Presentation on BLP Unit 1

Presented By
Sarita Yadav

Meaning of Indian financial system

- The financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by independent regulators in the sectors of insurance, banking, capital markets and various services sectors.
- **Features**

It plays a vital role in economic development of a country.

• It encourages both savings and investment.

• It links savers and investors.

• It helps in capital formation.

• It helps in allocation of risk.

• It facilitates expansion of financial markets.

COMPONENTS/ CONSTITUENTS OF INDIAN FINANCIAL SYSTEM

- Financial Institutions
- Financial Markets
- Financial Instruments/ Assets/ Securities
- Financial Services

FINANCIAL INSTITUTIONS

- Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities (individual, business, government) seeking advice on various issue ranging from restructuring to diversification plans.
- TYPES OF FINANCIAL INSTITUTION
- Banking Institutions
- Non - Banking Financial Institutions

Banking Institutions

- Organized
- Commercial Banks- Public Banks, Private Banks, Foreign Banks
- Cooperative Banks
- Regional Rural Banks
- Unorganized Sector
- Money lenders
- Indigenous Banks

Non Banking Institutions

- Organized Non – Banking Financial Institutions
- Development Financial Institutions: SIDBI, NABARD, SFC, ICICI, EXIM
- Investment Institutions
- Unorganized Non - Banking Financial Institutions

Economic Importance of Financial Markets

- To facilitate creation and allocation of credit and liquidity
- To serve as intermediaries for mobilization of savings.
- To assist the process of balanced economic growth.
- To provide financial convenience.
- To cater to the various credit needs of the business houses
- Minimizing risks by some strategies such as hedging or diversification.
- Act as a mirror reflecting the economic conditions of the country/states.

Capital Market

- **Primary Market**
- Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market.

i) Public issue (ii) Offer for sale (iii) Private placement (iv) Rights issue

- **Primary Market Issue Facilitator**
- Merchant Banking: Pre Issue and Post issue
- Registrar to the issue
- Bankers to an issue
- Share Transfer Agent
- Broker to an issue
- Underwriter

Secondary Market

- This market is popularly known as Stock Market of stock exchange where existing securities are resold or traded.

Functions

- Ready market of securities
- Continuous appraisal of securities
- Protects investors
- Channelization of capital in profitable ventures
- Encourage capital formation
- Facilities for speculation

Presentation on BLP Unit 2

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Legal Aspects of Securities of Loans and Advances

- Adequacy of Margin

In banking terminology, ‘margin’ means the difference between the market value of the security and the amount of the advance granted against it

- Factors Determining Margin
  - Fluctuations in the prices of the various commodities
  - In case of shares of industrial concerns the financial position and reputation of the issuing undertaking is also taken into account.
  - Credit and reputation of the borrower concern
  - Time of sanctioning an advance
  - In case of commodities which are subject to selective credit control of the Reserve Bank

Legal Aspects of Securities of Loans and Advances

- Marketability of Securities

Advances are usually granted for short periods by the commercial banks because their deposit resources (except term deposits) are either repayable on demand or at short notice. If the customer defaults in making payment, the banker has to liquidate the security. It is, therefore, essential that the security offered by a borrower may be disposed of without loss of time and money. A banker should be very cautious in accepting assets which are not marketable.

Legal Aspects of Securities of Loans and Advances

- Documentation

Documentation means that necessary documents, e.g. agreement of pledge or mortgage, etc., are prepared and signed by the borrower at the time of securing a loan from the bank.

- Realisation of the Advance

If the borrower defaults in making payment on the specified date, the banker may realize his debt from the sale proceeds of the securities pledged to him. As noted in previous chapter, a pledgee may sell the securities by giving proper notice to the pledger of his intention to sell the securities

Various Kind of Securities

- Land/Real Estate as a Security for the Loan/Advance
- Stocks and Shares as a Security for the Loan/Advance
- Debentures as a Security for the Loan/Advance
- Goods as a Security for the Loan/Advance
- Life Policies as a Security for the Loan/Advance
- Fixed Deposit as a Security for the Loan/Advance

Land/Real Estate as a Security for the Loan/Advance

- Advantages : (i) The advantage that land has over other types of securities is that its value generally increases with time. (ii) It cannot be shifted, a fact which sometimes is also a disadvantage.
- Disadvantages: i) Valuation is at times difficult ii) Ascertaining the title of the owner iii) Difficult to realize the security iv) Creating a charge is costly

