following data:

(i) As a result of acquisition, it is expected that the FCFF of Excellent Limited are likely to increase as follows for 6 years

	(₹ lakh)
Year-end 1	₹120
2	150
3	200
4	220
5	140
6	100

(ii) The FCFF of Pathetic Limited are expected to be constant after 6 years.

(iii) Unlevered cost of equity is 15 per cent.

(iv) 10% Debt (to the extent of ₹120 lakh) will finance part of acquisition cost. Debt will be reduced to ₹70 lakh at the end of year 6 by repaying ₹10 lakh at the end of the each year, commencing from year 1. Debt level is expected to remain at that level thereafter.

(v) Corporate tax rate is 35 per cent.

(vi) Advantage from debt is to be valued at cost of debt.

(vii) Bankruptcy costs are assumed to be zero.

Solution

(i) PV of FCFF, discounted at unlevered cost of equity (k_u) *(₹ lakh)*

Year-end	*FCFF*	*PV factor (0.15)*	*Total PV*
1	₹120	0.870	₹104.40
2	150	0.756	113.40
3	200	0.658	131.60
4	220	0.572	125.84
5	140	0.497	69.58
6	100	0.432	43.20
			588.02

(ii) PV of FCFF after the explicit forecast period/terminal value

TV_6 = $FCFF_6/k_u$ = ₹100 lakh/0.15 = ₹666.67 lakh

PV of terminal value = ₹666.67 lakh × 0.432 = ₹288.00 lakh

(iii) (a) PV of tax shield, year 1 – 6 *(₹ lakh)*

Year-end	*Debt outstanding at year-end*	*Interest @ 10%*	*Tax shield (Interest × 0.35)*	*PV factor (0.10)*	*Total PV*
1	₹120	₹12	₹4.20	0.909	₹3.82
2	110	11	3.85	0.826	3.18
3	100	10	3.50	0.751	2.63
4	90	9	3.15	0.683	2.15
5	80	8	2.80	0.621	1.74
6	70	7	2.45	0.564	1.38
					14.90

(b) PV of tax shield due to interest (on perpetual debt of ₹70 lakh) *(₹ lakh)*

Amount of 10% Debt	₹70
Interest on debt (₹70 lakh × 10%)	7
Tax savings on interest (₹7 lakh × 0.35)	2.45
Present value of tax shield (₹2.45 lakh/0.10 = ₹24.50 lakh × 0.564)	13.82

(iv) Value of Pathetic Limited as per APV *(₹ lakh)*

Present value of FCFF (years 1 – 6)	₹588.02
Present value of FCFF after year 6	288
Present value of tax shield due to interest (₹14.90 lakh + ₹13.82 lakh)	28.72
Total adjusted present value	904.74

Recommendation Excellent Limited should be willing to pay ₹904.74 lakh as the maximum cost of acquiring Pathetic Limited.

Mini Case

12.C.1 Following are the financial statements for A Ltd and T Ltd for the current financial year. Both firms operate in the same industry.

BALANCE SHEETS

Particulars	*Firm A*	*Firm B*
Total current assets	₹14,00,000	₹10,00,000
Total fixed assets (net)	10,00,000	5,00,000
Total assets	24,00,000	15,00,000
Equity capital (of ₹10 each)	10,00,000	8,00,000
Retained earnings	2,00,000	—
14% Long-term debt	5,00,000	3,00,000
Total current liabilities	7,00,000	4,00,000
	24,00,000	15,00,000

INCOME STATEMENTS

Net sales	₹34,50,000	₹17,00,000
Cost of goods sold	27,60,000	13,60,000
Gross profit	6,90,000	3,40,000
Operating expenses	2,96,923	1,45,692
Interest	70,000	42,000
Earnings before taxes (EBT)	3,23,077	1,52,308
Taxes (0.35)	1,13,077	53,308
Earnings after taxes (EAT)	2,10,000	99,000
Additional information:		
Number of equity shares	1,00,000	80,000
Dividend payment (D/P) ratio	0.40	0.60
Market price per share (MPS)	₹40	₹15

Assume that the two firms are in the process of negotiating a merger through an exchange of equity shares. You have been asked to assist in establishing equitable exchange terms, and are required to:

(i) Decompose the share prices of both the companies into EPS and P/E components, and also segregate their EPS figures into return on equity (ROE) and book value or intrinsic value per share (BVPS) components.

(ii) Estimate future EPS growth rates for each firm.

(iii) Based on expected operating synergies, A Ltd estimates that the intrinsic value of T's equity share would be ₹20 per share on its acquisition. You are required to develop a range of justifiable equity share exchange ratios that can be offered by A Ltd to T Ltd's shareholders. Based on your analysis in parts (i) and (ii), would you expect the negotiated terms to be closer to the upper, or the lower exchange ratio limits? Why?

(iv) Calculate the post-merger EPS based on an exchange ratio of 0.4 : 1 being offered by A Ltd. Indicate the immediate EPS accretion or dilution, if any, that will occur for each group of shareholders.

(v) Based on a 0.4:1 exchange ratio, and assuming that A's pre-merger P/E ratio will continue after the merger, estimate the post-merger market price. Show the resulting accretion or dilution in pre-merger market prices.

Solution

(i) DETERMINATION OF EPS, P/E RATIO, ROE AND BVPS OF A LTD AND T LTD

Particulars	*A Ltd*	*B Ltd*
EAT (₹)	2,10,000	99,000
N	1,00,000	80,000
EPS (EAT ÷ N) (₹)	2.10	1.24
Market price per share (MPS) (₹)	40	15
P/E ratio (MPS/EPS)	19.05	12.12
Equity funds (EF) (₹)	12,00,000	8,00,000
BVPS (EF ÷ N) (₹)	12	10
ROE (EAT ÷ EF)	0.175	0.1237

(ii) GROWTH RATES IN EPS		
Retention ratio (1 – D/P ratio)	0.6	0.4
Growth rate (ROE × Retention ratio)	0.105	0.0495

(iii) Justifiable equity share exchange ration

(a) Market price based = MPS_T/MPS_A = ₹15/₹40 = 0.375 : 1 (lower limit)

(b) Intrinsic value based = ₹20/40 = 0.5 : 1 (upper limit)

Since A Ltd has a higher EPS, ROE, P/E ratio, and higher EPS growth expectations, the negotiated terms would be expected to be closer to the lower limit, based on the existing share prices.

(iv) POST-MERGER EPS AND OTHER EFFECTS

Particulars	*A Ltd*	*B Ltd*	*Combined*
EAT (₹)	2,10,000	99,000	3,09,000
Shares outstanding	1,00,000	80,000	1,32,000*
EPS (₹)	2.10	1.24	2.34
EPS accretion or (dilution) (₹)	0.24	(0.30**)	—

(v) POST-MERGER MARKET PRICE AND OTHER EFFECTS

Particulars	*A Ltd*	*B Ltd*	*Combined*
EPS	₹2.10	₹1.24	₹2.34
P/E ratio	(×) 19.05	(×) 12.12	(×) 19.05
	40	15	44.60
MPS accretion	4.60	2.84***	

* 1,00,000 shares + (0.40 × 80,000) = 1,32,000 shares

** EPS claim per old share = ₹2.34 × 0.4 = ₹0.936

EPS dilution (₹1.24 – Re.0.936) = ₹0.304

***MPS claim per old share = ₹44.60 × 0.4 =	₹17.84
Less: MPS per old share	15.00
	2.84

Comprehensive Case is available in Appendix 12-A on the website. The website address is **http://www.mhhe.com/khanfs9e.**

REVIEW QUESTIONS

12.1 Provide the appropriate answers in the following:

(i) Merges can provide tax benefits in the case of set off and carry forward of losses. (True/False)

(ii) The cost of capital of a merged firm is different from both cost of capital of the acquiring firm and the target firm as synergy effects should be taken and risk complexion of both the firms changes on merger. (True/False)

(iii) In an amalgamation, the amalgamated company is entitled to carry forward accumulated losses as well as unabsorbed depreciation of the amalgamating company. (True/False)

(iv) Vertical merger is the merger of two firms which are involved
(a) in similar line of business **(b)** in different stages of distribution and production in same business activity **(c)** in different/unrelated business activities and **(d)** None of these

(v) Major advantages of merger are
(a) Tax benefits **(b)** Synergy **(c)** Economies of scale **(d)** All of these

(vi) The type of financing in which an initial payment (to the shareholders of acquired firm) is followed by additional payment in future years based on the target firm's increase in earnings is known as
(a) preference share financing **(b)** tender offer **(c)** deferred payment plan and **(d)** ordinary share financing.

(vii) The type of financing in which the purchaser approaches the shareholders directly instead of the management to acquire interest in acquired firm is known as
(a) preference share financing **(b)** tender offer **(c)** deferred payment plan and **(d)** ordinary share financing.

(viii) What is the terminal value of the firm if FCFF at the end of last year of explicit forecast period is ₹100 lakh. Cost of capital is 15% and growth rate of firm is constant at 5 per cent.
(a) ₹1000 lakh **(b)** ₹1050 lakh **(c)** ₹950 lakh and **(d)** None of these

(ix) Two firms A and B have earnings after taxes of ₹60,000 and ₹40,000 respectively, with identical EPS of ₹10. What will the EPS of the firm be after merger for share exchange ratio as 0.5:1, where A acquires B?
(a) ₹10 **(b)** ₹15 **(c)** ₹12.5 and **(d)** ₹20

(x) Firm A acquires firm B, MPS of B is ₹20 and EPS is ₹5. For an exchange ratio of 1.5: 1, what was the P/E ratio used in acquiring B?
(a) 4 **(b)** 5 **(c)** 6 and **(d)** 2.67

[Answers: (i) True, (ii) True, (iii) True, (iv) b, (v) d, (vi) c, (vii) b, (viii) b, (ix) c, and (x) c.]

12.2 **(a)** What is a merger? Enumerate different types of mergers. What are the potential economic advantages from mergers?
(b) What synergies do exist in **(a)** horizontal mergers, **(b)** vertical mergers and **(c)** conglomerate mergers?

12.3 'Conglomerate firm shares tend to have a higher market value due to lower cost of capital'. Elucidate the statement.

12.4 How are mergers financed? Analyse the impact of the various modes of finance on a company's EPS.

12.5 How are the expected gains from the merger shared between the acquiring and the acquired firms? Illustrate you answer with appropriate examples.

12.6 'The capital budgeting technique of evaluating a merger proposition is the most appropriate.' Elucidate the statement.

12.7 How are lower limit and upper limit of share exchange ratio between the acquiring company and the target company determined? Explain your answer with an appropriate numerical example.

12.8 What is the adjusted present value (APV) approach? How does it differ from the conventional net present value approach of evaluating a target firm?

12.9 What is corporate restructuring? State the major forms in which it can be carried out.

12.10 What is financial restructuring? What are the key components of the financial restructuring scheme? Draw an appropriate financial restructuring scheme for a financially troubled firm.

12.11 Distinguish between 'friendly takeover' and 'hostile takeover'. What strategies are adopted by the acquiring firm in the case of a hostile takeover?

12.12 What is demerger? What are the common methods used by firms to divest/demerge themselves off operating units?

12.13 What is a leveraged buyout (LBO)? What key points should be borne in mind in such an acquisition?

12.14 Critically examine the SEBI takeover code.

12.15 Describe the tax aspects related to amalgamations and demergers.

12.16 Discuss the legal process relating to approval of merger.

12.17 Examine the provisions of the Indian Companies Act governing corporate takeovers.

12.18 State the defences available to the target firm to prevent hostile takeover.

12.19 AB Ltd wishes to acquire CD Ltd on the basis of an exchange ratio of 0.8. Other relevant financial data is as follows:

	AB Ltd	*CD Ltd*
Earnings after taxes (EAT)	₹1,00,000	₹20,000
Equity shares outstanding	50,000	20,000
Earnings per share (EPS)	2	1
Market price per share	20	8

(i) Determine the number of shares required to be issued by AB Ltd for acquisition of CD Ltd

(ii) What would be the exchange ratio if it is based on the market prices of shares of AB Ltd and CD Ltd?

(iii) What is the current price-earnings ratio of the two companies?

(iv) Assuming the earnings of each firm remains the same, what is the EPS after the acquisition?

(v) What is the equivalent EPS per share of CD Ltd?

(vi) Ascertain the gain to shareholders of both the companies **(a)** at 0.8 exchange ratio, and **(b)** an exchange ratio based on market price.

12.20 A Ltd has acquired T Ltd in the current year. T Ltd has its base year earnings of ₹15 lakh. At the time of merger, its equity shareholders received initial payment of 1 lakh shares of A Ltd. The market value of A Ltd's share is ₹100 per share and the P/E ratio is 10. As a part of the agreement, it has been also decided to pay to the shareholders of T Ltd on deferred payment basis for next 3 years; the payment is contingent to the realisation of the potential projected earnings after merger.

The projected post-merger earnings of T Ltd for next 3 years are ₹18 lakh, ₹20 lakh and ₹25 lakh respectively.

Assuming no change in the P/E ratio and share prices of T Ltd, determine the number of shares required to be issued to the shareholders of T Ltd during these years.

12.21 The Sick Company Ltd (SCL) has total accumulated losses of ₹25 lakh caused by operating losses of past several years. The Strong Ltd has acquired the SCL to use these losses and to diversify its operations. The Strong Ltd 's expected earnings before taxes are ₹20 lakh per year for the next 3 years.

Assuming these earnings are realised and setting off the losses is allowed under tax laws, determine the likely benefit to Strong Ltd, given corporate tax rate of 35 per cent and its cost of capital as 15 per cent.

12.22 Royal Industries Ltd (RIL) is considering a takeover of Supreme Industries Ltd (SIL). The earnings, number of outstanding equity shares and P/E ratios of the two companies are as follows:

Particulars	*Royal Industries Ltd*	*Supreme Industries Ltd*
Earnings after taxes (EAT)	₹20,00,000	₹10,00,000
Equity shares outstanding	10,00,000	10,00,000
Earnings per share (EPS)	2	1
P/E ratio (times)	10	5

(i) What is the market value of each company before merger?

(ii) Assume that the management of RIL estimates that the shareholders of SIL will accept an offer of one share of RIL for four shares of SIL. If there are no synergic effects, what is the market value of the post-merger RIL? What is the new price per share? Are the shareholders of RIL better or worse-off than they were before the merger?

(iii) Assume because of synergic effects, the management of RIL estimates that the earnings will increase by 10 per cent, what is the new post-merger EPS and price per share? Are the shareholders better or worse off than before the merger?

12.23 Consider the following financial data of A Ltd and T Ltd just before the merger announcement of the latter by the former:

	AB Ltd	*T Ltd*
Market price per share	₹150	₹30
Number of shares (in lakh)	10	6
Market value (MV) of the firm (in ₹lakh)	1,500	180

Determine the cost of merger:

(i) if A Ltd intends to pay ₹240 lakh in cash to T Ltd;

(ii) if A Ltd intends to offer its 1,60,000 shares in exchange of shares of T Ltd. Assume further, the merger is expected to generate cost savings with present value of ₹94.80 lakh. It is expected that these cost savings would push up the market price.

(***Note:*** consider each case independently)

ANSWERS

12.19 **(i)** 16,000 shares, **(ii)** 0.4:1, **(iii)** P/E ratio 10 for AB Ltd. And 8 for CD Ltd. **(iv)** ₹1.82 (when exchange ratio is 0.8) and ₹2.07 (when exchange ratio is 0.4),

(v) ₹1.45, **(vi)** Loss "₹90,909 for shareholders of AB Ltd. and gain of ₹1,30,909 for shareholders of CD Ltd. (when exchange ratio is 0.8; Gain of ₹34.483 and of ₹5,517 for shareholders of AB Ltd. and CD Ltd. (when exchange ratio is 0.4).

12.20 Year 1 (30,000 shares); Year 2 (50,000 shares); Year 3 (1,00,000 shares).

12.21 ₹7.4 lakh.

12.22 **(i)** ₹200 lakh (RIL), ₹50 lakh (SIL).

(ii) ₹300 lakh (Post-merger market value of RIL); ₹24 (MPS); Gain to the shareholders of RIL is ₹40 lakh due to merger.

(iii) EPS ₹2.64; the shareholders are better in post-merger situation.

12.23 **(i)** ₹60 lakh **(ii)** ₹64.80.

CHAPTER 13

Stock Broking, Depositories, Custodial Services and Short Selling and Securities Lending and Borrowing Scheme

Learning Objectives

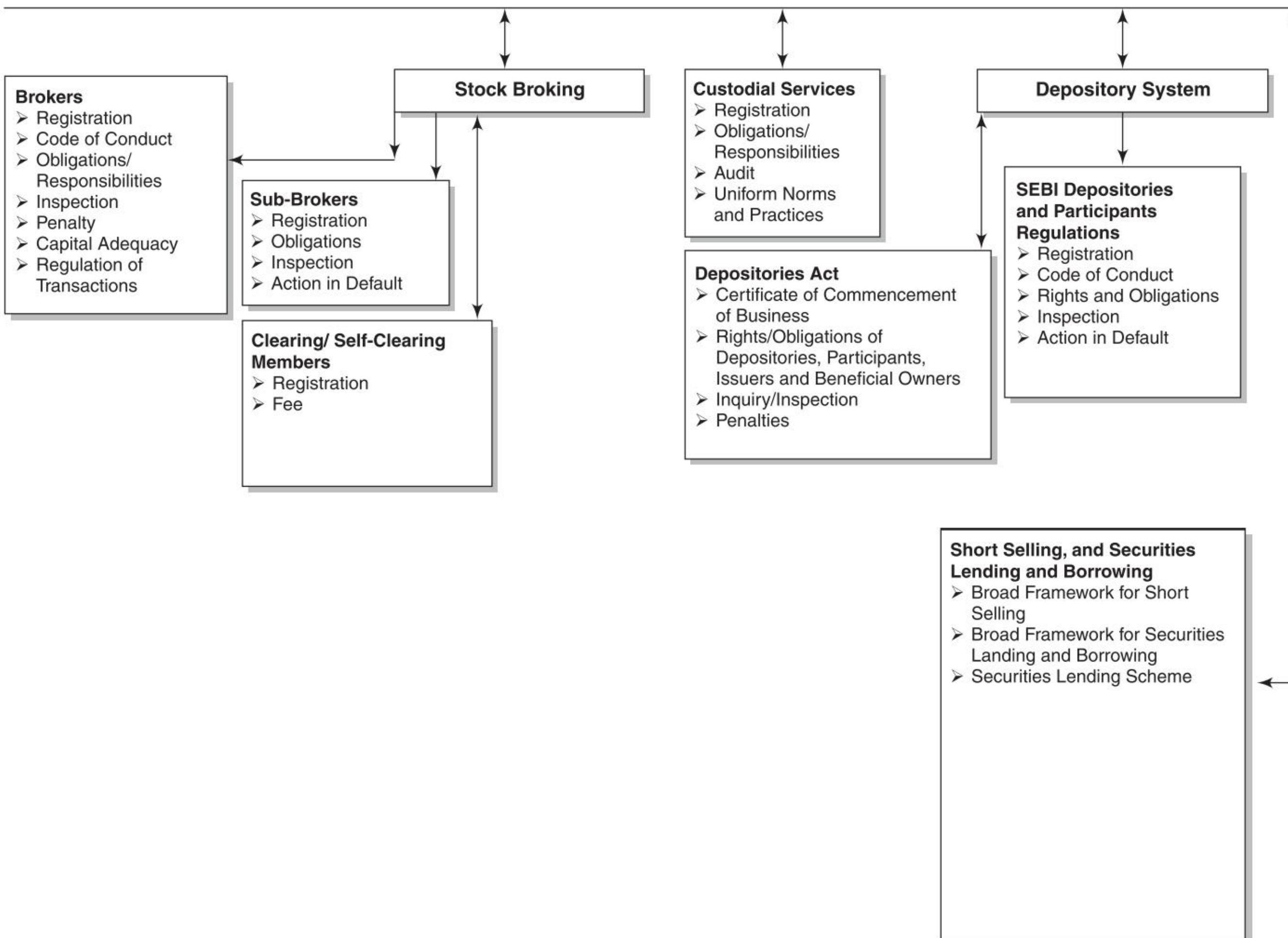
- Understand the framework of operation of stockbrokers, sub-brokers, and clearing members.
- Explain the main elements of the SEBI regulations relating to custodial services.
- Review the two components of the depository system - depositories act and depositories and participants regulations.
- Discuss the main elements of the short selling and securities lending and borrowing scheme.

INTRODUCTION

Until 1988, the stock exchanges were more or less self-regulatory organisations supervised by the Ministry of Finance under the Securities Contracts (Regulation) Act (SCRA). However, the stock exchanges had not been discharging their self-regulatory role well as the result of which malpractices had crept into trading adversely affecting the investors' interests. Several committees examined and made recommendations to reform the organisations of the stock exchanges: G.S. Patel Committee (1985), L.C. Gupta Committee (1991), Pherwani Committee (1991), G.S. Patel Committee (1995) and Varma Committee (1997). The SEBI has been setup to ensure that the stock exchanges discharge their self-regulatory role properly. To prevent malpractices in trading and to protect the rights of investors, the SEBI has assumed the monitoring function, requiring brokers to be registered and stock exchanges to report on their activities.

Ever since the SEBI began to monitor brokers, stock broking has emerged as a professional advisory service in tune with the requirements of a highly mature, sophisticated, screen-based, ringless, automated exchanges in the country in sharp contrast to the hitherto prevailing traditional, outdated closed-character, as inherited family business. **The present framework of stock broking, depository system, custodial services and short selling and securities lending and borrowing is depicted in Exhibit 13.1**. While Section 1 relates to stock broking, depository system, custodial services and short selling and securities lending and borrowing scheme are covered in Section 2-4 respectively. Some concluding observations are given in the last Section.

Exhibit 13.1 Stock Market Organisation in India



STOCK BROKING

This Section dwells on the organisation of stock broking in India with reference to stockbrokers, sub-brokers and clearing members.

Stock Brokers

A **stock broker** means a person having trading rights in any recognised stock exchange including a trading member. A certificate of registration from the SEBI is mandatory to act as a broker. No separate registration is required for a SEBI-registered broker to operate in more than one stock exchange subject to the approval of the concerned stock exchange. A SEBI-registered **clearing member** (i.e. a person having clearing and settlement rights in any recognised clearing corporation including a person having clearing and settlement rights on a commodity derivative exchange) would also not require a separate registration to act as a broker in the concerned stock exchange with its approval. A **clearing corporation** is an entity that undertakes clearing and settlement of trade in securities, other instruments/products dealt with/traded on a stock exchange and includes a clearing house.

> **Stock broker** means a person having trading rights in any recognised stock exchange including a trading member.

Registration A broker seeking registration with the SEBI has to apply through the stock exchange of which he is a member. The application must be forwarded by the exchange to the SEBI within 30 days from the date of receipt. The application should be accompanied by a nonrefundable fee of ₹50,000. For granting registration to the broker, the SEBI takes into account all matters relating to trading/settling/dealing in securities and in particular whether or not he is eligible to be admitted as a member of a stock exchange, has the necessary infrastructure including manpower to effectively discharge his activities, has past experience in the business of buying, selling or dealing in securities and is subject to disciplinary proceedings under the rules, regulations and bye-laws of the stock exchange with respect to his business, is a fit and proper person, has financial liability due/payable in terms of the SEBI Act, Securities (Regulation) Act/rules/regulations, has obtained certification in terms of SEBI Certification of Associated Persons in the Securities Market Regulation, and satisfies the minimum networth and deposit requirements. Networth means paid-up capital, free reserves and other SEBI-approval securities but not include fixed assets, pledged securities, value of a member's card, unlisted securities, bad deliveries, doubtful debts and advances overdue for more than 90 days or given to associates, prepaid expresses, losses, intangible assets and 30 per cent value of marketable securities. The net worth requirement is ₹1 crore for currency derivatives segment and ₹50 lakh for debt segment. For determining whether an applicant/stock broker, is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008.

Conditions of Registration The registration of a broker with the SEBI would be subject to conditions that he **(i)** holds the membership of any stock exchange, **(ii)** would abide by all the applicable rules/regulations and bye-laws of the stock exchange, **(iii)** would obtain SEBI's prior approval to act as a broker after a change in control, **(iv)** pay the requisite fee to the SEBI, **(v)** would take adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keep the SEBI informed about the number, nature and other particulars of investors complaints, **(vi)** at all times abid by the code of conduct (**discussed in the chapter later**), and **(vii)** maintain the specified minimum networth.

A SEBI-registered stock broker/clearing member who desires to operate in any other stock exchange or any other segment of the stock exchange can seek membership of the concerned stock exchange in a manner specified by the SEBI who would inform the SEBI about its grant of approval for the same. **Change in control** in case of a body corporate **(i)** if its shares are listed means control in terms of the SEBI Act, **(ii)** in any other case means a change in its controlling interest. In case of a non-body corporate, it means any change in its legal formation/ownership **Controlling interest** means an interest to the extent of at least 51 per cent of its voting rights. A SEBI-registered stock broker can operate in any other stock exchange/any other segment with the SEBI's approval.

Payment of Fee A stock broker has to pay a registration fee of ₹5,000 for each financial year on annual turnover upto ₹1 crore, ₹5000 plus one-hundredth of 1 per cent of the turnover in excess of ₹1 crore. To keep registration in force, after five years from the date of initial registration, he would have to pay ₹5000 for every block of five years commencing from the sixth year after registration. Every stock broker has to pay to the SEBI a fee in respect of securities transactions including off-market transaction undertaken by him as specified below:

Cash Segment: 0.0002 per cent (i.e. ₹20 per crore) of the price at which securities (other than debt securities) are purchased/sold;

Equity and Currency Derivatives Segment: 0.0002 per cent of turnover (i.e. value of all trades executed and settled on the expiration of the contracts);

Interest Rate Derivative Segment: 0.00005 per cent (i.e. ₹5 per crore) of turnover. In case of option contracts, turnover would be computed on the basis of premium traded and where the option is exercised/assigned, it should be additionally computed in the basis of notional value.

Debt Segment: 0.00002 per cent (i.e. ₹2 per crore) of turnover (i.e. aggregate value of trades executed including both sale and purchase including proprietary trading member).

Code of Conduct Registered stockbrokers have to abide by a code of conduct specified as follows:

General First, a stockbroker has to maintain high standards of integrity, promptness and fairness with due skills, care and diligence in the conduct of all his business. He should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting the market equilibrium or making personal gains. He should not create a false market either singly or in collusion with others, indulge in any act detrimental to investors' interests or which leads to interference with the fair and smooth functioning of the market and not involve himself in excessive speculative business in the market beyond reasonable levels, but commensurate with his financial soundness. Finally, he has to abide by all the provisions of the SEBI Act, and the rules and regulations issued from time to time by the Government, the SEBI and the stock exchanges.

Duty to the Investors The duties of a broker to the investors are: **(1)** In his dealings with clients and the general investing public, he should faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the grounds of the volume of business involved. He should promptly inform his client about the execution or non-execution of an order, make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients; **(2)** He should issue his clients, or clients of the broker, without delay, a contract note for all transactions in the form specified by the stock exchange; **(3)** To avoid breach of trust, he should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature regarding his clients, which he comes to know in the course of his business; **(4)** Merely for generating business, with the sole objective of earning commission and brokerage, he should not encourage sales or purchases of securities and/or furnish false or misleading quotations or give any other false or misleading advice or information to the clients; (5) He should avoid dealing or transacting business knowingly, directly or indirectly with a client who has failed to carry out his commitments in relation to securities with another stockbroker; (6) When dealing with a client, he is required to disclose whether he is acting as a principal or as an agent and should ensure, at the same time, that no conflict of interest arises between him and the client. In the event of such a conflict, he must inform the client accordingly and not seek to gain a direct or indirect personal advantage from the situation, and not consider the client's interest inferior to his own; (7) He should not give investment advice to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The stockbroker should seek such information from clients whenever he feels it is appropriate to do so; (7-A) A stockbroker or any of his employees should render investment advice directly or indirectly, about any security in the publicly accessible media, whether real-time or non-real-time, only after disclosing his interest/interest of his independent family members and the employer, including their short/long position in the security, while rendering such advice. The employee should also disclose the interest of his dependent family members and the employer including their short/long position; and (8) A stockbroker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.

Stockbrokers vis-a-vis Other Stockbrokers The code of conduct of stockbrokers in relation to other brokers are related to/covers the following aspects:

Conduct of Dealings A broker should cooperate with other brokers in comparing unmatched transactions. He should not, knowingly and wilfully, deliver documents which constitute bad delivery and should cooperate with other brokers for prompt replacement of documents that are declared as bad delivery.

Protection of Clients' Interests He should extend full cooperation to other brokers in protecting the interests of his clients regarding their rights to dividends, bonus shares, rights issues and any other rights related to such securities.

Transactions with Stockbrokers While carrying out his transactions with other brokers, he should comply with his obligations in completing the settlement of transactions with them.

Advertisement and Publicity A stockbroker should not advertise his business publicly unless permitted by the stock exchange.

Inducement of Clients He should not resort to unfair means to induce clients from other stockbrokers.

False or Misleading Returns A stockbroker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the SEBI and the stock exchange.

A stock broker should enter into an agreement specified by the SEBI with his client as also with the client by the sub-broker.

General Obligations and Responsibilities Every stock broker is required to keep and maintain the following books of accounts, records and documents: **(a)** Register of transactions (*sauda* book); **(b)** Client ledger; **(c)** General ledger; **(d)** Journals; **(e)** Cash book; **(f)** Bank pass book; **(g)** Documents register containing, *inter alia*, particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participant in respect of dematerialised (demat) securities; **(h)** Member's contract books showing details of all contracts entered into by him with other members of the same exchange, or counterfoils of duplicates of confirmation memos issued to such other members; **(i)** Counterfoils or duplicates of contract notes issued to clients; **(j)** Written consent of clients in respect of contracts entered into as principals; **(k)** Margin deposit book; **(l)** Registers of accounts of sub-brokers; **(m)** An agreement with a sub-broker specifying the scope of mutual authority and responsibilities. These books of accounts and other records should be preserved for at least five years, **(n)** An agreement with the sub-broker and with the client of the sub-broker to establish priority of contract between the stock broker and the client of the sub-broker.

Appointment of Compliance Officer Every stock broker should appoint a compliance officer to monitor the compliance of the SEBI Act/rules/regulations/notifications/ guidelines instructions issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report any non-compliance observed by him to the SEBI.

Stock Broker Not to Deal with Unregistered Sub-broker A stock broker should not deal with any person as a sub-broker unless he has obtained a certificate of registration from the SEBI.

Procedure for Inspection The SEBI is empowered to appoint one or more persons as inspection authority to inspect the books of accounts, other records and documents of the stockbroker: **(a)** to ensure that the books of accounts and other books are being maintained in the required manner and in accordance with the provisions of the SEBI Act, rules, regulations and the provisions of the SCRA; **(b)** to investigate into the complaints received from investors, other stockbrokers, sub-brokers or any other person on any matter having a bearing on the activities of the stockbroker; and **(c)** to investigate, *suo moto*, in the interest of the securities business or in the investors' interest, into the affairs of stockbrokers.

The SEBI can also appoint a qualified auditor to carry out inspection/investigation into the records of the brokers. On the basis of the inspection report, SEBI can take action in case of default as specified below.

Liability for Contravention of the SEBI Act, Rules/Regulations A stock broker or a sub-broker who contravenes any of the provisions of the SEBI Act, rules or regulations would be liable for any one or more of the following actions:

(i) Monetary penalty under chapter VI-A of the SEBI Act.

(ii) Penalties as specified under SEBI Intermediaries Regulation, 2008, including suspension or cancellation of certificate of registration.

(iii) Prosecution under section 24 of the SEBI Act.

Liability for Monetary Penalty A stock broker or a sub-broker would be liable for monetary penalty in respect of the following violations, namely:

(i) Failure to file any return or report with the SEBI.
(ii) Failure to furnish any information, books or other documents within 15 days of issue of notes by the SEBI.
(iii) Failure to maintain books of account or records as per the SEBI Act, rules or regulations.
(iv) Failure to redress the grievances of investors within 30 days of receipts of notice from the SEBI.
(v) Failure to issue contract notes in the form and manner specified by the stock exchange of which such broker is a member.
(vi) Failure to deliver any security or make payment of the amount due to the investor within 48 hours of the settlement of trade unless the client has agreed in writing otherwise.
(vii) Charging of brokerage which is in excess of brokerage specified in the regulation or the bye-laws of the stock exchange.
(viii) Dealing in securities of a body corporate listed on any stock exchange on his own behalf or on behalf of any person on the basis of any unpublished price sensitive information.
(ix) Procuring or communicating any unpublished price sensitive information except as required in the ordinary course of business or under any law.
(x) Counselling any person to deal in securities of any body corporate on the basis of unpublished price sensitive information.
(xi) Indulging in fraudulent and unfair trade practices relating to securities.
(xii) Failure to maintain client account opening form.
(xiii) Failure to segregate his own funds or securities from the client's funds or securities or using the securities or funds of the client for his own purpose or for purpose of any other client.
(xiv) Acting as an unregistered sub-broker or dealing with unregistered sub-brokers.
(xv) Failure to comply with directions issued by the SEBI under the SEBI Act or the regulations.
(xvi) Failure to exercise due skill, care and diligence.
(xvii) Failure to seek prior approval of the SEBI in case of any change in its control.
(xviii) Failure to satisfy the net worth or capital adequacy norms, if any, specified by the SEBI.
(xix) Extending use of trading terminal to any unauthorised person or place.
(xx) Violations for which no separate penalty has been provided.

