



MEASI Institute of Management

Subject Name: CAPITAL MARKET ND FINANCIAL SERVICES

Sub code: 534E71

Batch: 2024-2026

Prepared By: Dr.A. Govindarajan

VISION & MISSION STATEMENT

Vision: To be an oasis of knowledge to the seeker, to nurture one's creativity and research acumen, and to instil a unique blend of leadership, innovative spirit, and empathy in response to the ever-evolving business ecosystem.

Mission:

- Provide a pedagogy that blends academic rigor and experiential learning.
- Inculcate an entrepreneurial mindset through curated activities.
- Establish a conducive environment for research.
- Foster a culture of innovation and collaboration to progress in a dynamic business landscape.
- Promote humanistic values to produce socially responsible leaders.

Program Educational Objectives (PEOs)

PEO 1 – Employability:

To develop students with industry-specific knowledge & skills to meet the industry requirements, and also join a public sector undertaking through competitive examinations.

PEO 2 – Entrepreneur:

To create effective business service owners with a growth mindset by enhancing their critical thinking, problem-solving, and decision-making skills

PEO3 – Research and Development:

To instil and grow a mindset that focuses efforts towards inculcating and encouraging the students in the field of research and development



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PEO 4 – Contribution to Business World

To produce ethical and innovative business professionals to enhance the growth of the business world

PEO 5 – Contribution to the Society:

To work and contribute towards the holistic development of society by producing competent MBA professionals

Program Outcomes

PO1: Problem Solving Skill

Application of tools & techniques relevant to management theories and practices in analysing & solving business problems

PO2: Decision-Making Skill

Fostering analytical and critical thinking abilities for data-based decision making

PO3: Ethical Value

Ability to develop value-based leadership attributes

PO4: Communication Skill

Ability to understand, analyse, and effectively communicate global, economic, legal, and ethical aspects of business

PO5: Individual and Team Leadership Skill

Ability to be self-motivated in leading & driving a team towards the achievement of organizational goals and contributing effectively to establish industrial harmony

PO6: Employability Skill

Foster and enhance employability skills through relevant industry subject knowledge

PO7: Entrepreneurial Skill

Equipped with skills and competencies to become a global entrepreneur

PO8: Contribution to Society



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Strive towards becoming a global influencer and motivating future generations towards building a legacy that contributes to the overall growth of humankind

Syllabus

Subject Code	Subject Name	Category	L	T	P	O	Credits	Inst. Hours	Marks		
									CIA	External	Total
534E71	Capital Market and Financial Services	Elective	2	-	1	-	3	3	25	75	100
Course Objectives											
C1	To acquire knowledge on Indian financial systems and its regulators										
C2	To gain knowledge on listing and trading securities, Risk management in BSE & NSE, Index management.										
C3	To understand leasing and hire purchase										
C4	To familiarize with credit rating and securitization										
C5	To know Depositories & Contemporary Issues										
SYLLABUS											
UNIT	Details							No. of Hours	Course Objectives		
I	Indian Financial System:							9	C1		



	<p>Regulators: Finance Ministry, Securities Exchange Board of India, Reserve Bank of India, Forward Market Commission, Insurance Regulatory and Development Authority.</p> <p>Primary Market: Role of Primary Market, Functions, Intermediaries, methods of floatation of capital – IPO's, FPO's and Rights issues, Investor protection in primary market, Recent trends in primary market. Book building process.</p> <p>Secondary Market: Functions, intermediaries, Demutualization structure, Major stock exchanges in India.</p> <p>Indian Stock Exchanges: Market types, order types and books. BSE: BOLT System, NSE: NEAT system OTCEI – Need, Features, Participants, Listing procedure, Trading and Settlement. Legislative framework guiding the capital markets and intermediaries.</p>		
II	<p>Listing and trading of Securities: Listing requirements, procedure, fee- Listing conditions of BSE and NSE – Delisting. Legislations related to listing. Trading cycle: T+2, Pay in and Pay out, Bad Delivery, Short delivery, Auction, Clearing & Settlement: Different types of settlements -DEMAT settlement, Physical settlement, Institutional settlement and Funds settlement. Risk Management system in BSE & NSE: Margin s, Exposure limits, VAR, Circuit breakers and Surveillance system in BSE and NSE.</p> <p>Index Management: Importance of index</p>	9	C2



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	computation Methods: Weighted Aggregate Value method, Weighted Average of Price Relatives method, Free Float method. Stock market indices in India		
III	Leasing and Hire Purchase Lease and Hire purchase- – Meaning and Types of leasing – Legislative frameworks – Matters on Depreciation and Tax –Concepts and features – Tax and Depreciation implications Microfinance: Consumer Credit - Factoring and Forfaiting	9	C3
IV	Credit rating & Securitization: Credit rating: Definition and meaning- Process of credit rating of financial instruments - Rating methodology - Rating agencies – Rating symbols of different companies. Legislative framework guiding the CRAs. Securitization: Meaning-Features - Special Purpose Vehicle - Pass Through Certificate & mechanism – Benefits of Securitization – Issues in Securitization, Legislative framework guiding the securitization framework	9	C4



V	Depositories & Contemporary Issues Depository services - Role of depositories and their services — Advantages of depository system - NSDL and CDSL - Depository participants and their role- Stock Broking Services including SEBI guidelines - Contemporary developments in capital market performance and implication of securitization in Indian scenario.	9	C5
	Total	45	
Course Outcomes			
Course Outcomes	On completion of this course, students will;	Program Outcomes	
CO1	Estimate the Indian financial systems and its regulators	PO3,PO6	
CO2	Summarize the listing and trading securities, Risk management in BSE & NSE, Index management.	PO6, PO7	
CO3	Explain the leasing and hire purchase	PO7	
CO4	Prioritize the credit rating and securitization	PO2,PO6,PO7	
CO5	Summarize the depositories & contemporary Issues	PO6,PO7	
Reading List			
1.	Carow, K. A., & Heron, R. A. (2002). Capital market reactions to the passage of the Financial Services Modernization Act of 1999. The Quarterly Review of Economics and Finance.		
2.	Stiglitz, J. E. (2000). Capital market liberalization, economic growth, and instability. World development.		
3.	Mensah, Y. M., & Werner, R. H. (2008). The capital market implications of the frequency of interim financial reporting: an international analysis. Review of Quantitative Finance and Accounting.		



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4.	Micu, I., & Micu, A. (2016). Financial technology (Fintech) and its implementation on the Romanian non-banking capital market. SEA-Practical Application of Science.
References Books	
1.	Khan M.Y, Financial Services, 8th edition, McgrawHill ,2015,.
2.	K Sasidharan, Alex. K Mathews, Financial Services and System, Tata McGraw Hill, 2008.
3.	Jeff Madura, Financial Institutions and Markets, 10thEdition, Cengage Learning,2014..
4.	Stephen Cecchetti, Kermit Schoenholtz, Money, Banking and Financial Markets, 4thedition, McGraw-Hill Education, 2014.
5.	MadhuVij, Swati Dhawan , Merchant Banking and Financial Services, 1st edition, McGraw Hill, 2011.
6.	Tripathy, NaliniPrava, Financial Services, PHI, Learning Pvt. Ltd. NISM- Series-VI Depository Operation Exam Work Book, 2007.



Unit-1

1. FINANCIAL REGULATORS IN INDIA

1.1 Finance Ministry (Department of Economic Affairs)

Role and Functions:

- Apex policy-making body for financial sector
- Formulates policies for banking, insurance, capital markets
- Oversees public debt management
- Coordinates with all financial regulators
- Approves major regulatory changes and appointments

Key Responsibilities:

- Financial sector reforms and policy formulation
- Budget preparation and fiscal policy
- External borrowing and debt management
- Coordination between various financial regulators

1.2 Reserve Bank of India (RBI)

Establishment: 1935 **Role:** Central Bank and Banking Regulator

Key Functions:

- **Monetary Policy:** Controlling money supply and interest rates
- **Banking Regulation:** Licensing, supervision of banks and NBFCs
- **Currency Management:** Issuing and managing currency
- **Foreign Exchange Management:** FEMA compliance and forex reserves
- **Payment Systems:** Oversight of payment and settlement systems
- **Financial Stability:** Systemic risk monitoring



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Regulatory Powers:

- Bank licensing and branch approvals
- Prudential norms (CAR, NPA, provisioning)
- Interest rate regulations
- KYC/AML guidelines

1.3 Securities Exchange Board of India (SEBI)

Establishment: 1992 **Role:** Capital Markets Regulator

Primary Objectives:

- Protect investor interests
- Develop and regulate securities market
- Promote orderly and efficient market functioning

Key Functions:

- **Regulatory:** Registration and regulation of intermediaries
- **Developmental:** Market development and investor education
- **Protective:** Investor protection and grievance redressal

Regulated Entities:

- Stock exchanges, depositories, clearing corporations
- Brokers, sub-brokers, investment advisors
- Mutual funds, portfolio managers
- Credit rating agencies
- Listed companies (disclosure requirements)



1.4 Insurance Regulatory and Development Authority of India (IRDAI)

Establishment: 2000 **Role:** Insurance Sector Regulator

Key Functions:

- Licensing and supervision of insurance companies
- Protection of policyholders' interests
- Promoting growth and development of insurance industry
- Setting prudential norms for insurers

Regulatory Areas:

- Life and general insurance companies
- Insurance intermediaries (agents, brokers, surveyors)
- Third-party administrators
- Insurance repositories

1.5 Forward Markets Commission (FMC) - Now Merged with SEBI

Historical Role: Regulated commodity derivatives markets **Merger:** FMC merged with SEBI in 2015 **Current Status:** SEBI now regulates both securities and commodity derivatives

2. PRIMARY MARKET

2.1 Role and Importance of Primary Market

The primary market is where new securities are issued for the first time, enabling companies to raise capital directly from investors.