Stocks and Shares as a Security for the Loan/Advance

- Advantages:
- Value of the security can be ascertained without any difficulty.
- In normal times, stocks and shares enjoy stability of value and are not subject to wide fluctuations.
- Stocks and shares require very little formalities, for taking them as security.
- It is easier compared to real estate to ascertain the title, more so with the advent of depositories.
- Creating a charge of this is less expensive than real estate.
- They yield income by way of dividends, which can be appropriated towards the loan account.
- Being a tangible form of securities they are more reliable.
- Disadvantages:
- Being easy to realize, they are fraud prone and as such they must be properly secured.
- In the case of partly paid shares, the following demerits are there: (a) The banker may have to pay the calls. (b) Partly paid shares are subject to violent price fluctuations

Debentures as a Security for the Loan/Advance

- Advantages:
- Easy to sell.
- Not subject to violent price fluctuations.
- They can be transferred at minimum cost.
- Bearer debentures are fully negotiable.
- They rank in priority to shares and mostly secured by a charge on the company's property.
- Disadvantages
- If interest is not paid regularly on the debentures it would affect its price and marketability.
- If the charge on property of company is not registered, the subsequent charges will get a priority.
- Debentures may be issued by companies having no power to borrow money.

Goods as a Security for the Loan/Advance

- Merits of this Security
- Goods have a ready market and as such can be easily sold unlike other kinds of security.
- Valuation of the goods can be easily done.
- The banker gets a tangible form of security compared to unsecured advances, which in case of default by the borrower, can be realized by sale of pledged goods
- Advances against goods are normally given for short periods and therefore the risk of the banker is considerably reduced.

Goods as a Security for the Loan/Advance

- Demerits of this Security
- Certain goods are liable to perish or deteriorate in quality over a period of time,
- There are possible risks of fraud or dishonesty on the part of the borrower.
- The value of the security in certain cases more particularly electronic consumer goods are subject to wide fluctuations. Therefore, the valuation of such goods is difficult.
- The banker may find it difficult to store the goods.
- Transporting the goods from the borrower's premises to the banker's premises and thereafter to the market in case of sale is a considerably costly and time-consuming affair
- When the banker releases goods for sale on the execution of trust receipts, the money realized by the sale of such goods may not be deposited with the banker, and the borrowers may default to the bankers.
- If the goods are warehoused, the warehouse keeper enjoys a lien over the goods for any unpaid charges. The banker therefore, has to ensure periodically that all charges are duly paid.

Documents of Title to Goods

- As per the Section 2(4) of the Sale of Goods Act, 1930, a document of title to goods is ‘a document used in the ordinary course of business as a proof of possession or control of goods authorizing or purporting to authorize either, by endorsement or delivery, the possessor of the documents, to transfer or receive the goods thereby represented

Documents of Title to Goods

The essential requisites of a document of title to goods are:

- (i) The mere possession of the documents creates a right either by virtue of law or trade usage, to possess the goods represented by the documents. (ii) Goods represented by the documents can be transferred by endorsement and/or delivery of the documents. (iii) The transferee of the documents can take delivery of the goods in his own right. (iv) Although they appear to be negotiable instruments, documents of title to goods are not negotiable instruments. The title of bona fide transferee for value can be affected by defects in the title of transferor. They may be called quasi-negotiable instruments.
- Examples of documents of title to goods are bills of landing, dock warrant, warehouse-keeper’s certificate, railway receipts, delivery orders, etc.

Merits of this Security

- (i) By mere pledge of the instruments the goods are pledged and serve as a good security. (ii) The person in possession of the document can transfer the goods by endorsement and/or delivery. The transferee thereafter is entitled to take delivery of the goods in his own right. (iii) The documents are easily transferable, and the formalities involved are less compared to mortgage or assignment

Demerits of this Security

- (i) Possibility for fraud and dishonesty Since the bill of lading or a railway receipt or a warehouse-keeper's certificate does not certify or guarantee the correctness of the contents of the bags or packages, the banker will have no remedy against the carrier or warehouse-keeper, if they turn out to be containing worthless goods.
- (ii) Forged and altered documents The documents might be forged ones, or even if genuine, the quantity may be altered.
- (iii) Not Negotiable documents The document being "Not Negotiable", the transferee of such documents will not get a better title than that of the transferor. Therefore, if the person who pledged the documents has a defective title, the banker will not acquire a better title.
- (iv) Unpaid vendor's right of stoppage in transit: Under the Sale of Goods Act, 1930, an unpaid vendor has the 'right of stoppage in transit' and he is entitled to direct the carrier that the goods need not be delivered, if not already done.
- (v) In the case of lost documents, delivery of the goods is allowed on the execution of an indemnity bond, this option may be misused by the borrower by selling the goods to some other customer who may take delivery of the goods declaring that he had lost/misplace the document and indemnifying the carrier

Life Policies as a Security for the Loan/Advance

- Purpose of Life Policy A life policy is taken for two purposes: (i) It is a source of income for the dependents of the assured in case of his death. (ii) It is an ideal form of saving since along with income tax deduction on the premium, paid loans can be raised on the policies in times of need.
- Advantages

(i) Life insurance business being highly regulated and permitted only to companies having sound financial health, the banker need not doubt the realisation of the policies, which will be done without any difficulty, if the policy and the claim are in order.