Liability for Action Under the Enquiry Proceeding Regulations A stock broker or a sub-broker would be liable for any action as specified in the SEBI Intermediaries Regulation, including suspension or cancellation of his certificate of registration, if he:

(i) Ceases to be a member of a stock exchange; or
(ii) Has been declared defaulter by a stock exchange and not readmitted as a member within a period of six months; or
(iii) Surrenders his certificate of registration to the SEBI; or
(iv) Has been found to be not a fit and proper person by the SEBI under these or any other regulations; or
(v) Has been declared insolvent or order for winding up has been passed in the case of a broker or sub-broker being a company registered under the Companies Act; or

(vi) Any of the partners or any whole-time director in case a broker or sub-broker is a company registered under the Companies Act, has been convicted by a court of competent jurisdiction for an offence involving moral turpitude; or

(vii) Fails to pay the prescribed fee; or

(viii) Fails to comply with the rules, regulations and bye-laws of the stock exchange of which he is a member; or

(ix) Fails to cooperate with the inspecting or investigating authority; or

(x) Fails to abide by any award of the Ombudsman or decision of the SEBI under the SEBI (Ombudsman) Regulations, 2003; or

(xi) Fails to pay the penalty imposed by the adjudicating officer; or

(xii) Indulges in market manipulation of securities or index; or

(xiii) Indulges in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992;

(xiv) Violates SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003; or

(xv) Commits violation of any of the provisions for which monetary penalty or other penalties could be imposed; or

(xvi) Fails to comply with the circulars issued by the SEBI; or

(xvii) Commits violations specified pertaining to liability for monetary penalty which in the opinion of the SEBI are of a grievous nature.

Liability for Prosecution A stock broker or a sub-broker would be liable for prosecution under Section 24 of the SEBI Act for any of the following violations, namely:-

(i) Dealing in securities without obtaining certificate of registration from the SEBI.

(ii) Dealing in securities or providing trading floor or assisting in trading outside the recognised stock exchange in violation of provisions of the Securities Contract (Regulation) Act, or rules made or notifications issued thereunder.

(iii) Market manipulation of securities or index.

(iv) Indulging in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.

(v) Violating the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.

(vi) Failure without reasonable cause

- **(a)** to produce the investigating authority or any person authorised by him in this behalf, any books, registers, records or other documents which are in his custody or power; or
- **(b)** to appear before the investigating authority personally or to answer any question which is put to him by the investigating authority; or
- **(c)** to sign the notes of any examination taken down by the investigating authority.

(vii) Failure to pay penalty imposed by the adjudicating officer or failure to comply with any of his directions or orders.

Registration of Clearing Members

To act as a clearing member, a certificate of registration should be obtained from the SEBI. However, any SEBI-registered broker who acts as clearing member with the approval of the clearing corporation would not require a separate registration. Similarly a separate registration would not be required for a SEBI-registered clearing member to operate in more than one clearing corporation.

The application for registration accompanied by non-refundable fee of ₹50,000 should be submitted in the prescribed form through the concerned clearing corporation which should forward it to the SEBI within 30 days of the receipt.

Applicability of Provisions Applicable to Stock Brokers Except as other wise provided, *the provisions relating to registration* of brokers are applicable ***mutatis mutandis*** to registration of a clearing member.

Payment of Fee A **clearing/self clearing member** (i.e. a broker member of a clearing corporation who clears/settles trades on its own account or on account of its clients only) would pay ₹50,000 as fee is respect of transactions including off-market transactions undertaken by them. Such members should also satisfy the minimum net worth and deposit requirement for the segment for which membership is sought as specified below:

Equity Derivative Segment: (a) clearing member, networth ₹3 crore and deposit, ₹50 lakh, **(b)** self clearing member, net worth, ₹1 crore, and deposit, ₹50 lakh.

Currency Derivatives Segment: (a) clearing member, net worth, ₹10 crore and deposit ₹50 lakh, **(b)** self clearing member, networth, ₹5 crore and deposit ₹50 lakh, (c) stock broker, net worth, ₹1 crore.

Debt Segment: (a) clearing member, net worth, ₹3 crore, **(b)** self clearing member, net worth, ₹1 crore.

Commodity Derivatives on National Commodity Derivative Exchanges: (a) self-clearing member, net worth, ₹1 crore; deposit, ₹50 lakhs; **(b)** clearing member, net worth, ₹3 crore and deposit, ₹50 lakhs.

Operation in other Clearing Corporations/Segments Any SEBI-registered broker/clearing member who desires to operate in another clearing corporation/segment would require approval in SEBI-specified manner by the concerned clearing corporation/segment which should inform the SEBI of the grant of approval.

The provisions relating to general obligations/responsibilities, procedure for inspection and action in case of default applicable to brokers would *mutatis mutandis* apply to clearing /self-clearing members. A self-clearing member of clearing corporation who is also a stock broker and clears/settles trades on own account/on account of its clients only including a person having clearing/settlement rights on commodity derivative exchange.

Sub-Brokers

Sub-broker acts on behalf of a stockbroker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers.

A **sub-broker** acts on behalf of a stockbroker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers, but he is not a member of a stock exchange. To act as a sub-broker, a certificate of registration from the SEBI is required. It grants a registration certificate to a sub-broker subject to the condition that he **(a)** pays the prescribed fee, **(b)** takes adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps the SEBI informed about the number, nature and other particulars of the complaints and **(c)** is authorised in writing by a broker for affiliation in buying, selling or dealing in securities.

Sub-brokers wanting to do business with more than one broker need to be separately registered with the SEBI for each broker. Consequent to a broker having corporatised his membership, all sub-brokers affiliated to him would need to apply to the SEBI for transfer for their affiliation.

A sub-broker would have to mandatorily disclose the names of all sub-brokers/brokers with whom he has direct/indirect interest in the same firm that he/any of his relative being a sub-broker/broker or partner hold substantial stake in. The agreement between a sub-broker and broker can be terminated only after giving prior written notice of at least six months by either party. Sub-brokers are obliged to enter into agreements and maintain the data base of their client as per the SEBI format. It would be the responsibility of the broker to report the default, if any, of his sub-broker to all other brokers with whom the sub-broker is affiliated.

Registration of Sub-Brokers A sub-broker should hold a certificate of registration from the SEBI. However, he would not require a fresh certificate where a registered sub-broker **(i)** changes his affiliation from one broker to another, **(ii)** in affiliated to a broker who is eligible to trade on a SME exchange/platform **(discussed in Chapter 11)**. According to the SEBI regulations currently in force, a sub-broker is required to submit along with the application **(1)** a recommendation from a stockbroker with whom he will be affiliated and **(2)** two references, including one from his banker. The application has to be submitted to the concerned stock exchange, which has to verify the information contained in it. It has also to certify that the applicant is eligible for registration as per the specified eligibility criteria, namely, an individual applicant is not less than 21 years of age, has not been convicted of any offence involving fraud or dishonesty, has passed the equivalent of at least 12th standard examination from a recognised institution and is a fit and proper person. The educational qualification may be relaxed by the SEBI on the basis of merit and subject to the experience of the applicant. Similar eligibility criteria apply to the partners of a firm or the directors of a body corporate. In addition, the applicant **(i)** has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities and **(ii)** should be a person recognised by the stock exchange as a sub-broker affiliated to a member broker of the stock exchange. The stock exchanges should forward the application in the prescribed form with the recommendation letter in the prescribed form issued by the stock broker with whom he is affiliated and also the recognition letter in the prescribed from issued by the stock exchange to the SEBI within 30 days from the date of the receipt of the application.

Conditions of Registration In addition to the conditions applicable to the stock brokers, the sub-broker should be authorised in writing by a broker for affiliation in buying/selling/dealing in securities.

General Obligations

Payment of Fee The annual fee payable by a sub-broker is ₹20,000 for an initial period of five years. After the expiry of five years, an annual fee of ₹10,000 is payable for every subsequent block of five financial years.

Agreement There should be an agreement with the broker and the sub-broker specifying the scope of his authority and responsibilities.

The sub-brokers should **(i)** comply with the rules, regulations and bye-laws of the stock exchange and **(ii)** not be affiliated to more than one stock broker of one stock exchange.

Books of Accounts The same books of accounts and documents as are required to be maintained/ by brokers except those specified in clause **(h)** to **(m)** should be maintained by sub-brokers also.

Code of Conduct The sub-brokers have to follow the code of conduct as detailed below:

General A sub-broker should maintain high standards of integrity, promptness and fairness and act with due skill, care and diligence in the conduct of all investment business.

Duty to the Investors A sub-broker, in his dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and promptly inform his client about the execution or non-execution of an order.

He should render necessary assistance to his client in obtaining the contract note from the stock broker.

A sub-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of confidential nature about the client, which he comes to know in the course of his business.

He should not encourage sales or purchases of securities with the sole object of generating brokerage or commission, and not furnish false or misleading quotations or give any other false or misleading advice or information to the client with a view to inducing him to do business in particular securities, enabling himself to earn brokerage or commission thereby. He should also not charge from his clients a commission exceeding one and one-half of one per cent of the value mentioned in the respective sale or purchase notes.

A sub-broker should not deal or transact business knowingly, directly or indirectly, or execute an order for a client who has failed to carry out his commitments in relation to securities and has defaulted against another broker or sub-broker.

When dealing with a client, he should disclose that he is acting as an agent and should issue appropriate purchase/sale notes ensuring at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider the clients' interest inferior to his own.

The employee should also disclose the interest of his dependent family members and the employer, including their short/long position in the security, while rendering such advice.

A sub-broker should not make a recommendation to any client who might be expected to rely thereon to acquire, dispose off or retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client, as to his own security holdings, financial situation and objectives of such investment. The sub-broker should seek such information from clients wherever he feels it is appropriate to do so.

A sub-broker or any of his employees should not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real time, unless a disclosure of his interest, including his short/long position, in the security is made. The employee should also disclose the interest of his dependent family members and the employer, including their short/long position, in the security while rendering such advice.

He should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients and continuous compliance with the regulatory system.

Sub-Broker vis-a-vis Stockbrokers

Conduct of Dealings A sub-broker should cooperate with his broker in comparing unmatched transactions. He should not knowingly and wilfully deliver documents that constitute bad delivery. He should also cooperate with other contracting party(ies) for prompt replacement of documents that are declared as bad delivery.

Protection of Clients' Interests A sub-broker should extend full cooperation to his stockbroker in protecting the interests of the clients regarding the latter's rights to dividends, bonus shares, or any other rights related to such securities.

Transactions with Brokers A sub-broker should not fail to carry out his stockbroking transactions with his broker nor should he fail to meet his business liabilities or show negligence in completing the settlement of transactions with them.

Legal Agreement between Brokers A sub-broker should execute an agreement or contract with his affiliating brokers that would clearly specify the rights and obligations of the sub-brokers and the principal broker.

Advertisement and Publicity A sub-broker should not advertise his business publicly unless permitted by the stock exchange.

Inducement of Clients A sub-broker should not resort to unfair means to induce clients from other brokers.

Sub-Brokers vis-a-vis Regulatory Authorities A sub-broker should not indulge in dishonourable, disgraceful, disorderly or improper conduct on the stock exchange nor should he wilfully obstruct the business of the stock exchange. He should comply with its rules, bye-laws and regulations.

He should not neglect or fail or refuse to submit **(i)** to the SEBI or the stock exchange with which he is registered, such books, special returns, correspondence, documents and papers or any part thereof as may be required, **(ii)** the required returns, and not make any false or misleading statement on any returns required to be submitted to the SEBI or the stock exchanges.

In addition, a sub-broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting the market equilibrium or making personal gains.

Finally, he should not create a false market, singly or in concert with others, or indulge in any act detrimental to public interest or which interferes with the fair and smooth functioning of the market mechanism of the stock exchanges. He should not involve himself in excessive speculative business in the market, beyond a reasonable level not commensurate with his financial soundness.

No director of a stock broker should act as a sub-broker to the same stock broker.

General Obligations and Responsibilities, Procedure for Inspection/Action in Default The regulations applicable to stockbrokers in this respect are also applicable to sub-brokers.

CUSTODIAL SERVICES

Custodial services means safe-keeping of securities of clients and providing other incidental services such as maintenance of accounts and collection of benefits/rights.

The provision of efficient **custodial services** forms an important element in the evolution of a matured stock market system. The custodians of securities who provide custodial services play a critical role in the secondary market. Recognising their importance in the securities market, the SEBI Custodian of Securities Regulations, 1996 was framed for the proper conduct of their business. According to the SEBI regulations, custodial services in relation to securities of a client or gold/gold related instrument held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund mean safe-keeping of such securities or gold/gold related instruments or title deeds of real estate assets and providing services incidental thereto, including **(i)** maintaining their accounts, **(ii)** collecting the benefits/rights to the client in respect of them, **(iii)** keeping the client informed of the action(s) taken/to be taken by the issuer having a bearing on the benefits/rights accruing to the client and **(iv)** maintaining and reconciling records of services referred to above.

- Maintaining accounts of the securities of a client;
- Collecting the benefits/rights accruing to him in respect of securities;
- Keeping him informed of the actions taken/to be taken by the issuer of securities, having a bearing on the benefits/rights accruing to him; and
- Maintaining and reconciling records of the services referred to above.

The main elements of the SEBI framework of regulations for custodians of securities, briefly discussed in this section, are: **(i)** their registration, **(ii)** their general obligations and responsibilities, **(iii)** inspection and audit, **(iv)** action in case of default and **(v)** uniform norms and practices.

Registration

Registration of custodians of securities with the SEBI is mandatory. The application for registration should be made in the prescribed form accompanied by an application fee of ₹5,00,000. While granting registration, the SEBI would consider all matters relevant to the activities of a custodian of services with particular reference to whether the applicant **(a)** fulfils the requirement of net worth (paid-up capital plus free reserves) of ₹50 crore; **(b)** has the necessary infrastructure, including adequate office space, vaults for the safe custody of securities and computer systems capability required to effectively discharge his activities as a custodian; (ba) has the requisite approvals to provide custodial services in respect of gold/gold-related instruments of mutual funds; or title deeds of a real estate asset held by a real estate mutual fund; **(c)** has in employment adequate and competent persons who have the experience, capacity and ability to manage the business of a custodian; **(d)** has prepared a complete manual, setting out the systems and procedures to be followed by him for the effective/efficient discharge of his functions, and an arms' length relationship to be maintained with his other business(es); **(e)** is not a person who has been refused registration by the SEBI/whose registration has been cancelled by the SEBI; **(f)** his director/principal officer/any of his employees is involved in litigation connected with the securities market or has at any time been convicted of any offence involving moral turpitude/economic offence; **(g)** the registration is in the interest of investors; and **(h)** the applicant is a fit and proper person. For determining whether an applicant/custodian of securities is a fit and proper person, the SEBI would take into account the criteria specified in the SEBI Intermediaries Regulation, 2008. The applicant should be a body corporate. It has to pay a registration fee of ₹50,00,000. The registration would require renewal after every three years.

The registration of a custodian is subject to certain conditions. It **(a)** would not commence any custodial activities without fulfilment of capital requirement of ₹50 crore, **(b)** has to abide by the provisions of the SEBI Act and regulations in the discharge of its functions, **(c)** has to enter into a valid agreement with its clients for providing such services, and **(d)** has to pay an annual fee of ₹10,00,000 or 0.0005 per cent of the assets under custody (i.e. the value of the assets held by the custodian whichever is higher). Moreover, if any information submitted to the SEBI is found to be false/misleading in any material particular or if there is any change in such information, the SEBI should be forthwith informed in writing. Finally, in addition to providing custodial services, it would carry on activities relating to rendering of financial services only. The SEBI may restrict the certificate of registration to provide custodial services either in respect of securities or gold/gold-related instruments of a client or title deeds of a real estate asset held by a real estate asset mutual fund.

General Obligations/Responsibilities

Included in the general obligations and responsibilities of custodians are: **(i)** code of conduct, **(ii)** segregation of activities, **(iii)** monitoring/review/evaluation/inspection of systems/controls, **(iv)** separate custody account, **(v)** internal controls and **(vi)** maintenance of records.

Code of Conduct The custodians of securities should abide by the code of conduct set out below. He should

- maintain the highest standard of integrity, fairness and professionalism in the discharge of his duties.
- be prompt in distributing dividends/interest/any such accruals of income received/collected by him on behalf of his clients, on the securities held in custody.
- be continuously accountable for the movement of securities in/out of custody account, deposit and withdrawal of cash from the clients accounts and provide complete audit trail whenever called by the client/SEBI.
- establish and maintain adequate infrastructural facility to discharge custodial services to the satisfaction of clients and the operating procedures/systems should be well-documented and backed by operation manuals.
- maintain client confidentiality in respect of his affairs.
- take precautions to ensure that, where records are electronically maintained, continuity in record keeping is not lost/destroyed, and sufficient back-up of the records is available.
- create and maintain records of securities in such a manner that the tracing of securities/obtaining duplicate documents is facilitated in the event of loss of original records for any reason.
- extend to other custodial entities/depositories/ clearing organisations, all cooperation necessary for conduct of business in the areas of inter-custodial settlements and transfer of securities/funds. Ensure an arms' length relationship from other businesses, both in terms of staff and systems. Exercise due diligence in safekeeping/administration of assets of clients in custody.
- a custodian of securities or any of his employees should not directly/indirectly render any investment advance about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest, including long/short position in the security, has been made while rendering such advice. In case an employee is rendering such advice, he should also disclose the interest of his dependent family members and employer, including their short/long position.

Segregation of Activities The activities relating to his business as the custodian of securities should be separate and segregated from his all other activities. Similarly, its officers/employees engaged in custodial services should not be engaged in any other activity carried out by him.

Monitoring/Review/Evaluation/Inspection of Systems/Controls The custodian should have adequate mechanism for the purposes of reviewing, monitoring and evaluating the custodian's controls/systems/procedures and safeguards. It should be inspected annually by an expert. The inspection report should be sent to the SEBI within three months of inspection.

Prohibition of Assignment A custodian can assign/delegate its functions only to another custodian. It can, however, engage a non-custodian person for physical safekeeping of a mutual fund client having a gold exchange traded fund scheme provided **(i)** it would remain responsible for safekeeping including any associated risks, **(ii)** all books/documents/records would be maintained in its premises or made available if required by the SEBI, and **(iii)** it would continue to fulfill all duties to the client except for physical safekeeping.

Separate Custody Account and Agreement with Clients A separate custody account for each client should be opened by the custodian and the assets of one client should not be mixed with those of others. The custodian should enter into an agreement with each client providing for the circumstances under which he would **(i)** accept/release securities, asses/documents and money from the custody account, and **(ii)** receive rights/entitlement on the securities of the client. It should also include circumstances and the manner of registration of securities in respect of each client and details of insurance to be provided for by the custodian.

Internal Controls The custodians should have **(i)** adequate internal control to prevent the manipulation of records/documents including audit for securities and rights/ entitlements arising from securities held on behalf of clients and **(ii)** appropriate safekeeping measures to ensure that securities, assets and documents are protected from theft and natural hazards.

Maintenance of Records The custodians should maintain records/documents on behalf of/for each client containing details of: securities, assets/documents received/released, money received/ released, rights/entitlements arising from the securities held, registration of securities, ledger, instructions received from/to clients, and all reports submitted to the SEBI. These records should be maintained for at least five years and the place where they are maintained to the SEBI should be intimated.

Appointment of Compliance Officer Every custodian of securities should appoint a compliance officer to monitor the compliance of the SEBI Act/regulations/notifications/ guidelines/instructions and so on issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

Information to SEBI The SEBI can, at any time, ask for any information with respect to any matter relating to the activities of a custodian. Such information must be provided within such reasonable period as the SEBI may specify.

Inspection and Audit

The SEBI is empowered to conduct inspection/investigation, including inspection by an auditor of the books, of accounts/records/documents/of custodians for any of the following purposes:

- To ensure that they are being maintained in the manner specified in these regulations.
- To investigate into complaints received from the investors/clients/any other person on any matter having a bearing on his activities.
- To ascertain compliance with the provisions of the SEBI Act and these regulations.

On the basis of the inspection/investigation report, the SEBI can call upon the custodian to take such measures as it deems fit.

Action in Case of Default

In case of default, the SEBI can suspend/cancel registration of a custodian.

Suspension of Registration The registration of the custodians is liable to be suspended by the SEBI for the following reasons:

- Contravention of the provisions of the SEBI Act, rules framed under it and these regulations.

- Failure to furnish any information required by the SEBI/furnishing false/misleading information in any material particular.
- Non-submission of periodic returns/reports required by the SEBI.
- Non-cooperation in any enquiry/inspection by the SEBI.
- Failure to update its systems/procedures as recommended by the SEBI.
- Failure to resolve complaints of clients or give a satisfactory reply to the SEBI in this behalf.
- Guilty of misconduct/breach of code of conduct.
- Failure to pay annual fees.

Cancellation of Registration The SEBI can cancel the registration of a custodian when **(i)** it is guilty of fraud or has been found convicted of an offence involving moral turpitude, and **(ii)** it has been guilty of repeated defaults of the nature, leading to suspension.

DEPOSITORY SYSTEM

A major reform of the Indian stock markets has been the introduction of the **depository system** and scripless trading mec hanism, since 1996. This system of trading based on physical transfer/custody of securities militated against the efficient functioning of markets, particularly in the context of the large scale entry of Foreign Institutional Investors (FIIs). The main problems faced the investors in general and FIIs in particular were:

> **Depository system** is a system of dematerialisation of share certificates through scripless trading in which transactions in securities take place by a book entry method without the physical delivery of securities or movement of cheques for payment.

- Inordinate delays in transfer of securities,
- Return of share certificates as bad deliveries on account of forged signatures/mismatch of signatures or fake certificate/forged transfer deed,
- Delay in the receipt/non-receipt of securities after allotment/refund orders to non-allottees,
- Delay in getting duplicate shares/debentures certificates, and
- Inadequate infrastructure in banking and postal segments to handle a large volume of application and storage of share certificates.

To overcome the problem of a large number of transfer deeds and share certificates, the concept of jumbo transfer deed and jumbo certificate had been introduced. In a jumbo transfer deed only one transfer deed is to be executed for a large number of transfers, while a jumbo certificate reflects a large number of certificates. However, physical dealing in securities had to be completely eliminated to bring the Indian stock markets at par with the international markets, through scripless trading in which transactions in securities take place by a book entry method, without the physical delivery of securities or movement of cheques for payment. The essential part of scripless trading is the dematerialisation of share certificates through depositories. All certificates are surrendered to the issuer company that has issued the securities. On the receipt of the certificates through the depository participants and on the advice of the depository with whom the company has already entered into an agreement, the certificates are cancelled. The depositories' name is entered in the Register of Members of the company in respect of these securities, and the name of the beneficial owners whose name is recorded as such with a depository are deleted. The depository system in India operates within the framework of Depositories Act, 1996 and the SEBI Depositories and Participants Regulation, 1996.

Depositories Act

The objective of the Depositories Act is to provide for the regulation of depositories in securities and connected/incidental matters.

Certificate of Commencement of Business To act as a depository, a certificate of commencement of business from the SEBI, under regulations framed by it, is necessary. Before granting a certificate, the SEBI must satisfy that the depository has set up a company that has adequate systems and safeguards to prevent the manipulation of records in the form of books/store in a computer or in such other forms and transactions.

Rights/Obligations of Depositories, Participants, Issuers and Beneficial Owners A depository should enter into an agreement with depository participant(s) [DPs] as its agent. Any person can avail of depository services connected with the recording of allotment or transfer of securities in the record of a depository, through a DP, by surrendering the certificate of security to the issuer company in the specified manner. The issuer would cancel the certificate and substitute, in its records, the name of the depository as a registered owner in respect of that security. The depository would record the name of the person surrendering the certificate as the beneficial owner.

On receipt of information from any DP, a depository would register the transfer of security in the name of the transferee. Similarly, a depository would register any transfer of security in favour of an asset reconstruction company along with/consequent upon transfer/assignment of financial assets of a bank/financial institution. On intimation from a DP, it would register issue of new shares in favour of a bank/financial institution/asset reconstruction company/their assignees by conversion of debt into shares pursuant to reconstruction of debts agreed between them. If a beneficial owner/transferee seeks to have the custody of such security, the depository would inform the issuer company. Persons subscribing to securities have the option either to receive the certificates or hold them with a depository. In the latter case, the company should inform the depository about the details of allotment and the depository should enter in its record the name(s) of the allottee(s) as the beneficial owners of that security. All securities held by the depository would be dematerialised and would be in fungible form. A depository would be deemed to be the registered owner for the purposes of transfer of ownership of a security on behalf of a beneficial owner, though he would not have any voting rights in respect of the securities held. The beneficial owner is entitled to all rights/benefits and subjected to all liabilities in respect of such securities. Every depository should maintain a register and an index of beneficial owners in the manner provided by the Companies Act.

A beneficial owner, with the prior approval of the depository, can create a pledge/hypothecation held in a depository that would make entries in its records accordingly. This entry would be evidence of a pledge/hypothetication.

The depository should furnish to the issuing company with information about the transfer of securities in the name of the beneficial owners at intervals and in a manner specified by its bye-laws. The issuer should make copies of the relevant records (with respect to the securities held by it) available to the depository.

A beneficial owner can opt out of a depository. Within 30 days of receipt of information to this effect from the depository, and on fulfilment of conditions and on the payment of fee specified by the SEBI regulations, the issuer would issue a certificate for the securities to the beneficial owner/transferee. Depositories would be treated as banks in terms of Section 2 of the Bankers Book Evidence Act, 1891. The depository would indemnify the beneficial owner(s) for any loss caused to him due to negligence of the depository/DP. It would have the right to recover the loss from the DP. Subject to the provisions of the Depositories Act, the rights/obligations of depositories/participants/ issuers and the eligibility criterion for the admission of securities into the depository would be specified by the SEBI regulations.

Enquiry and Inspection On being satisfied that it is necessary in public interest/in the interest of the investors, the SEBI can call for information from, or make an enquiry or inspection in relation to the affairs of, the issuer/beneficial owner/depository participant. It may also give appropriate directions to any depository/participant/person associated with the securities market/ investor **(i)** in the interest of investors or orderly development of the securities market or **(ii)** to prevent the affairs of any depository/participant being conducted in a manner detrimental to the interest of the investors or securities market. The power to issue directions includes power to direct any person who made profit/averted loss by indulging in any transaction/activity in contravention of the Depositories Act/regulations to disgorge an amount equivalent to the wrongful gain made/loss averted by the contravention. Any person aggrieved by an order of the SEBI may like to appeal to the SAT.

Penalty for failure **(a)** by a person to **(i)** furnish any information/document/book/ returns/ report to the SEBI within the specified time, **(ii)** file any return/furnish any information, books, other documents within the time specified by the regulations/bye-laws, **(iii)** maintain books of accounts/records; **(b)** by a depository participant, issuer/agent/any person registered with the SEBI as an intermediary to enter into an agreement under the SEBI Act/regulations/redress inventors' grievances/dematerialise or issue the security certificate on opting out of depository by the investors within the specified time or abetment in delaying the process of dematerialisation/rematerialisation/reconcile the records of dematerialised recurities, **(c)** by any depository/ participant/issuer/agent/any person (intermediary) to redress investors grievances, **(d)** delay in dematerialisation/issue of certificate of securities, **(e)** reconcile records, and **(f)** comply with directions issued by the SEBI is minimum ₹1 lakh but may extend to ₹1 lakh each day during which the failure continues subject to a maximum of ₹1 crore for each failure.. Penalty for contravention where no separate penalty has been provided would not be less than ₹1 lakh but may extend to ₹1 crore.

The SEBI would appoint an adjudicating officer to hold an enquiry for imposing any penalty. He would give the concerned person reasonable opportunity of being heard. He would have powers to summon/enforce attendance of any person acquainted with the facts/circumstances of the case to give evidence/produce relevant/useful documents. On being satisfied about the failure of compliance, he would impose the penalty. He will have due regards to the amount of **(i)** disproportionate gain/fair advantage, **(ii)** loss to the investors as a result of the default and the repetitive nature of the default. The SEBI may enhance the quantum of penalty if circumstances justify.

The concerned person may approach the SEBI for a settlement of the proceedings for the default. After taking into consideration the nature/gravity/impact of defaults, the SEBI may agree for settlement on payment of a sum by the defaulter determined by it or on similar other terms. The concerned person would be debarred from filing an appeal with the Securities Appellate Tribunal.

If the concerned person fails to pay the penalty any fee due to the SEBI, a recovery officer would recover the amount by one/more mode, namely, **(i)** attachment/sale of his movable/immovable property/bank accounts, **(ii)** arrest/detention in prison, **(iii)** appoint a receiver for the management of his movable/immovable properties. The recovery of the amount by him would have precedence over any other claim against the person concerned. All the sums realised by way of penalties would be credited to the Consolidated Fund of India.

Penalties Contravention/attempt to or abatement of contravention of the provisions of this Act/ any regulations/bye-laws is punishable with imprisonment for a term up to 10 years or with fine upto ₹25 crore, or with both. Failure by any person to pay penalty imposed by the adjudicating officer/comply with any of his directions/orders would be punishable with imprisonment of at least one month but may extend to 10 years or with fine upto ₹25 crore or both.

In case of an offence under the Depositories Act by a company, the company as well as every person who was in charge of/responsible for the conduct of business would be deemed guilty and liable for punishment.

Power of the SEBI To carry out the purposes of this Act, the SEBI can make regulations, in particular, to provide for **(i)** the form in which the record is to be maintained/certificate of commencement of business issued, **(ii)** the manner of surrendering a security certificate/ creating pledge, hypothecation by beneficial owners, **(iii)** conditions/fee payable for the issue of certificate of securities, **(iv)** rights/obligations of depositories/participants/issuers and **(v)** eligibility criteria for the admission of securities into the depository **(vi)** terms determined by the SEBI for settlement of civil/administrative proceedings and **(vii)** any other matter.

Powers of Depositories to Make Bye-laws With the prior approval of the SEBI, the depositories can make bye-laws consistent with the provisions of this (Depositories) Act/SEBI regulation, and in particular to provide for:

(a) The eligibility criteria for admission and removal of securities in depositories;
(b) The conditions subject to which the securities would be dealt with;
(c) The eligibility criteria for admission of any person as a depository participant;
(d) The manner and procedure for the dematerialisation of securities;
(e) The procedure for transactions within the depository;
(f) The manner in which securities would be dealt with or withdrawn from a depository;
(g) The procedure for ensuring safeguards to protect the interest of participants and beneficial owners;
(h) The conditions of admission into, and withdrawal from a participant, by a beneficial owner;
(i) The procedure for conveying information to the participants and beneficial owners on dividend declaration, shareholders meetings and other matters of interest to the beneficial owners;
(j) The manner of distribution of dividends, interest and monetary benefits received from the company among beneficial owners;
(k) The manner of creating pledge or hypothecation in respect of securities held with a depository;
(l) Inter se rights and obligations among the depository, issuer, participants and beneficial owners;
(m) The manner and the periodicity of furnishing information to the SEBI, issuer and other persons;
(n) The procedure for resolving disputes involving the depository, issuer, company or a beneficial owner;
(o) The procedure for proceeding against participants committing breach of regulations, provisions for the suspension and expulsion of participants from the depository and cancellation of agreements entered with the depository and
(p) Internal control standards including procedure for auditing, reviewing and monitoring.

Where the SEBI considers it expedient so to do, it may, by order in writing, direct a depository to make any bye-laws or to amend or revoke any bye-laws already made within such a period as it may specify in this behalf. If the depository fails or neglects to comply with such an order within the specified period, the SEBI may make the bye-laws or amend or revoke the bye-laws made either in the form specified in the order or with such modifications thereof as the it thinks fit.

SEBI Depositories and Participants Regulation

The main provisions of the SEBI regulation are as follows:

Registration of Depository Depositories must be registered with the SEBI. The application for the grant of certificate of registration, in the prescribed form, should be accompanied by an application fee of ₹5,00,000 payable by the sponsor and ₹15,000 payable by participant together with draft bye-laws of the proposed depository. The sponsors of depositories who act alone or in combination with others proposing to establish a depository and undertaking to perform the obligations under these regulations can be: a **(i)** public financial institution, **(ii)** bank, **(iii)** foreign bank operating in India with RBI's approval, **(iv)** recognised stock exchange, **(v)** body corporate engaged in financial services, at least 75 per cent of whose capital is held by institutions in categories **(i)** to **(iv)** jointly or severally, **(vi)** body corporate constituted/recognised in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Government and **(vii)** an institution engaged in financial services outside India and approved by the Government. The applicant should be a fit and proper person. For determining whether an applicant/depository and participant is a fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**.

Eligibility for Acquiring/Holding Shares Only a fit and proper person can directly/indirectly acquire/hold shares/voting rights of a depository. Acquisition of shares directly/indirectly individually or together with person(s) acting in concert resulting in his shareholding in excess of 2 per cent of the paid-up capital of the depository would require SEBI's approval within 15 days. The excess would have to be divested forthwith in case of non-approval by the SEBI. Person(s) holding more than 2 per cent of the equity capital should file a declaration within 15 days from the end of the financial year to the depository that he complies with the fit and proper person criteria. Any instrument directly/indirectly held/owned/controlled by any person entitling him/providing for entitlement to the voting rights or equity shares or any other rights over equity shares at any future date would also be included for determining his shareholding.

Conditions for Registration The certificate of registration of a depository would be subject to the following:

- Payment of a registration fee of ₹1,00,00,000 payable by depository and ₹2,00,000 payable by participant within 15 days;
- Compliance with the provisions of the Depositories Act/bye-laws/agreements/these regulations;
- Prohibition on carrying on any activity other than that of a depository, unless it is incidental to the depository;
- Compliance with the shareholding and governance structure requirements **(discussed later)**;

- At least 51 per cent of the equity capital of the depository should be held by the sponsor(s). No participant can hold more than 5 per cent. However, stock exchange-sponsor cannot hold more than 24 per cent;
- A DP can hold upto 5 per cent of the capital of the depository;
- No resident/non-resident person, other than a sponsor would at any time individually or together with persons acting in concert hold more than 5 per cent of the equity capital for a depository;
- Subject to limits prescribed by Government, the combined holdings of all non-resident persons in the equity capital of a depository could be upto a maximum of 49 per cent.
- A foreign portfolio investor **(i)** can acquire shares of a depository only through the secondary market and **(ii)** would have no representation on the Board of Directors of the depository;
- The depository should immediately inform the SEBI if any information previously submitted by the sponsor/depository is found to be false/misleading or if there is any change in such information;
- Redressal of grievances of participants/beneficial owners within, 30 days and keep the SEBI informed about the number and nature of redressals;
- Within one year of registration, apply for commencement of business;
- Amendment of bye-laws from time to time, as may be directed by the SEBI; and
- Any other condition as the SEBI may deem fit in the interest of the securities market.