Key Roles:



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- **Capital Formation:** Facilitates mobilization of savings into productive investments
- **Economic Growth:** Provides long-term funding for business expansion
- **Wealth Creation:** Enables retail investors to participate in economic growth
- **Risk Distribution:** Spreads business risks among multiple investors

2.2 Functions of Primary Market

1. Origination Function:

- Identification of investment opportunities
- Feasibility studies and project evaluation
- Structuring of securities

2. Underwriting Function:

- Risk assessment and pricing
- Guarantee of subscription
- Distribution support

3. Distribution Function:

- Marketing securities to investors
- Ensuring wide distribution
- Price discovery mechanism

2.3 Intermediaries in Primary Market

1. Merchant Bankers/Lead Managers:

- Issue management and coordination
- Due diligence and documentation
- Regulatory compliance
- Post-issue services

2. Underwriters:



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- Risk assumption for unsold portions
- Financial commitment to the issue
- Market making support

3. Bankers to the Issue:

- Collection of application money
- Refund processing
- Escrow account management

4. Registrars and Share Transfer Agents:

- Processing applications
- Allotment of securities
- Maintaining investor records
- Share transfer services

5. Credit Rating Agencies:

- Risk assessment of debt securities
- Rating surveillance
- Investor guidance

6. Legal Advisors:

- Legal due diligence
- Documentation review
- Compliance verification

2.4 Methods of Capital Flotation

2.4.1 Initial Public Offer (IPO)

Definition: First public offering of shares by a private company

Types of IPOs:



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- **Fresh Issue:** New shares for capital raising
- **Offer for Sale (OFS):** Existing shareholders selling shares
- **Combination:** Mix of fresh issue and OFS

IPO Process:

1. Board resolution and shareholder approval
2. Appointment of intermediaries
3. Due diligence and documentation
4. SEBI filing and approval
5. Marketing and roadshows
6. Price discovery and bidding
7. Allotment and listing

Eligibility Criteria:

- Minimum post-issue paid-up capital
- Track record requirements
- Profitability norms
- Promoter holding limits

2.4.2 Follow-on Public Offer (FPO)

Definition: Additional public offering by already listed companies

Types:

- **Further Issue:** New shares for additional capital
- **Rights Issue:** Offered to existing shareholders
- **Bonus Issue:** Free shares to existing shareholders

Key Features:

- Simpler process than IPO
- Market price reference available



- Existing investor base

2.4.3 Rights Issue

Definition: Offering new shares to existing shareholders in proportion to their holdings

Key Features:

- Pre-emptive rights of existing shareholders
- Usually offered at discount to market price
- Tradeable rights certificates
- Renunciation facility available

Process:

1. Board resolution and regulatory approvals
2. Record date fixation
3. Rights entitlement and trading
4. Application and allotment
5. Listing of new shares

Advantages:

- Lower cost of capital raising
- Maintains ownership structure
- No dilution for participating shareholders

2.5 Investor Protection in Primary Market

SEBI Regulations:

- **Disclosure Requirements:** Comprehensive prospectus with material information
- **Due Diligence:** Mandatory verification by intermediaries
- **Pricing Guidelines:** Fair pricing mechanisms



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- **Refund Rules:** Timely refund of excess application money
- **Allotment Process:** Fair and transparent allotment procedures

Investor Rights:

- Right to complete information
- Right to fair treatment
- Right to grievance redressal
- Right to timely refund
- Right to listing within specified time

Protective Measures:

- Minimum subscription requirements
- Underwriting obligations
- Escrow account mechanisms
- Post-issue monitoring
- Penalty provisions for violations

2.6 Recent Trends in Primary Market

1. Digitalization:

- Online application processes (ASBA)
- Digital KYC and e-mandates
- Electronic allotment and dematerialization

2. Retail Investor Participation:

- Reserved categories for retail investors
- Lower lot sizes
- Investor education initiatives

3. Institutional Interest:

- QIB (Qualified Institutional Buyer) categories



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- Anchor investor mechanisms
- Private placement growth

4. Sectoral Trends:

- Technology and fintech IPOs
- Infrastructure and renewable energy
- Healthcare and pharmaceuticals

5. Regulatory Developments:

- Fast track procedures for certain issues
- Enhanced disclosure requirements
- Strengthened penalty framework

2.7 Book Building Process

Definition: Price discovery mechanism where investors bid for shares within a price band

Types:

1. **75% Book Building:** 75% through book building, 25% at cut-off price
2. **100% Book Building:** Entire issue through book building process

Process Steps:

1. Pre-Issue Stage:

- Filing of DRHP (Draft Red Herring Prospectus)
- SEBI observations and clearance
- Price band determination
- Marketing and roadshows



2. Bidding Stage:

- Investor bidding within price band
- Real-time bid monitoring
- Category-wise subscription tracking
- Bid modification facility

3. Post-Bidding:

- Price discovery and cut-off determination
- Allotment process
- Refund and credit of shares
- Listing arrangements

Key Features:

- Transparent price discovery
- Market-driven pricing
- Institutional participation
- Efficient allocation mechanism

Benefits:

- Better price realization for issuers
 - Market-determined valuations
 - Reduced pricing risk
 - Enhanced liquidity post-listing
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3. SECONDARY MARKET

3.1 Functions of Secondary Market

1. Liquidity Provision:

- Enables easy buying and selling of securities
- Facilitates portfolio adjustments
- Provides exit options for investors

2. Price Discovery:

- Continuous price discovery based on demand and supply
- Reflects market sentiment and company performance
- Provides benchmark for valuations

3. Market Efficiency:

- Ensures fair and transparent trading
- Reduces transaction costs
- Promotes market integrity

4. Capital Formation Support:

- Provides liquidity assurance for primary market investors
- Enhances attractiveness of securities
- Facilitates corporate actions

3.2 Intermediaries in Secondary Market

1. Stock Brokers:

- Execute trades on behalf of clients
- Provide investment advice and research



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- Maintain client accounts and records
- Risk management and compliance

2. Sub-brokers:

- Act as agents of stock brokers
- Client acquisition and servicing
- Limited trading authorization
- Local market presence

3. Depository Participants (DPs):

- Provide depository services
- Maintain investor accounts in electronic form
- Facilitate trading and settlement
- Corporate action processing

4. Market Makers:

- Provide continuous bid-offer quotes
- Enhance liquidity in securities
- Reduce bid-ask spreads
- Support price stability

5. Clearing Members:

- Settlement of trades
- Risk management in clearing
- Margin collection and monitoring
- Default management

3.3 Demutualization Structure

Traditional Mutual Structure:

- Brokers were owners of exchanges



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- Potential conflicts of interest
- Limited capital for technology upgrades
- Restricted ownership structure

Demutualized Structure:

- Separation of ownership and trading rights
- Corporate ownership structure
- Professional management
- Enhanced governance standards

Benefits of Demutualization:

- Reduced conflicts of interest
- Better capital access for technology
- Improved governance and transparency
- Enhanced competitiveness
- Greater regulatory oversight

Implementation in India:

- BSE demutualized in 2005
- NSE was established as demutualized entity
- Ownership diversification mandates
- Professional management requirements

3.4 Major Stock Exchanges in India

3.4.1 Bombay Stock Exchange (BSE)

Establishment: 1875 (Asia's oldest stock exchange) **Location:** Mumbai

Key Features:

- Over 5,000 listed companies
- Market capitalization-based indices (SENSEX)



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- SME platform for small companies
- Debt market segments

Major Indices:

- SENSEX (30 companies)
- BSE 100, BSE 200, BSE 500
- Sectoral indices

3.4.2 National Stock Exchange (NSE)

Establishment: 1992 **Location:** Mumbai

Key Features:

- Fully electronic trading since inception
- Largest derivatives market in India
- Advanced technology infrastructure
- Market making mechanisms

Major Indices:

- NIFTY 50 (50 companies)
- NIFTY Next 50, NIFTY 100
- Sectoral and thematic indices

3.4.3 Regional Stock Exchanges

Major Regional Exchanges:

- Calcutta Stock Exchange
- Madras Stock Exchange
- Delhi Stock Exchange
- Ahmedabad Stock Exchange

Current Status:



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- Reduced importance after NSE/BSE dominance
- Many have exited securities trading
- Some focus on debt markets
- Regulatory consolidation trends

4. INDIAN STOCK EXCHANGES - TRADING SYSTEMS

4.1 Market Types

1. Cash Market (Equity Segment):

- Immediate delivery and payment
- T+2 settlement cycle
- Intraday and delivery trading
- Rolling settlement system

2. Derivatives Market:

- **Futures:** Standardized contracts for future delivery
- **Options:** Right to buy/sell at predetermined price
- Index and stock derivatives
- Physical and cash settlement

3. Debt Market:

- Government securities
- Corporate bonds and debentures
- Commercial papers
- Certificate of deposits

4. Currency Derivatives:

- Currency futures and options
- USD-INR, EUR-INR, GBP-INR, JPY-INR



- Hedging and speculation instruments

4.2 Order Types

1. Market Orders:

- Executed immediately at best available price
- Price certainty not guaranteed
- High execution probability

2. Limit Orders:

- Specified maximum buy or minimum sell price
- Execution not guaranteed
- Price protection provided

3. Stop Loss Orders:

- Triggered when stock reaches stop price
- Becomes market order after trigger
- Risk management tool

4. Good Till Cancelled (GTC):

- Remains active until cancelled
- Maximum validity periods apply
- Suitable for long-term strategies

5. Immediate or Cancel (IOC):

- Execute immediately or cancel
- Partial execution allowed
- Suitable for large orders

6. Fill or Kill (FOK):



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- Execute completely or cancel entirely
- No partial execution
- All-or-nothing orders

4.3 Order Books

Components:

- **Bid Side:** Buy orders arranged by price priority
- **Ask Side:** Sell orders arranged by price priority
- **Last Traded Price:** Most recent transaction price
- **Volume Information:** Quantity at each price level

Price-Time Priority:

- Higher bid prices get priority
- Lower offer prices get priority
- Earlier orders get time priority
- Fair and transparent matching

4.4 BSE: BOLT System

BOLT (BSE On-Line Trading):

- **Launch:** 1995
- **Technology:** Screen-based electronic trading
- **Architecture:** Order-driven system

Key Features:

- Real-time order matching
- Price-time priority
- Risk management systems
- Market surveillance tools
- Multiple order types support



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Components:

- Trading workstations
- Communication networks
- Central matching engine
- Market data dissemination
- Clearing and settlement interface

Advantages:

- Transparent price discovery
- Reduced settlement risks
- Lower transaction costs
- Enhanced market efficiency
- Improved surveillance capabilities

4.5 NSE: NEAT System

NEAT (National Exchange for Automated Trading):

- **Launch:** 1994
- **Technology:** Fully automated screen-based trading
- **Innovation:** First in India to introduce electronic trading

Key Features:

- Satellite communication network
- Real-time gross settlement
- Anonymous order matching
- Comprehensive risk management
- Advanced market surveillance

Architecture:

- **Trading System:** Order routing and matching



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- **Clearing System:** Trade confirmation and settlement
- **Settlement System:** Money and security transfers
- **Surveillance System:** Market monitoring and compliance

Technological Advantages:

- High-speed order processing
- Reliable communication infrastructure
- Scalable system architecture
- Advanced backup systems
- Real-time risk monitoring

4.6 OTCEI (Over The Counter Exchange of India)

Need for OTCEI

Market Gap:

- Small and medium enterprises couldn't access main exchanges
- High listing costs and compliance requirements
- Need for alternative capital raising platform
- Venture capital exit mechanism required

Establishment: 1992 **Promoted by:** UTI, ICICI, IFCI, SBI Capital Markets, etc.