The annual fee is payable by depository ₹50,00,000 and payable by participant ₹1,000. The annual charges payable by the depository are 2 per cent of annual custody charges collected by them from issuers.

Governance of Depositories The elements of the regulatory framework are: **(i)** governing board, disclosures and corporate governance, **(ii)** conditions of appointment of directors, **(iii)** appointment of managing director, **(iv)** code of conduct for directors and key management personnel, **(v)** compensation and tenure of key management personnel and **(vi)** segregation of regulatory departments.

Governing Board, Disclosures and Corporate Governance The governing board of a depository should include **(a) shareholder directors** (i.e. a director who represents the interest of shareholders and is elected/nominated by them), **(b) public interest director** (i.e. an independent director who represents the interests of investors in securities market and does not have direct/indirect association which is in conflict with his role) and **(c)** managing director. With the SEBI's prior approval, the governing board would elect the chairperson from amongst the public interest directors, whose member should not be less than that of the shareholders directors. The managing director would be an *ex-officio* director and not included in categories **(a)** and **(b)** above. An employee director would be deemed to in category **(a)**. Quorum would require at least one director in category **(b)**. The disclosure requirements/corporate governance norms applicable to listed companies would *mutatis mutandis* apply to a depository.

Conditions of Appointment of Directors While the public interest directors would be nominated by the SEBI for a three year/extend period subject to retirement and re-appointment, its prior approval would be necessary for appointment/re-appointment of shareholder directors. The public interest directors would be entitled only to sitting fee specified in the Companies Act. Upon completion of their one term, they may be re-nominated after a cooing-off period of one year/a period as SEBI deems fit in the interest of the securities market. Its decision would be final on question of conflict of interest with their role.

Appointment of Managing Director Prior approval of SEBI would be required for his appointment/renewal of appointment/termination of service. Subject to the SEBI guidelines, a depository would determine qualifications/manner and terms and conditions of appointment and other related procedural formalities. The tenure would be 3-5 years. He should not be **(a)** **(i)** shareholder/associate of a shareholder of depository/associate of depository, **(ii)** depository participant (DP)/his associate/agent shareholder of a depository participant/shareholder of an associated/agent of a DP, **(b)** hold any position concurrently in the subsidiary of a depository/any other associated entity. He can, however, be appointed the director of a subsidiary/its associate. With its prior approval, the governing board can remove/terminate his services for failure to give effect to the SEBI's directions/guidelines/orders or the rules/instructions/articles of association/bye-laws of depository. The SEBI may *suo moto* remove/terminate his appointment if deemed fit in the interest of the securities market.

Code of Conduct for Directors/Key Management Personnel The directors of a depository should abide by the code of conduct specified below.

(i) Meetings and Minutes A director of the depository should **(a)** not participate in discussions on any subject-matter in which in any pecuniary or otherwise, conflict of interest exists or arises and it should be disclosed and recorded in the minutes of the meeting; **(b)** not encourage the circulation of agenda papers during the meeting unless circumstances so require; **(c)** offer their comments on the draft minutes and ensure that they are incorporated in the final minutes; **(d)** insist on the minutes of the previous meeting being placed for approval in the subsequent meeting; **(e)** endeavour to have the date of next meeting fixed at each governing board meeting in consultation with other broad members; **(f)** endeavour that in case of all the items of the agenda of a meeting were not covered for want of time, the next meeting is held within 15 days for considering the remaining items.

(ii) Code of Conduct for the Public Interest Directors In addition to the conditions stated above, public interest directors should **(a)** endeavour to attend all the governing board meetings and would be liable to vacate office if they remain absent for three consecutive meetings or do not attend 75 per cent of the total meetings in a calendar year, **(b)** meet separately, at least once in six months, to exchange views on crucial issues.

(iii) Strategic Planning Every director of the depository should: **(a)** participate in the formulation and execution of strategies in the best interest of the depository and contribute towards pro-active decision-making at the governing board level; **(b)** give benefits of their experience and expertise to the depository and provide assistance in strategic planning and execution of decisions.

(iv) Regulatory Compliances They should: endeavour **(a)** to ensure that the depository abides by all the provisions of the SEBI/Depositories Act/rules/regulations/circulars/ directions; **(b)** compliance at all levels so that the regulatory system does not suffer any breaches; **(c)** to ensure that the depository takes commensurate steps to honour the time limit prescribed by SEBI for corrective action; and **(d)** not support any decision in the meeting of the governing body which may adversely affect the interest of investors and report forthwith any such decision to the SEBI.

(v) General Responsibility They should **(a)** place priority for redressing investors grievances; **(b)** endeavour to analyse and administer the depository issues with professional competence,

fairness, impartiality, efficiency and effectiveness; **(c)** submit the necessary disclosures/statement of holdings/dealings in securities as required by the depository as per their bye-laws/articles of association; **(d)** unless otherwise required by law, maintain confidentiality and not divulge/ disclose any information obtained in the discharge of their duties and no such information should be used for personal gains; **(e)** maintain the highest standards of personal integrity, truthfulness, honesty and fortitude in discharge of their duties in order to inspire public confidence and not engage in acts discreditable to their responsibilities; **(f)** perform their duties in an independent and objective manner and avoid activities that may impair, or may appear to impair, their independence or objectivity or official duties; **(g)** perform their duties with a positive attitude and constructively support open communication, creativity, dedication and compassion; and **(h)** not engage in any act involving moral turpitude, dishonesty, fraud, deceit, or misrepresentation or any other act prejudicial to the administration of the depository.

Similarly, every director and **key management personnel** (i.e. a person serving as head of any department or in such senior executive position that stands higher in hierarchy to the head(s) of department(s) in, or any other position as declared by the depository) should **(i)** abide by the code of conduct specified below and **(ii)** satisfy the fit and proper person criteria.

The code of ethics for directors and key management personnel is aimed at improving the professional and ethical standards in the functioning of depository thereby creating better investor confidence in the integrity of the market.

(i) Objectives and Underlying Principles The code of conduct for directors and key management personnel seeks to establish a minimum level of business/professional ethics to be followed by them towards establishing a fair and transparent marketplace. It is based on the following fundamental principles: **(a)** fairness and transparency in dealing with matters relating to the depository and the investors, **(b)** compliance with all laws/rules/regulations laid down by regulatory agencies/ depositories, **(c)** exercising due diligence in the performance of duties, and **(d)** avoidance of conflict of interest between their self interest and interests of depository and investors.

(ii) Ethics Committee For overseeing implementation of the code, an ethics committee should be constituted by every depository under the governing board.

(iii) General Standards Directors and key management personnel should endeavour to promote greater awareness and understanding of ethical responsibilities and in the conduct of their business observe high standards of commercial honour and just and equitable principles of trade. Their conduct in business life should be exemplary. They should not use their position to give/get favours to/from the executive or administrative staff of the depository, suppliers of the depository, or any issuer company admitted to the depository, commit any act which will put the reputation of the depository in jeopardy. They should also comply with all rules and regulations applicable to the securities market.

(iv) Disclosure of Dealings in Securities by Key Management Personnel of the Depository They should disclose on a periodic (say, monthly) basis as determined by the depository, all their direct/indirect dealings in securities to the governing board/ethics/committee/compliance officer. The dealings in securities (exclusive of mutual fund units) should also be subject to trading restrictions for securities about which may have non-public price sensitive information. All transactions must be of an investment and not speculative in nature. All securities purchases must be held for a minimum period of 60 days before they are sold. However, in specific/exceptional circumstances, sale can be effected anytime by obtaining pre-clearance from the compliance office to waive this condition after recording in writing his satisfaction in this regard.

(v) Disclosure of Dealings in Securities by Directors of the Depository All transactions in securities by the directors and their family should be disclosed to the governing board of the depository. They should also disclose the trading conducted by firms/corporate entities in which they hold 20 per cent or more beneficial/a controlling interest to the ethics committee. However, Government nominee or nominees of statutory financial institutions governed by their own codes would be exempt from this requirement.

(vi) Avoidance of Conflict of Interest No director/member of any committee should participate in any decision-making/adjudication in respect of any person/matter in which he is directly or indirectly concerned or interested. Whether there is any conflict of interest or not, should be decided by the governing board.

(vii) Disclosure of Beneficial Interest All directors and key management personnel should disclose to the governing board, upon assuming office and during their tenure in office, the following: **(a)** any fiduciary relationship/directorship/partnership of self and family members in any depository participant or registrar and transfer agent; **(b)** shareholding in excess of 5 per cent or in any listed company or in other entities related to the securities market; and **(c)** any other business interests.

(viii) Role of the Chairman and Directors in the Day-to-Day Functioning of the Depository They should not interfere in the day-to-day functioning and should limit their role to decision-making on policy issues and to issues as the governing board may decide and abstain from influencing the employees in conducting their day-to-day activities. They should also not be directly involved in the function of appointment and promotion of employees unless specifically so decided by the governing board.

(ix) Access to Information The directors should call for information only as part of specific committees or as may be authorised by the governing. There should also be **(i)** prescribed channels through which information should move and **(ii)** audit trail of the same. Any retrieval of confidential documents/information should be properly recorded. All such information, especially non-public and price sensitive, should be kept confidential and not be used for any personal consideration/gain. Any information relating to the business/operations of the depository, which may come to their knowledge during performance of their duties should be held in strict confidence, not divulged to any third party and not used in an manner except for the performance of their duties.

(x) Misuse of Position Directors/committee members should not use their position to obtain business or any pecuniary benefit in the organisation for themselves or family members.

(xi) Ethics Committee to Lay Down Procedures The ethics committee should lay down procedures for the implementation and prescribe reporting formats for the disclosures required under the code. The compliance officer should execute the requirements laid down by the ethics committee.

While the objective of this code is to enhance the level of market integrity and investor confidence, it is emphasised that a written code of ethics may not completely guarantee adherence to high ethical standards. This can be accomplished only if directors and key management personnel of the depository commit themselves to the task of enhancing the fairness and integrity of the system in letter and spirit.

The SEBI, *suo moto,* or upon a reference from the depository may take appropriate action including removal/termination of the appointment of a director for failure to abide by the SEBI regulations/code of conduct/ethics or in case of a conflict of interest.

Compensation/Tenure of Key Management Personnel The depositories should constitute a compensation committee comprising a majority of public interest directors including the chairman to determine their compensation in terms of policy in accordance with the SEBI norms. The compensation payable to the managing director as well as any change in the terms/conditions would be approved by the SEBI. The compensation committee would decide the fixed tenure of the key management personnel and their compensation should be disclosed in the report of the depository under Section 217 of the Companies Act.

Segregation of the Regulatory Department The depository should segregate its **regulatory department** (i.e. department entrusted with regulatory powers/duties including a SEBI-specified department) from other departments in the manner of specified below.

In order to ensure the segregation of regulatory departments, every depository should adopt a "Chinese wall" policy which separates the **regulatory departments** (i.e. departments maintained by law/entrusted with regulatory powers/duties including departments performing the following functions: risk management; surveillance; depository participant registration; issuer/securities admission; compliance; inspection; enforcement; arbitration, investor protection/services) from the other departments. The employees in the regulatory departments should not communicate any information concerning regulatory activity to any one in other departments. They may be physically segregated from the employees in other departments including with respect to access controls. In exceptional circumstances, employees from other departments may be given confidential information on "need to know" basis, under intimation to the compliance officer.

Certificate of Commencement of Business Within a year of registration with the SEBI, the depository is required to apply for a certificate of commencement of business. While granting the certificate, the SEBI would consider all matters relevant to the efficient and orderly functioning of the depository and in particular the following, namely, whether:

(a) The depository has a net worth of not less than ₹100 crore;
(b) The bye-laws of the depository have been approved by the SEBI;
(c) The automatic data processing systems of the depository have been protected against unauthorised access, alteration, destruction, disclosure or dissemination of records and data;
(d) The network, through which means of continuous electronic communication are established between the depository, participants, issuers and issuers' agents is secure against any unauthorised entry or access;
(e) The depository has established standard transmission and encryption formats for the electronic communication of data between the depository, participants, issuers and issuers' agents;
(f) The physical or electronic access to the premises, facilities, automatic data processing systems, data storage sites and facilities including back-up sites and facilities and the electronic data communication network connecting the depository, participants, issuers and issuers' agents is controlled, monitored and recorded;
(g) The depository has a detailed operations manual explaining all aspects of its functioning, including the interface and method of transmission of information between the depository, issuers, issuers' agents, participants and beneficial owners;
(h) The depository has established adequate procedures and facilities to ensure that its records are protected against loss or destruction and arrangements have been made for maintaining back-up facilities at a location different from that of the depository;

(i) It has made adequate arrangements, including insurance, for indemnifying the beneficial owners for any loss that may be caused to them by the wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participant and

(j) The grant of certificate of commencement of business is in the interest of investors in the securities market.

Before granting the certificate, the SEBI would make a physical verification of the infrastructure facilities and systems established by the depository.

Networth Certificate Every depository should submit an audited **networth** [i.e. paid-up capital **plus** free reserves (excluding statutory/benefits funds and reserves created out of revaluation) **minus** related/unrelated investments in business, aggregate value of accumulated losses and deferred expenditure (including miscellaneous expenses) not written off] certificate from the statutory auditors on a yearly basis by September 30 of every year for the preceding financial year. It should also within one month of its annual general meeting furnish to the SEBI a copy of its audited balance sheet/profit and loss account for the preceding financial year.

Code of Conduct The depository holding a certificate of commencement of business should always abide by the code of conduct specified below:

A depository should always **(i)** abide by the provisions of the SEBI/Depositories Act/ rules/regulations/circulars/guidelines and any other directions issued by the SEBI; **(ii)** take appropriate measures towards investor protection and education of investors; **(iii)** treat all its applicants/participants in a fair and transparent manner; **(iv)** promptly inform the SEBI of violations of the provisions of the SEBI/Depositories Act/rules/regulations/circulars/ guidelines or any other directions by any of its participants or issuer's agent; **(v)** take a pro-active and responsible attitude towards safeguarding the interests of investors, integrity of the depository system and the securities market; **(vi)** make endeavours for introduction of best business practices amongst self and its participants; **(vii)** act in utmost good faith and shall avoid conflict of interest in the conduct of its functions; **(viii)** not indulge in unfair competition, which is likely to harm the interests of other depository, participants or investors or is likely to place them in a disadvantageous position while competing for or executing any assignment; **(ix)** be responsible for the acts or omissions of its employees in respect of the conduct of its business; and **(x)** monitor the compliance of the rules and regulations by the participants and further ensure that their conduct is in a manner that will safeguard the interest of investors and the securities market.

Registration of Participants An application for initial registration as a participant should be made to the SEBI in the prescribed form together with a fee of ₹5,000, through the depository. The depository should forward the application to the SEBI within 30 days along with its recommendations and certifying that the participant-applicant complies with the eligibility criteria, including adequate infrastructure, as provided for in the regulations and the bye-laws of the depository.

Consideration of Application for Initial Registration All matters which are relevant to or related to the efficient and orderly functioning of a participant would be taken into account by the SEBI for granting registration. In particular, the SEBI insist that the applicant:

1. Must belong to one of the following categories:

(i) a public financial institution

(ii) a bank
(iii) a foreign bank
(iv) a State Financial Corporation (SFC)
(v) a financial services institution promoted by any of the institutions listed in **(i)** to **(iv)**, jointly or separately
(vi) a custodian of securities registered with the SEBI
(vii) a clearing corporation/house of a stock exchange
(viii) a registered stock broker who has a minimum net worth of ₹50 lakh and the aggregate value of the portfolio of securities of the beneficial owners held in a dematerialised form in a depository through him should not be more than 100 times the networth. However, where the stock broker has a minimum networth of ₹10 crore, the limits on the aggregate value of the portfolio of securities of the beneficial owners held in a dematerialised form in a depository through him would not be applicable. Moreover, if he seeks to act as a participant in more than one depository, he should comply with these stipulations separately for each depository,
(ix) a non-banking finance company (NBFC) with a net worth of at least ₹50 lakh can act as a participant only on behalf of itself. It may act on behalf of others only if its net worth is ₹50 crore in addition to the net worth specified by any other authority.
(x) a registrar to an issue or share transfer agent who has a minimum networth of ₹10 crore.

2. Is eligible to be admitted as a participant of the depository through which it has applied;
3. Has adequate infrastructure, systems, safeguards and trained staff to carry on as a participant;
4. Is registered in the interest of the investors and the securities market and
5. Is a fit and proper person.
6. Grant of certificate of initial registration is in the interest of investors in the securities market.

Conditions The initial registration of a participant with the SEBI is subject to the undermentioned conditions. The participant should pay a registration fee of ₹1,00,000 within 15 days and comply with the provisions of the Depositories Act, bye-laws, agreements and regulations. The depository, through whom the registration is obtained, holds a certificate of commencement of business from the SEBI. The participant should obtain prior approval of the SEBI for continuing to act after change in its control. He should forthwith inform the SEBI if any information already submitted to it is found to be false/misleading in any material respect or if there is any change in such information. The grievances of beneficial owners should be redeemed within 30 days and the depository kept informed about the number/nature of redressals of complaints. The participant has to pay the SEBI an annual fee of ₹1,000. The registration of a depository participant is valid for five years. It can be renewed on payment of a fee of ₹l0,00,000, for a period of five years.

Certificate of Permanent Registration Three months before the expiry of the period of initial registration, the participant should apply for permanent registration through the concerned depository together with the specified fee and accompanied by details of changes that have taken place in the information submitted to the SEBI while seeking initial registration and a declaration that no other changes have taken place. On being satisfied about the eligibility of the applicant, the SEBI would grant permanent registration on payment of the requisite fee within 15 days. The participant would also pay the requisite annual fee.

Code of Conduct for Participants

The participant holding a certificate of initial/permanent registration should abide by the code of conduct specified below: A participant should:

1. Make all efforts to protect the interests of investors.
2. Always endeavour to **(a)** render the best possible advice to the clients having regard to the client needs and the environments and his own professional skills; **(b)** ensure that all professional dealings are affected in a prompt, effective and efficient manner; **(c)** inquiries from investors are adequately dealt with; **(d)** grievances of investors are redressed without any delay.
3. Maintain high standards of integrity in all its dealings with its clients and other intermediaries, in the conduct of its business.
4. Be prompt and diligent in opening of a beneficial owner account, dispatch of the dematerialisation request form, rematerialisation request form and execution of debit instruction slip and in all other activities undertaken by him on behalf of the beneficial owners.
5. Endeavour to resolve all the complaints against it or in respect of the activities carried out by it as quickly as possible, and not later than one month of receipt.
6. Not increase charges/fees for the services rendered without proper advance notice to the beneficial owners.
7. Not indulge in any unfair competition, which is likely to harm the interests of other participants or investors or is likely to place such other participants in a disadvantageous position while competing for or executing any assignment.
8. Not make any exaggerated statement, whether oral or written; to the clients either about its qualifications or capability to render certain services or about its achievements in regards to services rendered to other clients.
9. Not divulge to other clients, press or any other person any information about its clients which has come to its knowledge except with the approval/authorisation of the clients or when it is required to disclose the information under the requirements of any Act, rules or regulations.
10. Cooperate with the SEBI as and when required.
11. Maintain the required level of knowledge and competency and abide by the provisions of the SEBI Act/rules/regulations and circulars and directions issued by the SEBI. He should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.
12. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.
13. Not neglect or fail or refuse to submit to the SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.
14. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
15. Maintain proper inward system for all types of mail received in all forms.
16. Follow the maker-checker concept in all of its activities to ensure the accuracy of the data and as a mechanism to check unauthorised transaction.
17. Take adequate and necessary steps to ensure that continuity in data and record keeping is maintained and that the data or records are not lost or destroyed. It should also ensure that for electronic records and data, up-to-date back up is always available with it.

18. Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
19. Ensure that it has satisfactory internal control procedures in place as well as adequate financial and operational capabilities which can be reasonably expected to take care of any losses arising due to theft, fraud and other dishonest acts, professional misconduct or omissions.
20. Be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.
21. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
22. Ensure that good corporate policies and corporate governance are in place.

A participant may act as a participant of another depository without a separate certificate of registration. The other depository would grant approval to the applicant-participant subject to the payment of the specified registration fee within 15 days of the intimation from the depository who would also inform the SEBI. The participant would pay the specified annual fee separately for each depository. To keep the registration in force, the concerned participant would pay the specified registration fee for every five years from the sixth year of the date of grant of approval by the depository.

Rights/Obligations of Depositories/Participants/Issuers/Surrender of Certificate of Security and Creation of Pledge/ Hypothecation The depositories, participants, issuers and their agents have, in addition to the rights and obligations laid down in the Depositories Act and the bye-laws, all the rights and obligations arising from the agreements entered into by them.

Depositories They should state, in the bye-laws, the specific securities eligible for being held in dematerialised form in the depository, namely: **(a)** shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in/or of any company, **(b)** units of mutual funds, rights under collective investment schemes and venture capital funds, commercial papers, certificates of deposit, securitised debt, money market instruments, Government securities and unlisted securities, and **(c)** any other security specified by the SEBI from time to time.

The issuers should enter into an agreement with the depository to enable the investor to dematerialise the securities except where the depository itself is an issuer of securities. Where the issuer has appointed a SEBI approved registrar to the issue and share transfer agent (RISTA), the depository would enter into a tripartite agreement with the issuer, the RISTA, with respect to the securities to be declared by the depository as eligible to be held in dematerialised form.

The depository should have systems/procedures to coordinate and reconcile the records of ownership of securities with the issuer/its agent and the participants on a daily basis. It should also maintain means of continuous electronic communication with all its participants/issuers or their agents, clearing houses/corporations of stock exchanges and with other depositories. Moreover, a depository should:

- Satisfy the SEBI that it has a mechanism in place to ensure that the interests of persons buying and selling securities held in the depository are adequately protected;
- Allow any participant to withdraw/transfer its account in accordance with the stipulations in the bye- laws of the depository;
- Have an adequate mechanism for reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards and cause their inspection annually and forward a copy of the same to the SEBI;

- Should have adequate business continuity plan for data and electronic records to prevent, prepare for, and recover from disaster.
- Devise/maintain a wind-down plan in accordance with the SEBI specified guidelines. The **window-down plan** means a process/plan of action for transfer of beneficial owner accounts/other operational powers of the depository to an alternative institution to take over its operations in scenarios such as erosion of its net worth, insolvency/bankruptcy/ inability to provide critical depository operations/services.
- Take adequate measures, including insurance, to protect the interest of the beneficial owners against risks likely to be incurred on account of its activities as a depository;
- Ensure, where records are stored electronically by it, that the integrity of the automatic data processing system is always maintained, and all precautionary measures to ensure that the records are not lost/destroyed/tampered with and, in the event of loss/ destruction, ensure that sufficient back-up of records is available at all times at a different place;
- Maintain the undermentioned records/documents: **(a)** records of securities dematerialised/ rematerialised, **(b)** name of transferors/transferees and the date of transfer of securities, **(c)** a register and index of beneficial owners; details of their holdings at the end of each month, **(d)** records of instructions received from and sent to participants, issuers and their agents and beneficial owners, **(e)** records of approval, notice, entry and cancellation or pledge/hypothecation, **(f)** details of participants and securities declared to be eligible for dematerialisation in the depository and **(g)** such other records as may be specified by the SEBI from time to time to carry on activities as a depository. These records must be maintained for at least five years. The depository must inform the SEBI of the place where the records/documents are maintained;
- Extend such cooperation to beneficial owners/issuers and their agents/custodians/other depositories/clearing organisations as is necessary for effective, prompt and accurate clearance/ settlement of securities transactions and conduct of business;
- Not assign/delegate to any other person its functions as a depository without the SEBI's prior approval.
- Enter with necessary agreements for sharing information regarding generation of a consolidated statement for the use of a beneficial owner is respect of all demat assets held by him.

Participants Every participant should enter into an agreement with a beneficial owner before acting as a participant on his behalf in a manner specified by the bye-laws of the depository.

Separate accounts should be opened by the participants for each beneficial owner and his securities segregated and not mixed up with those of others, including participants. The transfer of securities to or from a beneficial owners' account should be registered by the participants only on instructions from him, and the same should be confirmed in a manner specified by the bye-laws of the depository. Every entry in his account should be supported by electronic instructions or any other mode of instruction from him in accordance with the agreement with him. Every participant should:

(i) Provide a statement of accounts in a form/manner and at such time, as per the agreement with the beneficial owner;
(ii) Allow him to withdraw/transfer from his account as per agreement with him;
(iii) Maintain continuous electronic means of communication with each depository in which it is a participant;

(iv) Have an adequate mechanism for reviewing, monitoring and evaluating its internal accounting controls and systems;

(v) Reconcile his records with every depository in which it is a participant on a daily basis;

(vi) Submit periodic returns to the SEBI and to every depository in a format specified by them;

(vii) Maintain the following records/documents:

- Record of transactions with depositories and beneficial owners,
- Details of securities dematerialised/rematerialised on behalf of beneficial owners,
- Records of instructions received from and statements of accounts provided to them,
- Records of approvals, notice, entry and cancellation of pledge.

All these records should be made available to the depository for inspection and persons authorised by the depository should be allowed entry in its premises for such inspection during normal office hours. These records should be preserved for five years and the SEBI should be intimated about the place where they are being maintained.

(viii) Ensure that the **(a)** integrity of the data processing system is always maintained and **(b)** records are not lost, destroyed or tampered with, and in the event of loss/destruction sufficient back-up of record is available at a different place and

(ix) Not assign or delegate its functions as a participant to any other person without prior approval of the depository.

Issuers All issuers whose securities have been declared as eligible to be held in a dematerialised form should enter into an agreement with a depository. However, no such agreement would be required where the issuer of securities is **(i)** the depository itself or **(ii)** the Central/State Government.

All matters relating to transfer of securities; maintenance of records of holders of securities, handling of physical securities and establishing connectivity with the depositories should be handled and maintained at a single point, that is, either in-house by the issuer or by SEBI-registered share transfer agent.

Every issuer/agent/any person registered as an intermediary under the SEBI Act should redress the grievances of the beneficial owners within 30 days of the date of receipt of the complaint and keep the depository informed about the number and nature of grievances redressed by it/pending before it.

Every depository should establish/maintain an investor protection fund **(fund)** for the protection of interest of beneficial owners but it cannot be used to indemnify them for any loss caused due to the negligence of the depository/participant. Five per cent profits of the depository every year should be credited to the fund. The contribution and utilisation of the fund would have to conform to the SEBI norms.

The beneficial owners have to inform the details of the security certificates to be dematerialised and surrender the same to the participants, either directly or through the custodians of the securities. On receipt of this information, the participant forwards the details to the depository along with a confirmation of the agreement with the beneficial owner. The participant maintains records indicating the names of beneficial owners of securities surrendered, number of securities and details of security certificates received. The participants should within 7 days of the receipt of the certificate of security furnish to the issuer details of the security together with the certificate of security.

Within 15 days of the receipt of the certificate from the participant, the issuer should **(i)** confirm to the depository the listing of the securities on the stock exchange(s) where the securities issued earlier are listed, **(ii)** after due verification immediately mutilate and cancel the certificate,

(iii) substitute in its record the name of the depository as the registered owner and **(iv)** send a certificate to this effect to the depository and the stock exchange(s) where the security is listed. In the case of unlisted companies, the condition of listing on all the stock exchanges where earlier issued securities are listed would not be applicable. The depository would immediately enter in its records, the names of the beneficial owners as well as the participants and intimate the participants accordingly. The issuer should maintain a record of Certificates of securities which have been dematerialised.

The issuer or his agent should reconcile the records of dematerialised securities with all the securities issued by it on a daily basis; and where the Government is issuer of the depository, it should, on a daily basis, reconcile the records of the dematerialised securities. Every issuer should submit audit report on a quarterly basis to the concerned stock exchange by a charactered accountant/company secretary for reconciliation of **(i)** the total issued capital, **(ii)** listed capital, **(iii)** capital held by the depositories demat form, **(iv)** details of change in share capital during the quarter and **(v)** the in-principle approval from all the stock exchange(s) where it is listed in respect of such further issued capital. The audit report should also give the updated status of the register of members of the issuer confirming that the securities have been dematerialised within 21 days from the date of request. Where demat has not been effected within the stipulated period, the reasons for delay should be disclosed. The issuer should immediately bring to the notice of the depositories/stock exchange(s) any difference observed in its issued, listed and capital held by depositories in demat form.

Every issuer/its agent should **(i)** establish means of continuous electronic communication with the depository, and **(ii)** give information regarding dematerialised securities-book closures, record dates, dates for the payment of interest/dividend, for annual general/other meetings, redemption of debentures and the conversion of debentures/warrants-to the depository at the time/in the manner specified by the latter in its bye-laws/agreement.

Creating Pledge/Hypothecation A beneficial owner intending to create a pledge/hypothecation on a security should apply to the depository through the participant who would make a note in its records of the notice of pledge/hypothecation and forward the application to the depository. The depository would create and record the pledge/hypothecation within 15 days and intimate the participants of the pledgor (hypothecator) and the pledge (hypothecatee) who, in turn inform them of the entry of creation of pledge/hypothecation. If the pledge/hypothecation is not created, the depository would intimate the reasons to the respective participants. The cancellation of pledge/hypothecation by the depository on request from the pledgor/pledgee (hypothecator/ hypothecatee) through participants would require the prior approval of the latter. Subject to the provisions of the pledge/hypothecation document, the pledgee/hypothecatee may invoke the pledge/hypothecation and the depository would register him as the beneficial owner and inform the respective participants accordingly who would in turn would make the necessary changes in their records and inform the concerned parties. A security in respect of which a notice/entry of pledge/ hypothecation is in force can be transferred by a participant only with the concurrence of the pledgee/hypothecatee.

Investment Advice A depository/participant or any of his employees can render directly/indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, only after disclosing his interest, including long/short position, in the security at the time of rendering the advice. The employee should also disclose the interest of his dependent family members and the employer.

Appointment of Compliance Officer Every depository/participant should appoint a compliance officer who would be responsible for monitoring the compliance with the SEBI Act/rules and regulations/notifications/guidelines/instructions and so on issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

A depository should ensure equal/unrestricted/transparent/fair access to all persons without any bias towards its associates/related entities.

Listing of Securities With the SEBI's approval, a depository may seek listing of its securities on a recognised stock exchange after completing three years of continuous operations immediately preceding the date of application. It should also be in compliance with the SEBI regulations particularly those relating to ownership and governance. However, a depository associate should not list securities on a stock exchange that is sponsor/associate of the depository.

Inspection The SEBI can undertake the inspection of books of accounts/records/documents and infrastructure/systems/ procedures or to investigate the affairs of a depository/participant/ beneficial owner/issuer or its agent for any of the following purposes:

- To ensure maintenance of books of accounts by them as specified by these regulations;
- To look into complaints from them/any other person;
- To ascertain compliance, by them, with the provisions of the SEBI Act, Depositories Act, bye-laws, agreements and these regulations;
- To ascertain the adequacy of the system, procedures and safeguards followed by them and
- To suo moto ensure the conduct of their affairs in a manner which are in the interest of the investors/securities market.

On the basis of the findings of the inspection/investigation report, the SEBI may call upon them to take such measures as it deems fit in the interest of the securities market and for due compliance with the provisions' of the SEBI/Depositories Act, regulations, bye-laws and agreements.

Action in Case of Default A depository/participant who **(i)** contravenes any of the provisions of the SEBI/Depositories Act, bye-laws, agreements and these regulations, **(ii)** fails to furnish information relating to activity as required under these regulations, **(iii)** does not furnish/furnish false/ misleading information, **(iv)** does not cooperate in any inspection/investigation/inquiry by the SEBI and **(v)** fails to comply with the SEBI directions and pay the annual fee would be dealt with in the manner specified by the **SEBI Intermediaries Regulation**.

If an issuer/agent **(a)** contravens provision(s) of the Depositories Act/bye-laws/agreements/ Depositories and Participants Regulations (DPRs)/directions, **(b)** fails to furnish information relating to its activities under the DPRs **(c)** does not furnish information called for by the SEBI relating to the securities held in a depository/furnishes false or misleading information in any material particular, **(d)** does not cooperate in any inspection/investigation/enquiry by the SEBI, **(e)** fails to comply with any SEBI direction(s) under the Depositories Act, the SEBI may, in addition to action under the SEBI Act, taken any action under the Depositories Act.

The depository should conduct inspection of the records of the issuers/agents to ensure that the records of the dematerialised securities are reconciled with all the securities issued by the issuer and submit report to the SEBI on failure in the reconciliation of records.

Miscellaneous ***Power to Call for Information*** SEBI may from time to time call for any information/documents/records from **(i)** the depository/its governing board or any shareholder/ sponsor and **(ii)** depository participant.

Directions In the interest of public/trade/investors/securities market, the SEBI may issue directions as it deems fit including all/any of the following: **(i)** directing **(a)** a person holding equity shares/ rights over equity shares in a depository in contravention of the applicable regulations to divest his holdings in the specified manner, **(b)** transfer of any proceeds/securities to the investor protection fund of the depository; **(ii)** debarring a depository/its shareholder, an associate/agent of shareholder, or any transferee of shares, or sponsors/directors/key personnel management of the depository from accessing the securities market and/or dealing in securities for a specified period.

SHORT SELLING AND SECURITIES LENDING AND BORROWING SCHEME, 2008

Short sellers provide liquidity to genuine investors.

Short sellers provide liquidity to genuine investors. In a falling market, the purchases of short sellers, to cover their sales, lead to recovery in prices. In a rising market, short sales can arrest further rise. In order to provide a mechanism for borrowing of securities to enable settlement of securities short, the SEBI has put in place a full-fledged securities lending and borrowing (SLB) scheme (2008) for all market participants in the Indian securities market under the overall framework of its Securities Lending Scheme 1997. The main elements of the SEBI framework relating to the SLB scheme, namely, broad framework for short selling, broad framework for securities lending and borrowing and the securities lending scheme 1997 are discussed in this Section.

Broad Framework for Short Selling

The main elements of the framework for short selling are as follows.