Features of OTCEI

1. Screen-Based Trading:

- Electronic trading system
- Transparent price discovery
- Real-time information dissemination

2. Market Making System:

- Designated market makers



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- Continuous bid-offer quotes
- Enhanced liquidity provision

3. Lower Entry Barriers:

- Reduced listing requirements
- Lower compliance costs
- Simplified procedures

4. Settlement System:

- Electronic settlement
- Reduced settlement risks
- Efficient clearing mechanism

Participants

1. Trading Members:

- Authorized to trade on OTCEI
- Capital adequacy requirements
- Risk management obligations

2. Market Makers:

- Provide liquidity in assigned stocks
- Maintain continuous quotes
- Price stabilization role

3. Investors:

- Individual and institutional investors
- Retail and wholesale participants
- Domestic and foreign investors

Listing Procedure



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Eligibility Criteria:

- Minimum paid-up capital requirements
- Track record specifications
- Promoter contribution norms
- Project completion criteria

Documentation:

- Listing application
- Financial statements
- Project reports
- Legal clearances

Process:

1. Application submission
2. Due diligence by OTCEI
3. Market maker appointment
4. Listing approval
5. Trading commencement

Trading and Settlement

Trading Mechanism:

- Screen-based anonymous trading
- Price-time priority matching
- Market maker obligations
- Circuit breaker systems

Settlement Features:

- T+2 rolling settlement
- Dematerialized holdings



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- Delivery vs. payment
- Risk management systems

Current Status:

- Merged with BSE in 2015
 - Limited trading activity
 - Focus shifted to main exchanges
 - Historical importance in market development
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5. LEGISLATIVE FRAMEWORK

5.1 Securities Contracts (Regulation) Act, 1956 (SCRA)

Objective: Regulation of securities contracts and stock exchanges

Key Provisions:

- Definition of securities and contracts
- Recognition of stock exchanges
- Regulation of contracts in securities
- Powers of Central Government
- Penalties for violations

Recent Amendments:

- Expansion of securities definition
- Enhanced regulatory powers
- Stricter penalty provisions
- Technology adaptation clauses

5.2 SEBI Act, 1992

Establishment: Securities and Exchange Board of India



Powers of SEBI:

- **Regulatory Powers:** Making rules and regulations
- **Investigative Powers:** Inspection and investigation
- **Enforcement Powers:** Penalties and prosecution
- **Adjudicatory Powers:** Settlement and consent procedures

Key Regulations:

- SEBI (Issue of Capital and Disclosure Requirements) Regulations
- SEBI (Stock Brokers and Sub-brokers) Regulations
- SEBI (Mutual Funds) Regulations
- SEBI (Foreign Portfolio Investors) Regulations

5.3 Companies Act, 2013

Relevance to Capital Markets:

- Corporate governance requirements
- Disclosure and transparency norms
- Board composition and independence
- Related party transactions
- Audit committee requirements

Key Provisions:

- Enhanced director responsibilities
- Stakeholder protection measures
- Stricter compliance requirements
- Corporate social responsibility
- Class action suits provisions

5.4 Depositories Act, 1996

Objective: Legal framework for depositories and dematerialization

**Key Features:**

- Establishment of depositories
- Rights and obligations of participants
- Dematerialization process
- Electronic settlement systems
- Investor protection measures

5.5 Prevention of Money Laundering Act, 2002 (PMLA)

Application: All financial institutions including capital market intermediaries

Requirements:

- Customer due diligence
- Record maintenance
- Suspicious transaction reporting
- Compliance officer appointment
- Regular training programs

5.6 Foreign Exchange Management Act, 1999 (FEMA)

Relevance: Foreign investment in Indian securities

Key Provisions:

- FDI and FPI regulations
- External commercial borrowings
- Overseas investments by Indians
- Repatriation of funds
- Reporting requirements

6. KEY CONCEPTS AND DEFINITIONS



6.1 Market Participants

- **Retail Investors:** Individual investors with small investments
- **HNIs:** High Net Worth Individuals with substantial wealth
- **QIBs:** Qualified Institutional Buyers (mutual funds, insurance companies, etc.)
- **FPIs:** Foreign Portfolio Investors
- **AI Fs:** Alternative Investment Funds

6.2 Trading Concepts

- **Circuit Breakers:** Price bands to control volatility
- **Market Hours:** Trading timings (9:15 AM to 3:30 PM)
- **Pre-open Session:** Price discovery before market opening
- **After Hours Trading:** Limited trading post market hours
- **Block Deals:** Large transactions above specified threshold
- **Bulk Deals:** Transactions above 0.5% of company's equity

6.3 Settlement System

- **T+2 Settlement:** Trade plus two days settlement cycle
- **Rolling Settlement:** Continuous daily settlement
- **Pay-in and Pay-out:** Collection and distribution of funds/securities
- **Auction Market:** For settlement failures
- **Close-out:** Compulsory settlement at prevailing prices

7. RECENT DEVELOPMENTS AND REFORMS

7.1 Technology Upgrades

- Co-location services for high-frequency trading
- Direct market access (DMA) facilities
- Algorithmic trading regulations



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- Cyber security frameworks
- Cloud computing adoption

7.2 Market Reforms

- Unified license for intermediaries
- Investment advisor regulations
- Research analyst regulations
- Corporate governance reforms
- Insider trading enforcement

7.3 Investor Protection

- Investor education initiatives
- Online dispute resolution mechanisms
- Compensation mechanisms
- Enhanced disclosure requirements
- Strengthened surveillance systems

Unit-2

Securities Listing, Trading & Risk Management in Indian Stock Exchanges

Table of Contents

1. [Listing and Trading of Securities](#)
2. [Trading Cycle and Settlement Systems](#)
3. [Risk Management Systems](#)
4. [Index Management](#)

Listing and Trading of Securities



1.1 Introduction to Securities Listing

Securities listing refers to the process by which a company's shares are admitted for trading on a stock exchange. It provides a platform for companies to raise capital from the public and offers investors liquidity for their investments.

1.2 Listing Requirements

General Requirements for BSE and NSE:

Financial Criteria:

- Minimum paid-up capital of ₹10 crores for main board listing
- Minimum net worth of ₹1 crore in each of the preceding three years
- Average operating profit of ₹15 crores in the preceding three years
- Net tangible assets of at least ₹3 crores in each of the preceding three years

Track Record:

- Company should be in existence for at least 3 years
- Audited financial statements for the last 3 years
- No default in payment of statutory dues

Management Quality:

- Competent management with adequate experience
- No involvement in securities market violations
- Good corporate governance practices

Public Issue Requirements:

- Minimum public shareholding of 25%
- Minimum number of shareholders (varies by exchange)
- Minimum issue size requirements

1.3 Listing Procedure



Step-by-Step Process:

Step 1: Pre-Application Stage

- Appointment of merchant banker
- Due diligence by intermediaries
- Preparation of draft documents

Step 2: Application Filing

- Filing application with stock exchange
- Submission of required documents
- Payment of listing fees

Step 3: Exchange Review

- Document verification by exchange
- Compliance check
- Query resolution

Step 4: Approval Process

- Exchange approval/conditional approval
- SEBI approval (for public issues)
- Final listing approval

Step 5: Post-Listing Requirements

- Continuous disclosure obligations
- Corporate governance compliance
- Annual listing fees

1.4 Listing Fees

BSE Listing Fees Structure:



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Initial Listing Fees:

- Based on paid-up capital
- Ranges from ₹50,000 to ₹15 lakhs
- Additional fees for simultaneous listing

Annual Listing Fees:

- Percentage of paid-up capital
- Minimum ₹25,000 to maximum ₹25 lakhs
- Calculated annually

NSE Listing Fees Structure:

Initial Listing Fees:

- Similar structure to BSE
- Based on issue size and paid-up capital
- Technology and processing fees additional

Annual Listing Fees:

- Based on market capitalization
- Tiered structure with caps
- Additional fees for various services

1.5 Listing Conditions

BSE Listing Conditions:

Ongoing Obligations:

- Quarterly financial results disclosure
- Annual report submission
- Material event disclosures
- Corporate governance report



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- Minimum public shareholding maintenance

Trading Requirements:

- Minimum market making arrangements
- Designated market maker (if required)
- Trading lot specifications
- Price discovery mechanisms

NSE Listing Conditions:

Similar Structure to BSE with Additional:

- Technology infrastructure requirements
- Real-time disclosure systems
- Enhanced surveillance compliance
- Derivatives eligibility criteria (if applicable)

1.6 Delisting

Types of Delisting:

Voluntary Delisting:

- Company-initiated process
- Shareholder approval required
- Reverse book building process
- Exit opportunity for public shareholders

Compulsory Delisting:

- Exchange-initiated due to non-compliance
- Failure to meet listing requirements
- Corporate governance violations
- Financial distress situations



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Delisting Process:

Voluntary Delisting Steps:

1. Board resolution and shareholder approval
2. Public announcement
3. Reverse book building process
4. Price discovery
5. Final delisting upon acceptance

Compulsory Delisting Process:

1. Exchange notice to company
2. Show cause notice
3. Hearing process
4. Final delisting order
5. Appeal process (if applicable)

1.7 Legislations Related to Listing

Primary Legislations:

Securities Contracts (Regulation) Act, 1956 (SCRA):

- Regulates stock exchanges
- Listing requirements
- Trading regulations
- Contract specifications

Companies Act, 2013:

- Corporate governance requirements
- Disclosure obligations
- Shareholder protection
- Board composition requirements



SEBI Act, 1992:

- Regulatory framework
- Investor protection
- Market development
- Enforcement powers

Key SEBI Regulations:

SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR):

- Comprehensive listing requirements
- Continuous disclosure obligations
- Corporate governance norms
- Penalty framework

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR):

- Public issue requirements
- Rights issue procedures
- Preferential allotment norms
- Disclosure requirements

Trading Cycle and Settlement Systems

2.1 Trading Cycle Overview

The trading cycle in Indian stock exchanges follows a T+2 settlement cycle, where 'T' represents the trading day and '+2' indicates that settlement occurs two working days after the trading day.

2.2 T+2 Settlement Cycle



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Timeline Breakdown:

T Day (Trading Day):

- Order matching and trade execution
- Trade confirmation
- End-of-day reporting
- Trade validation

T+1 Day:

- Trade confirmation and modification window
- Pay-in and pay-out instructions
- Corporate action processing
- Pre-settlement activities

T+2 Day:

- Final settlement
- Securities and funds transfer
- Settlement completion
- Post-settlement reporting

2.3 Pay-in and Pay-out Process

Pay-in Process:

Securities Pay-in:

- Delivery of securities by selling clients
- Transfer to clearing corporation account
- Verification and validation
- Allocation to buying clients

Funds Pay-in:



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- Payment by buying clients
- Credit to clearing member accounts
- Margin adjustments
- Net settlement calculation

Pay-out Process:

Securities Pay-out:

- Delivery to buying clients
- DEMAT account crediting
- Physical certificate delivery (if applicable)
- Confirmation of delivery

Funds Pay-out:

- Payment to selling clients
- Bank account crediting
- Net settlement transfers
- Final confirmation

2.4 Bad Delivery

Definition and Causes:

Bad Delivery occurs when securities delivered do not meet the standard delivery requirements.

Common Causes:

- Forged or fake certificates
- Mutilated certificates
- Transfer deed irregularities
- Signature mismatches
- Corporate action complications



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Resolution Process:

Steps for Resolution:

1. Identification of bad delivery
2. Return to delivering member
3. Replacement or rectification
4. Re-delivery process
5. Penalty implications

2.5 Short Delivery

Definition:

Short Delivery occurs when a selling client fails to deliver the promised securities on the settlement day.

Consequences:

- Auction process initiation
- Close-out at prevailing market price
- Loss allocation to defaulting member
- Penalty charges
- Regulatory reporting

Management:

- Early warning systems
- Margin adjustments
- Member monitoring
- Risk mitigation measures

2.6 Auction Process

Auction Mechanism:



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When Auction is Triggered:

- Short delivery situations
- Settlement failures
- Corporate action complications
- Member defaults

Auction Process:

1. Auction notice publication
2. Bid submission by members
3. Price discovery
4. Allocation process
5. Settlement completion

Types of Auctions:

- Regular auctions (for routine shortages)
- Special auctions (for specific situations)
- Close-out auctions (for persistent defaults)

2.7 Clearing and Settlement

Clearing Corporation Role:

Functions:

- Trade guarantee
- Risk management
- Multilateral netting
- Settlement facilitation
- Default management

Key Players:

- National Securities Clearing Corporation (NSCCL) for NSE



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- Indian Clearing Corporation Limited (ICCL) for BSE
- Clearing members
- Custodians

2.8 Types of Settlements

2.8.1 DEMAT Settlement

Features:

- Electronic form of securities
- Faster settlement process
- Reduced paperwork
- Lower settlement risks
- Automatic corporate action processing

Process:

- Trade execution in electronic form
- DEMAT account debiting/crediting
- Instant transfer confirmation
- Real-time position updates

2.8.2 Physical Settlement

Characteristics:

- Paper-based certificates
- Manual processing required
- Higher settlement risks
- Longer processing time
- Gradually being phased out

Process:

- Physical certificate delivery



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- Document verification
- Transfer deed processing
- Manual reconciliation

2.8.3 Institutional Settlement

Special Features:

- Bulk transaction processing
- Institutional delivery instruction (IDI)
- Custodial settlement
- Enhanced reporting
- Risk management protocols

Participants:

- Foreign Institutional Investors (FIIs)
- Domestic Institutional Investors (DIIs)
- Mutual funds
- Insurance companies
- Banks and custodians

2.8.4 Funds Settlement

Mechanism:

- Multilateral netting of fund obligations
- Bank guarantee systems
- Real-time gross settlement (RTGS)
- Delivery versus payment (DVP)
- Settlement guarantee fund

Process Flow:

1. Net position calculation



2. Margin adjustment
 3. Bank transfer initiation
 4. Settlement confirmation
 5. Reconciliation process
-

Risk Management Systems

3.1 Overview of Risk Management

Risk management in stock exchanges involves identifying, measuring, monitoring, and controlling various risks that could impact the stability and integrity of the market.

3.2 Types of Margins

3.2.1 Initial Margin (IM)

Purpose:

- Cover potential losses from adverse price movements
- Based on historical volatility
- Calculated using Value at Risk (VAR) methodology

Calculation:

- Look-back period of 6 months
- 99% confidence level
- Square root of time scaling
- Minimum margin requirements

3.2.2 Exposure Margin

Characteristics:



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- Additional margin over initial margin
- Fixed percentage of contract value
- Covers liquidity risk
- Uniform across all contracts

Rates:

- Equity derivatives: 3% to 5%
- Currency derivatives: 1% to 3%
- Commodity derivatives: Variable based on commodity

3.2.3 Additional Margin

Types:

- Special margin for volatile stocks
- Ad-hoc margin for market conditions
- Delivery margin for physical settlement
- Tender period margin

3.2.4 Mark-to-Market (MTM) Margin

Features:

- Daily settlement of profits/losses
- Variation margin collection/payment
- Real-time position monitoring
- Automatic margin calls

3.3 Exposure Limits

Position Limits:

Market-wide Position Limit (MWPL):

- 20% of free float market capitalization



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- Applicable to all derivative contracts
- Monitored on real-time basis
- Breach results in position closure

Client-wise Position Limit:

- Individual client limits
- Based on client category
- Aggregate across all exchanges
- Regulatory reporting requirements

Concentration Limits:

Sector Concentration:

- Limits on sector exposure
- Diversification requirements
- Risk spreading mechanisms
- Regular monitoring and reporting

3.4 Value at Risk (VAR)

VAR Methodology:

Calculation Parameters:

- Historical simulation method
- 99% confidence level
- One-day holding period
- 6-month lookback period

Process:

1. Historical price data collection
2. Return calculation
3. Scenario generation



4. Loss distribution creation
5. VAR estimation at 99th percentile

Applications:

- Initial margin calculation
- Risk capital allocation
- Portfolio risk assessment
- Regulatory compliance

3.5 Circuit Breakers

Index-based Circuit Breakers:

Broad Market Levels:

- 10% movement: 15-minute halt
- 15% movement: 45-minute halt
- 20% movement: Trading halt for the day

Implementation:

- Applied to benchmark indices
- Market-wide trading suspension
- Automatic trigger mechanism
- Resumption procedures

Individual Stock Circuit Breakers:

Daily Price Limits:

- $\pm 5\%$ for illiquid stocks
- $\pm 10\%$ for most stocks
- $\pm 20\%$ for certain categories
- No limits for highly liquid stocks in derivatives



Features:

- Price band restrictions
- Order rejection outside bands
- Dynamic price discovery
- Cooling-off periods

3.6 Surveillance System

BSE Surveillance System:

BOSS (BSE Online Surveillance System):

- Real-time monitoring
- Pattern recognition
- Alert generation
- Investigation tools
- Reporting mechanisms

Key Features:

- Price and volume surveillance
- Member activity monitoring
- Client behavior analysis
- Market manipulation detection
- Regulatory compliance checking

NSE Surveillance System:

SMARTS (Securities Market Automated Risk and Trading Surveillance):

- Advanced analytics
- Machine learning algorithms
- Multi-asset monitoring
- Cross-market surveillance



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- Behavioral pattern detection

Monitoring Parameters:

- Unusual price movements
- Volume spikes
- Concentration of trades
- Synchronized trading
- Insider trading patterns

3.7 Real-time Risk Management

Features:

Position Monitoring:

- Real-time position tracking
- Exposure limit monitoring
- Margin requirement calculation
- Risk alert generation

Auto Square-off:

- Automatic position closure
- Margin deficiency triggers
- Risk limit breaches
- End-of-day procedures

Index Management

4.1 Importance of Index

Functions of Stock Market Indices:



Market Barometer:

- Reflects overall market performance
- Economic indicator
- Sentiment measurement
- Trend identification

Benchmark for Performance:

- Portfolio performance comparison
- Fund manager evaluation
- Investment strategy assessment
- Risk-adjusted return analysis

Basis for Financial Products:

- Index funds creation
- ETF underlying
- Derivatives contracts
- Structured products

Investment Decision Tool:

- Market timing decisions
- Asset allocation guidance
- Risk management
- Diversification strategies

4.2 Index Computation Methods

4.2.1 Weighted Aggregate Value Method

Formula:

Index = (Current Market Value of Sample / Base Market Value of Sample) × Base Index Value



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Characteristics:

- Market capitalization weighted
- Larger companies have higher impact
- Automatic adjustment for stock splits
- Reflects actual investable universe

Advantages:

- Represents market reality
- Easy to replicate
- Minimal maintenance required
- Widely accepted methodology

Limitations:

- Concentration risk
- Large stock dominance
- May not reflect broad market sentiment

4.2.2 Weighted Average of Price Relatives Method

Formula:

$$\text{Index} = \frac{\sum(W_i \times P_{ri})}{\sum(W_i)}$$

Where:

- W_i = Weight of stock i
- P_{ri} = Price relative of stock i (Current Price/Base Price)

Features:

- Each stock assigned specific weight
- Price relatives calculated individually



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- Weights can be based on various criteria
- Flexible weighting schemes possible

Applications:

- Equal-weighted indices
- Sector-specific weightings
- Factor-based weightings
- Custom benchmark creation

4.2.3 Free Float Method

Concept: Free float refers to the portion of shares that are available for trading by general public investors.