1. "Short selling" should be defined as selling a stock which the seller does not own at the time of trade.
2. All classes of investors, namely, retail and institutional investors, should be permitted to short sell.
3. Naked short selling would not be permitted in the Indian securities market and accordingly, all investors would be required to mandatorily honour their obligation of delivering the securities at the time of settlement.
4. No institutional investor would be allowed to do day trading, that is, square-off their transactions intra-day. In other words, all transactions would be grossed for institutional investors at the custodians', level and the institution would be required to fulfil their obligation on a gross basis. The custodians, however, would continue to settle their deliveries on a net basis with the stock exchanges.
5. The stock exchanges should frame necessary uniform deterrent provisions and take appropriate action against the brokers for failure to deliver securities at the time of settlement which should act as a sufficient deterrent against failure to deliver.
6. A scheme for Securities Lending and Borrowing (SLB) should be put in place to provide the necessary impetus to short sell. The introduction of a full-fledged securities lending and borrowing scheme should be simultaneous with the introduction of short selling by institutional investors.

7. The securities traded in F&O segment should be eligible for short selling. The SEBI may review the list of stocks that are eligible for short selling transactions from time to time.
8. The institutional investors should disclose upfront at the time of placement of order whether the transaction is a short sale. However, retail investors would be permitted to make a similar disclosure by the end of the trading hours on the transaction day.
9. The brokers should be mandated to collect the details on scrip-wise short sell positions, collate the data and upload it to the stock exchanges before the commencement of trading on the following trading day. The stock exchanges should then consolidate such information and disseminate the same on their websites for the information of the public on a weekly basis. The frequency of such disclosures may be reviewed from time to time with the approval of the SEBI.

Broad Framework for Securities Lending and Borrowing

The main elements of the framework are as follows.

1. The stock exchange should put in place, a full-fledged securities lending and borrowing (SLB) scheme, within the overall framework of "Securities Lending Scheme, 1997" (**SLS)**, that is open for all market participants in the Indian securities market.
2. To begin with, the SLB should be operated through the Clearing Corporation/ House of stock exchanges having nation-wide terminals who will be registered as Approved Intermediaries (AIs) under the SLS, 1997.
3. The SLB should take place on an automated, screen based, order-matching platform which will be provided by the AIs. This platform should be independent of the other trading platforms.
4. To begin with, the securities traded in F&O segment should be eligible for lending and borrowing under the scheme.
5. All categories of investors including retail, institutional, and so on will be permitted to borrow and lend securities. The borrowers and lenders should access the platform for lending/borrowing set up by the AIs through the clearing members (CMs) (including banks and custodians) who are authorised by the AIs in this regard.
6. The AIs, CMs and the clients should enter into an agreement (which may have one or more parts) specifying the rights, responsibilities and obligations of the parties to the agreement. The agreement should include the basic conditions for lending and borrowing of securities as prescribed unde the SLS. In addition to that, AIs may also include suitable conditions in the agreement to have proper execution, risk management and settlement of lending and borrowing transactions with the clearing member and the client. Given the nature of the client base, while the major responsibility of ensuring compliance with "**Know Your Client**" (KYC) norms in respect of the clients rests with the CMs, the exact role of AIs/CMs *vis-à-vis* the clients in this regard need to be elaborated in the aforesaid agreement. In this regard, there would be one master agreement with two individual parts to the same. The first part of the agreement would be between the AIs and the CMs and the second part would be between the CMs and the clients. There would be adequate cross referencing between the two parts of the agreement so that all the concerned parties, namely, the AIs/CMs and the clients agree completely and are aware of the provisions governing the SLB transactions between them. However, there should be o direct agreement between the lender and the borrower. The CM will attach a certified copy of the first part of the

agreement signed with the AI in the second part of the agreement signed with each client. The model agreements in this regard would be devised by the stock exchanges.

7. The AIs should allot a unique ID to each client which should be mapped to the Permanent Account Number (PAN) of the respective clients. They should put in place appropriate systemic safeguards to ensure that a client is not able to obtain multiple client IDs.

8. The tenure of lending/borrowing should be fixed as standardised contracts. To start with, contracts with tenure of 30 trading days may be introduced. It may be 12 months now.

9. The SLB tenure of 30 days will result in the need for appropriate adjustment for corporate actions. These may be treated as follows:

   (a) The dividend amount should be worked out and recovered from the borrower on the book closure/record date and passed on to the lender.

   (b) In regard to stock split, the position of the borrower should be proportionately adjusted so that the lender receives the revised quantity of shares.

   (c) Other corporate actions such as bonus/merger/amalgamation/open offer and so on: The transactions should be foreclosed from the day prior to the *ex-date*. The lending fee should be recovered on *pro rata* basis from the lender and returned to the borrower.

10. The time for the SLB session would be the normal trade timings of 9:55 to 3:30 P.M.

11. The settlement cycle of SLB transactions should be on T+1 basis. The settlement of lending and borrowing transactions should be independent of normal market settlement.

12. The settlement of the lending and borrowing transactions should be done on a gross basis at the level of the clients, that is, no netting of transactions at any level will be permitted.

13. The AIs would frame suitable risk management systems to guarantee delivery of securities to borrower and return of securities to the lender. In the case of lender failing to deliver securities to the AI or borrower failing to return securities to the AI, the AI should conduct an auction for obtaining securities. In the event of exceptional circumstances resulting in non-availability of securities in auction, such transactions would be financially closed-out at appropriate rates, which may be more than the rates applicable for the normal close-out of transactions, so as to act as a sufficient deterrent against failure to deliver securities.

With regard to risk management, common risk management practices should be followed by the stock exchanges for SLB. They should ensure that the risk management framework strikes a balance between ensuring commercial viability of SLB transactions and adequate and proper risk management. They should satisfy themselves regarding the adequacy of the risk management system. Margins in SLB may be taken in the form of cash and cash equivalents.

14. Position limits at the level of market, CM and client should be decided from time to time by AIs in consultation with the SEBI. To begin with **(a)** the market-wide position limits for SLB transactions would be 10 per cent of the free-float capital of the company in terms of number of shares, **(b)** no clearing member should have open position of more than 10 per cent of the market-wide position limits or ₹50 crore (base value), whichever is lower, **(c)** for a FII mutual fund, the position limits should be the same as of a clearing member, **(d)** The client level position limits should be not more than 1 per cent of the market-wide position limits.

15. Any borrowing/lending and return of securities would not amount to purchase/disposal/ transfer of the same for the purpose of compliance with the FDI/FII limits and the norms regarding acquisition of shares/disclosure requirements specified under the various regulations of the SEBI.

16. Adequate systems should be put in place by the stock exchanges/depositories to distinguish the SLB transactions from the normal market transactions in the demat system.

17. The AIs should provide suitable arbitration mechanism for settling the disputes arising out of the SLB transactions executed on the platform provided by them.

18. The AIs should disseminate in public domain, the details of SLB transactions executed on the platform provided by them and the outstanding positions on a weekly basis. The frequency of such disclosure may be reviewed from time to time with the approval of the SEBI.

19. The lenders/borrowers should have the facility for early recall/repayment of shares before completion of the contract. The lending fee for the balance period would be a market determined rate. In case of failure of the borrower to meet the margin obligations the AI should obtain securities and square off their position failing which there would be financial close-out. In case of early recall by the lender the **(i)** AI on a best effort basis should try to borrow for the balance period and pass on the security to him and collect the lending fee, **(ii)** original contract between the AI and the lender will exist till the execution of the contract with the new lender for the balance period and return of the securities to the original lender. In case of early repayment by the borrower, the margins should be released immediately. The AI should on a best effort basis try to onward lend the securities and the resulting income passed on to the concerned borrower. In case of the inability of the AI to find a new borrower for the balance period, the original borrower would have to forego the applicable lending fee.

20. **Roll-over facility** A lender/borrower who wishes to extend an existing lent/borrow position can roll-over such position, that is, a lender who is due to receive securities in the payout of an SLB session may extend the period of lending. Similarly, a borrower who has to return securities may extend the period of borrowing. The rollover would be conducted as part of the SLB session. However, netting of counter positions, that is, netting between the borrowed and lent position of a client would not be permitted. The roll-over would be available for 3 months, that is, the original contract plus two roll-over contracts.

21. **Liquid Index Exchange Traded Funds (ETFs)** The liquid ETFs (i.e. the ETF has traded on at least 80 per cent of the days and its impact cost is less than or equal to 1 per cent over the past six months) would be eligible for trading in the SLB segment. The position limits for SLB would be based on the assets under their management.

Securities Lending Scheme (SLS), 1997

The **securities lending** scheme enables lending of securities through an approved intermediary, registered with the SEBI, through whom the lender would deposit and the borrower would borrow the securities to a borrower, under an agreement for a specified period, with the condition that the borrower would return equivalent securities of the same type/class at the end of the period along with the corporate benefits accruing on the securities, including dividends (gross), rights, bonus, redemption benefits, interest or any other right/benefit accruing on the securities lent.

> **Securities lending scheme**
> enables lending of securities to a borrower for a specified period who would return equivalent securities of the same type/class at the end of the period with all the corporate benefits.

The lender(s) [i.e. any person(s) who deposits the securities registered in his name/in the name of any other person duly authorised on his behalf with the approved intermediary for lending unde the SLS] as well as borrower(s) [i.e. person(s) who borrow securities through an approved intermediary] have to enter into an agreement with the approved intermediary to lend/borrow securities respectively. There is no direct agreement between them for this. The agreement would provide that the beneficial interest in the securities deposited would continue to remain with the lender and the corporate benefits would also accrue him. He is entitled to deposit with the approved intermediary, for lending only, securities registered in his name/in the name of any other person duly authorised on his behalf. The lending of securities or the return of equivalent securities of the same type and class by the borrower does not constitute disposal of securities. On depositing the securities, a receipt would be issued by the intermediary. Unless otherwise provided in the agreement, the intermediary would guarantee the return of equivalent securities to the lender along with the corporate benefits accrued on them during the tenure of borrowing. In the event of failure of the borrower, the intermediary would be liable to make good the loss caused to the lender. The intermediary may return the deposited securities as a trustee on behalf of the lender.

The intermediary is entitled to lend the securities deposited to the borrower from time to time. It may retain them in its custody as a trustee on behalf of the lenders. The title of securities lent vests with the borrower and he would be entitled to deal with or dispose them off in any manner.

The borrower has an obligation to return the equivalent number of securities of the same type and class borrowed, to the approved intermediary, within the specified time, together with the corporate benefits that have accrued during the period of borrowing. He cannot discharge his liabilities through payment in cash or kind. The approved intermediary is entitled to receive from the borrower collateral security and fee for lending securities. The collaterals may be in the form of cash, bank guarantee, government securities, certificates of deposits or other securities.

The agreement between the lender/intermediary/borrower also provides for the following terms and conditions: period of lending/depositing of securities, charges/fee for depositing/lending and borrowing, collateral securities for borrowing, provision for the return/premature return of the securities deposited/lent and mechanism for the resolution of disputes through arbitration.

The intermediary should maintain a complete record of securities **(i)** deposited/lent **(ii)** received from the borrower/returned to the lender. In the event of failure, the borrower would become a defaulter and the intermediary would have the right to liquidate the collateral securities in order to purchase the equivalent securities, from the market, to be returned to the lender. It can also take any appropriate action against the defaulter to make good its loss, if any. Such defaults would be notified by the intermediary to the SEBI, concerned stock exchange(s) or authorities for the initiation of appropriate action against the defaulter.

Eligibility Criteria The criteria for registration with the SEBI as an approved intermediary are: a minimum net worth of the ₹50 crore; a clearing house/corporation with a net worth specified by the SEBI in consultation with stock exchange(s); adequate infrastructure facilities like office space, equipment and manpower experienced in dealing in securities, to effectively discharge its activities. The non-refundable application fee is ₹10,000. The registration would be valid for 3 years, renewable. The initial registration fee is ₹10 lakh and the renewal fee after 3 years would be ₹5 lakh. The annual fee would be ₹2 lakh.

Obligations/Responsibilities An approved intermediary for security lending has to comply with the undermentioned obligations/responsibilities. He should:

- Abide by the schemes and the guidelines issued by the SEBI from time to time.
- Comply with the requirements of eligibility criteria for the lender/borrower specified by the SEBI.
- Specify, **(i)** in the respective agreements, the fee payable to the lender/charged to the borrower; **(ii)** the amount and type of collateral acceptable for lending securities as well as the norms for valuation of securities; and **(iii)** the mechanism of sharing the income on collateral with the borrower.
- Issue, at the request of the lender, a receipt acknowledging the deposit of securities specifying the complete details of securities such as name, quantity, face value, certificate/folio number of the lender along with the date from when he became the registered holder of the security. On returning the securities to him, it should similarly issue a receipt containing the above details as proof of continuity of his holdings.
- Issue, at the request of the lender, a receipt acknowledging the deposit of securities specifying the complete details of securities such as name, quantity, face value, certificate/folio number of the lender along with the date from when he became the registered holder of the security. On returning the securities to him, it should similarly issue a receipt containing the above details as proof of continuity of his holdings.
- Maintain a complete record of securities **(i)** deposited by lender/lent to borrower, **(ii)** received from the borrower/returned to the lender. These records would be open for inspection by the SEBI or any person duly authorised by SEBI for this purpose.
- Maintain or make available to SEBI such information or documents/returns/reports as may be specified from time to time. Abide by the SEBI code of conduct specified below:

Code of Conduct for Approved Intermediaries An approved intermediary will be deemed to be guilty of misconduct or unprofessional conduct if it violates intentionally or otherwise any of the following provisions of the Code of Conduct: The approved intermediaries:

1. Agrees and undertakes to perform its duties with the highest standards of integrity and fairness in all its dealings,
2. Abide by the obligation as specified under the securities lending scheme and the terms of the agreement entered into by him with the lenders/borrowers,
3. Inform the client before taking up any assignment that it is obliged to comply with the code of conduct and it would deliver a copy of the same to its client, if the client is not aware of the same or does not have it,
4. Maintain true and correct record of the securities lending transactions undertaken by it under the scheme and in particular the records in respect of the securities **(a)** held by it on behalf of the lenders/ lent by it to the borrowers, **(b)** the time and tenure of such lending, **(c)** the tenure of equivalent security by the borrower after the tenure of lending to him, and **(d)** the return of equivalent security by him.
5. Ensure that the lending of security is not misused or disguised by the lender or borrower for the sale of security or for avoidance of capital gains tax.
6. **(i)** Render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment; **(ii)** Disclose to the clients its possible sources or potential areas of conflict of duties and interest and provide unbiased services.

7. Maintain confidentiality of information about a lender or borrower which it has come to possess as a consequence of dealings with it and should not divulge the same to other clients, the press or any other interested party.
8. Being fully aware of its obligations, endeavour to ensure that true and adequate information is provided to the SEBI, Income-tax Department, any other Government authority.
9. Abide by all the provisions of the SEBI Act, Rules, Regulations, Guidelines, Resolutions, Notifications, Directions, Circular, etc., as may be issued by the Government of India and SEBI from time to time as may be applicable to the approved intermediary.

The approved intermediary cannot be exempted from discharging any obligations placed on it by any law/regulation/guidelines.

Terms of Registration The registration of an intermediary would be for three years on the payment of fee specified by SEBI. It would have the right to suspend/cancel the registration in case of violation of terms of the scheme.

Taxation According to a clarification issued by the Central Board of Direct Taxes, transactions of lending shares/any other security under the securities lending scheme would not result in transfer for the purpose of involving the provisions relating to capital gains under Section 2 of the Income-tax Act.

Recapitulation

- The major elements of the stock market organisation in India are: stock broking, custodial services, depository system and short selling and securities lending and borrowing scheme.
- The components of stock broking are: brokers, sub-brokers, trading and clearing members and foreign brokers.
- A stockbroker is a member of a recognised stock exchange, who buys/sells/deals in securities. He must be registered with the SEBI to carry on his activities. He should abide by the code of conduct in terms of the general requirements, duty to investors and relationship with other stockbrokers. The SEBI can conduct an inspection/ investigation into the records of the brokers. Any broker who contravenes any of the provisions of the SEBI Act/rules/regulations would be liable to any or more of the following actions: monetary penalty, liability for action under the enquiry proceedings regulations, including suspension/cancellation of registration and prosecution. The capital adequacy requirements for brokers consist of a base minimum capital and an additional capital related to the volume of business.
- A sub-broker acts on behalf of a stockbroker, as an agent or otherwise, for assisting investors in buying/selling/dealing in securities through such brokers, but he is not a member of a stock exchange. However, he must be registered with the SEBI. The code of conduct applicable to him covers his duty to investors, his relationship with stock brokers and regulatory authorities. The general obligations and responsibilities and inspection and activities in default applicable to brokers are also applicable to sub-brokers.
- Custodial services mean safe-keeping of securities of a client and providing incidental services such as maintaining accounts of the securities; collecting the benefits/rights accruing to him in this respect; keeping him informed of the actions of the issuer of the securities having a bearing on the benefit accruing to him; and maintaining and reconciling a record of the above

services. Registration of custodians with SEBI is mandatory. The custodian should abide by the specified code of conduct. The activities relating to his business as a custodian should be segregated from his all other activities. A separate custody account for each client should be opened and the assets of one client should not be mixed with those of others. The custodians should have adequate internal control to prevent manipulation of records/documents and appropriate safekeeping measures to ensure that securities are protected from theft and natural hazards. They should follow the uniform norms and practices prescribed by SEBI, during their interaction with other market participants.

- A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism. The essential element of scripless trading is the dematerialisation of share certificates through depositories. Conversion of physical share certificates into dematerialised holdings is called dematerialisation.
- The depository system in India operates within the framework of the Depositories Act and the SEBI Depositories and Participants Regulations. Any person can avail of depository services through a depository participant, by surrendering the certificate of security to the issuer company in the specified manner. The issuer would cancel the certificate and substitute in its records, the name of the depository as a registered owner in respect of that security. The depository would record the name of the person surrendering the certificate as the beneficial owner.
- All securities held by the depository would be dematerialised and would be in fungible form. A depository would be deemed to be the registered owner for the purpose of transfer of ownership of the security on behalf of a beneficial owner, though it would not have any voting rights in respect of the securities held. The beneficial owner would be entitled to all the rights/benefits and would be subjected to all liabilities.
- A beneficial owner can opt out of a depository. Rematerialisation is a process by which a client can get his electronic holding converted back into physical holdings-that is, he can get back the physical form of the share certificates.
- The depository system consists of depositories and depository participants (DPs). A depository is an organisation which holds the securities of shareholders (investors) in electronic form, transfers securities between accountholders, facilitates the transfer of ownership without handling securities and facilitates their safekeeping. The functions of depositories include, *inter-alia*, account opening, dematerialisation, rematerialisation, settlement and clearing and so on. Their sponsors can be public financial institutions, Indian and foreign banks, stock exchanges, financial services companies, companies/institutions providing custodial, clearing/ settlement services in a securities market outside India.
- The DP is the key player in the system which acts as an agent of the depository and is, in fact, the customer interface of the depository. The DPs are the service providers for the investors.
- In order to provide a mechanism for borrowing of securities to enable settlement of securities, the SEBI has put in place a full-fledged SLB scheme (2008) fro all market participants under the overall framework of the Securities Lending Scheme, 1997.
- The main elements of the SLB are: Broad Framework for Securities Lending and Borrowing, SLS, 1997; and Broad Framework for Short Selling.
- Short selling is selling a stock which the seller does not own at the time of trade. All classes of investors are permitted to sell. Naked short selling is not allowed. No institutional investor can do day trading. The stock exchanges should frame uniform deterrent provisions and take appropriate action against brokers for failure to deliver securities at the time of settlement.

- A SLB scheme has been put in place to provide the necessary impetus to short sell. · The securities traded on the F&O Segment are eligible for short selling. The institutional investors should disclose upfront whether the transaction is a short sale.
- The main elements of the broad framework for SLB scheme are: **(1)** It would be operated through Clearing Corporation/House of the stock exchange; **(2)** It would take place an automatic screen-based order matching platform independent of all other platforms; **(3)** Securities trading in the F&O Segment are eligible for lending/borrowing; **(4)** All categories of investors are eligible; **(5)** The authorised intermediary, clearing members and clients should enter into an agreement(s) specifying their respective rights, responsibilities and obligations; **(6)** The intermediary should allot a unique ID to each client; **(7)** The tenure of contract should be 7 days; **(8)** The settlement cycle of SLB transaction should b T+1 basis and on a gross basis; **(9)** The intermediary should frames suitable risk management system to guarantee delivery/return of securities; **(10)** The market-wide position limit for SLB transaction should be 10 per cent of the free float capital of the company; **(11)** There should be no activity during the period of corporate action in the security and so on.
- The securities lending scheme of the SEBI enables lending of securities through an approved intermediary, to a borrower, for a specified period, with the condition that the borrower would return equivalent securities of the same type/class at the end of the period, along with the corporate benefits accruing on the securities, including dividends, rights, bonus, redemption benefits, interest or any other benefit/right accruing on the securities lent.
- There is no direct agreement between the lender(s) and the borrower(s). The intermediary should maintain a complete record of the securities deposited/lent, received from the borrower/returned to the lender. In the event of a default by the borrower, the intermediary would have the right to liquidate collateral securities in order to purchase the equivalent securities from the market, to be returned to the lender. It can also take appropriate action against the defaulter to make good its loss.
- Transactions of lending shares under the securities lending scheme would not result in a transfer for the purposes of capital gains.

REVIEW QUESTIONS

13.1 Briefly explain the code of conduct for brokers as specified by SEBI.

13.2 Write notes on
- General obligations and responsibilities of a broker
- Liabilities of a broker in case of a violation of SEBI Act/rules/regulations
- Capital adequacy norms for brokers

13.3 Briefly discuss the framework of operation of clearing/self-clearing members of a stock exchange.

13.4 Explain the basic features of the short selling and securities lending and borrowing scheme.

13.5 Briefly outline the framework of operations of the depository system with reference to the Depositories Act and SEBI Depositories and Participants Regulations.

CHAPTER 14

Credit Rating

Learning Objectives

- Review the SEBI Credit Rating Agencies Regulations.
- Examine the SEBI guidelines to credit rating agencies.
- Discuss the profile of the three important rating agencies—CRISIL, ICRA and CARE.
- Explain the rating process and methodology.
- Examine the SEBI guidelines relating to standardisation of rating symbols and definitions.
- Illustrate selected ratings symbols as the final expression of investment quality of financial instruments for which SEBI guidelines are not applicable.

INTRODUCTION

Credit rating is, essentially, the symbolic indicator of the current opinion of the rating agency regarding the relative ability and willingness of the issuer of a financial (debt) instrument to meet the (debt) service obligations as and when they arise. It provides a relative ranking of the credit quality of debt/financial instruments or their grading according to investment qualities. In other words, credit rating provides a simple system of gradation by which the relative capacities of companies (borrowers) to make timely repayment of interest and principal on a particular type of debt/financial instrument can be noted.

Credit rating is the symbolic indicator of the current opinion of the rating agency regarding the relative ability of the issuer of the financial (debt) instrument to meet the (debt) service obligations as and when they arise.

Credit rating, however, is neither a general purpose evaluation of a corporate entity nor an overall assessment of the credit risk likely to be involved in all the debts/financial instruments contracted/to be contracted by such issuers. A rating is specific to a debt/financial instrument and is intended to grade different and specific instruments in terms of the credit risk associated with the particular instruments. Although it is an opinion expressed by an independent professional organisation, on the basis of a detailed study of all the relevant factors, the rating does not amount to any recommendation to buy, hold or sell an instrument as it does not take into consideration factors such as market prices, personal risk preferences of an investor and such other considerations, which may influence an investment decision.

As a fee based financial advisory service, credit rating is, obviously, extremely useful to investors, corporates (borrowers), banks, and financial institutions. For the investors, it is an indicator expressing the underlying credit quality of an (debt) issue programme. The investor is fully informed about the company as any effect of changes in business/economic conditions on the company is evaluated and published regularly by the rating agencies. The corporate borrower can raise funds at a cheaper rate, with a good rating. It minimises the role of 'name recognition' and lesser known companies can also approach the market on the basis of their rating. Fund ratings are useful to the banks and other financial institutions when they decide on lending and investment strategies.

Although credit rating has been a long established part of the financial mechanism abroad, it is of relatively recent origin in the country. The first rating agency, the Credit Rating Information Services of India Ltd (CRISIL), was started in 1988. Initially, it played a rather subdued role, presumably because institutional investors did not require the wisdom of a rating agency. In the changed scenario where corporates are increasingly dependent on the public, the removal of restrictions on interest rates and the stipulation of a mandatory credit rating of a number of instruments, since 1991 by the Government/SEBI, credit rating has emerged as a critical element in the functioning of the Indian debt/financial markets. In response to the ever increasing role of credit rating, two more agencies were set up, the Information and Credit Rating Services (ICRA) Ltd in 1990 and the Credit Analysis and Research (CARE) Ltd in 1990 and 1993, respectively. The first private sector credit rating institution was set up as a joint venture between the JM Financials, Alliance Group and the international rating agency Duffs and Phelps, in 1995, known as Phelps Credit Rating India Ltd. It is now known as FITCH India Ltd. The Small Industries Development Bank of India (SIDBI) launched in September 2005 in association with several banks a rating agency, namely, Small and Medium Enterprises Rating Agency (SMERA). It has commenced operation only recently. In addition to the mandated ratings, these agencies are also diversifying into other instruments/sectors. Unlike abroad, unsolicited rating is still not done in India. Nevertheless, the increasing recognition to credit rating in the emerging financial services industry in the country marks a major transition from a corporate culture where names mattered to one where abstract gradings count.

This chapter examines the present status of the credit ratings industry/system **and is portrayed in Exhibit 14.1**. Section 1 briefly outlines the regulatory framework in terms of the SEBI Credit Rating Agencies Regulation. This is followed by a brief profile of the credit rating agencies, namely, CRISIL, ICRA, CARE and FITCH India in Section 2. Sections 3–4 respectively discuss the rating process/methodology and the rating symbols. The main points are summarise in the last Section.

REGULATORY FRAMEWORK

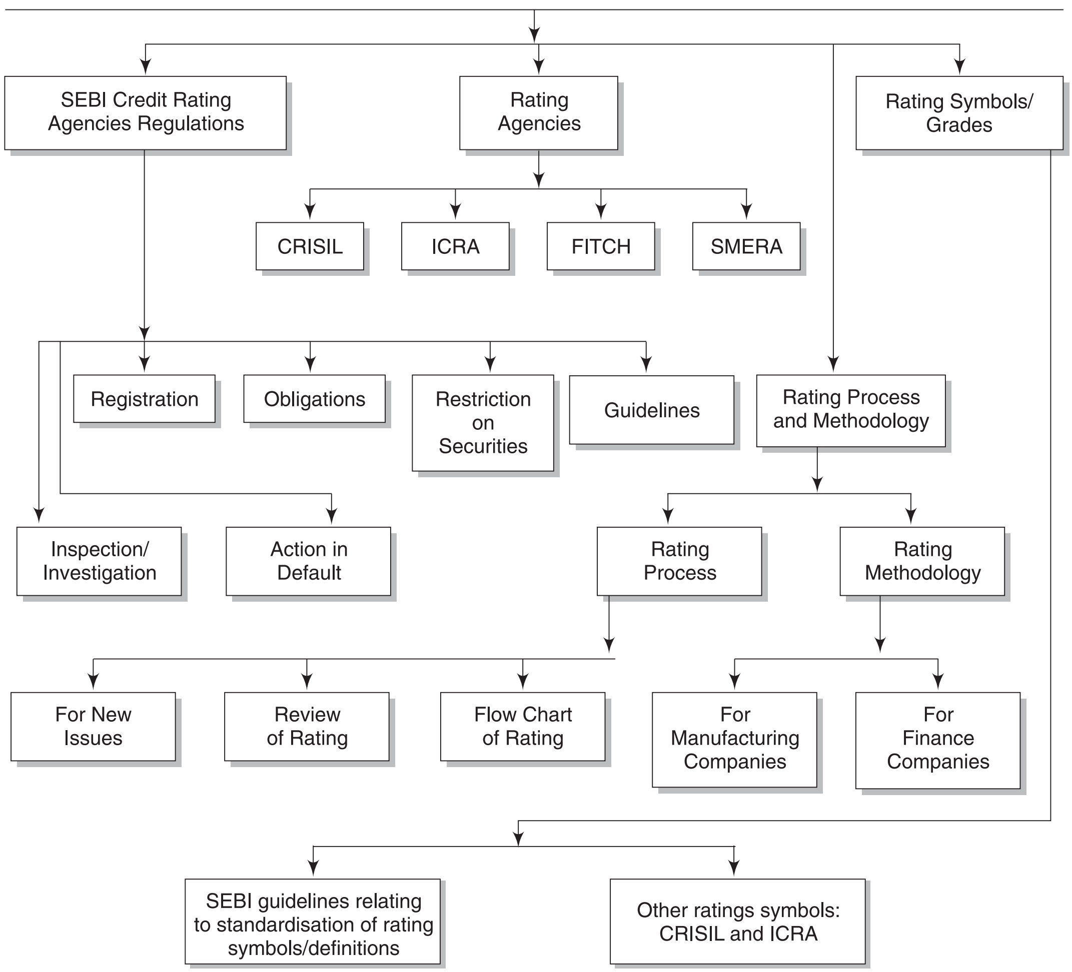
Credit rating agencies are regulated by the SEBI. The main elements of its Credit Rating Agencies Regulations are: **(i)** their registration, **(ii)** their general obligations, **(iii)** restrictions on the rating of securities, **(iv)** procedure for inspection and investigation and **(v)** action in case of default. The SEBI has also issued guidelines for the CRAs.

> **Credit rating agency** means a body corporate engaged in the business of rating of securities.

Registration of Credit Rating Agencies

Registration with the SEBI is mandatory for carrying on the rating business. The application for the grant of certificate of initial registration should be

Exhibit 14.1 Credit Rating System in India



made to the SEBI in **Form A (Appendix 14-A on the website)** and accompanied by a non-refundable fee of ₹50,000. A **credit rating agency** means a body corporate engaged/proposed to be engaged in the business of rating of securities offered by way of public/rights issues. **Rating** is defined by the SEBI Regulations as an opinion regarding securities, expressed in the form of standard symbols/in any other standardised form, assigned by a credit rating agency and used by the issuer of such securities to comply with a requirement specified by these (SEBI) regulations.

> **Rating**
> is an opinion regarding securities, expressed in standard symbols/any other standardised form assigned by a credit rating agency and used by the issuer of such securities.

Promoter of Credit Rating Agency A credit rating agency (CRA) can be promoted by a **(i)** public financial institution, (PFI), as defined in Section 4-A of the Companies Act, **(ii)** scheduled bank, **(iii)** foreign bank operating in India with RBI approval, **(iv)** foreign credit rating agency, having at least five years experience in rating securities and **(v)** any company incorporated under the Companies Act/body corporate, having a continuous networth [i.e. paid-up equity capital plus free reserves (excluding reserves created out of revaluation) less accumulated losses and deferred expenditure, including miscellaneous expenses not written off] of a minimum of ₹100 crore as per its audited annual accounts for the previous five years prior to filing of the application with the SEBI for registration.

Eligibility Criteria The eligibility criteria for a rating agency are as specified below.
The agency:

- is set up and registered as a company;
- has specified rating activity as one of its main objects in its Memorandum of Association;
- as a minimum networth of ₹5 crore;
- has adequate infrastructure;
- its promoters have professional competence, financial soundness and a general reputation of fairness and integrity in business transactions, to the satisfaction of the SEBI;
- has employed persons with adequate professional and other relevant experience, as per the SEBI directions;
- applicant or its promoter(s), any director of the applicant or its promoter(s) **(i)** is not involved in any legal proceedings connected with the securities market that may have an adverse impact on the interests of the investors, **(ii)** has not at any time in the past been convicted of any offence involving moral turpitude or for any economic offence [in terms of Economic Offences (Inapplicability of Limitation) Act, 1974].
- applicant or any person (i.e. an associate/subsidiary/interconnected or group company or a company under the same management) in the past has not been, directly or indirectly **(i)** refused by the SEBI a certificate under these regulations or **(ii)** subjected to any proceedings against contravening a SEBI Act/any rules or regulations made under it. An associate person in relation to a CRA includes a person:
  - **(i)** who directly/indirectly by himself/in combination with relatives owns/controls shares carrying at least 10 per cent of the voting rights of the CRA; or
  - **(ii)** in respect of whom the CRA directly/indirectly by itself/in combination with other persons owns/ controls not less than 10 per cent of the voting rights; or
  - **(iii)** majority of the directors who own/control shares carrying at least 10 per cent of the voting rights of the CRA; or
  - **(iv)** who is a director/officer/employee and also a director/officer/employee of the CRA.
- is one to whom grant of certificate is in the interest of the investors and the securities market.
- is in all respects a fit and proper person for the grant of the certificate. To determine whether an applicant is a fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**.

Grant of Certificate of Initial/Permanent Registration The SEBI will grant to eligible applicants a certificate of initial registration on the payment of a fee of ₹26,66,700. Three months before the expiry of the 5-year validity of the initial registration, the CRA should apply for permanent registration together with a fee of ₹15,00,000. It should also be accompanied by details of the changes in the information submitted to the SEBI while seeking initial registration and a declaration that no changes other than those mentioned in such details have taken place. After permanent registration, the CRA would pay a fee ₹10,00,000 every three years.

Conditions of Registration The registration would be subject to the following conditions:

(A) The CRA would comply with the provisions of the SEBI Act/regulations and guidelines/directions/circulars and instructions issued by the SEBI, from time to time, on the subject of credit rating;

(B) Where any information/particulars furnished to the SEBI by a CRA **(i)** is found to be false/misleading in any material particular or **(ii)** has undergone change subsequent to its furnishing at the time of application, it would immediately inform SEBI in writing. It should obtain prior approval of the SEBI for continuing to act as a CRA after the change in control. **Change in control** means change in control in terms of the SEBI Substantial Acquisition of Shares and Takeover Regulation in relation to a listed CRA and in other cases in relation to direct/indirect change in controlling interest to the extent of at least 51 per cent of the voting rights of the body corporate. The CRAs should periodically report to the SEBI, the following: **(i)** amalgamation/demerger/consolidation/any other kind of corporate restructuring in terms of Section 391 of the Companies Act/provisions of any other law, **(ii)** change in director/managing director/whole-time director and **(iii)** change in share-holding not resulting in change of control.