Calculation:

Free Float Market Cap = Number of Shares × Price × Free Float Factor

Free Float Factor Determination:

- Excludes promoter holdings
- Excludes strategic holdings
- Excludes locked-in shares
- Considers only freely tradeable shares

Advantages:

- Better representation of investable universe
- Reduces impact of closely held companies
- Aligns with global practices
- Improves index replicability

Implementation in India:

- NSE Nifty uses free float methodology



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- BSE Sensex adopted free float method
- Regular review of free float factors
- Quarterly updates based on shareholding patterns

4.3 Stock Market Indices in India

4.3.1 NSE Indices

Nifty 50:

- Flagship index of NSE
- 50 large-cap stocks
- Free float market cap weighted
- Base date: November 3, 1995
- Base value: 1,000

Composition Criteria:

- Listed on NSE for at least 6 months
- Average daily turnover requirements
- Market capitalization requirements
- Free float requirements

Nifty Next 50:

- Next 50 companies after Nifty 50
- Represents mid-cap segment
- Similar methodology as Nifty 50
- Provides broader market representation

Sectoral Indices:

- Nifty Bank: Banking sector stocks
- Nifty IT: Information technology stocks
- Nifty Pharma: Pharmaceutical companies



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- Nifty Auto: Automobile sector
- Nifty FMCG: Fast-moving consumer goods

Thematic Indices:

- Nifty 100: Top 100 companies
- Nifty 200: Top 200 companies
- Nifty 500: Broad market index
- Nifty Midcap 100/150
- Nifty Smallcap 100/250

4.3.2 BSE Indices

BSE Sensex:

- Oldest index in India (since 1986)
- 30 large-cap stocks
- Free float market cap weighted
- Base date: 1978-79
- Base value: 100

Selection Criteria:

- Market capitalization ranking
- Trading frequency
- Industry representation
- Financial track record
- Corporate governance standards

BSE 100:

- Broader representation than Sensex
- 100 large-cap stocks
- Sector diversification
- Alternative benchmark



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Sectoral Indices:

- BSE Bankex: Banking stocks
- BSE IT: Technology stocks
- BSE Healthcare: Pharma and healthcare
- BSE Oil & Gas: Energy sector
- BSE Consumer Durables

Thematic Indices:

- BSE 200: Top 200 companies
- BSE 500: Broad market representation
- BSE Midcap: Mid-capitalization stocks
- BSE Smallcap: Small-capitalization stocks

4.3.3 Other Important Indices

India VIX:

- Volatility index
- Measures market volatility expectation
- Based on Nifty options prices
- Fear gauge for Indian markets

Nifty Dividend Opportunities 50:

- Dividend-focused strategy
- High dividend yielding stocks
- Regular income focus
- Alternative investment approach

Nifty Quality 30:

- Quality factor-based index
- Financial quality parameters



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- Fundamental analysis based
- Long-term investment focus

4.4 Index Maintenance and Review

Review Process:

Regular Reviews:

- Semi-annual reviews (March and September)
- Quarterly fast track reviews
- Special reviews for corporate actions
- Methodology updates as needed

Criteria for Changes:

- Market capitalization changes
- Free float factor updates
- Liquidity parameters
- Corporate action impacts

Index Adjustments:

Corporate Actions:

- Stock splits and bonuses
- Rights issues
- Mergers and acquisitions
- Spin-offs and demergers

Methodology:

- Divisor adjustment method
- Chain linking for continuous series
- Base value preservation
- Historical data maintenance



4.5 Global Integration

International Benchmarking:

- MSCI India Index
- FTSE India Index
- S&P BSE Indices
- Global emerging market indices

Cross-listing Considerations:

- ADR/GDR impact on indices
- Foreign institutional investment flows
- Global economic correlation
- Currency impact analysis

Conclusion

The Indian securities market infrastructure has evolved significantly with robust systems for listing, trading, settlement, and risk management. The T+2 settlement cycle, comprehensive risk management frameworks including VAR-based margins and circuit breakers, and sophisticated index methodologies have made Indian stock exchanges comparable to global standards.

Key takeaways include the importance of regulatory compliance, the evolution toward electronic systems, the critical role of risk management in maintaining market stability, and the growing sophistication of index products that serve as benchmarks and investment vehicles.

Understanding these systems is crucial for market participants, regulators, and investors to navigate the Indian securities market effectively and make informed investment decisions.



. Meaning of Hire Purchase

- **Hire Purchase (HP)** is a system of credit sale where the buyer takes delivery of goods immediately by paying an initial down payment and agrees to pay the remaining balance in **regular instalments** over a specified period.
- Ownership of goods is transferred to the buyer only after the **last instalment** is paid. Until then, the seller or the financier retains ownership, and the buyer only has possession and the right to use the goods.

Example:

If a car costs ₹10,00,000, the buyer may pay ₹2,00,000 as down payment and the rest in monthly instalments over 3–5 years. Ownership passes only after the last payment.

2. Key Features of Hire Purchase

1. **Ownership vs. Possession:** Buyer gets possession of the goods immediately, but ownership is transferred only after full payment.
 2. **Instalment Payment:** Payments are spread out over time, making high-value items affordable.
 3. **Right to Return:** If the buyer defaults, the seller can repossess the goods.
 4. **Interest Component:** Instalments usually include both principal and finance charges (interest).
 5. **Legal Framework:** Governed by the **Hire Purchase Act, 1972** (in India).
-

3. Importance of Hire Purchase

Hire Purchase plays an important role in trade, consumer finance, and industrial growth:

(a) For Consumers



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- **Affordability:** Enables middle-income buyers to acquire costly goods (cars, furniture, electronics, machinery).
- **Convenience:** Payments are spread over time instead of a lump sum.
- **Better Standard of Living:** Allows access to goods earlier than otherwise possible.

(b) For Businesses

- **Sales Promotion:** Helps manufacturers and dealers increase sales of consumer durables and industrial machinery.
- **Liquidity Management:** Business firms can acquire assets without heavy upfront capital outlay.
- **Market Expansion:** Makes products affordable to wider sections of society.

(c) For the Economy

- **Encourages Production:** More demand leads to higher production of consumer durables and capital goods.
- **Boosts Financial Services:** Creates opportunities for banks, NBFCs, and finance companies.
- **Credit Growth:** Increases circulation of money in the economy through instalment financing.

4. Types of Hire Purchase

Hire Purchase arrangements can be classified based on **purpose, parties involved, or payment structure**.

(A) Based on Nature of Agreement

1. Consumer Hire Purchase

- Used by individuals for personal goods like vehicles, appliances, or furniture.



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- Payments are made in instalments; ownership passes after final payment.

2. **Industrial/Business Hire Purchase**

- Used by firms to acquire machinery, equipment, or commercial vehicles.
 - Helps avoid large capital expenditure at once.
-

(B) Based on Financing

1. **Direct Hire Purchase**

- The seller directly enters into the hire purchase agreement with the buyer.
- Example: Furniture shop selling on instalment basis.

2. **Indirect Hire Purchase (Through Finance Company)**

- A finance company or bank purchases the asset from the seller and provides it to the buyer under hire purchase.
 - Example: Car finance through an NBFC or bank.
-

(C) Based on Payment Methods

1. **Fixed Instalment Hire Purchase**

- Buyer pays equal monthly/quarterly instalments that include principal + interest.
- Most common method in consumer markets.

2. **Variable Instalment Hire Purchase**

- Instalments vary depending on agreed terms (e.g., higher instalments in peak season, lower during off-season).
 - Common in agricultural or seasonal businesses.
-



5. Difference between Hire Purchase and Instalment System

- In **Hire Purchase**, ownership passes only after final payment.
- In **Instalment System**, ownership transfers immediately, even though payment is in instalments

1. Lease and Hire Purchase

A. Meaning

- **Lease:** A contractual arrangement where the owner of an asset (lessor) allows another party (lessee) to use the asset in exchange for periodic lease rentals.
 - **Hire Purchase (HP):** A financing arrangement where the buyer takes delivery of goods by paying an initial installment and the balance in installments; ownership transfers only after the last installment is paid.
-

B. Types of Leasing

1. Operating Lease

- Short-term, cancellable.
- Lessor bears risks and enjoys residual value.
- Example: Car rentals.

2. Financial Lease

- Long-term, non-cancellable.
- Lessee bears risks and rewards of ownership, though legal ownership remains with lessor.
- Example: Machinery lease for 5–7 years.

3. Sale and Lease Back

- Owner sells asset to lessor and leases it back for liquidity.



4. Leveraged Lease

- Multiple financiers involved; lessee pays rentals → trustee → lenders.

5. Cross-border Lease

- Lease agreements across countries; often structured for tax benefits.
-

C. Legislative Frameworks in India

- **Indian Contract Act, 1872** – Governs contractual obligations.
 - **Sale of Goods Act, 1930** – Relevant for Hire Purchase.
 - **Hire Purchase Act, 1972** – Provides legal framework, rights & remedies.
 - **Income Tax Act, 1961** – Deals with depreciation and tax benefits.
 - **Companies Act, 2013** – Governs company accounts and disclosure of lease/hire purchase.
 - **AS 19 (Accounting Standard on Leases) / Ind AS 116** – Accounting treatment of leases.
-

D. Depreciation and Taxation

- In **Lease**:
 - **Lessor** is the legal owner → entitled to claim depreciation.
 - Lessee can claim lease rental as an expense (tax deductible).
 - In **Hire Purchase**:
 - Ownership transfers to hirer after final payment.
 - Hirer can claim depreciation (once ownership passes).
 - Interest portion of installment = deductible expense.
-

E. Concepts and Features

- Lease: No transfer of ownership, only right to use.



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- HP: Ownership after final installment.
 - Both are forms of **asset financing**, reducing upfront capital investment.
 - Lease is **off-balance sheet financing** (in operating lease), whereas HP is reflected in accounts.
-

2. Microfinance

Meaning

- Provision of financial services (credit, savings, insurance) to low-income individuals or groups who lack access to formal banking.

Features

- Small loans, often without collateral.
- Group lending models (Self-Help Groups, Joint Liability Groups).
- Focus on women empowerment & rural development.
- High repayment rates due to peer pressure/social collateral.

Importance

- Promotes financial inclusion.
 - Provides livelihood opportunities.
 - Reduces dependence on moneylenders.
-

3. Consumer Credit

Meaning

- Credit extended to individuals for personal consumption rather than business use.
- Examples: Credit cards, personal loans, vehicle loans, housing loans.



Features

- Unsecured or secured.
- Higher interest rates compared to corporate loans.
- Helps improve living standards but may lead to over-indebtedness.

Types

1. **Revolving Credit** – Credit cards.
 2. **Installment Credit** – Fixed EMIs.
 3. **Non-installment Credit** – Short-term, payable in lump sum.
-

4. Factoring

Meaning

- A financial service where a **factor** (specialized financial institution) purchases the receivables (invoices) of a company at a discount and provides immediate liquidity.

Types

1. **Recourse Factoring** – Client bears bad debt risk.
2. **Non-recourse Factoring** – Factor bears risk of non-payment.
3. **Domestic & Export Factoring** – Based on location of parties.
4. **Maturity Factoring** – Payment made on due date irrespective of collection.

Benefits

- Improves working capital.
 - Outsources collection function.
 - Helps small businesses manage cash flow.
-



5. Forfaiting

Meaning

- Similar to factoring but deals with **export receivables** (medium/long-term, usually 180 days to 7 years).
- An exporter sells receivables to a forfaiter (usually a bank) at a discount, on a **without-recourse** basis.

Features

- Covers political, transfer, and credit risk.
- Typically involves capital goods, large projects.
- Exporter gets immediate cash; forfaiter takes risk of default.