General Obligations

The general obligations of CRAs are as specified below:

Code of Conduct A credit rating agency should:

- Make all efforts to protect the interests of investors.
- In the conduct of its business, observe high standards of integrity, dignity and fairness in the conduct of its business.
- Fulfil its obligations in a prompt, ethical and professional manner.
- At all times exercise due diligence, ensure proper care and exercise independent professional judgement in order to achieve and maintain objectivity and independence in the rating process.
- Have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It should also maintain records to support its decisions.
- Have in place a rating process that reflects consistent and international rating standards.
- Not indulge in any unfair competition nor should it wean away the clients of any other agency on assurance of higher rating.
- Keep track of all important changes relating to the client companies and develop efficient and responsive systems to yield timely and accurate ratings. Further, it should also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
- Disclose its rating methodology to clients, users and the public.
- Wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further, it should ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
- Not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
- Not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the board, stock exchange or public at large.

- Ensure that the SEBI is promptly informed about any action, legal proceedings and so on, initiated against it alleging any material breach of non-compliance by it, of any law, rules, regulations and directions of the SEBI or of any other regulatory body.
- Maintain an appropriate level of knowledge and competence and abide by the provisions of the SEBI Act, regulations and circulars, which may be applicable and relevant to the activities carried on by it. It should also comply with award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
- Ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
- Not render, directly or indirectly any investment advice about any security in the public accessible media.
- Ensure that any change in registration status/any penal action taken by SEBI or any material changes in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
- Maintain an arm's length relationship between its credit rating activity and any other activity.
- Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a party of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, and so on. Such a code should also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.
- Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
- Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
- Ensure that good corporate policies and corporate governance are in place.
- Not, generally and particularly in respect of issue of securities rated by it, be party to or instrumental for **(a)** creation of false market; **(b)** price rigging or manipulation; or **(c)** dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.

Agreement with the Client The CRA should enter into a written agreement with each client containing the following provisions:

(a) rights and liabilities of each party in respect of the rating of securities,
(b) fee to be charged,
(c) a periodic review of the rating during the tenure of the rated instruments,
(d) client's agreement to cooperate, in order to enable the CRA to arrive at, and maintain, a true and accurate rating of the clients' securities and in particular provide to him true, adequate and timely information for the purpose,
(e) disclosure by the CRA to the client regarding the rating assigned to its securities through regular methods of dissemination, irrespective of whether the rating is or is not accepted by him,

(f) client's agreement to disclose in the offer document **(i)** the rating assigned to its listed securities during the last three years, and **(ii)** any rating that has not been accepted by it, and
(g) client's agreement to obtain a rating for any issue of debt.

Monitoring of Ratings The CRA should continuously monitor the rating of securities rated by it during their lifetime. It should disseminate information regarding newly assigned ratings and changes in the earlier ratings promptly through press releases and websites, and, in the case of securities issued by listed companies, provide such information simultaneously to the respective regional stock exchange(s) and to all the stock exchanges where the securities are listed.

Procedure for Review of Rating The CRA should carry out periodic reviews of all published ratings during the lifetime of the securities. If its client does not cooperate, so as to enable it to comply with its obligations relating to monitoring of ratings, the CRA should carry out the review on the basis of the best available information and should disclose this fact to the investors. It cannot withdraw a rating so long as the obligations under the rated security are outstanding, except where the company is wound up/merged/amalgamated with another company.

Internal Procedures Every CRA should frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of **(a)** the SEBI Insider Trading Regulations, 1992; **(b)** the SEBI Prohibition of Fraudulent and Unfair Practices Relating to the Securities Market Regulations, 1995 and **(c)** other laws relevant to trading of securities.

Disclosure of Rating Definitions and Rationale The credit rating agency should **(a)** make public the definitions of the concerned rating, along with the symbol, and **(b)** also state that the ratings do not constitute recommendations to buy, hold or sell any securities. It should also provide the general public with information relating to the rationale of the ratings, which should cover an analysis of the various factors justifying a favourable assessment, as well as the factors constituting a risk.

Submission of Information to the SEBI Where any information is called for by the SEBI for the purposes of these regulations, including any report relating to its activities, the CRA must furnish such information **(a)** within the specified period; or **(b)** if no such period is specified, within a reasonable period of time. It should also, at the close of each accounting period, furnish the SEBI with copies of its balance sheet and profit and loss account.

Compliance with Circulars Issued by the SEBI The CRAs have to comply with the SEBI guidelines, directions, circulars and instructions issued from time to time.

Appointment of Compliance Officer Every CRA should appoint a compliance officer to monitor compliance with the SEBI Act/rules/regulations/modifications/ guidelines/instructions and so on issued by the SEBI/Government. He should immediately and independently report any non-compliance observed by him, to the SEBI.

Maintenance of Books of Accounts and Records Every CRA has to keep and maintain, for a minimum period of five years, the following books of accounts, records and documents and intimate to the SEBI the place where they are maintained.

(a) A copy of its balance sheet, as at the end of each accounting period,
(b) A copy of its profit and loss account for each accounting period,
(c) A copy of the auditor's report on its accounts, for each accounting period,

(d) A copy of the agreement entered into with each client,
(e) Information supplied by each of the clients,
(f) Correspondence with each client,
(g) Ratings assigned to various securities, including upgradation and downgradation (if any) of the ratings so assigned,
(h) Rating notes, considered by the rating committee,
(i) Record of decisions of the rating committee,
(j) Letter assigning rating,
(k) Particulars of fees charged for rating and such other records as the SEBI may specify from time to time.

Steps on Auditor's Report Within two months from the date of the auditor's report, the CRAs should take steps to rectify the deficiencies, if any, made out in the auditor's report, in so far as they relate to the activity of rating securities.

The audit should include internal audit and conducted on a half-yearly basis by a practising chartered/cost/management accountant who does not have any conflict of interest with the CRA. It should cover all aspects of CRA's operations/procedures including investors grievances redressal mechanism, compliance with the requirements stipulated in the SEBI Act/rules/regulations/guidelines. Moreover, it should **(a)** state the methodology adopted, deficiencies observed and consideration of management response on them, **(b)** include a summary of operations/audit covering the size of operations, number of transactions audited/instances of violations/deviations on/from the compliance of any regulatory requirement, and **(c)** comment on the adequacy of the system adopted by the CRA for compliance with the requirements of the SEBI regulations/guidelines and investor grievance redressal. The CRA should receive the internal audit report within two months of the half-year end and submit to the SEBI an action taken report on the steps to rectify the deficiencies within the next two months.

Confidentiality The CRA should treat information supplied to it by the client as confidential and not disclose the same to any other person, except where such disclosure is required or permitted by or under any law in force at the time.

Rating Process The CRA should:

- specify the rating process, file a copy of the same with the SEBI for record and also file any modifications or additions made therein from time to time;
- follow, in all cases, a proper rating process;
- have professional rating committees, comprising members who are adequately qualified and knowledgeable, to assign a rating; all rating decisions, including those regarding changes in rating, should be taken by the rating committee;
- be staffed by analysts qualified to carry out a rating assignment;
- inform the SEBI about new rating instruments or symbols introduced by it;
- exercise, while rating a security, due diligence in order to ensure that the rating given is fair and appropriate;
- not rate securities issued by it;
- not change rating definition, as well as structure for a particular rating product, without prior information to the SEBI;
- disclose to the stock exchange concerned, through press releases and websites for general investors, the rating assigned to the securities of a client after periodic review, including changes in rating, if any.

Restrictions on Rating of Securities

Restrictions on rating by CRAs relate to securities issued by **(i)** promoters and **(ii)** certain other entities.

> **Promoter**
> means a person who holds atleast 10 per cent of shares of the CRA.

Securities Issued by Promoters A CRA is prohibited from rating securities issued by its promoter(s), who holds 10 per cent, or more, of its shares. If the promoter is a lending institution, its chairman/director(s)/employee(s) cannot hold a similar position in the CRA or its rating committee. However, a CRA may rate a security issued by its associate having a common independent director (i.e. a director who apart from receiving remuneration as a director does not have any other material pecuniary relationship/transactions with the company/its promoters/its management/its subsidiaries which in the judgement of the Board of the company may affect the independence of the judgement of such director) with it or rating company if

- the independent director does not participate in the discussion in the rating decision; and
- the CRA makes a disclosure in the rating announcement of such associate (about the existence of common independent director) on its Board or of its rating committee and that the independent director did not participate in the rating process or in the meeting of the Board of Directors or in the meeting of the rating committee when the securities rating of the associate was discussed.

Securities Issued by Certain Entities The securities of an entity cannot be rated by a CRA if it is **(a)** a borrower of its promoter, **(b)** a subsidiary of its promoter, **(c)** an associate (ie, a person holding at least 10 per cent of the share capital) of its promoter, when there are common **(i)** chairman/directors, **(ii)** employees common to the CRA and these entities and **(iii)** there are common chairman/director/employees on the rating committee. It should also not rate a security issued by its associate/ subsidiary if the chairman/director/employee of the ACR/its rating committee also holds a similar position in such an entity.

Procedure for Inspection/Investigation

The SEBI is empowered to appoint inspecting officer(s) to undertake inspection/ investigation of the books of accounts/records/documents of the CRAs: **(i)** to ascertain whether they are being maintained properly, **(ii)** to ascertain whether the provisions of the SEBI Act/these regulations are being complied with, **(iii)** to investigate into complaints from investors/clients, whose securities are rated by any other person, regarding any matter having a bearing on the activities of the CRA and **(iv)** in the interest of the securities market/ investors.

The inspection would ordinarily not go into an examination of the appropriateness of ratings assigned on merit. In case of complaints of a serious nature, however, the appropriateness of the ratings may also be covered by the inspection, which would be carried out either by the officer(s) of the SEBI or independent experts with relevant experience, or a combination of both.

Before ordering an inspection/investigation, the SEBI would give at least 10 days' written notice to the CRA, except where satisfied that, in the interest of investors, no notice is required. The CRA and its directors/officers/employees are duty bound to produce, to the investigating/ inspecting officer, all books/ accounts/documents in their custody/control as well as furnish all the statements and information required, within a reasonable/specified period. It should **(1)** allow the officer(s) reasonable access to the premises occupied by it/any other person on his behalf, **(2)** make available any books/records/ documents and computer data in his possession and **(3)** provide copies of documents/other material relevant to the officer(s) for the purpose of investigation/inspection. The investigation officer would be entitled to examine/record statements of officers/directors/employees of the CRA in this connection. They are bound to render all the assistance that he may require. After consideration of inspection/investigation report, the SEBT/Chairman would take such action as deemed fit and appropriate including action under the SEBI **Intermediaries Regulation, 2008.**

Action in Case of Default

The CRAs that **(a)** fail to comply with any condition, subject to which certificates of registration had been granted, or **(b)** contravene any of the provisions of the SEBI Act/these regulations/ any other regulation under the SEBI Act, would be dealt with in the manner provided under the SEBI **Intermediaries Regulation.**

Guidelines for Credit Rating Agencies (CRAs)

Effective use of credit ratings is crucially dependent upon quantity/quality of disclosures made by them. In the wake of recent events in the global financial system and in order to impart higher credibility to the credit rating processes/procedures, the SEBI has prescribed transparency and disclosure norms for the CRAs. The elements of the framework are: **(i)** rating process, **(ii)** default studies, **(iii)** dealing with conflict of interest, **(iv)** obligations in respect of rating of structured financial products, **(v)** unsolicited rating, **(vi)** disclosure, **(vii)** implementation schedule/reporting, and **(viii)** additional disclosures.

Rating Process The CRAs should keep/maintain till five years after maturity of the instrument(s) and make available to the auditors/regulatory bodies when sought by them the following records in support of each rating and its review/surveillance: **(a)** Important factors underlying the rating and its sensitivity to change(s) in these factors, **(b)** Summary of discussions with the issuer/ management/auditors having a bearing on the rating, **(c)** Decisions of the rating committee(s), including voting details/note of dissent by any member, **(d)** Rationale for any material difference between the rating actually assigned and the rating implied by any quantitative model which is a substantial component of the rating process.

Default Studies Default studies are central to evaluating the performance of a CRA and whether its ratings can predict default over a period of time. In order to promote transparency and enable the market to best judge the performance of the rating(s), the CRAs should publish information about the historical defaults rates of its rating categories and change(s) in them over time so as to enable a quality comparison among ratings by different CRAs.

The default rates should be calculated in the manner specified below:

- One-year default rate (i.e. number of defaults among rated agencies in the static pool as a percentage of the total number of entities in the static pool) is the weighted average of default rates of all possible one-year static pools in the 5-year period. **Default** means non-payment of interest/principal in full on the pre-agreed date which should be recognised at the first instance of delay of servicing of the instrument. **Static pool** means non-defaulted ratings outstanding at the beginning of a period. The number of ratings in each static pool would be the weights for computing the weighted average of default rates.
- The cumulative default rate (CDR) represents the likelihood of an entity rated at the beginning of any multi-year period defaulting any time during the period. The 3-year CDR for rating category X = Number of defaulting issues during the period ÷ Number of issues outstanding at the beginning of the period.

Dealing with Conflict of Interest The CRAs should formulate policies and internal codes for dealing with conflict of interests. They should ensure **(i)** that **(a)** their analysts do not participate in any kind of marketing/business development including negotiations of fees with the issuer(s), **(b)** the employees involved in the rating process and their dependants do not own shares of the issuer; and (ii) prompt review of rating if any of their employees join the respective issuer(s).

Obligations in Respect of Structured Financial Products (SFPs) An SPF means an instrument(s)/pay-outs resulting from securitisation transactions. In addition to all the applicable requirements in case of non-structured ratings, the CRA/subsidiaries should not provide consulting/advisory services in designing the SPF and the rating symbols should clearly indicate that they relate to SFPs.

Unsolicited Ratings An **unsolicited** rating is rating without any agreement between the CRA and the issuer. The word **UNSOLICITED** should accompany the rating symbol in the same font size. The CRA should monitor/disclose the rating during the life of the instrument as if it were a solicited rating.

Disclosures The CRAs should make all the disclosures listed below on their websites. The disclosures should also be made to the concerned stock exchange in case of listed securities. The assigned ratings/periodic reviews should be released through press and kept on the websites. The disclosures should be made in the prescribed format.

Rating Procedure Formulation/disclosure of policies/methodology/procedure in detail in respect of both solicited and unsolicited ratings;

Rating History/Defaults The CRAs should disclose in the prescribed format:

- Details of new ratings during the last 6 months,
- Movement of rating of all outstanding securities during the last 6 months: **(i)** movement of each rating, **(ii)** movement of each rating from investment to non-investment grade and *vice versa*, **(iii)** movement of each rating that has moved by more than one notch,
- History of rating of all outstanding securities,
- List of defaults on annual basis separately for each rating category (for example, **AAA, AA, A, BBB, BB, B, C**). This should include the initial rating, month/year of rating/default, last rating assigned before default and comments of CRAs,
- Weighted average one-year/3-year cumulative default rates on annual basis for the last five years separately for **(i)** each rating category and **(ii)** structured/non-structured instruments.

Income The CRA should disclose **(i)** the general nature of its compensation arrangement with the issuer, **(ii)** its conflict of interest in case of accepted ratings including details of commercial/otherwise relationship between the issuer/associate and the CRA/subsidiaries, **(iii)** annually **(a)** total receipts from rating/non-rating services, **(b)** issue-wise percentage share of non-rating income to the total revenue from the issuer concerned and **(c)** names of rated issuers/associates contributing 10 per cent or more of the total revenue of the CRA/subsidiaries.

Structured Finance Products (SFPs) In addition to all the applicable requirements in case of non-structured ratings, the CRA should disclose the track record including financials of the originator, rating migration to speculative categories, and defaults of the originator and details of nature of the underlying assets. They should also disclose at least every six months the performance of **rated pool**, that is, collection efficiency/delinquencies. A detailed description of the underlying pool including ageing, credit enhancements such as liquidity supports, first/second loss guarantor should also be provided.

Unsolicited Ratings In addition to all the applicable requirements in respect of solicited ratings, the following disclosures should be made: **(i)** the extent of participation by the issuer/management/bankers/auditors in the rating process and **(ii)** information used and its source in arriving at/reviewing the rating.

The other annual disclosures are: **(i)** all the unsolicited ratings carried out in the last three financial years, and **(ii)** names of such issuers which were given solicited rating in the last financial year.

Shareholding The CRAs should disclose their shareholding pattern as prescribed by stock exchanges for listed companies **(under clause 35 of the listing agreement)**.

Compliance Status of IOSCO Code of Conduct The compliance status of each provision of the code should be disclosed.

Implementation Schedule/Reporting The stipulated half-yearly and yearly disclosures should be made by the CRAS within 15 and 30 days from the end of the respective half-year (March/September) and financial year separately.

Additional Disclosures With the prior approval of the SEBI, additional disclosures can be made by the CRAs.

CREDIT RATING AGENCIES

This Section presents a brief profile of the credit rating agencies in the country, namely, CRISIL Ltd, ICRA Ltd, CARE Ltd, FITCH Ltd and SMERA. The focus is on the two leading agencies, namely, CRISIL and ICRA.

Crisil Ltd

As the first credit rating agency in India, the CRISIL was promoted in 1987 jointly by the ICICI Ltd and the Unit Trust of India. Other shareholders include the Asian Development Bank, Life Insurance Corporation of India, HDFC Ltd, General Insurance Corporation of India and several foreign and Indian banks. It commenced operation on January 1, 1988. As a matter of fact, it pioneered the concept of credit rating in the country and has, since, been the vanguard of innovations by introducing new concepts in rating services and has diversified into related areas of information and advisory activities. It offered its share capital to the public in 1993. In 1996, the CRISIL forged a strategic business alliance with the Standard and Poors (S&P) Rating Group, New York. In May 1997, S&P acquired equity stake in the CRISIL. Apart from the financial collaboration, the CRISIL derives other benefits from this alliance, such as international experience, revamping of operating systems, introduction of value added methodologies in new areas and assistance to the client companies in raising funds across the country.

Initially, the CRISIL was set up to rate debt obligations that would guide investors as to the risk of timely payment of interest and principal. Over the years it has crystallised the following main objectives:

- To assist both individual and institutional investors in making investment decisions in fixed interest securities;
- To enable companies to mobilise funds in large amounts from a wide investor base, at a fair cost;
- To enable intermediaries to place debt instruments with investors by providing them with an effective marketing tool,

- To provide regulators with a market-driven system for bringing about discipline and a healthy growth of capital markets.

To achieve these objectives, the functions performed by the CRISIL currently fall under four broad categories/division of services: **(i)** credit rating services, **(ii)** advisory services, **(iii)** credibility first rating and evaluation services and **(iv)** training services. In addition, it has three subsidiaries: **CRIS-Infac**, a leader in the research and information services business; **Global Data Services of India Ltd**, a provider of reliable database and analysis of Indian corporates and **Information Solution Company Ltd (CRIS-RISC),** formerly known as CRISIL.com Ltd, a capital markets research, information and news company.

A brief account of the (i) CRISL Advisory Services, (ii) CRISIL Research and Information Services, (iii) CRISIL Index Services and (iv) CRISIL Training Services is given in Appendix 17-B on the website. The website address is http://www.mhhe.com/khanfs9e.

Credit Rating Services (CRS) The principal function of the CRISIL is to rate mandated debt obligations of Indian companies, chit funds, real estate developers, LPG/kerosene dealers, non-banking finance companies, Indian states and so on.

Rating of Debt Obligations The debt obligations include rupee-denominated credit instruments—long, medium and short-term—namely, debentures, preference shares, deposits, certificates of deposits, commercial papers and structured obligations of manufacturing/finance companies, banks, financial institutions, builders, insurance companies, collective investment schemes and so on. To ensure the stable and healthy growth of the capital markets, the thrust of the CRISIL's credit rating is focused on the following:

- Shifting the primary responsibility of established corporate credit quality from merchant bankers/brokers/underwriters/financial advisors to the CRISIL, and making available widely acceptable standards and uniform rating for investors;
- Providing for increased disclosures, better accounting standards and improved financial information to users;
- Reducing the cost of issue by helping direct mobilisation of resources, without depending on intermediary agencies and
- Protecting the interest of investors by constantly monitoring the results of rated companies and altering the gradings (through rating watch/update) to reflect the true and fair state of affairs of the company's financial position.

Rating of Structured Obligations The rating of structured obligations (SOs) reflects CRISIL's opinion regarding an obligor's capacity and willingness to make timely payments of financial obligations on rated instruments. It takes into consideration any arrangements for payment on the instrument by an obliger other than from the issuer or from sources independent of him, external support for fulfilling financial obligations on the instrument or any means of enhancing credit, including arrangements like guarantors, letters of credit and asset backing.

Rating of Real Estate Developers' Projects/Builders The CRISIL has developed a framework for the composite rating of real estate projects. Such a rating is expected to help prospective investors to identify and narrow down their investment options. A rating would also provide incentives to developers to maintain standards with respect to legal and construction practices in the industry. Moreover, the rating is expected to help developers mobilise funds for their projects and also market them effectively. Banks, financial institutions and other lending institutions are likely to use the ratings as an additional tool to determine exposure levels and interest rates for lending to specific projects. The rating is specific to a project rather than a developer so that different projects of a developer could get different ratings.

The methodology broadly assesses a project in terms of project risk factors and developers' risk factors. Under each of these, the CRISIL has identified factors that it believes would have an impact on the ability of a developer to build the agreed quality levels in a reasonable time frame and transfer title to customers. These factors are crystallised into a composite rating expressed in the form of symbols. The letters **PA** are prefixed to the retaining symbols to indicate **Project Development Ability**. The CRISIL has joined hands with National Real Estate Development Council (NAREDCO) to provide credit ratings of real estate developers.

Bond Fund Ratings This rating is an opinion on the credit quality of bond funds underlying portfolio holdings. The main concentration is on fixed income securities, including money market instruments. The rating methodology adopted by the CRISIL takes the following aspects into account: **(1)** credit associated with securities in the fund portfolio; **(2)** the systems and procedures followed by funds and **(3)** management quality and expertise.

Bond fund rating is an opinion on the credit quality of bond funds underlying portfolio holdings.

Bank Loan Rating The creditworthiness of a bank's borrower-clients is assessed by CRISIL, offering comments on the likelihood of repayment of loans to banks. The rating methodology takes into consideration the following aspects: **(1)** for the borrower-manufacturing client company's underlying assets liquidity profile, operating systems and risk management initiative of the management; **(2)** for non-banking finance companies quality-of-assets portfolio, loans and investments.

Bank loan rating is the assessment of the credit worthiness of a bank's borrower-clients.

Collective Investment Schemes Rating This covers the rating of collective investment schemes of plantations and other companies, offering opinions on the degree of certainty of the scheme to deliver the assured returns in terms of the quantity of produce and/or cash, as mentioned in the offer document. Rating does not cover or offer comments on the quality of the produce or the monetary value that the investor will get from the produce.

Grading for Healthcare Institutions The CRISIL's grading for healthcare institutions is an opinion on the relative quality of healthcare delivered by the institution to its patients. Healthcare institutions graded higher would have better facilities, superior quality levels, and greater consistency in the service industry compared to healthcare facilities in lower grades.

Grading of health-care institutions is an opinion on the relative quality of healthcare delivered by the institution to the patient.

The grade assigned to a healthcare institution is applicable for a specific healthcare facility (ie, single hospital, generally in a single location) and is not applicable to the entire healthcare organisation.

The grade assigned to a healthcare institution should, however, not be construed to be:

- A comment on the probability of outcome of any particular treatment, procedure or surgery,
- A comment on the suitability of a particular healthcare organisation for any specific ailment(s),
- A certification that the healthcare institution is complying with all applicable regulations of the State Government and Government of India,
- A recommendation to buy/sell or invest in the financial instruments issued by the health-care institution,
- A recommendation to provide funds through grants, loans or donations to the hospital.

Grading Scale and Definition The grading scale has two components. The first is the hospital classification, such as: nursing home, general secondary care, speciality secondary care, multi-speciality tertiary care and single-speciality tertiary care. The second component of the grading scale is the hospital's grading, within that classification, on a four-point scale. Thus, a typical grading could read: General Secondary care hospital assigned Grade C or Nursing Home assigned Grade B. The hospital classification is based on the number of specialities offered by the hospital. The definition for various grades, as envisaged currently, is given below:

Grade A **Reflects Very Good Quality** of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels that are consistent with the **highest** standards in the Indian healthcare industry.

Grade B **Reflects Good Quality** of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels that are consistent with **high** standards in the Indian healthcare industry, although these would be lower than healthcare quality levels in Grade A hospitals.

Grade C **Reflects an Average Quality** of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels that are consistent with **adequate** standards in the Indian healthcare industry. Improvements in specific areas would be required for such hospitals to be eligible for a higher grade.

Grade D **Reflects Poor Quality** of delivered patient care. Healthcare institutions graded in this category have facilities, equipment, manpower and service quality levels which are below the **average** standards in the Indian healthcare industry. The grading indicates that quality standards would need to be set up in the institution and substantial improvements in patient care would be needed to obtain a higher grade.

A typical definition would read as follows:

"CRISIL has classified the XYZ Hospital as a *Speciality Secondary Care Hospital* and assigned it '*Grade B*'. The grading reflects a *Good Quality* of delivered patient care. The healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are consistent with high standards in the Indian healthcare industry."

Grading Process The CRISIL employs a multi-layered decision making process in assigning a grading. This results in thoroughness and transparency in the grading process. A team, of at least two suitably qualified analysts, is assigned to interact with the health case institution's management. The topics discussed during the management meeting are wide ranging, including, mission and policy, regulatory compliance, medical specialities, support services, management evaluation, patient rights, nursing care and financial performance. The process from the initial management meeting to the final assignment of the grade normally takes around three to four weeks for a multi-speciality tertiary care hospital and around one to two weeks for a nursing home.

Confidentiality The grading process ensures complete confidentiality of the information provided by the healthcare organisation. A substantial portion of the information provided to the CRISIL is only for the purpose of arriving at gradings. Such information is kept strictly confidential and is not used for any other purpose, or by any third party.

Grading Committee and Assignment of the Grading After meeting with the management, a report is prepared, analysing the medical facilities available, support services, procedures undertaken, clinical parameters, quality and adequacy of personnel, financial performance, functioning of various review committees and so on. This report is then presented to the Grading Committee that comprises of eminent people drawn from the healthcare industry. Individual grades are assigned drawing on the knowledge, experience and expertise of the committee members. The grading is a composite assessment of all the factors concerning the healthcare organisation, with key issues getting greater attention. The Grading Committee process ensures objectivity in grading, as the decision results from the collective thinking of a group. The process also ensures a consistent level of analytical quality, as reports and discussions are focused on critical grading factors that are relevant to a particular healthcare organisation.

Publication Once a final grade is assigned and accepted, it is disseminated to the subscriber clientele, as well as to the news media. In addition, the CRISIL publishes detailed analytical reports on its range of information products.

Surveillance and Annual Review After a grade has been assigned, the CRISIL monitors the ongoing performance of the organisation. Surveillance also enables analysts to stay abreast of current developments and discuss potential problem areas with the management. The primary analyst maintains periodic contact and ensures that regular surveillance information is shared on a timely basis. All gradings are under continuous surveillance and even where there is no obvious reason to change the grade, the CRISIL conducts a formal annual review, which involves a meeting with the company.

Grading Methodology for Healthcare Organisations The CRISIL has developed the healthcare grading methodology based on eight broad parameters, after an in-depth analysis of various criteria adopted by several international agencies in USA, Australia and Canada. It has also taken extensive inputs from several healthcare industry experts, hospital administrators, consulting doctors from medical specialities, hospital design and consultancy teams, state nursing home associations, research professors from healthcare administration colleges and so on. The eight broad parameters, assessed for grading a healthcare institution are:

Medical Specialities Medical and diagnostic specialities are evaluated based on essential and desirable equipment available, qualification and adequacy of medical and other personnel, availability of requisite support services, number and nature of procedures or surgeries performed by the concerned departments, process efficiency and clinical parameters.

Quality of Support Services Hospital support services are evaluated based on the quality of service and degree of support provided to the medical specialities. These include: billing, hospital information system, central sterile supplies department (CSSD), front office, house keeping, medical records, out-patient department (OPD), biomedical engineering, maintenance and pharmacy.

Regulatory Compliance The CRISIL assesses the degree of compliance with various regulations stipulated by the Government of India, respective state governments and other independent bodies while grading a healthcare institution. Some of the key regulations include: Bio-Medical Waste Management and Handling Rules, Transplantation of Human Organs Act, Nursing Home Regulation Act (wherever applicable), Drugs and Cosmetics Act, and BARC Standards for Radiology.

Financial Performance The financial performance of the hospital is evaluated based on the financial benchmarks developed by the CRISIL for credit rating of hospitals and also based on its international technology partner's (Standard and Poor) experience in rating both corporate sector and not-for-profit healthcare organisations. The financial benchmarks developed by S&P

for healthcare organisations have been fine-tuned to suit the Indian healthcare sector. Financial performance is only evaluated to check whether the hospital is generating sufficient cash flows from operations to upgrade essential equipment and retain qualified professionals. In case of not-for-profit organisations, the evaluation is also based on the adequacy of grants and donations to hospitals for maintaining the existing quality of patient care.

Management Evaluation Management philosophies and strategies are evaluated and the CRISIL compares the hospitals business strategies and financial plans to provide insights into the management's ability to forecast and implement plans. Specific areas reviewed include goals and strategies of the management, track record of the management in planning and control systems, ability to retain key consultants, depth of managerial talent, succession plans and quality improvement plans.

Hospital Mission and Policy All healthcare facilities must have clearly defined mission and policy for providing quality healthcare to the patients. The implementation of the mission, throughout the hospital, in policies and procedure is an important prerequisite. The established quality improvement process throughout the organisation and diligent functioning of various review committees in the hospital are carefully assessed in the grading process.

Patient Rights Patient rights followed by the hospital are evaluated based on the patient feedback and the basic rights followed by the hospital. This parameter reflects the evaluation of the planning and providing of care, treatment and rehabilitation. It also considers how the organisation sets care goals for each patient, and selects qualified personnel to provide and evaluate the care. However, the CRISIL does not directly evaluate the nature of care provided to any individual patient. Rather, the assessment process is based on the willingness of the organisation to monitor the results of care processes. The feedback of patients, during the course of treatment and after discharge, is observed to assess this parameter. Policies and procedures of the hospital and the individual departments are also assessed in this module.

Nursing Care Nursing care provided to the patients in critical care, emergency care, private and general wards and so on is evaluated, based on the nurses to beds ratio, experience and ability of the nurses training programmes for nurses and so on. Documented and practiced nursing procedures in the hospital for admitting and nursing patients in emergency care, the operation theatre, intensive care units, labour wards, in-patient wards and so on are also evaluated. The ability of the hospital management to retain qualified and experienced nurses is assessed.

Based on the evaluation of the parameters mentioned above, the CRISIL arrives at final grade for the healthcare institution. Broadly, the degree of importance of these parameters is in the order mentioned above. However, the relative importance of these parameters in any particular grade may vary depending on the facts of the case.

Benefits of Healthcare Institution Grading Grading of healthcare institutions would be a useful tool for inter-institution comparison, for all constituents associated with the healthcare industry, namely, hospitals, patients, healthcare insurance companies and government and third party administrators. The specific benefits to each of these constituents is outlined below:

Hospitals

- Improved credibility which enhances potential business revenues through increased patient flow from insurance companies/third party administrators.
- Improved viability for graded healthcare facilities as the rationale is disseminated by the CRISIL in its publications.

- Unbiased assessment by an external agency that can provide valuable inputs to the management on relative benchmarks vis à vis other hospitals.

Patients

- Ability to choose healthcare institutions on the basis of unbiased assessment of an independent agency instead of word of mouth.
- Improved access to in-depth information on the healthcare institution.

Healthcare Insurance Companies

- Useful input for developing sophisticated products linking level of premium with the grades assigned to the healthcare institutions, thereby providing a host of choice to prospective clients.
- Facilitates introduction of pre-approved treatment mechanism as opposed to 'post-payment claims', which eliminates the risk to false claims.

Government

- Improved transparency of healthcare institutions.
- Useful input for policy decision and improvement of healthcare delivery standards.

Third Party Administrators (TPAs)

- Provides objective criteria to selection of hospitals to be included in their network.
- Can help curtail fraudulent claims and achieve optimum claims to premium ratio from the insured population.

IPO (Initial Public Offering) Grading As per the SEBI (ICDR) Regulations, it is mandatory for all issuers in the primary market who file their draft red-herring prospectus (DRHP)/offer document to get an IPO grading from a SEBI-registered rating agency. The grading can be done at any stage of the IPO planning process, that is, before/after filing the DRPH with the SEBI. It should be completed and disclosed in the final/red hearing prospectus. The CRISIL grading normally takes 3-4 weeks to complete.

An IPO grading is an independent opinion on the fundamentals of the graded issue expressed as a relative assessment in relation to other listed equity shares in India. The assessment is based on a grading exercise comprising an analysis of: **(A) Business Prospects** in terms of **(a)** industry prospects, **(b)** company prospects: the competitive position of the issuer *vis-à-vis* the relevant homogenous companies sector-wise/the alignment between industry opportunities, the company's strategy and its capabilities; **(B) Financial Prospects** in terms of a forward looking assessment/independent forecasting of key financial indicators of the issuer relevant for an equity investor, namely, ROCE, ROE, PAT and EPS; **(C) Management Evaluation/Quality**: an assessment of the ability of the management to handle uncertainty in terms of capitalising on future business opportunity and mitigating the impact of contingencies; and **(D) Corporate Governance** on the basis of evaluation of governance structure of the company to determine if it is structured such that the risks and rewards of business are equally available to all shareholders in keeping with the basic tenets of a joint stock company.