Difference from Factoring

Basis	Factoring	Forfaiting
Tenure	Short-term (30–180 days)	Medium/long-term (6 months–7 years)
Recourse	With or without recourse	Always without recourse
Use	Domestic & export	Primarily export
Assets Covered	Receivables/invoices	Export bills backed by promissory notes or bills of exchange



Part I: Lease and Hire Purchase

Meaning and Definitions

Lease is a contractual arrangement where the owner (lessor) of an asset grants the right to use that asset to another party (lessee) for a specified period in exchange for periodic payments. The lessor retains ownership throughout the lease term.

Hire Purchase is a financing arrangement where the buyer (hirer) pays for goods in installments while using them, with ownership transferring to the hirer only after all payments are completed. Unlike leasing, hire purchase agreements typically include an option or obligation to purchase.

Key Differences Between Lease and Hire Purchase

Aspect	Lease	Hire Purchase
Ownership	Remains with lessor	Transfers to hirer after final payment
Purpose	Use of asset	Eventual ownership
Duration	Fixed term, renewable	Until full payment
Depreciation	Borne by lessor	Borne by hirer (after ownership transfer)

Types of Leasing

1. Operating Lease (Service Lease)

- **Characteristics:** Short-term, cancellable, maintenance included
- **Duration:** Usually less than the asset's economic life
- **Risk:** Lessor bears obsolescence and residual value risk
- **Examples:** Vehicle rentals, equipment rentals, office space
- **Accounting Treatment:** Off-balance sheet (under old standards)

2. Finance Lease (Capital Lease)



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- **Characteristics:** Long-term, non-cancellable, transfers substantially all risks and rewards
- **Duration:** Covers major portion of asset's economic life
- **Criteria for Classification:**
 - Lease term \geq 75% of asset's useful life
 - Present value of lease payments \geq 90% of asset's fair value
 - Ownership transfers at lease end
 - Contains bargain purchase option
- **Accounting Treatment:** On-balance sheet as asset and liability

3. Sale and Leaseback

- **Process:** Owner sells asset and immediately leases it back
- **Benefits:** Provides immediate cash while retaining use
- **Applications:** Real estate, heavy machinery, aircraft
- **Accounting:** Complex, depends on whether sale meets revenue recognition criteria

4. Leveraged Lease

- **Structure:** Three parties - lessor, lessee, and long-term lender
- **Financing:** Lessor finances only 20-40% of asset cost
- **Benefits:** Tax advantages for lessor, lower cost for lessee
- **Complexity:** Requires sophisticated structuring

5. Direct Lease vs. Sublease

- **Direct Lease:** Direct agreement between asset owner and user
- **Sublease:** Lessee becomes sub-lessor to third party
- **Legal Issues:** Original lessee remains liable to head lessor

Legislative Frameworks



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International Standards

IFRS 16 (Leases)

- Effective from January 1, 2019
- **Single Model Approach:** Most leases on-balance sheet for lessees
- **Right-of-Use Asset:** Lessee recognizes asset representing right to use
- **Lease Liability:** Present value of unpaid lease payments
- **Exemptions:** Short-term leases (≤ 12 months) and low-value assets

Previous Standard (IAS 17)

- Distinguished between operating and finance leases
- Operating leases were off-balance sheet
- Created opportunities for off-balance sheet financing

Indian Framework

Companies Act, 2013

- Defines lease transactions and disclosure requirements
- Regulates related party lease transactions
- Specifies board approval requirements for material leases

Income Tax Act, 1961

- Section 32: Depreciation allowances
- Section 194-I: TDS on lease rentals
- Distinction between lease and hire purchase for tax purposes

Goods and Services Tax (GST)

- Lease transactions subject to GST
- Input tax credit implications



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- Reverse charge mechanism for certain transactions

Regulatory Bodies

- **Reserve Bank of India (RBI):** Regulates NBFCs involved in leasing
- **Securities and Exchange Board of India (SEBI):** Disclosure norms for listed companies
- **Institute of Chartered Accountants of India (ICAI):** Accounting standards interpretation

Depreciation and Tax Implications

For Lessors

Depreciation Rights

- Lessor retains ownership and depreciation benefits
- Can claim accelerated depreciation under Income Tax Act
- Depreciation calculated on original cost of asset

Tax Benefits

- Depreciation under Section 32 of Income Tax Act
- Additional depreciation for new plant and machinery (20%)
- Set-off of lease losses against other income

GST Implications

- Lease rentals subject to GST
- Input tax credit available on asset purchase
- Regular GST compliance requirements

For Lessees

Operating Lease (Pre-IFRS 16)



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- Lease payments expensed as incurred
- No depreciation (asset not on books)
- Full deductibility of lease rentals

Finance Lease / IFRS 16

- Depreciation on right-of-use asset
- Interest expense on lease liability
- Total expense higher in initial years

Tax Deductibility

- Lease rentals generally deductible as business expense
- Restrictions on excessive payments to related parties
- TDS obligations under Section 194-I

Hire Purchase - Tax Treatment

For Hirer

- Depreciation available from year of installation
- Interest component of installments deductible
- Ownership and depreciation risks transferred

For Vendor

- Sale proceeds recognized as per accounting standards
- Interest income taxable over hire purchase period
- Bad debt provisions available

Concepts and Features Analysis

Economic Benefits of Leasing

For Lessees



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1. **Capital Conservation:** No large upfront payment
2. **Off-Balance Sheet Financing** (Operating leases under old standards)
3. **Maintenance Services:** Often included in operating leases
4. **Flexibility:** Easy upgradation and replacement
5. **Tax Efficiency:** Lease rentals fully deductible

For Lessors

1. **Steady Income Stream:** Regular lease rentals
2. **Tax Benefits:** Depreciation and investment allowances
3. **Residual Value:** Asset returns at lease end
4. **Market Expansion:** Serve customers unable to purchase

Risk Analysis

Lessor Risks

- **Credit Risk:** Lessee default on payments
- **Residual Value Risk:** Asset worth less than expected
- **Obsolescence Risk:** Technology changes
- **Interest Rate Risk:** Fixed rate leases with floating cost of funds

Lessee Risks

- **Usage Risk:** Penalties for excess usage
- **Maintenance Risk:** In net leases
- **Renewal Risk:** Lease non-renewal affecting operations
- **Total Cost Risk:** May exceed purchase cost over time

Financial Statement Impact (IFRS 16)

Balance Sheet

- **Assets:** Right-of-use asset (cost - accumulated depreciation)
- **Liabilities:** Lease liability (present value of future payments)



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- **Equity:** Reduced by lease expenses

Profit & Loss

- **Depreciation:** On right-of-use asset
- **Interest Expense:** On lease liability
- **Front-loaded expense pattern:** Higher costs in early years

Cash Flow Statement

- **Operating Activities:** Interest portion of lease payments
- **Financing Activities:** Principal portion of lease payments
- **Improved operating cash flow:** Compared to old standard

Part II: Microfinance and Consumer Credit

Microfinance Overview

Definition: Provision of financial services to low-income individuals and small businesses lacking access to traditional banking services.

Core Services

1. **Microcredit:** Small loans without collateral
2. **Micro-savings:** Small-scale saving products



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3. **Micro-insurance:** Affordable insurance products
4. **Money Transfer:** Remittance services

Institutional Models

- **Self-Help Groups (SHGs):** Community-based savings and credit groups
- **Joint Liability Groups (JLGs):** Mutual guarantee among borrowers
- **Individual Lending:** Direct lending to individuals
- **Bank-Linkage Model:** SHGs linked with formal banking

Consumer Credit

Definition: Credit extended to individuals for personal, family, or household purposes rather than business use.

Types of Consumer Credit

1. Installment Credit

- Fixed payment schedule
- Secured (auto loans, mortgages) or unsecured (personal loans)
- Fixed or variable interest rates

2. Revolving Credit

This is a key feature that distinguishes credit cards and lines of credit from traditional loans. Instead of receiving a lump sum that you pay back, you get access to a revolving credit facility where you can borrow, repay, and borrow again up to your approved limit.

Credit Cards

How They Work:



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You're approved for a maximum credit limit (e.g., \$5,000)

You can make purchases or cash advances up to that limit

Each month, you receive a statement showing what you owe

You must make at least a minimum payment, but you can pay more or the full balance

The Flexibility:

Borrow what you need, when you need it - Use \$100 today, \$500 next week, or nothing at all

Revolving credit - If your limit is \$5,000 and you spend \$2,000, you have \$3,000 available. When you pay back \$1,000, your available credit increases to \$4,000

No fixed repayment schedule - Unlike a car loan with fixed monthly payments, you choose how much to pay (above the minimum)

Interest only on what you use - If you don't carry a balance, you typically pay no interest during the grace period

Example:

Your credit card has a \$10,000 limit. In January, you charge \$3,000. You have \$7,000 available. You pay \$1,500 in February. Now you have \$8,500 available credit (\$10,000 - \$1,500 remaining balance).

Lines of Credit



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How They Work:

Similar to credit cards but often used for larger expenses:

Personal lines of credit (unsecured)

Home equity lines of credit (HELOCs) - secured by your home

Business lines of credit

The Flexibility:

Draw funds as needed - Access money through checks, transfers, or a linked card

Pay interest only on borrowed amounts - If approved for \$50,000 but only use \$10,000, you only pay interest on \$10,000

Flexible repayment - Often interest-only payments during the "draw period," then you repay principal

Reusable - Like credit cards, as you pay down the balance, that credit becomes available again

Example:

You have a \$50,000 HELOC. You draw \$20,000 for home renovations. Your available credit is \$30,000. You pay back \$5,000. Now you have \$35,000 available again.

Key Advantages of This Flexibility



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Emergency access - Having available credit provides a financial safety net

Cash flow management - Cover expenses when income is irregular

Only pay for what you use - Unlike a loan where you get the full amount immediately

No reapplication needed - Once approved, you can borrow repeatedly within your limit

Adjustable borrowing - Your needs change month to month, and these products adapt

Important Considerations

Interest Rates:

Credit cards typically have higher rates (15-25%+)

Lines of credit usually have lower rates, especially secured ones

Interest accrues daily on outstanding balances

Minimum Payments:

While flexible, you must meet minimum payment requirements



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Paying only minimums results in significant interest charges over time

Credit Limit Management:

Using too much of your available credit can hurt your credit score

Lenders may reduce your limit if they perceive increased risk

Discipline Required:

The flexibility can lead to overspending

Easy access to credit doesn't mean free money

This flexible structure makes these products ideal for ongoing, variable expenses rather than one-time purchases, but requires responsible management to avoid falling into expensive debt cycles.**3. Open Credit**

- Service credit (utilities, medical bills)
- Payment expected in full each period
- No interest if paid on time

Regulatory Framework

- **Fair Credit Reporting Act:** Credit bureau regulations
- **Truth in Lending Act:** Disclosure requirements
- **Equal Credit Opportunity Act:** Anti-discrimination provisions



- **RBI Guidelines:** For Indian consumer credit market

Part III: Factoring and Forfaiting

Factoring

Definition: A financial service where a business sells its accounts receivable to a third party (factor) at a discount to obtain immediate cash.