The IPO grading reflects CRISIL's assessment of the equity fundamentals as distinct from debt fundamentals. It is based on a process that is totally independent of the credit rating process. Though the basic elements of the analysis are the same, the orientation is very different in view of very distinct objectives. The credit rating assessment of these factors—business/financial prospects, management quality and corporate governance – from creditors perspective is very different and sometimes opposite to an equityholders perspective. For instance, companies which raise excessive equity and suffer a depressed return on equity (ROE) are likely to be unfavourably assessed in the IPO grading but they are likely to be assessed more favourably in credit rating as huge equity cushions debt repayment. Secondly, the focus on financial prospects in IPO grading is on equity-related parameters, while it is on cash flows in relation to debt servicing. Finally, the relative emphasis on the various elements of the analysis is also different. For instance, the assessment of corporate governance is more important in IPO grading than in credit rating with focus on cash protection available to service debt.

An IPO grading, however, is not a: **(i)** recommendation to invest/not invest in the graded instruments, **(ii)** comments on the issue of the shares being offered, likely listing movement of price post-listing, **(iii)** valuation of the equity offering, **(iv)** assessment of the market risk associated with equity investments, **(v)** audit of the of the issuer, **(vi)** forensic exercise to detect fraud, and **(vii)** opinion which has an ongoing validity.

The IPO grading process involves the following four steps:

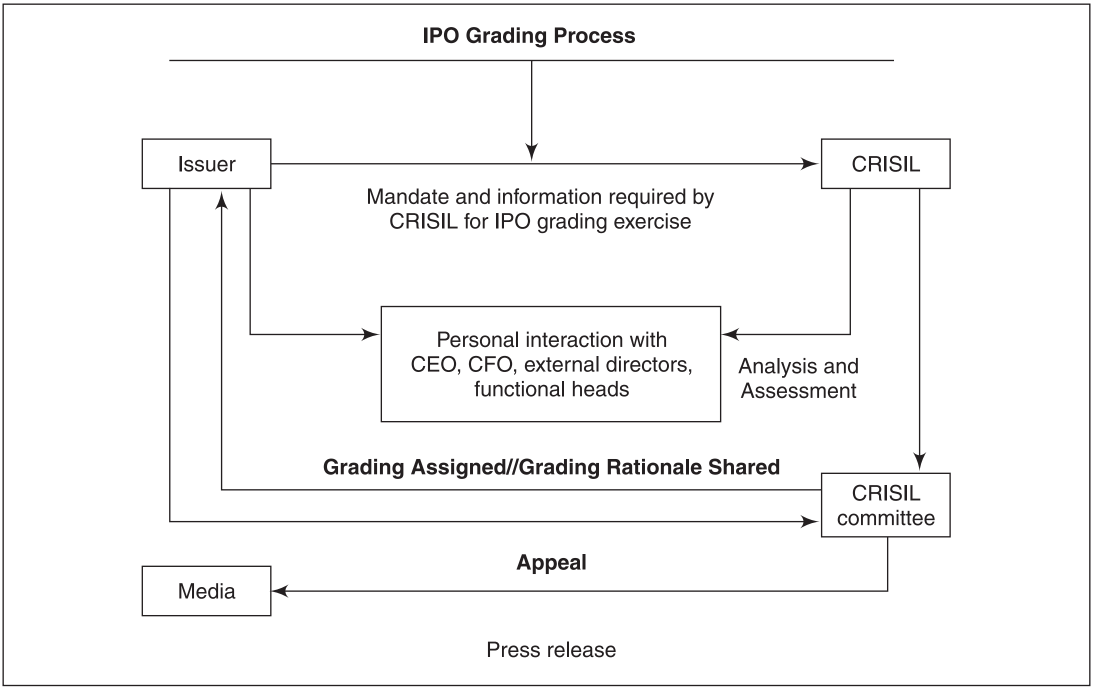
- The issuer shares the required information with the grading team with the mandate. The information needed, *inter alia*, includes: **(i)** last 5 years annual reports, **(ii)** hard copies of the draft prospectus, **(iii)** detailed project report for a new project, **(iv)** details on promoters background, other main companies within the group and last 5 years annual reports of group companies, **(v)** financial projections for the next 5 years with relevant assumptions, **(vi)** details of the instrument to be graded and **(vii)** any additional information required in specific circumstances.
- This is followed by detailed management meetings and plant/site visits. They comprise meetings with the CFO, functional/plant/sub-heads, independent directors and the CEO preferably in that order.
- The grading team prepares a detailed note and presents it to the grading committee comprising senior internal resources and eminent external experts which assigns the rating.
- The issuer is provided the grading report/rationale and the grade. In case the issuer believes that material relevant information has not been considered in the grading and laid out in the rationale, an appeal can be made to the grading committee. The committee would consider the appeal and reassess the assigned grade. In case the company is still not satisfied, it can opt for a second grading from another SEBI-registered rating agency. All disclosures with respect to the assigned gradings would be governed by the applicable SEBI regulations/guidelines. A one-page public release on the subject is also published.

  The grading process is illustrated on next page:

The CRISIL's grading scale/symbol is assigned on a 5-point scale;

IPO Grading Scale

Grade	*Assessment*
5/5	Strong fundamentals
4/5	About average fundamentals
3/5	Average fundamentals
2/5	Below average fundamentals
1/5	Poor fundamentals



ICRA Ltd

The ICRA Ltd has been promoted by the IFCI Ltd as the main promoter to meet the requirements of the companies based in the northern parts of the country. Apart from the main promoter, which holds 26 per cent of the share capital, the other shareholders are the Unit Trust of India, banks, LIC, GIC, Exim Bank, HDFC Ltd and ILFS Ltd. It started operations in 1991. In order to bring international experience and practices to the Indian capital markets, the ICRA has entered into a MOU with Moody's Investors Services to provide, through its company Financial Programmes Inc (FPI), credit education, risk management software, credit research and consulting services to banks, financial/investment institutions, financial services companies and mutual funds in India. As in the case of the CRISIL, the main objectives of the ICRA are:

- To assist investors, both individual and institutional, in making well informed decisions;
- To assist issuers in raising funds, from a wider investor base, in large amounts and at a lower cost for highly rated entities;
- To enable banks, investment bankers, brokers in placing debt with investors by providing them with a marketing tool and
- To provide regulators with market driven systems to encourage the healthy growth of the capital markets in a disciplined manner, without additional burden on the Government.

Over the years, the ICRA has diversified the range of its services. It currently provides three types of services: **(1)** rating services; **(2)** information services and **(3)** advisory services.

A brief account of the ICRA Information and Advisory Services is given in Appendix 14-C on the webstie. The website address is http://www.mhhe.com/khanfs9e.

Rating Services The ICRA rates rupee-denominated debt instruments issued, *inter-alia*, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and municipalities. The obligations include long-term instruments such as bonds/debentures, medium-term instruments such as fixed deposit programmes and short-term instruments such as commercial paper programmes and certificates of deposit. It also rates structured obligations and sector-specific debt obligations such as instruments issued by power, telecom and infrastructure companies. The other services offered include corporate governance rating; rating of claims paying ability of insurance companies, line of credit rating; credit assessment of large, medium and small scale units for obtaining specific lines of assistance from commercial banks, financial institutions and financial services companies. The other services in the area of credit rating include the following:

Credit Assessment The ICRA takes up assignments for credit assessment of companies/undertakings intending to use the same for obtaining a specific line of assistance from commercial banks, financial/investment institutions, factoring companies and financial services companies. The assessment indicates the broad opinion of the ICRA as to the relative degree of capability of the company undertaking to repay the interest and principal, as per the terms of the contract.

General Assessment The ICRA provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. This service is also likely to be useful for other non-banking non-financial agencies for the purpose of merger, amalgamation, acquisition, joint venture, collaboration and factoring of debts and so on. It does not assign any specific symbols in respect of such general assessments. It provides a report on different aspects of the companies' operations/managements.

Structured Finance Rating The ICRA's structured finance ratings (SFRs) are an opinion regarding the likelihood of the timely servicing of debt obligations, in accordance with the terms of the structure. An SFR, which is generally different from the corporate credit rating of the issuer, is based on the risk assessment of the individual components of the structured instrument. These components include legal risk, credit quality of the underlying asset and the various features of the structure. The symbols used for SFRs are similar to the credit rating symbols, except that the SFRs carry a suffix of SO (for structured obligation) in parentheses. ICRA's major SFR products include asset-backed securitisation (ABS), mortgage-backed securitisation (MBS), collateralised debt obligation (CDO) and future flow transaction (FFT) ratings. Besides, a number of other structured finance products, like securitisation of trade receivables, and partial guarantee are also rated by ICRA.

Claims Paying Ability Rating (for Insurance Companies) The ICRA's **claims paying ability ratings** (CPRs) for insurance companies are an opinion regarding the ability of the insurers concerned to honour policyholder claims and obligations on time. In other words, a CPR is the ICRA's opinion on the financial strength of the insurer, from a policyholder's perspective. Following deregulation, a paradigm shift is expected in the domestic insurance sector as newer players and products enter the market. Given this scenario, the ICRA expects its CPRs to be an important input influencing the consumer's choice of insurance companies and products. Its rating process involves analysis of an insurer's business fundamentals and its competitive position, and focuses primarily on the insurer's franchise value, its management, organisational structure/ownership and underwriting and investment

> **Claims paying ability rating**
> is an opinion regarding the ability of the concerned insurer to honour policy-holder's claim on time.

strategies. Besides, the analysis includes an assessment of an insurance company's profitability, liquidity, operational and financial leverage, capital adequacy and asset/liability management method.

Corporate Governance Rating The ICRA's **Corporate Governance Rating** (CGR) provides a current opinion regarding the extent to which an organisation accepts and agrees to codes and guidelines of corporate governance practices that serve the interests of stakeholders such as shareholders, customers, creditors, bankers, employees, government and society at large. The aspects examined during a CGR exercise include: ownership structure, financial stakeholder relations, financial transparency and information disclosure and Board structure and process. A CGR, carrying the ICRA stamp, helps the corporate entity concerned in raising funds, listing on stock exchange, dealings with third parties like creditors, providing comfort to regulators; improving image/credibility, improving its valuation and bettering its corporate governance practices through benchmarking.

> **Corporate governance rating** provides a current opinion regarding the extent to which an organisation accepts and agrees to codes and guidelines of corporate governance practices that serve the interest of stakeholders.

Line of Credit Rating The line of credit rating (LCR) service from the ICRA entails evaluating the capability of an issuer to meet its debt obligations, timely, against a specific line of credit, in the light of the relevant terms, conditions and covenants. The rating services covers any line of credit being made available from any corporate/non-corporate entity, which includes, but is not limited to, commercial banks, financial institutions, non-banking finance companies, and residuary non-banking companies. An LCR is not disclosed to the public, even if the rating is accepted by the issuer/lender. The LCR service is offered at the behest of the borrower/lender of the line of credit.

> **Line of credit rating** entails evaluation of the capability of an issuer to meet its debt obligations, timely against a specific line of credit.

Credit Assessment for Small Scale and Medium Scale Industries These units have traditionally faced a problem of obtaining finance for operations on account of their small size and level of operations. The ICRA provides credit assessment services to such units. The assessment indicates the broad opinion of the ICRA as to the relative degree of capability of the small/medium-sized unit to repay the interest and principal, as per the terms of the contract. The assessment can be used to obtain financing from banks and/or financial/investment institutions. The ICRA and Confederation of Indian Industry (CII) jointly identify the small and medium sector industrial enterprises on a cluster basis. The clusters would be identified on a sectoral or geographical basis. These units could then approach ICRA, through the CII, to get themselves assessed on a cluster basis. The cluster approach would serve to reduce the cost and time of the exercise, which would be of benefit to the units. The small/medium scale units can also approach ICRA directly for credit assessment. Thus, credit assessment is used by small/medium scale industry for the use of obtaining a specific line of assistance from banks and/or financial/investment institutions. The assessment is a symbolic indicator of the current opinion regarding the relative degree of capability of the borrower to repay the interest and principle, as per the terms of the contract.

The assessments are based on an in-depth study of the industry as also an evaluation of the strengths and weaknesses of the unit. The inherent protective factors, marketing strategies, competitive edge, level of technological development, operational efficiency, competence and effectiveness of management, hedging of risks, cash flows trends and potential, liquidity, financial flexibility, asset quality and past record of servicing debts and obligations as well as the government policies and statutes affecting the industry and the unit are looked into.

Earnings Prospects and Risk Analysis (EPRA) The **EPRA** range of information services are structured with a view to providing authentic information on the relative quality of equity shares in diverse corporates. The relative quality of equity of a company and the growth, stability and composition of its earnings is assessed by analysing the underlying fundamentals that would affect its future performance over the medium-term. A complex combination of variables is examined, namely, industry outlook, management quality, financial strength, corporate operation, competitive strength and outlook. The EPRA includes **(i)** equity grading and **(ii)** equity assessment.

> **EPRA**
> provides authentic information on the relative quality of equity shares in diverse corporates.

Equity Grading The **equity grading** process commences at the request of the prospective issuer, on receipt of the required information from him, and culminates in an opinion from the ICRA, expressed symbolically as an equity grade. A team of analysts takes up the work of collection of data and information from the books and records of the concern and meets with its executives. The support of in-house research and the database of the ICRA as well as secondary data are also availed of.

> **Equity grading**
> is done at the request of the issuer.

After interacting with the management and analysing the data, the analysts present their findings to a committee, which then decides on the relative equity grade of the issuer. The process generally takes three to four weeks from the time of receiving the required data from the management. The ICRA offers the issuer an opportunity to get itself analysed confidentially and also an option regarding use of ICRA' s grade. However, once the issuer decides to use the grade, the ICRA monitors the working of the company on a continuous basis. Based on the information obtained from the company, or collected by the ICRA on its own, during the period, the equity grade may be changed suitably. The ICRA reserves the right to make public such equity grade/change in equity grade.

Equity Assessment The **equity assessment** process commences at the request of an investor and the consent of the company being assessed. ICRA may or may not disclose the investor's identity to the company depending upon the investor's preference. The rest of the assessment process is similar to the equity grading process, except that the end result is not in the form of a symbol but as an assessment report specific to the investor's need and intended to be used by the investor only.

> **Equity assessment**
> is done at the request of an investor.

Methodology The ICRA analyses and appraises all relevant factors that have a bearing on the equity quality of the issuer/company. The key factors looked into depend on the nature of the issuer/company. The opinions are based on an in-depth study of the industry and economic/business environment, competence and effectiveness of the management, promoter's profile, marketing strategies, size and growth of revenues, competitive edge, state of technology, operational efficiency, liquidity, financial flexibility, asset quality as also the accounting quality, profitability and the hedging of risks. These factors further suggest the level, growth and composition of earnings as also the financial strength that may be expected in the future.

CARE Ltd

The CARE Ltd is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public/private sector banks and private finance companies. It commenced its credit rating operations in October 1993 and offers a wide range of products and services in the field of credit information and equity research.

Unlike the CRISIL and the ICRA, the CARE is very cautious in entering new areas of business. Currently, it offers the following services:

Credit Rating The CARE undertakes credit rating of all types of debt instruments, both short-term and long-term.

Advisory Services The CARE provides advisory services in the areas of:

- Securitisation transactions;
- Structuring financial instruments;
- Financing of infrastructure projects and
- Municipal finances.

Information Services The broad objective of the information services is to make available information on any company, industry or sector required by a business enterprise. The value addition, through inclusive analysis enables the users of the service, like individuals, mutual funds, investment companies, residents or non-residents, to make informed decisions regarding investments.

Equity Research Equity research involves an extensive study of the shares listed/to be listed in the major stock exchanges, and identification of the potential winners and losers among them, on the basis of the fundamentals affecting the industry, market shares, management capabilities, international competitiveness and other relevant factors. The CARE provides equity research service with specific objectives to be accomplished by the client.

Publications The CARE's publications include **(i)** Rating Reckoner—an update on its accepted ratings and **(ii)** CAREVIEW—a quarterly bulletin providing information on its ratings.

Other Services Other ratings services introduced by are as the CARE follows: **(i)** The CARE loan rating, **(ii)** Credit analysis rating, **(iii)** Interest rate structural model, **(iv)** Performance rating of parallel marketers of LPG and kerosene oil, as per the scheme notified by the Government and **(v)** Rating of collective investment schemes of plantations, as required by the SEBI.

CARE Loan Rating (CLR) The CARE loan ratings are opinions on the ability and willingness of a borrower to make timely payments on the specific loan obligation, over its life. It was introduced in the wake of financial market reforms. It is difficult to distinguish between the activities of banks, development financial institutions (DFIs), NBFCs and other players in the financial system as their functions are overlapping. Commercial banks, whose traditional forte has been working capital lending, are increasingly moving into term financing, while DFIs are moving into working capital financing. In this context, the CLR is aimed at providing a valuable input in assisting the decision making process in banks and DFIs. No doubt, banks and DFIs often use credit rating on debt securities or fixed deposits as an indicator of the issuer's ability to honour its obligations on loans, but the CLR would directly address their needs by rating the loan itself and incorporating the specific characteristics of the loan in the analysis. The following benefits accrue from using the CLR as it will meet the requirements of banks and institutions for the following purposes: **(a)** assessing the creditworthiness of borrowers; **(b)** serve as a simple objective indicator for the internal credit risk exposure guidelines; **(c)** determining the premium to be charged; **(d)** portfolio monitoring and **(e)** making quick credit decisions. It would also help borrowers in **(a)** accessing a range of potential lenders; **(b)** accessing more stable capital and **(c)** reducing the cost of borrowing, by establishing a risk-reward relationship.

Credit Analysis Rating (CAR)/Credit Assessment **Credit analysis ratings** are meant for business entities intending to obtain/enhance credit facilities from banks/financial institutions/NBFCs and so on. It reflects the overall debt management capability of the entity. The assessment indicates the broad opinion of the CARE on the entity's relative capability to make timely payments of interest and principal on its debt obligations. The rating incorporates credit risk over the immediate time horizon of up to three years. The salient characteristics of the credit analysis rating are: **(a)** it is issuer specific and not instrument specific, **(b)** one time assessment of credit quality, which can be renewed on the specific request of the issuer and **(c)** confidential ratings meant for the specific use of institutional investors/lenders, and not for raising funds from public.

> **Credit analysis ratings**
> reflects the overall debt management capability of the entity as a whole.

Interest Rate Structure Model With the deregulation of the interest rates over the years, lending institutions (Banks/FIs) are now free to charge interest rates on individual loans, based on their risk perception. A need to evolve a model to arrive at an appropriate interest rate that would consider the quantitative as well as qualitative factors has been felt necessary. The CARE has developed a software package, Interest Rate Structure Model (IRSM), to aid interest rate determination commensurate with the track record and credit risk of corporate borrowers. The basic hardware is applied to all manufacturing companies with a minimum track record of four years, for short as well as long-term assistance.

FITCH Ratings India Ltd

It is a joint venture between the international credit rating agency Duff and Phelps and JM Financial and Alliance Group. In addition to debt instruments, it also rates companies and countries, on request.

Small and Medium Enterprises Rating Agency (SMERA)

It is the latest entrant in the credit rating business. It has been launched by the SIDBI in association with several banks to focus on rating of small and medium enterprises. It has commenced operation only recently.

RATING PROCESS AND METHODOLOGY

The process/procedure followed and the methodology used generally by CRAs in respect of mandated and other instruments are briefly outlined in this Section.

Rating Process/Procedure

All the four rating agencies in the country adopt a similar rating process. The steps followed by them in the rating process are illustrated with reference to **(1)** new issues/instruments **(2)** review of rating and **(3)** flow chart of rating.

Rating Process of New Issues The following steps are involved in rating the issuers of instruments for the first time, before going public.

Rating Agreement and Assignment of Analytical Team The process of rating starts with the issue of the rating request letter by the issuer of the instrument and the signing of the rating agreement.

On receipt of the request, the credit rating agency (CRA) assigns an analytical team, comprising two/more analysts, one of whom would be the lead analyst and would serve as the issuer's primary contact. The analysts who have expertise in the relevant business area are responsible for carrying out the rating assignments.

Meeting with Management Prior to meeting with the issuer, the analytical team obtains and analyses information relating to its financial statements, cash flow projections and other relevant information detailed below:

(i) Annual reports for the past five years and interim reports for past three years
- if annual reports do not include cash flow statements, then cash flow statements should be provided for the above periods;
- if the interim reports do not contain balance sheets, these should also be provided.

(ii) Two copies of the latest prospectus offering statements and applications for listing on any major stock exchanges.

(iii) Consolidated financial statements for the past three fiscal years by the principal, subsidiary or division.

(iv) Two copies of the statements of projected sources and application of funds, balance sheets and operating statements for at least the next three years, along with assumptions on which projections have been based.

(v) Copies of the existing loan agreements along with recent compliance letters, if any. In the case of outstanding public debt issues, copies of compliance letters required by indenture of such debt should be also furnished.

(vi) A certified copy of the resolution adopted by the board of the company authorising the issuance of commercial paper and or other short-term debt instruments, including the name of authorised signatories.

(vii) List of the banks, showing lines of credit and contact officers for each, along with duly completed short-term borrowings from them, in the prescribed format.

(viii) If applicable, the name of commercial paper dealer of the company, the planned use of proceeds from the sale of commercial paper, the amount of commercial paper to be used, and a specimen copy of the commercial paper note.

(ix) Biographical information on the company's principal officers and the names of the board members.

There is no prescribed format for supplying the above information. Hence, any format could be flexibly used to cover all the required information adequately.

A complete brief followed by a discussion on management philosophy and plans should also be obtained. There are certain important aspects that should be known since these impact the credit quality of the instrument being rated. Discussions with the management might reveal more information, as such discussions should cover the following matters:

(a) Discussion on the management philosophy and plan should cover the financial and operating data for the past five years, and three to five years for future projections;

(b) Discussion on projections should reveal management objectives and future plans, that is, future growth plan of the company should be crystallised. These projections are supposed to reflect the "management's" best estimates of the future financial picture of the company and incorporate the underlying economic assumptions for the future as well as the growth objectives, marketing strategies, spending plans and financing needs and alternatives. Financial projections play a significant role in the rating process as they indicate a management plan for the future. They illustrate the financial strategies of the company in terms of anticipated reliance on internal cash flow or outside funds;

(c) Discussions must help reveal the risks and opportunities that affect credit quality over the period covered under projections.

Other key factors that the issuer believes will have an impact on the rating, including business segments analysis, portfolio analysis and so forth, should also be discussed.

The analytical team then proceeds to have detailed meetings with the company's management. To best serve the interests of the investors, a direct dialogue is maintained with the issuer as this enables the CRAs to incorporate non-public information in a rating decision and also enables the rating to be forward looking. The topics discussed during the management meeting are wide ranging, including competitive position, strategies, financial policies, historical performance and near and long-term financial and business outlook. Equal importance is placed on discussing the issues, business risk profile and strategies, in addition to reviewing financial data.

The rating process ensures complete confidentiality of the information provided by the company. All information is kept strictly confidential by the rating group and is not used for any other purpose or by any third party other than CRAs.

Rating Committee After meeting with the management, the analysts present their report to a rating committee, which then decides on the rating. The rating committee meeting is the only aspect of the process in which the issuer does not participate directly. The rating is arrived at after a composite assessment of all the factors concerning the issuer, with the key issues getting greater attention from the rating committee.

Communication to the Issuer After the committee has assigned the rating, the rating decision is communicated to the issuer, with the reasons or rationale supporting the rating.

For a rating to have value or an issuer or an investor, the CRA must have credibility. The thoroughness and transparency of its rating methodology and the integrity and fairness of its approach are important factors in establishing and maintaining credibility. The CRAs are, therefore, always willing to discuss with the management, the critical analytical factors that the committee focused on while determining the rating and also any factors that the company feels may not have been considered while assigning the rating.

In the event that the issuer disagrees with the rating outcome, he may appeal the decision for which new/additional information, which is material to the appeal and specifically addresses the concerns expressed in the rating rationale, need to be submitted to the analysts. Subsequently, a note is put up once again before the rating committee, where the rating may or may not undergo a change. The client has the right to reject the rating and the whole exercise is kept confidential.

The rating process, from the initial management meeting to the assignment of the rating, normally takes three to four weeks. However, when required, the CRAs deliver the rating decision in shorter time frames.

Dissemination to the Public Once the issuer accepts the rating, the CRAs disseminate it, along with the rationale, through the print media.

Rating Review for Possible Change In the case of rated instruments, the rated company is on the surveillance system of the CRA, and from time to time, the earlier rating is reviewed. The CRA constantly monitors all ratings with reference to new political, economic and financial developments and industry trends. All this information is reviewed regularly to identify the companies for potential rating changes. The CRA prepares annual review proposals for the rating review committee. The following steps are necessary in the rating process for review cases.

New Data of Company Analysts review the new information or data available on the company, which might be sent to it by the company or it might have been procured through routine channels, as strategic information under its surveillance approach. If the new information is crucial for rating decisions. then analysts take action to collect more information as may be available from different sources and study the same from the angle of relevance and authenticity.

Rating Change On preliminary analysis of the new data, if the analysts feel that there is a possibility for changing the rating, then the analysts request the issuer for a meeting with its management and proceed with a comprehensive rating analysis. The rest of the procedure of presenting the rating opinion to a rating committee and so on is the same as is followed in the cases of new issues, discussed above.

Credit Rating Watch During the review monitoring or surveillance exercise, rating analysts might become aware of imminent events like mergers and so on, which affect the rating and warrants a rating change. In such a possibility, the issuer's rating is put on 'credit watch' indicating the direction of a possible change and supporting reasons for a review. Once a decision to either change or present the rating has been made, the issue will be removed from 'credit watch'. The duration of credit watch is for 90 days. In case the rating is modified, the same procedure of presentation to the rating committee and so on are followed. 'Credit watch' indicates four situations for changing the rating, namely: **(1)** "Negative" change, indicating the possibility of a downgrade; **(2)** "Positive" change, indicating an upgrade; **(3)** "Stable", implying no change in rating and **(4)** 'Developing", implying an unusual situation in which the future events are so unclear that the rating may be changed either in negative or positive directions.

Flow Chart of the Rating Process The steps for the rating process discussed in the previous paragraphs can be summed up in the flow chart in **Exhibit 14.2**.

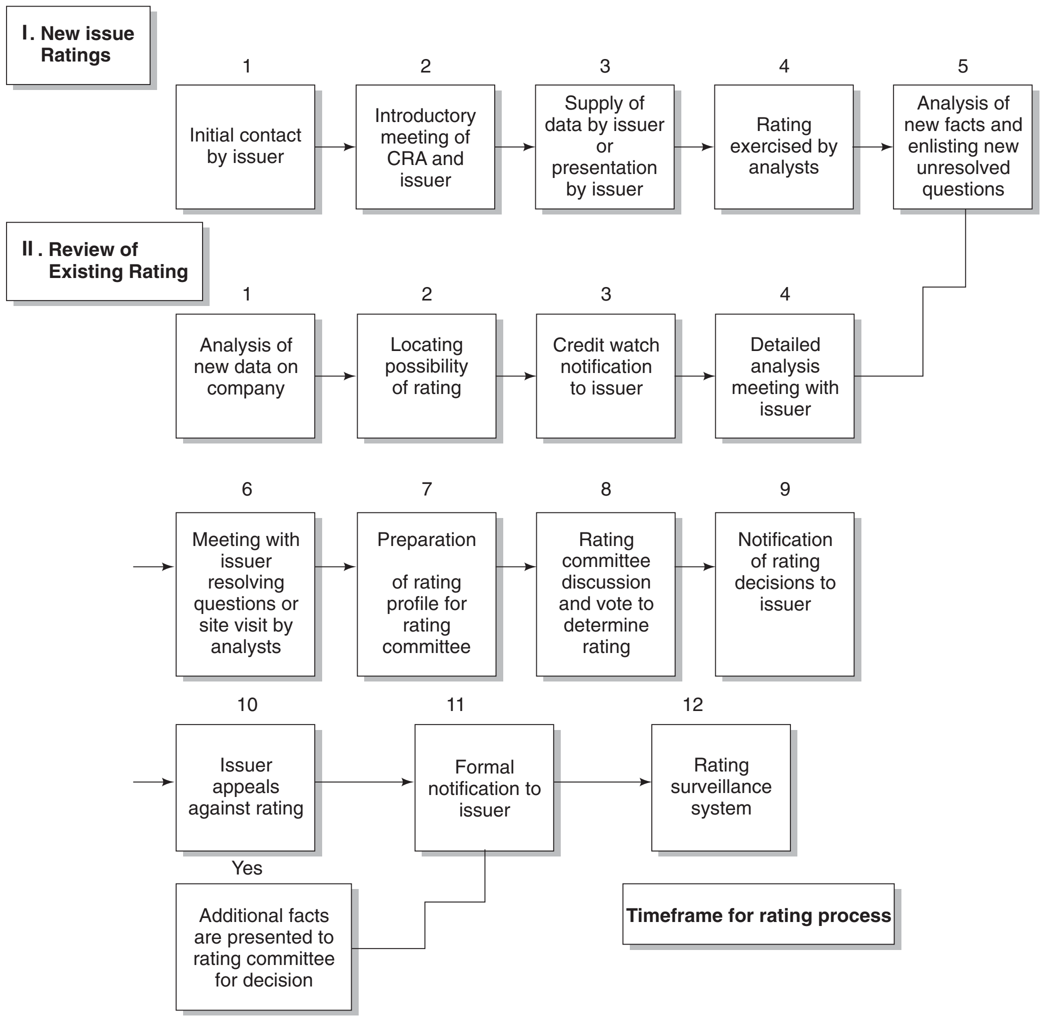
Rating Methodology

The rating methodology involves an analysis of the industry risk, the issuer's business and financial risks. A rating is assigned after assessing all the factors that could affect the credit worthiness of the entity. Typically, the industry risk assessment sets the stage for analysing more specific company risk factors and establishing the priority of these factors in the overall evaluation. For instance, if the industry is highly competitive, careful assessment of the issuer's market position is stressed. If the company has large capital requirements, the examination of cash flow adequacy assumes importance. The ratings are based on the current information provided by the issuer or facts obtained from reliable sources. Both qualitative and quantitative criteria are employed in evaluating and monitoring the ratings. The rating methodology is illustrated below with reference to **(i)** manufacturing companies and **(ii)** financial services companies.

For Manufacturing Companies The main elements of the rating methodology for manufacturing companies are outlined below.

Business Risk Analysis The rating analysis begins with an assessment of the company's environment, focusing on the strength of the industry prospects, pattern of business cycles as well as the competitive factors affecting the industry. The vulnerability of the industry to government controls/regulations is assessed.

Exhibit 14.2 Rating Process Flow Chart



From	To	Time frame
Initial request	Meeting with management	4-6 weeks
Meeting with management	Initial rating indication	4-6 weeks
Initial rating indication	Publication of rating	Time depends upon Completion of formalities

Note: Rating process given in the chart is followed by all CRAs, with suitable adjustments to the conditions of each issuer.

The nature of competition is different for different industries, based on price, product quality, distribution capabilities, image, product differentiation, service and so on. The industries characterised by a steady growth in demand, ability to maintain margins without impairing future prospects, flexibility in the timing of capital outlays, and moderate capital intensity are in a stronger position.

When a company participates in more than one business, each segment is analysed separately. A truly diversified company does not have a single business segment that is dominant, and the company's ability to manage diverse operations is a significant factor. As part of the industry analysis, key rating factors are identified into key to success and areas of vulnerability. The main industry and business factors assessed include:

Industry Risk Nature and basis of competition, key success factors, demand and supply position, structure of industry, cyclical/seasonal factors, government policies and so on.

Market Position of the Issuing Entity Within the Industry Market share, competitive advantages, selling and distribution arrangements, product and customer diversity and so on.

Operating Efficiency of the Borrowing Entity Locational advantages, labour relationships, cost structure, technological advantages and manufacturing efficiency as compared to competitors and so on.

Legal Position Terms of the issue document/prospectus, trustees and their responsibilities, systems for timely payment and for protection against fraud/forgery and so on.

While the CRAs do not have a minimum size criterion for any given rating level, the size of the company is a critical factor in the rating decision as smaller companies are more vulnerable to business cycle swings as compared to larger companies. In general, small companies are more concentrated in terms of product, number of customers and geography and, consequently, lack the benefits of diversification that can benefit larger firms.

If the company being rated is a subsidiary or an affiliate, controlled by/has strong links with a dominant parent company, then the rating also includes an analysis of the parent company's credit quality. The parent company's credit quality could have an impact on the issuer's own credit quality.

Financial Risk Analysis After evaluating the issuer's competitive position and operating environment, the analysts proceed to analyse the financial strength of the issuer. Financial risk is analysed largely through quantitative means, particularly by using financial ratios. While the past financial performance of the issuer is important, emphasis is placed on the ability of the issuer to maintain/improve its future financial performance.

As ratings rely on audited data (the rating process does not entail auditing a company's financial records), the analysis of the audited financial results begins with a review of accounting quality. The purpose is to determine whether ratios and statistics derived from financial statements can be used to accurately measure a company's performance and its position, relative to both its peer group and the larger universe of companies.

The profitability of a company is an important determinant of its ability to withstand business adversity, as well as generate capital internally. The main measures of profitability studied include operating and net margins and return on capital employed. The absolute levels of these ratios, trends in movement of the ratios as well as comparison of the ratios with other competitors analysed. As a rating exercise is a forward looking exercise, greater emphasis is laid on the future, rather than the past earning capability of the issuer.

Emphasis is also laid on an analysis of cash flow patterns, as it provides a better indictor of the issuer's debt servicing capability, compared to reported earnings. A cash flow analysis reveals the usage of cash for different purposes, and, consequently, the extent of cash available for debt servicing.

The future debt claims on the issuer as well as the issuer's ability to raise capital is also assessed in order to arrive at the level of the issuer's financial flexibility. The areas considered in financial analysis include:

Accounting Quality Overstatement/understatement of profits, auditors qualifications, method of income recognition, inventory valuation and depreciation policies, off-balance sheet liabilities and so on.

Earnings Prospects Sources of future earnings growth, profitability ratios, earnings in relation to fixed income charges and so on.

Adequacy of Cash Flows In relation to debt and working capital needs, stability of cash flows, capital spending flexibility, working capital management and so on.

Financial Flexibility Alternative financing plans in times of stress, ability to raise funds, asset deployment potential and so on.

Interest and Tax Sensitivity Exposure to interest rate changes, tax law changes, hedging against interest rates and so on.

Management Risk A proper assessment of debt protection levels requires an evaluation of the management philosophies and its strategies. The analyst compares the company's business strategies and financial plans (over a period of time) to provide insights into a management's abilities, with respect to forecasting and implementing of plans. Specific areas reviewed include: **(i)** Track record of the management: planning and control systems, depth of managerial talent, succession plans; **(ii)** Evaluation of capacity to overcome adverse situations and **(iii)** Goals, philosophy and strategies.

Financial Services Sector When rating debt instruments of financial institutions, banks and non-banking finance companies, in addition to the financial analysis and management evaluation outlined above, the assessment also lays emphasis on the following factors:

Regulatory and Competitive Environment **(i)** Structure and regulatory framework of the financial system; **(ii)** Trends in regulation/deregulation and their impact on the company/institution.

Fundamental Analysis Fundamental analysis should include:

Capital Adequacy Assessment of the true networth of the issuer, its adequacy in relation to the volume of business and the risk profile of the assets.

Resources Overview of funding sources; funding profile; cost and tenor of various sources of funds.

Asset Quality Quality of the issuer's credit risk management; systems for monitoring credit; sector risk; exposure to individual borrowers, management of problem credits and so on.

Liquidity Management Capital structure; term matching of assets and liabilities; policy on liquid assets in relation to financing commitments and maturing deposits.

Profitability and Financial Position Historic profits; spreads on funds deployment; revenues on non-fund based services; accretion to reserves and so on.

Interest and Tax Sensitivity Exposure to interest rate changes; tax law changes and hedging against interest rate.

The summary of information to be submitted by manufacturing and financial companies for rating assignment is given in **Appendix 14-D and Appendix 14-E respectively on the website. The website address is http://www.mhhe.com/khanfs9e.**

RATING SYMBOLS/GRADES

Rating symbols are a symbolic expression of the opinion/assessment of the credit rating agency(ies) regarding the investment/credit quality/grade of the debt/obligations/ instrument. They group together similar, though not necessarily identical, entities in terms of their relative capacity for timely servicing of the obligations, as per the terms of the contract. The SEBI has recently issued guidelines for standardisation of rating symbols and definitions. They are discussed in this section. **An illustrative list of other rating symbols as the final expression of the investment quality of a financial instrument used by two Indian rating agencies, namely CRISIL and ICRA, is also profiled in this Section.**

Standardisation of Rating Symbols and Definitions

The SEBI-registered CRAs have been using different rating symbols and definitions. There is need to have common rating symbols and definitions **(i)** for their easy understanding and meanings by the investors, and **(ii)** to achieve high standards of integrity and fairness in ratings. The standardised symbols and their definitions have been devised for the following: **(a)** Long-term debt instruments; **(b)** Short-term debt instruments; **(c)** Long-term structured finance instruments; **(d)** Short-term structured finance instruments; **(e)** Long-term mutual fund schemes; and **(e)** Short-term mutual fund schemes. The new symbols and definitions as given in the annexure below should henceforth be used for the new ratings/reviews by the CRAs. For existing outstanding ratings, they should: **(i)** disclose new ratings symbols and definitions on their websites; **(ii)** update their rating lists on their websites; and **(iii)** inform their clients about the change in the rating symbols and definitions and specifying that this should not be construed as a change in the ratings.

Annexure Standardised Rating Symbols/Definitions

I. Rating Symbols and Definitions for Long Term Debt Instruments: ***The instruments with original maturity exceeding one year*****. The rating symbols should have CRA's first name as prefix.**

AAA Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations and carry lowest credit risk.

AA Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations and carry very low credit risk.

A Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations and carry low credit risk.

BBB Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations and carry moderate credit risk.

BB Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.

D Instruments with this rating are in default or are expected to be in default soon.

Modifiers {"+" (plus) / "–"(minus)} can be used with the rating symbols for the categories AA to C. The modifiers reflect the comparative standing within the category.

II. Rating Symbols and Definitions for Short Term Debt instruments: ***The instruments with original maturity of upto one year Rating symbols should have CRA's first name as prefix***

A1 Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations and carry lowest credit risk.

A2 Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations and carry low credit risk.

A3 Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations and carry higher credit risk as compared to instruments rated in the two higher categories.

A4 Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations and carry very high credit risk and are susceptible to default.

D Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. The modifier reflects the comparative standing within the category.

III. Rating Symbols and Definitions for Long Term Structured Finance Instruments: ***The instruments with original maturity exceeding one year*****. Rating symbols should have CRA's first name as prefix**

AAA(SO) Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations and carry lowest credit risk.

AA(SO) Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations and carry very low credit risk.

A(SO) Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations and carry low credit risk.

BBB(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations and carry moderate credit risk.

BB(SO) Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B(SO) Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C(SO) Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

D(SO) Instruments with this rating are indefault or are expected to be in default soon.

Modifiers {"+" (plus) / "–"(minus)} can be used with the rating symbols for the categories AA(SO) to C(SO). The modifiers reflect the comparative standing within the category.

IV. Rating Symbols and Definitions for Short Term Structured Finance Instruments: *The instruments with original maturity of upto one year*. Rating symbols should have CRA's first name as prefix

A1(SO) Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation and carry lowest credit risk.

A2(SO) Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation and carry low credit risk.

A3(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation and carry higher credit risk as compared to instruments rated in the two higher categories.

A4(SO) Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation and carry very high credit risk and are susceptible to default.

D(SO) Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1(SO) to A4(SO). The modifier reflects the comparative standing within the category.

V. Rating Symbols and Definitions for Long Term Debt Mutual Fund Schemes: The debt mutual fund schemes that have an original maturity exceeding one year. Rating symbols should have CRA's first name as prefix

AAAmfs Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.

AAmfs Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.

Amfs Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investment s that they have made.

BBBmfs Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.

BBmfs Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.

Bmfs Schemes with this rating are considered to have high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

Cmfs Schemes with this rating are considered to have very high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

Modifiers {"+" (plus) / "–"(minus)} can be used with the rating symbols for the categories AAmfs to Cmfs. The modifiers reflect the comparative standing within the category.

VI. Rating Symbols and Definitions for Short Term Debt Mutual Fund Schemes: The debt mutual fund schemes that have an original maturity of upto one year. Rating symbols should have CRA's first name as prefix

A1mfs Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.

A2mfs Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.

A3mfs Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.

A4mfs Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1mfs to A4mfs. The modifier reflects the comparative standing within the category.

CRISIL Rating Symbols

The rating symbols of the CRISIL are illustrated below with reference to **(1)** credit assessment, **(2)** collective investment schemes, **(3)** chit funds and **(4)** real estate developers/builders.

Credit Assessment The assessment indicates the CRISIL's broad opinion as to the relative degree of capability of the entity to repay the interest and principal, as per the terms of the contract. It indicates credit assessment symbols (as distinct from credit rating symbols) by numerals ranging from 1 to 14, detailed below, which roughly correspond to the medium-term instruments rating symbols.

1-Very Strong Capacity This indicates that the capacity for timely payment of interest and principal is very strong.

2, 3, 4 Strong Capacity This indicates that the capacity for timely payment of interest and principal is strong. However, the capacity is not as strong as for borrowers with a credit assessment of "1".

5, 6, 7 Adequate Capacity This indicates that the capacity for timely payment of interest and principal is satisfactory. Changes in circumstances can affect the capacity of the borrower, more than those in the stronger credit assessment categories.

8, 9, 10 Inadequate Capacity This indicates inadequate capacity for timely payment of interest and principal. Such borrowers are less susceptible to default than borrowers with credit assessment below this category, but the uncertainties that the borrower faces could lead to inadequate capacity to make timely interest and principal payment.

11, 12, 13 Poor Capacity This indicates that the capacity for timely payment of interest and principal is doubtful. At present, such borrowers face circumstances that make them vulnerable to default; adverse business or economic conditions would lead to a lack of capacity to pay interest or principal.

14 Default This indicates that the borrower is either in default or is expected to be in default upon the maturity of the debt.

Collective Investment Schemes The CRISIL has developed a framework for the rating of collective investment schemes of plantations and other companies. The rating is an opinion on the degree of certainty of the scheme to deliver the assured returns, in terms of the quantity of produce and/or cash, as mentioned in the offer document. The rating is not a comment on the quality of the produce or the monetary value that all the investors will get from the produce.

The methodology broadly assesses the scheme-related risk factors as well as promoter-related risk factors. Under each of these, the CRISIL has identified factors that it believes, would have impact on the degree of certainty of the scheme providing an assured return to the investor. These factors are crystallised into a composite rating expressed in the form of grades. The symbols divide them into five grades, as detailed below:

Grade I (High Certainty) This rating indicates high certainty that the collective investment scheme will provide the assured returns in the form of produce and/or cash.

Grade II (Adequate Certainty) This rating indicates adequate certainty that the collective investment scheme will provide the assured returns in the form of produce and/or cash.

Grade III (Moderate Certainty) This indicates moderate certainty that the collective investment scheme will provide the assured returns in the form of produce and/or cash.

Grade IV (Inadequate Certainty) This rating indicates inadequate certainty that the collective investment scheme will provide the assured returns in the form of produce and/or cash. Risk factors for the scheme are high and the scheme is prone to default.

Grade V (High Uncertainty) This rating indicates high uncertainty that the collective investment scheme will provide the assured returns in the form of produce and/or cash. Risk factors for the scheme are extremely high expectation of default on obligations.

Rating of Chit Funds The CRISIL undertakes rating of chit funds incorporated as public/private limited companies, typically having an operating track record of at least 10 years, with a reported minimum net worth of ₹5 1akh. Such rating is, however, not mandatory. The purpose of the rating of chit funds is to assess their ability to make timely payment of the prize money to the subscribers. It also reflects the relative degree of risk associated with subscription to the chit series floated by chit funds. Moreover, a rating enhances the marketability of chits, widens the access to subscribers, provides a distinct identity to the chit fund and an objective evaluation of its strengths and weaknesses. The rating process and methodology is the same as in the case of mandated instruments. The rating symbols and their broad interpretations are listed below.

Investment Grade: **CHIT AAA-Very High Safety** This rating indicates that the degree of safety regarding timely payment to the subscribers is very strong.

CHIT AA+/CHIT AA/CHIT AA-High Safety This rating indicates that the degree of safety regarding timely payment to the subscribers is strong.

CHIT A+/CHIT A/CHIT A-Adequate Safety This rating indicates that the degree of safety regarding timely payment to the subscribers is satisfactory.

Speculative Grade: CHIT B+/CHIT B/CHIT B- Inadequate Safety This rating indicates inadequate safety of timely payment to subscribers. While such chit funds are less susceptible to delay/default than chit funds rated below this category, the uncertainties that such chit funds face could lead to inadequate capacity to make timely payments to subscribers.

CHIT C+/CHIT C/CHIT C-High Risk This rating indicates that the degree of safety regarding timely payment to the subscriber is doubtful. Such chit funds have factors at present which make them vulnerable to default; adverse business conditions would lead to lack of ability or willingness to pay subscribers.

CHIT D Default This indicates that the chit fund is either in default or is expected to be in default.

Rating of Real Estate Developers/Builders The CRISIL undertakes rating of real estate projects. The rating pertains to a particular project and not to the company as a whole. Only projects with an approved plan and planning permit from the appropriate local authorities are considered for a rating.

Methodology The CRISIL assigns ratings after assessing the factors that could affect the ability of the developer to meet agreed specifications in terms of quality and time, as well as the ability to transfer clear title to customers. The ratings are based on current information provided to the CRISIL. The considered factors are: **(i)** project risk analysis and **(ii)** developer risk analysis.

Project Risk Analysis The quality of legal title, in respect of the property to be constructed, quality of construction and timeliness of delivery of the proposed/completed unit are assessed. The analysis of quality takes into account the specifications agreed upon by the developer and the buyers.

Developer Risk Analysis The track record of the developer, existing financial position, financial flexibility and management evaluation are some of the factors considered in order to assess the standing of the developer. The key documents for scrutiny at the time of rating are:

- Registered sale deeds for all transfers over the past 30 years or from the time a clear proof of title is established;
- A report on the title, from a reputed legal firm/lawyer or from the appropriate authority;
- Copy of the sanctioned plan, together with commencement and completion certificates, as applicable;
- Copies/formats of all agreements between the developer and the buyer(s);
- Receipts of all municipal and government rates, duties and taxes in respect of the property paid to date;
- Exemption order under the Urban Land Ceiling Act, 1976, from a competent authority, if applicable and
- Clearance certificate under the Income Tax Act.

Rating Symbols The rating of builders is not mandatory. The CRISIL, however, rates them as a part of its diversification strategy. It uses the prefix (**PA**) to the rating symbols to indicate the project development ability of the developer. The rating symbols it uses and their interpretation are indicated below.

PA1 Highest Ability Projects rated PA1 indicate the highest ability of the developer to specify and build to the agreed quality levels, and transfer clear titles within stipulated time schedules.

PA2 High Ability The developer's ability to build the project to specified quality levels and time schedules and transfer clear title is high. Project risks are marginally higher in this category as compared to projects in the PA1 category.

PA3 Adequate Ability Adequate ability of the developer to build to reasonable quality levels and time schedules and transfer clear title for the present. However, changing circumstances are likely to adversely affect these projects more than those in the higher rated categories.

PA4 Inadequate Ability The developer's ability to build to specified quality levels and adhere to time schedules is inadequate. Uncertainties facing the project could result in inability and/or unwillingness to complete projects.

PA5 Inability Projects rated PA5 indicate the inability of the developer to complete projects or transfer clear titles.

Note: The CRISIL may apply '+' (plus) sign for ratings PA1 to PA3 to reflect comparative standing within the category.

ICRA Rating Symbols/Grades/Scales

The ICRA credit rating symbols illustrated here relate to **(1)** equity grading, **(2)** insurance companies, **(3)** corporate governance rating, **(4)** rating of banks, **(5)** credit assessment/analysis, **(6)** grading of construction entities, and **(7)** project finance rating.

Equity Grading Under EPRA Scheme The ICRA has ventured into equity rating in the form of Earnings Prospects and Risk Analysis (EPRA). It is done at the instance of issuers. The grading is classified into six broad categories, in descending order of earning prospects: excellent, very good, good, moderate, weak and poor. Each category/group/grade has three sub-groups correlated with the degree of risk as a result of the changes in the economic and business condition/circumstances, that is, high, moderate and low. The grades and their interpretation are summarised below.

Excellent Earnings Prospects

ER1A Low Risk Indicates a fundamentally exceptionally strong position. The level, growth and quality of earnings over the medium term are of the highest grade and changes in the business/economic circumstances, as may be visualised, are unlikely to significantly impair the underlying fundamentals.

ER1B Moderate Risk Indicates fundamentally a very strong position. The level, growth and quality of earnings over the medium term are of the highest grade. However, changes in the business/economic circumstances, as may be visualised, may moderately impair the likely earnings and underlying fundamentals.

ER1C High Risk The likely level, growth and quality of earnings over the medium term are of the highest grade, but there are also some inherent elements of risk, which can significantly impair the likely earnings and underlying fundamentals.

Very Good Earnings Prospects These ratings include the following:

ER2A Low Risk Indicates fundamentally a very strong position. The level, growth and quality of earnings over the medium term are of a very high grade and changes in the business/

economic circumstances, as may be visualised, are unlikely to significantly impair the underlying fundamentals.

ER2B Moderate Risk Indicates fundamentally a strong position. The level, growth and quality of earnings over the medium term are of a very high grade. However, changes in the business/economic circumstances, as may be visualised, may moderately impair the likely earnings and underlying fundamentals.

ER2C High Risk The likely level, growth and quality of earnings over the medium term are of a very high grade, but there are also some inherent elements of risk, which can significantly impair the likely earnings and underlying fundamentals.

Good Earning Prospects Ratings of good earning prospects consist of:

ER3A Low Risk Indicates a fundamentally strong position. The level, growth and quality of earnings over the medium term are of a high grade and changes in the business/economic circumstances, as may be visualised, are unlikely to significantly impair the underlying fundamentals.

ER3B Moderate Risk Indicates fundamentally an above average position. The level, growth and quality of earnings over the medium term are of a high grade. However, changes in the business/economic circumstances may moderately impair the likely earnings and underlying fundamentals.

ER3C High Risk The likely level, growth and quality of earnings over the medium term are of a high grade, but there are also some inherent elements of risk, which can significantly impair the likely earnings and underlying fundamentals.

Moderate Earnings Prospects The ratings include:

ER4A Low Risk Indicates fundamentally an above average position. The level, growth and quality of earnings over the medium term are moderate and changes in the business/economic circumstances, as may be visualised, are unlikely to significantly impair the underlying fundamentals.

ER4B Moderate Risk Indicates fundamentally an average position. The level, growth and quality of earnings over the medium term are moderate. Changes in the business/economic circumstances, as may be visualised, can moderately impair the likely earnings and underlying fundamentals.

ER4C High Risk The likely level, growth and quality of earnings over the medium term are moderate but there are also some inherent elements of risk, which can significantly impair the likely earnings and underlying fundamentals.

Weak Earnings Prospects These rating comprise of:

ER5A Low Risk Indicates fundamentally a below average position. The level, growth and quality of earnings over the medium term are low but changes in the business/economic circumstances, as may be visualised, are unlikely to significantly impair the underlying fundamentals.

ER5B Moderate Risk Indicates fundamentally a weak position. The level, growth and quality of earnings over the medium term are low. Changes in the business/economic circumstances, as may be visualised, may moderately impair the likely earnings.

Poor Earnings Prospects Equity ratings that indicate poor earnings prospects are listed below:

ER6A Low Risk Indicates fundamentally a poor position. The level, growth and quality of earnings over the medium term are the lowest but changes in the business/economic circumstances, as may be visualised, are unlikely to significantly affect the likely earnings.

ER6B Moderate Risk Indicates fundamentally a very poor position. The level, growth and quality of earnings over the medium term are the lowest. Changes in the business/economic circumstances, as may be visualised, may moderately impair the likely earnings.

ER6C High Risk The likely level, growth and quality of earnings over the medium term are the lowest and changes in the business/economic circumstances, as may be visualised, can significantly impair the likely earnings.
Note: Equity grades do not forecast the future market price of the stock and do not indicate the company's compliance or violation of any statutory requirements related to the issue or stock market listing. They group together similar (but not necessarily identical) entities in terms of earning prospects and inherent risk.

Insurance Companies (Claims Paying Ability) The ICRA's rating symbols of insurance companies and their interpretation are specified below.

iAAA Highest Claims Paying Ability Indicates a fundamentally strong position. The prospect of meeting a policyholder's obligations is the best.

iAA High Claims Paying Ability Risk factors are modest and may vary slightly. The prospect of meeting a policyholder's obligations is high and differs from iAAA only marginally.

iA Adequate Claims Paying Ability The prospect of meeting a policyholder's obligations is adequate. Risk factors are more variable and greater in periods of economic stress and any adverse changes in business/economic circumstances, as may be visualised, may alter the fundamental strength.

iBBB Moderate Claims Paying Ability Protective factors are below average and adverse changes in the business/economic circumstances are likely to affect the prospect of meeting the policyholder's obligations.

iBB Inadequate Claims Paying Ability Protective factors fluctuate in case of change in business/economic conditions, and the prospect of meeting a policyholder's obligations is more likely to be affected by such changes.

iB Weak Claims Paying Ability Protective factors fluctuate in the case of changes in the business/economic conditions, which could result in the inability/unwillingness to service a policyholder's obligations.

iC Lowest Claims Paying Ability Indicates fundamentally a poor position. Such companies may often default on a policyholder's obligations and may be placed under supervision of insurance regulators.
Note: The suffix '+' or '–' may be used with the rating symbol to indicate the comparative position within the group covered by the symbol.

Corporate Governance Rating ICRA Ltd's **corporate governance rating** (CGR) is meant to indicate the relative level to which an organisation accepts and follows the codes and guidelines of corporate governance practices. The key variables that are analysed while arriving at the CGR for a corporate entity are as follows:

- Shareholding structure

- Governance structure and management processes
- Board structure and processes
- Stakeholders relationship
- Transparency and disclosures
- Financial discipline

The starting point of ICRA's rating process is assessment of the corporate's compliance with statutory regulations as laid out in Clause 49 of the Listing Agreement. Besides, regulatory compliance, the CGR exercise involves perusal of various corporate documents like Board notes, agenda papers, minutes of meetings, statutory returns submitted to the Registrar of Companies, the stock exchanges, and the SEBI annual reports, disclosures in the web site and so on. Additionally, the CGR process involves meeting key officials of the corporate being rated, its statutory auditors, directors (including independent directors) on the Board, and some institutional investors. Each of these variables is scored on a set of parameters and a composite score is obtained using a proprietary model developed by the ICRA.

Rating Scale The CGR by ICRA is not a certificate of statutory compliance or a commitment on the company's future financial performance, credit rating or stock price. The CGR has the following rating scales.

CGR1: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders the highest assurance on the quality of corporate governance.

CGR2: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders a high level of assurance on the quality of corporate governance.

CGR3: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders adequate level of assurance on the quality of corporate governance.

CGR4: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders moderate level of assurance on the quality of corporate governance.

CGR5: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders inadequate level of assurance on the quality of corporate governance.

CGR6: Implies that the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders low level of assurance on the quality of corporate governance.

A sign of '+' may be suffixed to any of the rating symbols other than **CGRI** to indicate a relatively higher standing within the category represented by the particular symbol.

Rating of Banks The ICRA has tied up with the international bank rating agency, IBCA Ltd, for rating banks. The CRISIL also rates banks. The public sector banks that have been rated so far include the Bank of Baroda and the State Bank of India. A credit rating is an objective opinion on the debt servicing ability of a bank.

Bank rating is an objective opinion on the debt servicing ability of a bank.

Methodology Rating agencies typically follow the CRAMEL model, under which banks are evaluated on six different parameters:

- C (capital adequacy)
- R (resource raising ability)
- A (asset quality)
- M (management evaluation)
- E (earnings potential)
- L (liquidity)

Capital Adequacy This indicates the kind of cushion the bank has to absorb future losses. A minimum capital adequacy ratio of nine per cent is mandatory for all banks in India.

Resource Raising Ability The main aspects of resource raising by banks, as seen in their rating are:

- Trends and diversity of the deposits base;
- Trends in cost of funds;
- Funding policies, namely, tenure matching and interest rate sensitivities and
- Future plans.

Asset Quality The important elements in the evaluation of the asset quality of banks include, *inter-alia*,

- The quality of credit-risk management of banks, as reflected in the appraisal system and prudential norms prescribed by the RBI;
- The quality of the loan portfolio, in terms of position of concentration/diversity, recovery and overdues and the relative share of non-performing assets;
- Specific steps to expedite recovery and
- Plans to improve asset quality.

Management Evaluation The two crucial aspects of management evaluation of banks are **(1)** management style and **(2)** in-depth study of the tenure of personnel.

Earnings Potential This is analysed on the basis of considering the following factors:

- Diversity of income profile;
- Trends in lending spreads;
- Trends in investments yields;
- Trends in fee-based income and
- Expense level.

Liquidity Liquidity of banks is examined with reference to three factors, namely:

- Liquid assets;
- Dependence on volatile funds and
- Unutilised line of credit.

> **Credit assessment** indicates a broad opinion as to the relative degree of capability of a company to meet obligations on lines of credit.

Credit Assessment, General Assessment and Credit Analysis Credit rating agencies in the country also take up assignments for credit assessment, general assessment and credit analysis.

Credit Assessment The ICRA does **credit assessment** for companies/ undertakings intending to use the same for obtaining a specific line of assistance from commercial banks, financial/investment institutions, factoring companies and financial service companies. The assessment indicates its broad opinion as to the relative degree of capability of the company/undertaking to repay the interest and principal as per the terms of the contract. It indicates credit assessment symbols (as distinct from credit rating symbols) by numerals ranging from 1 to 14, which roughly correspond to the medium-term instrument rating symbols, as detailed below.

Fixed Deposit Rating Symbols		*Credit Assessment Symbols*	
MAAA	Highest safety	1	Very strong capacity
MAA+		2	
MAA	High safety	3	Strong capacity
MAA-		4	
MA+		5	
MA	Adequate safety	6	Adequate capacity
MA-		7	
MB+		8	
MB	Inadequate safety	9	Inadequate capacity
MB-		10	
MC+		11	
MC	High risk	12	Poor capacity
MC-		13	
MD	Default	14	Default

General Assessment The ICRA provides general assessment services at the request of banks/potential users of such general assessment reports. This service is also likely to be useful for other non-banking, non-financial agencies for the purpose of merger, amalgamation, acquisition, joint venture, collaboration and factoring of debts and so on. The ICRA does not assign any specific symbol in respect of such general assessment. It provides a report on different aspects of the companies' operations/management.

General assessment provides a report on different aspects of the operation of management of a company for the use of banks.

Grading of Construction Entities The grading of the construction agencies by the ICRA in collaboration with the Construction Industry Development Council (CIDC) is designed to provide lenders/sector participants with an independent opinion on the quality of the entity concerned, namely, **(1)** contractors, **(2)** consultants and **(3)** project owners. They are graded under two broad risk categories, that is, business and financial risk. The indicative criteria, *inter-alia*, include:

Assessment of Contractors The criteria to assess the contractors are listed below.

Business Risk The business risk determinants include: sectors of operation, project composition, market position, client category and diversity, ability to be an integrator, project quality track record, project management and design system for timely completion, human resources and management quality, MIS and documentation, labour relations track record, safety at sites and contract evaluation.

Financial Risk The determinants are leverage, financial flexibility and cash flow, cost structure, working capital management, customer advances, liquidated damages exposure, contingent liabilities, bank guarantee rates, insurance cover, contract composition and accounting quality.

Assessment of Consultants The assessment criteria for consultants are:

Business Risk Determinants Market reputation, sectors of operation, client category and diversity, project quality track record, engineering, procurement, inspection and planning services, human resource quality, quality of design systems and project composition and size.

Financial Risk Determinants Financial flexibility, liquidated damages exposure and insurance cover.

Project Owner Assessment The factors considered include:

Business Risk Industry characteristics, market position, operational efficiency, new projects and management quality.

Financial Risk Funding policy, financial flexibility and accounting quality.

Project Risk Assessment The criteria to assess project risks include an analysis, inter-alia, of the following factors: completion risk, price risk, resource risk, technology risk, political risk, casualty risk, environmental risk, exchange rate risk, insolvency risk, interest rate risk, project development risk, site risk and financial closure risk.

Grading Symbols The ICRA-CIDC grading symbols for construction entities, and their interpretation, are as follows.

For Contractors The symbols and their implications are:

CR1 (Very Strong Contract Execution Capacity) The prospect of timely completion of a project, without cost overruns, is the best and the ability to pay liquidated damages, for non-conformance with contract, is the highest.
CR2+, CR2, CR2– (Strong Contract Execution Capacity) The prospect of timely completion of a project, without cost overruns, and the ability to pay liquidated damages for non-conformance are high, but not as high as CR1.
CR3+, CR3, CR3– (Moderate Contract Execution Capacity) The prospect of timely completion of a project, without cost overruns, and the ability to pay liquidated damages for non-conformance are moderate. Contract execution capacity can be affected moderately by changes in the prospects of the construction sector.
CR4+, CR4, CR4 – (Inadequate Contract Execution Capacity) The prospect of timely completion of a project, without cost overruns, and the ability to pay liquidated damages for non-conformance are inadequate. Contract execution capacity can be affected severely by changes in the construction sector prospects.
CR5 (Weak Contract Execution Capacity) The prospect of timely completion of a project, without cost overruns, and the ability to pay liquidated damages for non-conformance are poor.

For Consultants The grading symbols and their implications are:

CT1 (Very Strong Project Engineering/Project Management Services Capacity) The prospects of good technical design/project management services and the ability to pay liquidated damages, for non-conformance with contract, are the highest.
CT2+, CT2, CT2 – (Strong Project Engineering/Project Management Services Capacity) The prospects of good technical design/project management services and the ability to pay liquidated damages for non-conformance are high, but not as high as CT1.
CT3+, CT3, CT3 – (Moderate Project Engineering/Management Services Capacity) The prospects of good technical design/project management services and the ability to pay liquidated damages for non-conformance are moderate.

CT4+, CT4, CT4 – (Inadequate Project Engineering/Project Management Services Capacity) The prospects of good technical design/project management services and the ability to pay liquidated damages for non-conformance are inadequate. The track record of the consultant in project designing/project management services is not impressive.
CT5 – (Weak Project Engineering/Project Management Capacity) The prospects of good technical design/project management services and the ability to pay liquidated damages for non-conformance are poor. The consultant, either has no track record or has one of design flaws and disputes with clients.

For Project Owners The grading symbols and their implication are:

OR1 – (Very Strong Project Promoter) The likelihood of good project management and adequacy of project finance is the highest.
OR2+, OR2, OR2 – (Strong Project Promoter) The likelihood of good project management and adequacy of project finance is high, but not as high as OR1.
OR3+, OR3, OR3 – (Moderate Project Promoter) The likelihood of good project management and adequacy of project finance is moderate. Adverse changes in the economic situation might prevent the owner from being able to financially close the project.
OR4+, OR4, OR4 – (Inadequate Project Promoter) The likelihood of good project management and adequacy of project finance is inadequate. The project promoter has inadequate experience and/or financial strength in implementing projects.
OR5 – (Weak Project Owner) The likelihood of good project management and adequacy of project finance is weak.

For Projects The symbols and their implications are:

PT1 – (Very Strong Project) The prospects of successful implementation of the project, as per plan, is the highest. The project risk factors are the lowest.
PT2+, PT2, PT2 – (Strong Project) The prospects of successful implementation of the project, as per plan, are high. The project risk factors are low.
PT3+, PT3, PT3 – (Moderate Project) The prospects of successful implementation of the project, as per plan, are moderate. The project risk factors are moderate.
PT4+, PT4, PT4 – (Inadequate Project) The prospects of successful completion of the project, as per plan, are inadequate. The project risk factors are high.
PT5 – (Weak Project) The prospects of successful implementation of the project, as per plan, are poor. The project risk factors are the highest.

ICRA-NAREDCO Grading of Real Estate Developers and Projects The unique grading methodology developed by the ICRA, along with the National Real Estate Development Council (NAREDCO), encompasses both real estate developers and projects. The gradings, by providing an independent opinion on the relative performance capability of real estate entities, seek to serve as a tool for identifying and managing the risks associated with the entities concerned. For the investor (buyer of property), the gradings communicate the risks involved in the developer's ability to deliver in accordance with the terms, quality parameters and time stipulated. For developers, the gradings, by providing a scientific assessment of their abilities and risk profiles, serve to assist them in presenting their case to lenders. The ICRA-NAREDCO grading symbols for real estate developers, and their implications, are as follows:

DR1 Very strong project execution capacity.

DR2+, DR2, DR2– Strong project execution capacity.

DR3+, DR3, DR3– Moderate project execution capacity.

DR4+, DR4, DR4– Inadequate project execution capacity.

DR5 Weak project execution capacity.

The ICRA-NAREDCO grading symbols for real estate projects, and their implications, are as follows:

RT1 Very strong project.

RT2+, RT2, RT3– Strong project.

RT3+, RT3, RT3– Moderate project.

RT4+, RT4, RT4– Inadequate project.

RT5 Weak project.

Project Finance Rating The envisaged demand for private sector investments in infrastructure projects—'particularly in the energy and road sectors, suggests considerable potential for adequately structured project finance transactions. Growth in such transactions is also expected to be driven by the inability of many potential project sponsors to implement such capital intensive and highly leveraged projects on their balance sheets, without having their own credit risk profile materially impacted.

For lenders, typically financial intermediaries like banks and financial institutions, Project Finance Ratings (PFR) would: **(i)** facilitate informed decision making, **(ii)** provide an independent and reliable second option, **(iii)** assist in risk pricing, **(iv)** facilitate portfolio risk management, and **(v)** help meet specific investment objectives. For borrowers, PFRs may help to: **(i)** increase the comfort level with prospective/existing lenders and enhance marketability of the project to various lenders, and **(ii)** reduce the time involved in obtaining loan approval.

The Rating Process The ICRA assigns a PFR to a project on receipt of a formal request from the lender or the project entity. For carrying out the PFR exercise, it analyses the project appraisal and/or techno-commercial feasibility study reports prepared by a creditable institution, the independent engineers' report (IER), and all contracts signed or proposed to be signed. This is followed by the site visits and discussions with key operating personnel and other project participants. Subsequently, ICRA's team of analysts presents a detailed Rating Report to ICRA's Rating Committee, which then assigns the rating. Usually, the assignment of rating takes four to six weeks after all the necessary information has been provided.

ICRA does not carry out any unsolicited PFR, the rating involves the full co-operation of, and interaction with, the entity being rated. If the case so merits, ICRA also obtains the views of expert agencies on the project or entity/entities in question. Unlike normal credit ratings, PFRs are not subject to annual surveillance, unless specifically requested for by the lender.

It may be noted that if a project entity proposes to issue a debt instrument that requires a credit rating, ICRA would assign a credit rating on its conventional credit rating scale.

Rating Methodology Project financing usually involves setting up of a special purpose vehicle (SPV)—bound by a contractual matrix to various project participants—which raises debt and services it from its own cash flows, without recourse to its sponsors. ICRA's rating approach emphasises the importance of carefully assessing the risks that characterise such transactions and suitably structuring the projects to mitigate the risks. The rating methodology, therefore, involves an assessment of three broad areas, among others: **(i)** Sponsor strength, **(ii)** Project-risk analysis and **(iii)** Cash flow adequacy.

Sponsor Strength Despite the "non-recourse" nature of project finance transactions, evaluating sponsor strength is an essential part of the rating methodology. Apart from the ability to bring in the equity component—a pre-requisite for the financial closure of a project—the sponsor has an important role of providing the necessary managerial support to the project during the implementation stage. The sponsor is also evaluated for its ability to fund time and cost overruns, if any, during the construction phase.