Types of Factoring

1. Recourse vs. Non-Recourse

- **Recourse:** Client liable if debtor defaults
- **Non-Recourse:** Factor bears credit risk
- **Risk allocation affects pricing**

2. Disclosed vs. Undisclosed

- **Disclosed:** Debtors notified of assignment
- **Undisclosed:** Confidential arrangement
- **Collection method varies**

3. Domestic vs. International

- **Domestic:** Within single country
- **International:** Cross-border transactions
- **Additional currency and political risks**

Factoring Process

1. **Credit Assessment:** Factor evaluates debtor creditworthiness
2. **Agreement Signing:** Terms and conditions established
3. **Invoice Assignment:** Client transfers receivables
4. **Advance Payment:** Factor provides immediate cash (70-90%)
5. **Collection:** Factor collects from debtors



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6. **Final Settlement:** Remaining amount less fees paid

Benefits and Costs

- **Benefits:** Immediate cash flow, reduced collection efforts, credit protection
- **Costs:** Factor fees (1-5% of invoice value), interest on advances
- **Suitability:** Businesses with large receivables, credit management challenges

Forfaiting

Definition: The purchase of export receivables by a forfaiter, typically medium-term (1-5 years) trade finance instrument without recourse to the exporter.

Key Features

- **Without Recourse:** Forfaiter bears all risks
- **Medium-term:** Usually 1-5 years maturity
- **Export Finance:** Specifically for international trade
- **Negotiable Instruments:** Bills of exchange, promissory notes

Forfaiting Process

1. **Export Contract:** Exporter and importer agree on terms
2. **Forfaiting Quote:** Forfaiter provides pricing
3. **Documentation:** Bills of exchange/promissory notes created
4. **Guarantee:** Bank guarantee or aval obtained
5. **Purchase:** Forfaiter buys instruments at discount
6. **Collection:** Forfaiter collects at maturity

Risk Mitigation

- **Credit Risk:** Covered by bank guarantee/aval
- **Political Risk:** May require additional insurance
- **Currency Risk:** Usually in major currencies
- **Interest Rate Risk:** Fixed rate transactions



Comparison: Factoring vs. Forfaiting

Aspect	Factoring	Forfaiting
Duration	Short-term (30-90 days)	Medium-term (1-5 years)
Recourse	May be with/without recourse	Always without recourse
Geography	Domestic/International	Primarily international
Instruments	Invoices, receivables	Bills of exchange, promissory notes
Guarantees	Optional	Usually required (bank guarantee)

Market Development and Trends

Global Factoring Market

- Growing acceptance in emerging markets
- Technology-driven solutions (fintech)
- Supply chain finance integration
- Regulatory standardization efforts

Challenges and Opportunities

- **Challenges:** Credit assessment, legal frameworks, collection mechanisms
- **Opportunities:** SME financing gap, trade finance demand, technological advancement

Future Outlook

- Digital transformation of processes
- Blockchain and smart contracts adoption
- Enhanced risk assessment through AI/ML
- Greater integration with banking services



UNIT IV: Credit Rating & Securitization

Credit Rating

Credit rating is an assessment of the creditworthiness of a borrower (corporate or sovereign) or a financial instrument.

Definition and Meaning

Credit rating is an opinion provided by credit rating agencies regarding the ability and willingness of an issuer to meet its financial obligations in full and on time.

Purpose:

- Risk assessment for investors
- Pricing of securities
- Regulatory compliance
- Market credibility
- Investment decision-making

What is Rated:

- Corporate bonds/debentures
- Commercial paper
- Bank loans
- Structured finance instruments
- Sovereign debt
- Municipal bonds
- Preferred stock

Process of Credit Rating

Step 1: Request and Engagement

- Issuer approaches rating agency



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- Engagement agreement signed
- Fee structure agreed
- Information access granted

Step 2: Information Collection

- Financial statements (3-5 years)
- Business plans and projections
- Industry reports
- Management discussions
- Legal documents
- Site visits
- Meetings with management

Step 3: Analysis

Quantitative Analysis:

- Financial ratios
- Cash flow analysis
- Debt service coverage
- Liquidity metrics
- Profitability trends
- Leverage indicators

Qualitative Analysis:

- Management quality and experience
- Business risk profile
- Industry position and competition
- Regulatory environment
- Market conditions
- Corporate governance
- Promoter background



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Step 4: Rating Committee

- Analysts present findings
- Committee discusses and deliberates
- Rating decision made by consensus/vote
- Independent from commercial interests

Step 5: Communication

- Issuer informed of rating
- Opportunity to appeal/present additional information
- Final rating confirmed

Step 6: Publication

- Rating published with rationale
- Press release issued
- Available on agency website and regulatory platforms

Step 7: Surveillance

- Continuous monitoring
- Annual review minimum
- Periodic updates requested
- Rating reaffirmed, upgraded, or downgraded
- Alert for material events

Rating Methodology

Rating agencies use comprehensive frameworks considering multiple factors:

1. Business Risk Assessment

Industry Analysis:

- Growth prospects



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- Cyclicalities
- Competitive intensity
- Regulatory environment
- Entry barriers
- Technological changes

Company Position:

- Market share and rank
- Product diversification
- Geographic diversification
- Brand strength
- Customer concentration
- Supplier relationships

2. Financial Risk Assessment

Key Ratios Analyzed:

Leverage Ratios:

- Debt-to-Equity
- Total Debt to Total Assets
- Net Debt to EBITDA

Coverage Ratios:

- Interest Coverage Ratio (EBIT/Interest)
- Debt Service Coverage Ratio
- Fixed Charge Coverage

Profitability Ratios:

- Return on Equity (ROE)
- Return on Assets (ROA)



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- Operating Margin
- Net Profit Margin

Liquidity Ratios:

- Current Ratio
- Quick Ratio
- Cash Flow to Current Liabilities

Cash Flow Analysis:

- Operating cash flow strength
- Free cash flow generation
- Cash conversion cycle
- Capital expenditure requirements

3. Management Assessment

- Track record
- Strategic vision
- Execution capability
- Corporate governance
- Succession planning
- Related party transactions

4. Financial Flexibility

- Access to capital markets
- Banking relationships
- Unutilized credit lines
- Asset quality and liquidity

5. External Factors

- Economic environment



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- Political stability
- Regulatory changes
- Currency risks (for international operations)

Rating Agencies in India

1. CRISIL (Credit Rating Information Services of India Limited)

- Established: 1987
- Majority owned by S&P Global
- Largest rating agency in India
- Covers corporates, financial institutions, infrastructure

2. ICRA Limited

- Established: 1991
- Associate of Moody's
- Strong in structured finance
- Comprehensive coverage across sectors

3. CARE Ratings (Credit Analysis and Research Limited)

- Established: 1993
- Independent Indian agency
- Focus on SMEs and mid-sized companies
- Diverse portfolio

4. India Ratings and Research (Fitch India)

- Wholly-owned by Fitch Group
- Operates in India since 1996
- International rating methodologies
- Strong in infrastructure and banks

5. Brickwork Ratings



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- Established: 2007
- Independent Indian agency
- Focus on SME segment
- Technology-driven processes

6. SMERA Ratings (Now Acuité Ratings & Research)

- Established: 2011
- Focus on MSMEs
- Simplified processes

Rating Symbols of Different Companies

Long-Term Instruments (Bonds, Debentures):

CRISIL:

- AAA: Highest degree of safety
- AA: High degree of safety
- A: Adequate degree of safety
- BBB: Moderate degree of safety
- BB: Moderate risk of default
- B: High risk of default
- C: Very high risk of default
- D: Default

Modifiers: + (plus) or - (minus) for AA through C

ICRA:

- ICRA AAA to ICRA D
- Similar structure to CRISIL
- Modifiers: + and -

CARE:



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- CARE AAA to CARE D
- Similar structure
- Modifiers: + and -

Fitch India:

- IND AAA to IND D (IND prefix for India)
- Follows global Fitch scale
- Modifiers: + and -

Short-Term Instruments (Commercial Paper, Short-Term Bonds):

CRISIL:

- A1+: Highest degree of safety (best quality)
- A1: High degree of safety
- A2: Adequate degree of safety
- A3: Moderate degree of safety
- A4: Minimal degree of safety
- D: Default

ICRA:

- ICRA A1+ to ICRA A4 and ICRA D
- Similar structure

CARE:

- CARE A1+ to CARE A4 and CARE D

Rating Outlooks:

- Positive: May be upgraded
- Stable: Likely to remain unchanged
- Negative: May be downgraded
- Developing: Rating under review, uncertain direction



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Investment Grade vs. Speculative Grade:

- Investment Grade: AAA to BBB- (generally acceptable for conservative investors)
- Speculative Grade: BB+ and below (higher risk, higher return potential)

Legislative Framework Guiding CRAs

1. SEBI (Credit Rating Agencies) Regulations, 1999

Key Provisions:

- Registration requirements for CRAs
- Net worth criteria (minimum ₹5 crores, now higher)
- Professional qualifications of staff
- Code of conduct
- Rating process and criteria
- Disclosure requirements
- Surveillance obligations

Rating Mandate:

- Compulsory rating for public/rights issues of debt
- Continuous surveillance required
- Timely dissemination of rating changes

Conflict of Interest:

- Chinese wall between rating and other business
- Restrictions on cross holdings
- Disclosure of shareholding

2. RBI Guidelines

For banks and financial institutions:



- Use of credit ratings in lending decisions
- Risk weights based on ratings
- Portfolio quality assessment
- External ratings vs. internal ratings

3. Companies Act, 2013

- Disclosure of credit ratings in offer documents
- Rating mandatory for debenture issues

4. Insurance Act, 1938 (Amended)

- Investment restrictions based on credit ratings
- Minimum rating requirements for insurance funds

5. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

- Minimum rating for debt issues
- Multiple rating requirements
- Disclosure in offer documents

Regulatory Oversight:

- SEBI supervises and regulates CRAs
- Periodic inspections
- Action against non-compliance
- Investor protection measures

Securitization

Securitization is the process of pooling various financial assets and converting them into marketable securities that can be sold to investors.

Meaning and Concept



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Definition: Securitization involves:

1. Pooling of illiquid financial assets (loans, receivables)
2. Transferring them to a Special Purpose Vehicle (SPV)
3. Issuing securities backed by these assets
4. Selling securities to investors

Purpose:

- Convert illiquid assets into liquid securities
- Remove assets from balance sheet
- Access capital markets
- Diversify funding sources
- Transfer risk

Basic Structure:

Originator → Loans/Assets → SPV → Securities → Investors

Cash flows from underlying assets → SPV → Investors

Features of Securitization

1. Asset Pool:

- Homogeneous assets with predictable cash flows
- Examples: Home loans, auto loans, credit card receivables, trade receivables

2. True Sale:

- Legal transfer of assets to SPV
- Assets isolated from originator's bankruptcy risk
- Originator cannot reclaim assets

3. SPV (Special Purpose Vehicle):



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- Independent legal entity
- Sole purpose: Hold assets and issue securities
- Bankruptcy remote

4. Credit Enhancement:

- Improve credit quality of securities
- Internal or external mechanisms
- Provide protection to investors

5. Tranching:

- Securities issued in different classes
- Different risk-return profiles
- Senior, mezzanine, subordinated tranches

6. Servicing:

- Originator or third party services loans
- Collects payments
- Handles defaults and recoveries

Special Purpose Vehicle (SPV)

Purpose:

- Isolate securitized assets from originator
- Issue securities to investors
- Ensure bankruptcy remoteness

Structure:

- Trust (most common in India)
- Company
- Limited liability partnership



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Characteristics:

- Single purpose entity
- Limited scope of activity
- No employees typically
- No operational business
- Governed by trust deed or incorporation documents

Functions:

- Acquire assets from originator
- Issue Pass Through Certificates (PTCs)
- Collect cash flows from assets
- Distribute to investors
- Maintain accounts and records

Bankruptcy Remoteness:

- SPV designed to minimize bankruptcy risk
- Restrictions on activities
- Prohibition on additional debt (beyond securitization)
- Independent from originator's financial distress

Pass Through Certificate (PTC) & Mechanism

What is PTC: Pass Through Certificates are securities issued by SPV, representing undivided interest in the underlying asset pool.

Features:

1. Undivided Interest:

- Investors own proportionate share of cash flows
- No specific asset ownership
- Pro-rata distribution



2. Pass Through:

- Cash flows from assets passed through to investors
- Principal and interest payments
- Proportionate to holding

3. Asset-Backed:

- Backed by specific pool of assets
- Investors have claim on assets (through SPV)
- Not liability of originator

4. Credit Rating:

- PTCs are rated by credit rating agencies
- Based on asset quality, structure, credit enhancement

Mechanism:

Step 1: Origination

- Originator identifies assets to securitize
- Creates asset pool

Step 2: SPV Formation

- SPV established as trust or company
- Trustee appointed

Step 3: Asset Transfer

- Assets sold to SPV (true sale)
- Consideration paid to originator
- Legal assignment completed

Step 4: PTC Issuance



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- SPV issues PTCs to investors
- Private placement or public offering
- Different tranches with varying risk-return

Step 5: Servicing

- Servicing agent collects from borrowers
- Deposits in SPV collection account
- Manages delinquencies and defaults

Step 6: Cash Flow Distribution

- SPV distributes collections to PTC holders
- According to waterfall structure
- Senior tranches paid first, then subordinated

Step 7: Wind-Up

- All assets realized
- Final distributions made
- SPV dissolved

Types of PTCs:

1. Senior PTCs:

- First claim on cash flows
- Highest credit rating
- Lowest yield
- Lowest risk

2. Mezzanine PTCs:

- Subordinated to senior
- Medium risk-return
- Provide credit enhancement to senior



3. Subordinated/Junior PTCs:

- Last claim on cash flows
- Highest risk
- Highest potential return
- First loss piece

4. Residual/Equity PTCs:

- Claim on residual cash flows after all tranches paid
- Often retained by originator
- Highest risk, uncertain returns

Benefits of Securitization

For Originators (Banks, NBFCs, Companies):

1. Funding:

- Access to capital markets
- Lower cost of funds (for good quality assets)
- Diversified funding sources

2. Balance Sheet Management:

- Off-balance sheet treatment
- Improves capital adequacy ratios (for banks)
- Deleveraging
- Asset-liability management

3. Risk Transfer:

- Credit risk transferred to investors
- Frees up risk capital
- Improved risk profile



4. Liquidity:

- Convert illiquid assets to cash
- Recycle capital into new lending
- Improved liquidity ratios

5. Regulatory:

- Better capital adequacy
- Priority sector lending (for securitized portfolios)

For Investors:

1. Investment Opportunity:

- Access to new asset class
- Diversification
- Predictable cash flows

2. Risk-Return Profile:

- Choose tranches matching risk appetite
- Typically higher yields than corporate bonds for similar ratings

3. Secured:

- Backed by asset pool
- Credit enhancement provides protection
- Bankruptcy remote structure

For Economy:

1. Financial Intermediation:



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- Efficient allocation of capital
- Connects lenders and investors

2. Credit Availability:

- Enhances credit flow
- Supports lending growth

3. Market Development:

- Develops debt capital markets
- Financial innovation

Issues in Securitization

1. Adverse Selection:

- Originator may securitize poor quality assets
- "Cherry-picking" problem
- Moral hazard

2. Complexity:

- Complex structures difficult for investors to understand
- Opaque pricing
- Rating dependence

3. Credit Enhancement Dependency:

- Heavy reliance on credit enhancement
- May mask true asset quality

4. Servicing Risk:

- Quality of servicing impacts performance
- Originator conflicts (if also servicer)



5. Prepayment Risk:

- Early repayments reduce returns
- Uncertainty in cash flows

6. Legal and Regulatory:

- True sale vs. secured borrowing debates
- Stamp duty costs
- Tax treatment uncertainties

7. Market Risk:

- Limited secondary market liquidity
- Difficult to exit before

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8. Systemic Risk:

- Interconnectedness in financial system
- Lessons from 2008 global financial crisis

9. Origination Standards:

- "Originate to distribute" model may reduce lending standards
- Lack of skin in the game

10. Information Asymmetry:

- Originator knows assets better than investors
- Disclosure quality varies



Legislative Framework Guiding Securitization

1. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

Key Provisions:

- Defines securitization
- Legal framework for asset reconstruction
- Enforcement of security without court intervention
- Registration of securitization/reconstruction companies

Securitization Related:

- Transfer of financial assets
- True sale criteria
- Rights of investors
- Disclosure requirements

2. RBI Guidelines on Securitization of Standard Assets (2012, Revised 2021)

Eligibility:

- Only standard assets can be securitized
- Minimum holding period before securitization
- Seasoning requirements

Minimum Holding Period (MHP):

- Originator must hold assets for minimum period before securitization
- Typically 6-12 months depending on asset type
- Ensures originator has skin in the game

Minimum Retention Requirement (MRR):

- Originator must retain specified percentage (typically 5%)



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- Retains stake in performance
- Aligns interests with investors

Credit Enhancement:

- Limits on credit enhancement
- Arm's length transactions
- Disclosure requirements

Risk Weights:

- Capital requirements for originators
- Based on retention and credit enhancement
- Risk weights for investors based on ratings

Servicing:

- Servicer qualifications
- Reporting requirements
- Conflict management

3. SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations, 2008

Coverage:

- Public issuance of PTCs
- Listing requirements
- Disclosure norms
- Investor protection

Key Requirements:

- Minimum credit rating
- Disclosure document
- Asset pool characteristics



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- Risk factors
- Offer structure

4. Income Tax Act, 1961

Tax Treatment:

For SPV:

- Pass-through status
- No tax at SPV level (subject to conditions)
- Income taxed at investor level

For Originator:

- Transfer to SPV: Not a taxable transfer (if conditions met)
- Servicing income: Taxable as business income

For Investors:

- Income from PTCs: Taxed as per investor's tax status
- Interest income or capital gains depending on structure

5. Indian Stamp Act, 1899 (State-wise variations)

Stamp Duty:

- Payable on transfer of assets to SPV
- Varies by state
- Can be significant cost
- Some states provide concessions

6. Companies Act, 2013

- SPV incorporation (if company structure)
- Trustee regulations (if trust structure)



- Disclosure requirements

7. Banking Regulation Act, 1949

- Restrictions on banks' securitization activities
- Compliance with RBI guidelines
- Capital adequacy implications

8. Indian Trusts Act, 1882

- Governance of trust-based SPVs
- Trustee duties and responsibilities
- Beneficiary rights

Recent Developments:

1. Direct Assignment:

- Alternative to securitization
- Direct sale of loan pools
- Similar regulations apply

2. Co-Origination:

- Banks and NBFCs co-originate loans
- Risk sharing mechanism
- Promoted by RBI

3. Technology:

- Blockchain for securitization
- Automated servicing
- Enhanced transparency

4. Asset Classes:



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- Expansion beyond traditional assets
 - Microfinance, gold loans, MSME loans
 - Infrastructure receivables
-

Practical Applications and Examples

Example 1: Home Loan Securitization

Scenario: ABC Bank has ₹1,000 crores of home loans on books.

Process:

1. ABC Bank selects ₹500 crores of performing home loans
2. Creates SPV - "ABC Home Loan Trust"
3. Transfers loans to SPV for ₹500 crores
4. SPV issues PTCs:
 - Senior: ₹400 crores, rated AAA, 7% yield
 - Mezzanine: ₹75 crores, rated AA, 9% yield
 - Junior: ₹25 crores, rated A, 12% yield
5. ABC Bank retains 10% (₹50 crores) of junior tranche (MRR)
6. Investors subscribe to PTCs
7. ABC Bank services loans, collects EMIs
8. Cash flows distributed per waterfall:
 - Servicing fees
 - Senior PTC holders
 - Mezzanine PTC holders
 - Junior PTC holders

Benefits for ABC Bank:

- ₹500 crores liquidity
- Capital adequacy improved
- Can lend ₹500 crores fresh loans



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Benefits for Investors:

- Secured investment
- Predictable cash flows
- Attractive yields

Example 2: Credit Rating Process

Company: XYZ Manufacturing Ltd. plans to issue ₹100 crore debentures

Step 1: Approaches CRISIL for rating

Step 2: Provides information:

- 5 years financials
- Business plan
- Industry position
- Management details

Step 3: CRISIL analyzes:

- Debt/Equity: 1.2 (moderate leverage)
- Interest Coverage: 4.5x (comfortable)
- ROE: 18% (good profitability)
- Strong market position
- Experienced management

Step 4: Rating Committee assigns: **CRISIL AA/Stable**

Rationale: High degree of safety; strong financial profile; leading market position; stable industry outlook

Step 5: Company includes rating in offer document

Step 6: CRISIL monitors annually; reaffirms or changes rating based on performance



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