Project-Risk Analysis Non-limited-recourse project structures are exposed to several risks. ICRA's rating approach focuses primarily on the economic fundamentals of the project and the effectiveness of its contractual and financial structure in being able to mitigate the principal risks it is exposed to. The various risks that an infrastructure project is exposed to may be categorised as follows: Completion risk, Financing risk, Operating and technology risk, Market risk, Counter-party risk, Political and regulatory risk and Force majeure risk. ICRA's analysis involves an assessment of the likely risks under reach of the categories mentioned, the risk mitigants in place, and the adequacy of such risk mitigants.

Cash Flow Adequacy The qualitative analysis as discussed so far is completed by financial projections for the project, which seek to evaluate the adequacy of cash flows *vis-à-vis* the debt servicing requirements. Sensitivities are also drawn up to forecast the project's performance under a range of stress scenarios, the most common being: **(a)** the time and cost overrun; **(b)** volatility in input prices; **(c)** interest rates; **(d)** currency values; and **(e)** demand/payment risks. The financial projections enable ICRA to gain a thorough understanding of the adequacy of the project's cash flows and its debt servicing ability.

On conclusion of the PFR assignment, ICRA will assign a rating from the PFT rating scale and also deliver: **(i)** A detailed rationale highlighting all the risk factors and mitigants, and **(ii)** Results of sensitivity analyses. ICRA would provide a detailed assessment report on the project without assigning a formal PFR if lenders/project entities require only that.

PFR Rating Scale and Its Implications:

PFR 1 Projects classified as PFR 1 have adequate attributes of investment grade credit. The protective factors are satisfactory.

PFR 2 Projects classified as PFR 2 have moderate attributes of investment grade credit. The protective factors are average.

PFR 3 Projects classified as PFR 3 have inadequate attributes of investment grade credit and obligations can be met only under very favourable circumstances.

PFR 4 Projects classified as PFR 4 are exposed to high risk and obligations may not be met when due.

Note: A sign of **'+' or '–'** may be suffixed to any of the rating symbols other than PFR 1 to represent the relative standing within the category.

RECAPITULATION

- Credit rating is essentially a symbolic indicator of the relative grading of the investment/credit qualities of financial instruments and reflects the relative ability of the issuers of such instruments to meet the servicing obligations as and when they arise. It is neither a general purpose evaluation nor an over-all assessment of the credit risk associated with all the obligations of the issuers/corporates. A rating is specific to an instrument. It does not amount to any recommendations to buy, hold or sell an instrument.
- As a fee-based advisory financial service, credit-rating is of comparatively recent origin in India, the first institution having been set up in 1988.
- The increasing recognition to credit rating in the country marks a major transition from a corporate culture where names mattered to one where abstract gradings count.

  There are four credit rating agencies in the country which rate corporate entities: CRISIL, ICRA, CARE, FITCH, and SMERA.
- CRISIL is the most important rating agency in the country. Its main business is rating services although it has diversified into information and advisory services. While it undertakes rating of mandated instruments, namely, debentures, deposits, commercial papers, LPG/kerosene dealers, its rating services also extend to preference shares, structured obligations, chit funds, real estate developers/builders, banks and states. The extensive compilation and analysis of data for rating business is also used by CRISIL to provide information services to corporate clients. It has leveraged its information base and expertise in credit rating to provide counselling to government, banks and financial institutions on aspects such as privatisation of PSUs, debt securitisation, credit evaluation and so on.
- ICRA focuses on rating of instruments for which credit rating is mandatory, namely, debentures/bonds, deposits, commercial papers, kerosene/LPG dealers. In addition, it rates banks. It has also ventured into EPRA for grading the primary market at the instance of the issuing companies and assessing the secondary market for the investors. It also provides credit assessment and general assessment services.
- CARE confines to normal rating business only and has not diversified its operations. The instruments credit-rated by CARE are debentures, deposits, commercial papers and structured obligations. It also undertakes general credit analysis of companies for the use of banks, other lenders and business enterprises.
- SMERA focuses exclusively on the rating of small and medium enterprises.
- Procedurally, credit rating is done in India at the instance of the issuers of the instruments. Unsolicited rating at the initiative of the rating agencies has still not emerged. The clients have, moreover, the option not to accept the ratings.
- Rating is a search for fundamentals and the possibilities of change in these in the long-term. All the credit agencies follow broadly the same analytical framework of rating methodology. It comprises of three broad sets of factors: **(i)** business analysis in terms of analysis of industry risk, market position, operating efficiency and legal position; **(ii)** financial analysis on the basis of consideration of accounting quality, earnings protection, adequacy of cash flows and financial flexibility and **(iii)** management evaluation. For finance companies, in addition, the assessment by the rating agencies lays emphasis on regulatory environment and fundamental analysis which includes liquidity management, asset quality, profitability and financial position and interest and tax sensitivity.

- The main elements of the regulatory framework of CRAs in terms of the SEBI Regulations are: **(i)** registration, **(ii)** general obligations, **(iii)** restrictions on rating of securities, **(iv)** procedure for inspection/investigation and **(v)** action in case of default.
- For carrying on rating business, a CRA must by registered with SEBI. A CRA can be promoted by a **(i)** PFI, **(ii)** bank, **(iii)** foreign bank, **(iv)** foreign CRA with five years experience, and **(v)** company/body corporate having a continuous network of ₹100 crore.
- The eligibility criteria for a CRA:
  - is set up and registered as a company.
  - has specified rating activity as one of its main objects in Memorandum of Association;
  - has a minimum networth of ₹5 crore;
  - has adequate infrastructure;
  - its promoters have professional competence, financial soundness and a general reputation of fairness and integrity in business transactions, to the satisfaction of the SEBI;
  - has employed persons with adequate professional and other relevant experience, as per the SEBI directions;
  - applicant or its promoter(s), any director of the applicant or its promoter(s) **(i)** is not involved in any legal proceedings connected with the securities market that may have an adverse impact on the interest of the investors, **(ii)** has not at any time in the past been convicted of any offence involving moral turpitude or for any economic offence [in terms of Economic Offences (Inapplicability of Limitation) Act, 1974].
  - applicant or any person (i.e. an associate/subsidiary/interconnected or group company or a company under the same management) in the past has not been directly or indirectly **(i)** refused by the SEBI a certificate under these regulations or **(ii)** subjected to any proceedings against contravening a SEBI Act/any rules or regulations made under it. An associate person in relation to a CRA includes a person:
    - **(i)** who directly/indirectly by himself/in combination with relatives owns/controls shares carrying at least 10 per cent of the voting rights of the CRA; or
    - **(ii)** in respect of whom the CRA directly/indirectly by itself/in combination with other persons owns/controls not less than 10 per cent of the voting rights; or
    - **(iii)** majority of the directors who own/control shares carrying at least 10 per cent of the voting rights of the CRA; or
    - **(iv)** who is a director/officer/employee and also a director/officer/employee of the CRA.
  - is one to whom grant of certificate is in the interest of the investors and the securities market.
  - is in all respects a fit and proper person for the grant of the certificate. To determine whether an applicant is a fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008.**
- The general obligations of the CRAs are: **(i)** code of conduct, **(ii)** agreement with clients, **(iii)** monitoring of ratings, **(iv)** review of ratings, **(v)** internal procedures, **(vi)** disclosure of rating definitions/rationale, **(vii)** submission of information to the SEBI, **(viii)** compliance with SEBI circulars, **(ix)** appointment of compliance officer, **(x)** maintenance of books of accounts/records, **(xi)** steps on auditors report, **(xii)** confidentiality, **(xiii)** rating process.
- The restrictions on ratings of securities by the CRAs relate to securities issued by **(a)** promoters, **(b)** certain other entities.
- A CRA is prohibited from rating securities issued by its promoters. It may, however, rate a security issued by its associates having a common independent director who does not participate in the rating decision and requisite disclosures are made by the CRA.

- The securities of an entity cannot be rated by a CRA if it is a borrower/subsidiary/associate of its promoter.
- The SEBI can appoint inspecting officers to undertake inspection/investigation of the books of accounts/ records/documents of the CRAs to **(i)** ascertain whether they are being maintained properly/the provisions of the SEBI Act/regulations are being complied with, **(ii)** investigate into complaints from investors/clients/any other person regarding any matter having a bearing on their activities and **(iii)** in the interest of the securities market/investors.
- The CRAs which **(a)** fail to comply with any condition subject to which registration was granted or **(b)** contravenes provisions of the SEBI Act/regulations/other regulation would be liable to action under the SEBI Intermediaries Regulations.
- The main elements of the SEBI guidelines for the CRAs are: **(i)** rating process, **(ii)** default studies, **(iii)** dealing with conflict of interest, **(iv)** rating of SFPs, **(v)** unsolicited ratings and **(vi)** disclosures.
- The CRAs should maintain for 5 years, all records relating to important factors underlying the rating; summary of discussion with the issuer/management/auditors; decisions of the rating committee including voting details; and rationale for any material difference between actual rating and rating implied by any quantitative model used.
- The historical default rates of rating categories and changes in the overtime should be published for inter-CRA quality comparisons. The CRAs should calculate **(i)** one-year default rate in terms of number of defaults among the CRAs as a percentage of the total number of entities, and **(ii)** cumulative default rate in terms of number of defaulting issues during the 3-year period divided by number of outstanding issues.
- Policies/code of conduct relating to dealing with conflict of interest should ensure that analysts do not participate in marketing/business development; and employees/dependants do not own shares of the issuers; and prompt review of rating on any employee joining the issuer(s).
- All the applicable requirements of non-structured rating would apply to SFPs, that is, instruments resulting from securitisation transaction. The CRAs/subsidiaries should not provide any advisory services in designing them and the rating symbols should indicate that they relate to SFPs.
- The fact of unsolicited rating should be disclosed and the rating should be monitored like solicited ratings.
- The disclosure requirements for the CRAs are:
  - **(i)** Formulation/disclosure of policies/methodology/procedure in respect of solicited/unsolicited ratings;
  - **(ii)** The rating history/defaults should include details of new ratings, movement of all outstanding ratings, list of default on annual basis for each category of rating, weighted average one-year/three-year cumulative default rate for structured/non-structured products;
  - **(iii)** The general nature of the compensation arrangement with the issuer(s); conflict of interest in terms of revenue from rating/non-rating services, name of issuer contributing more than 10 per cent of its total revenue and so on;
  - **(iv)** In respect of SFPs, track record of the originator, rating migration to speculative categories, and defaults of the originator and details of the underlying assets.
  - **(v)** The extent of participation by issuer/management/bankers/auditors in the rating process and information used and its source in arriving at/reviewing unsolicited rating.

- The technique of credit rating is rating symbols. They group together similar entities in terms of their relative capacity of timely servicing of obligations as per the terms of the contract. The suffixes **plus** (+) or **minus** (–) are added to the symbols to indicate the relative position of the instrument within the group covered by the symbol. Appropriate prefixes and suffixes such are used to denote specific instruments.

- The SEBI-registered CRAs have been using different rating symbols and definitions. There is need to have common rating symbols and definitions **(i)** for their easy understanding and meanings by the investors, and **(ii)** to achieve high standards of integrity and fairness in ratings. The standardised symbols and their definitions have been devised for the following: **(a)** Long term debt instruments; **(b)** Short term debt instruments; **(c)** Long term structured finance instruments; **(d)** Short term structured finance instruments; **(e)** Long term mutual fund schemes; and **(f)** Short term mutual fund schemes. The new symbols and definitions as given below.

I. Rating Symbols and Definitions for Long Term Debt Instruments: *The instruments with original maturity exceeding one year*. **The rating symbols should have CRA's first name as prefix**

AAA Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations and carry lowest credit risk.

AA Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations and carry very low credit risk.

A Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations and carry low credit risk.

BBB Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations and carry moderate credit risk.

BB Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.

D Instruments with this rating are in default or are expected to be in default soon.

Modifiers {"+" (plus) / "–"(minus)} can be used with the rating symbols for the categories AA to C. The modifiers reflect the comparative standing within the category.

II. Rating Symbols and Definitions for Short Term Debt instruments: *The instruments with original maturity of upto one year Rating symbols should have CRA's first name as prefix*

A1 Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations and carry lowest credit risk.

A2 Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations and carry low credit risk.

A3 Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations and carry higher credit risk as compared to instruments rated in the two higher categories.

A4 Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations and carry very high credit risk and are susceptible to default.

D Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. The modifier reflects the comparative standing within the category.

III. Rating Symbols and Definitions for Long Term Structured Finance Instruments: *The instruments with original maturity exceeding one year.* **Rating symbols should have CRA's first name as prefix**

AAA(SO) Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations and carry lowest credit risk.

AA(SO) Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations and carry very low credit risk.

A(SO) Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations and carry low credit risk.

BBB(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations and carry moderate credit risk.

BB(SO) Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B(SO) Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C(SO) Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

D(SO) Instruments with this rating are indefault or are expected to be in default soon.

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA(SO) to C(SO). The modifiers reflect the comparative standing within the category.

IV. Rating Symbols and Definitions for Short Term Structured Finance Instruments: *The instruments with original maturity of upto one year.* **Rating symbols should have CRA's first name as prefix**

A1(SO) Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation and carry lowest credit risk.

A2(SO) Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation and carry low credit risk.

A3(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation and carry higher credit risk as compared to instruments rated in the two higher categories.

A4(SO) Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation and carry very high credit risk and are susceptible to default.

D(SO) Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1(SO) to A4(SO). The modifier reflects the comparative standing within the category.

V. Rating Symbols and Definitions for Long Term Debt Mutual Fund Schemes: The debt mutual fund schemes that have an original maturity exceeding one year. Rating symbols should have CRA's first name as prefix

AAAmfs Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.

AAmfs Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.

Amfs Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investment s that they have made.

BBBmfs Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.

BBmfs Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.

Bmfs Schemes with this rating are considered to have high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

Cmfs Schemes with this rating are considered to have very high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

Modifiers {"+" (plus) / "-"(minus)}can be used with the rating symbols for the categories AAmfs to Cmfs. The modifiers reflect the comparative standing within the category.

VI. Rating Symbols and Definitions for Short Term Debt Mutual Fund Schemes: The debt mutual fund schemes that have an original maturity of upto one year. Rating symbols should have CRA's first name as prefix

A1mfs Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.

A2mfs Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.

A3mfs Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.

A4mfs Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1mfs to A4mfs. The modifier reflects the comparative standing within the category.

REVIEW QUESTIONS

14.1 Describe the main features of the SEBI regulations relating to credit rating agencies.

14.2 Discuss the main elements of the SEBI guidelines to the CRAs.

14.3 Discuss the steps followed by the credit rating agencies in the rating process.

14.4 Explain briefly the rating methodology used by the rating agencies for manufacturing and financial services companies.

14.5 Write brief notes:

- Corporate governance rating
- Equity grading
- Grading for Healthcare Institutions.

14.6 Discuss the SEBI guidelines relating to standardisation of rating symbols and definitions.

Appendix

Table A-1 The Present Value of One Rupee

Year	*1%*	*2%*	*3%*	*4%*	*5%*	*6%*	*7%*	*8%*	*9%*	*10%*
1	.990	.980	.971	.962	.952	.943	.935	.926	.917	.909
2	.980	.961	.943	.925	.907	.890	.873	.857	.842	.826
3	.971	.942	.915	.889	.864	.840	.816	.794	.772	.751
4	.961	.924	.888	.855	.823	.792	.763	.735	.708	.683
5	.951	.906	.863	.822	.784	.747	.713	.681	.650	.621
6	.942	.888	.837	.790	.746	.705	.666	.630	.596	.564
7	.933	.871	.813	.760	.711	.665	.623	.583	.547	.513
8	.923	.853	.789	.731	.677	.627	.582	.540	.502	.467
9	.914	.837	.766	.703	.645	.592	.544	.500	.460	.424
10	.905	.820	.744	.676	.614	.558	.508	.463	.422	.386
11	.896	.804	.722	.650	.585	.527	.475	.429	.388	.350
12	.887	.789	.701	.625	.557	.497	.444	.397	.356	.319
13	.879	.773	.681	.601	.530	.469	.415	.368	.326	.290
14	.870	.758	.661	.577	.505	.442	.388	.340	.299	.263
15	.861	.743	.642	.555	.481	.417	.362	.315	.275	.239
16	.853	.728	.623	.534	.458	.394	.339	.292	.252	.218
17	.844	.714	.605	.513	.436	.371	.317	.270	.231	.198
18	.836	.700	.587	.494	.416	.350	.296	.250	.212	.180
19	.828	.686	.570	.475	.396	.331	.227	.232	.194	.164
20	.820	.673	.554	.456	.377	.312	.258	.215	.178	.149
21	.811	.660	.538	.439	.359	.294	.242	.199	.164	.135
22	.803	.647	.522	.422	.342	.278	.226	.184	.150	.123
23	.795	.634	.507	.406	.326	.262	.211	.170	.138	.112
24	.788	.622	.492	.390	.310	.247	.197	.158	.126	.102
25	.780	.610	.478	.375	.295	.233	.184	.146	.116	.092
30	.742	.552	.412	.308	.231	.174	.131	.099	.075	.057
35	.706	.500	.355	.253	.181	.130	.094	.068	.049	.036
40	.672	.453	.307	.208	.142	.097	.067	.046	.032	.022
45	.639	.410	.264	.171	.111	.073	.048	.031	.021	.014
50	.608	.372	.228	.141	.087	.054	.034	.021	.013	.009

Table A-1 The Present Value of One Rupee *(Contd.)*

Year	*11%*	*12%*	*13%*	*14%*	*15%*	*16%*	*17%*	*18%*	*19%*	*20%*
1	.901	.893	.885	.877	.870	.862	.855	.847	.840	.833
2	.812	.797	.783	.769	.756	.743	.731	.718	.706	.694
3	.731	.712	.693	.675	.658	.641	.624	.609	.593	.579
4	.659	.636	.613	.592	.572	.552	.534	.516	.499	.482
5	.593	.567	.543	.519	.497	.476	.456	.437	.419	.402
6	.535	.507	.480	.456	.432	.410	.390	.370	.352	.335
7	.482	.452	.425	.400	.376	.354	.333	.314	.296	.279
8	.434	.404	.376	.351	.327	.305	.285	.266	.249	.233
9	.391	.361	.333	.308	.284	.263	.243	.225	.209	.194
10	.352	.322	.295	.270	.247	.227	.208	.191	.176	.162
11	.317	.287	.261	.237	.215	.195	.178	.162	.148	.135
12	.286	.257	.231	.208	.187	.168	.152	.137	.124	.112
13	.258	.229	.204	.182	.163	.145	.130	.116	.104	.093
14	.232	.205	.181	.160	.141	.125	.111	.099	.088	.078
15	.209	.183	.160	.140	.123	.108	.095	.084	.074	.065
16	.188	.163	.141	.123	.107	.093	.081	.071	.062	.054
17	.170	.146	.125	.108	.093	.080	.069	.060	.052	.045
18	.153	.130	.111	.095	.081	.069	.059	.051	.044	.038
19	.138	.116	.098	.083	.070	.060	.051	.043	.037	.031
20	.124	.104	.087	.073	.061	.051	.043	.037	.031	.026
21	.112	.093	.077	.064	.053	.044	.037	.031	.026	.022
22	.101	.083	.068	.056	.046	.038	.032	.026	.022	.018
23	.091	.074	.060	.049	.040	.033	.027	.022	.018	.015
24	.082	.066	.053	.043	.035	.028	.023	.019	.015	.013
25	.074	.059	.047	.038	.030	.024	.020	.016	.013	.010
30	.044	.033	.026	.020	.015	.012	.009	.007	.005	.004
35	.026	.019	.014	.010	.008	.006	.004	.003	.002	.002
40	.015	.011	.008	.005	.004	.003	.002	.001	.001	.001
45	.009	.006	.004	.003	.002	.001	.001	.001	.000	.000
50	.005	.003	.002	.001	.001	.001	.000	.000	.000	.000

Table A-1 The Present Value of One Rupee *(Contd.)*

Year	*21%*	*22%*	*23%*	*24%*	*25%*	*26%*	*27%*	*28%*	*29%*	*30%*
1	.826	.820	.813	.806	.800	.794	.787	.781	.775	.769
2	.683	.672	.661	.650	.640	.630	.620	.610	.601	.592
3	.564	.551	.537	.524	.512	.500	.488	.477	.466	.455
4	.467	.451	.437	.423	.410	.397	.384	.373	.361	.350
5	.386	.370	.355	.341	.328	.315	.303	.291	.280	.269
6	.319	.303	.289	.275	.262	.250	.238	.227	.217	.207
7	.263	.249	.235	.222	.210	.198	.188	.178	.168	.159
8	.218	.204	.191	.179	.168	.157	.148	.139	.130	.123
9	.180	.167	.155	.144	.134	.125	.116	.108	.101	.094
10	.149	.137	.126	.116	.107	.099	.092	.085	.078	.073
11	.123	.112	.103	.094	.086	.079	.072	.066	.061	.056
12	.102	.092	.083	.076	.069	.062	.057	.052	.047	.043
13	.084	.075	.068	.061	.055	.050	.045	.040	.037	.033
14	.069	.062	.055	.049	.044	.039	.035	.032	.028	.025
15	.057	.051	.045	.040	.035	.031	.028	.025	.022	.020
16	.047	.042	.036	.032	.028	.025	.022	.019	.017	.015
17	.039	.034	.030	.026	.023	.020	.017	.015	.013	.012
18	.032	.028	.024	.021	.018	.016	.014	.012	.010	.009
19	.027	.023	.020	.017	.014	.012	.011	.009	.008	.007
20	.022	.019	.016	.014	.012	.010	.008	.007	.006	.005
21	.018	.015	.013	.011	.009	.008	.007	.006	.005	.004
22	.015	.013	.011	.009	.007	.006	.005	.004	.004	.003
23	.012	.010	.009	.007	.006	.005	.004	.003	.003	.002
24	.010	.008	.007	.006	.005	.004	.003	.003	.002	.002
25	.009	.007	.006	.005	.004	.003	.003	.002	.002	.001
30	.003	.003	.002	.002	.001	.001	.001	.001	.000	.000
35	.001	.001	.001	.001	.000	.000	.000	.000	.000	.000
40	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000
45	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000
50	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000

Table A-2 The Present Value of an Annuity of One Rupee

Year	*1%*	*2%*	*3%*	*4%*	*5%*	*6%*	*7%*	*8%*	*9%*	*10%*
1	.990	.980	.971	.962	.952	.943	.935	.926	.917	.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.326	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.746	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.560	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.352	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514
21	18.857	17.011	15.415	14.029	12.821	11.764	10.836	10.017	9.292	8.649
22	19.661	17.658	15.937	14.451	13.163	12.042	11.061	10.201	9.442	8.772
23	20.456	18.292	16.444	14.857	13.489	12.303	11.272	10.371	9.580	8.883
24	21.244	18.914	16.936	15.247	13.799	12.550	11.469	10.529	9.707	8.985
25	22.023	19.524	17.413	15.622	14.094	12.783	11.654	10.675	9.823	9.077
30	25.808	22.397	19.601	17.292	15.373	13.765	12.409	11.258	10.274	9.427
35	29.409	24.999	21.487	18.665	16.374	14.498	12.948	11.655	10.567	9.644
40	32.835	27.356	23.115	19.793	17.159	15.046	12.332	11.925	10.757	9.779
45	36.095	29.490	24.519	20.720	17.774	15.456	13.606	12.108	10.881	9.863
50	39.197	31.424	25.730	21.482	18.256	15.762	13.801	12.234	10.962	9.915

Table A-2 The Present Value of an Annuity of One Rupee *(Contd.)*

Year	*11%*	*12%*	*13%*	*14%*	*15%*	*16%*	*17%*	*18%*	*19%*	*20%*
1	.901	.893	.885	.877	.870	.862	.855	.847	.850	.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.487	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	5.303	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.669	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.585	5.316	5.070	4.843
20	7.963	7.469	7.024	6.623	6.259	5.929	5.628	5.353	5.101	4.870
21	8.075	7.562	7.102	6.687	6.312	5.973	5.665	5.384	5.127	4.891
22	8.176	7.645	7.170	6.743	6.359	6.011	5.696	5.410	5.149	4.909
23	8.266	7.718	7.230	6.792	6.399	6.044	6.723	5.432	5.167	4.925
24	8.348	7.784	7.283	6.835	6.434	6.073	5.747	5.451	5.182	4.937
25	8.422	7.843	7.330	6.873	6.464	6.097	5.766	5.467	5.195	4.948
30	8.694	8.055	7.496	7.003	6.566	6.177	5.829	5.517	5.235	4.979
35	8.855	8.176	7.586	7.070	6.617	6.215	5.858	5.539	5.251	4.992
40	8.951	8.244	7.634	7.105	6.642	6.233	5.871	5.548	5.258	4.997
45	9.008	8.283	7.661	7.123	6.654	6.242	5.877	5.552	5.261	4.999
50	9.042	8.305	7.675	7.133	6.661	6.246	5.880	5.554	5.262	4.999

Table A-2 The Present Value of an Annuity of One Rupee *(Contd.)*

Year	*21%*	*22%*	*23%*	*24%*	*25%*	*26%*	*27%*	*28%*	*29%*	*30%*
1	8.26	.820	.813	.806	.800	.794	.787	.781	.775	.769
2	1.509	1.492	1.474	1.457	1.440	1.424	1.407	1.392	1.376	1.361
3	2.074	2.042	2.011	1.981	1.952	1.923	1.896	1.868	1.842	1.816
4	2.540	2.494	2.448	2.404	2.362	2.320	2.280	2.241	2.203	2.166
5	2.926	2.864	2.803	2.745	2.689	2.635	2.583	2.532	2.483	2.436
6	3.245	3.167	3.092	3.020	2.951	2.885	2.821	2.759	2.700	2.643
7	3.508	3.416	3.327	3.242	3.161	3.083	3.009	2.937	2.868	2.802
8	3.726	3.619	3.518	3.421	3.329	3.241	3.156	3.076	2.999	2.925
9	3.905	3.786	3.673	3.566	3.463	3.366	3.273	3.184	3.100	3.019
10	4.054	3.923	3.799	3.682	3.570	3.465	3.364	3.269	3.178	3.092
11	4.177	4.035	4.902	3.776	3.656	3.544	3.437	3.335	3.239	3.147
12	4.278	4.127	3.985	3.851	3.752	3.606	3.493	3.387	3.286	3.190
13	4.362	4.203	4.053	3.912	3.780	3.656	3.538	3.427	3.322	3.223
14	4.432	4.265	4.108	3.962	3.824	3.695	3.573	3.459	3.351	3.249
15	4.489	4.315	4.153	4.001	3.859	3.726	3.601	3.483	3.373	3.268
16	4.536	4.357	4.189	4.033	3.887	3.751	3.623	3.503	3.390	3.283
17	4.576	4.391	4.219	4.059	3.910	3.771	3.640	3.518	3.403	3.295
18	4.608	4.419	4.243	4.080	3.928	3.786	3.654	3.529	3.413	3.304
19	4.635	4.442	4.263	4.097	3.942	3.799	3.664	3.539	3.421	3.311
20	4.657	4.460	4.279	4.110	3.954	3.808	3.673	3.546	3.427	3.316
21	4.675	4.476	4.292	4.121	3.963	3.816	3.679	3.551	3.432	3.320
22	4.690	4.488	4.302	4.130	3.970	3.822	3.684	3.556	3.436	3.323
23	4.703	4.499	4.311	4.137	3.976	3.827	3.689	3.559	3.438	3.325
24	4.713	4.507	4.318	4.143	3.981	3.831	3.692	3.562	3.441	3.327
25	4.721	4.514	4.323	4.147	3.985	3.834	3.694	3.564	3.442	3.329
30	4.746	4.534	4.339	4.160	3.995	3.842	3.701	3.69	3.447	3.332
35	4.756	4.541	4.345	4.164	3.998	3.845	3.703	3.571	3.448	3.333
40	4.760	4.544	4.347	4.166	3.999	3.846	3.703	3.571	3.448	3.333
45	4.761	4.545	4.347	4.166	4.000	3.846	3.704	3.571	3.448	3.333
50	4.762	4.545	4.348	4.167	4.000	3.846	3.704	3.571	3.448	3.333

Table A-3 Relationship Between Nominal and Effective Rates of Interest and Discount

Interest \ Effective rate	$i^{(2)}$	$i^{(4)}$	$i^{(12)}$	d	$d^{(2)}$	$d^{(4)}$	$d^{(12)}$
0.01	0.0100	0.0100	0.0100	0.0099	0.0099	0.0099	0.0099
0.02	0.0199	0.0199	0.0198	0.0196	0.0197	0.0198	0.0198
0.03	0.0298	0.0297	0.0296	0.0291	0.0293	0.0294	0.0295
0.04	0.0396	0.0394	0.0393	0.0385	0.0388	0.0390	0.0392
0.05	0.0494	0.0491	0.0489	0.0476	0.0482	0.0485	0.0487
0.06	0.0591	0.0587	0.0584	0.0566	0.0574	0.0578	0.0581
0.07	0.0688	0.0682	0.0678	0.0654	0.0665	0.0671	0.0675
0.08	0.0785	0.0777	0.0772	0.0741	0.0755	0.0762	0.0767
0.09	0.0881	0.0871	0.0865	0.0826	0.0843	0.0853	0.0859
0.10	0.0976	0.0965	0.0957	0.0909	0.0931	0.0942	0.0949
0.11	0.1071	0.1057	0.1048	0.0991	0.1017	0.1030	0.1039
0.12	0.1166	0.1149	0.1139	0.1071	0.1102	0.1117	0.1128
0.13	0.1260	0.1241	0.1228	0.1150	0.1186	0.1204	0.1216
0.14	0.1354	0.1332	0.1317	0.1228	0.1268	0.1289	0.1303
0.15	0.1448	0.1422	0.1406	0.1304	0.1350	0.1373	0.1390
0.16	0.1541	0.1512	0.1493	0.1379	0.1430	0.1457	0.1475
0.17	0.1633	0.1601	0.1580	0.1453	0.1510	0.1540	0.1560
0.18	0.1726	0.1690	0.1667	0.1525	0.1589	0.1621	0.1644
0.19	0.1817	0.1778	0.1752	0.1597	0.1666	0.1702	0.1727
0.20	0.1909	0.1865	0.1837	0.1667	0.1743	0.1782	0.1809
0.21	0.2000	0.1952	0.1921	0.1736	0.1818	0.1861	0.1891
0.22	0.2091	0.2039	0.2005	0.1803	0.1893	0.1940	0.1972
0.23	0.2181	0.2125	0.2088	0.1870	0.1967	0.2017	0.2052
0.24	0.2271	0.2210	0.2171	0.1935	0.2039	0.2094	0.2132
0.26	0.2450	0.2379	0.2334	0.2063	0.2183	0.2246	0.2289
0.28	0.2627	0.2546	0.2494	0.2188	0.2322	0.2394	0.2443
0.30	0.2804	0.2712	0.2653	0.2308	0.2459	0.2539	0.2595
0.32	0.2978	0.2875	0.2809	0.2424	0.2592	0.2682	0.2744
0.34	0.3152	0.3036	0.2963	0.2537	0.2723	0.2822	0.2891
0.36	0.3324	0.3196	0.3115	0.2647	0.2850	0.2960	0.3036
0.38	0.3495	0.3354	0.3264	0.2754	0.2975	0.3095	0.3178
0.40	0.3664	0.3510	0.3412	0.2857	0.3097	0.3227	0.3318

Table A-3 Relationship Between Nominal and Effective Rates of Interest and Discount

i/effective rate / *Interest*	$i/i^{(2)}$	$i/i^{(4)}$	$i/i^{(12)}$	$i/d^{(2)}$	$i/d^{(4)}$	$i/d^{(12)}$
+0.01	1.0025	1.0037	1.0046	1.0075	1.0062	1.0054
0.02	1.0050	1.0075	1.0091	1.0150	1.0125	1.0108
0.03	1.0074	1.0112	1.0137	1.0224	1.0187	1.0162
0.04	1.0099	1.0149	1.0182	1.0299	1.0249	1.0215
0.05	1.0123	1.0816	1.0227	1.0373	1.0311	1.0269
0.06	1.0148	1.0222	1.0272	1.0448	1.0372	1.0322
0.07	1.0172	1.0259	1.0317	1.0522	1.0434	1.0375
0.08	1.0196	1.0295	1.0362	1.0596	1.0495	1.0428
0.09	1.0220	1.0331	1.0406	1.0670	1.0556	1.0481
0.10	1.0244	1.0368	1.0450	1.0744	1.0618	1.0534
0.11	1.0268	1.0404	1.0495	1.0818	1.0679	1.0586
0.12	1.0292	1.0439	1.0539	1.0892	1.0739	1.0639
0.13	1.0315	1.0475	1.0583	1.0965	1.0800	1.0691
0.14	1.0339	1.0511	1.0626	1.1039	1.0861	1.0743
0.15	1.0362	1.0546	1.0670	1.1112	1.0921	1.0795
0.16	1.0385	1.0581	1.0714	1.1185	1.0981	1.0847
0.17	1.0408	1.0617	1.0757	1.1258	1.1042	1.0899
0.18	1.0431	1.0652	1.0800	1.1331	1.1102	1.0950
0.19	1.0454	1.0687	1.0843	1.1404	1.1162	1.1002
0.20	1.0477	1.0722	1.0887	1.1477	1.1222	1.1053
0.21	1.0500	1.0756	1.0929	1.1550	1.1281	1.1104
0.22	1.0523	1.0791	1.0972	1.1623	1.1341	1.1155
0.23	1.0545	1.0825	1.1015	1.1695	1.1400	1.1206
0.24	1.0568	1.0860	1.1057	1.1768	1.1460	1.1257
0.26	1.0612	1.0928	1.1142	1.1912	1.1578	1.1359
0.28	1.0657	1.0996	1.1226	1.2057	1.1696	1.1460
0.30	1.0701	1.1064	1.1310	1.2201	1.1814	1.1560
0.32	1.0745	1.1131	1.1393	1.2345	1.1931	1.1660
0.34	1.0788	1.1197	1.1476	1.2488	1.2047	1.1759
0.36	1.0831	1.1264	1.1559	1.2631	1.2164	1.1859
0.38	1.0874	1.1330	1.1641	1.2774	1.2280	1.1957
0.40	1.0916	1.1395	1.1722	1.2916	1.2395	1.2055

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