(ii) The assignment of the policy in favour of the banker requires very little formalities and the banker obtains a perfect title.

(iii) The longer the period for which the policy has been in force, the greater the surrender value. It is also useful as an additional security because, in the event of the borrower's death, the debt is easily liquidated from the proceeds of the policy.

(iv) The security can be realized immediately on the borrower's default of payment by surrendering the policy to the insurance company.

(v) The policy is a tangible security and is in the custody of the bank. The banker only has to ensure that regular payment of premiums is made.

Disadvantages

- (i) If the premium is not paid regularly, the policy lapses and reviving the policy is complicated.
- (ii) Insurance contracts being contracts of utmost good faith, any misrepresentation or non-disclosure of any particulars by the assured would make the policy void and enable the insurer to avoid the contract.
- (iii) The person (proposer) who has obtained the policy must have an insurable interest in the life of the assured or the contract is void.
- (iv) The policy may contain special clauses, which may restrict the liability of the insurer.
- (v) When the banker accepts a policy coming under Married Women Property Act he must ensure that all the parties sign in the bank's form of assignment.
- (vi) There is facility to obtain the duplicate policy if the original is lost. This can be misused by persons by obtaining duplicate policies. Banker should therefore, verify that no duplicate policy has been issued and there are no encumbrances on the policy.

Book Debts as a Security for the Loan/Advance

- Borrowers can take advances by assigning book debts in favour of the bank. Section 130 of the Transfer of Property Act, permits assignment of actionable claim and the procedure to be followed is:
- (i) The assignment must be in writing and signed by the transferor or his duly authorised agent
- (ii) Notice of the assignment in writing must be given to the debtor
- (iii) The assignment may be absolute or by way of charge

Legal Implication of assignment

(i) The assignee can sue in his/ their own name and can give a valid discharge

(ii) The debtor can exercise any right of set off against the assignee, which but for such transfer, he could have exercised against assignor

(iii) As an actionable claim includes future debts, there can be a valid assignment of future debts as well

CHARGE OVER SECURITIES

Charging a security means that the borrower gives the lending bank a right to:

- Transfer the title from the borrower to the bank
- Take possession of the securities
- Recover the dues through legal course

Creation of charge on securities is done as per the nature of the security as under:

- Hypothecation (for movable stocks such as, goods, plant and machinery)
- Pledge (for movable stocks)
- Mortgage (in respect of immovable property)
- Assignment of debts (life like insurance policy/book debts)
- Lien on deposits with the bank

Pledge of Security

- Pledge means bailment of goods for the purpose of providing security for payment of debt or performance of promise. Section 172 of Indian Contract Act, 1872 defines pledge.
- Valid Pledge - Important requirements There should be delivery of goods (bailment). The bailment (delivery of goods) must be by or on behalf of the debtor. The bailment (delivery of goods) must be for the purpose of providing security for the payment of a debt or performance of a promise.

(1) There is bailment of gold (delivery of gold)

(2) The bailment of gold is made by the debtor (borrower)

(3) The bailment of gold is provided as a security to the gold loan (debt)

Pledge – important features

- (i) The person, whose goods are bailed is called pawnor or pledger, and to whom the goods are pledged as pawnee or pledgee.
- (ii) Ownership of the property is retained by the pledger, which is subject only to the qualified interest which passes to the pledgee by the bailment. Securities for Bank Loans
- (iii) The essential feature of a pledge is the actual or constructive delivery of the goods to the pledgee. By constructive delivery it is meant that there will be no physical transfer of goods from the custody of the pledger/ pawnor to the pledge/ pawnee. All that is required is that the goods must be placed in the possession of the pawnee or of any person authorized to hold them on his behalf.
- (iv) The delivery of the goods may be 'physical' when goods are actually transferred and 'symbolic' as in the case of delivery of the key or 'constructive' as in the case of attornment.
- (v) Pledge can be created only in the case of existing goods (and not on future goods) which are in the possession of the pledger himself.
- (vi) Since the possession of goods is the important feature of pledge and therefore, pledge is lost when possession of the goods is lost.
- (vii) An agreement of pledge also known as deed of pledge may be implied from the nature of the transaction or the circumstances of the case
- (viii) To protect the interests of the concerned parties the agreement in writing should clearly indicate the terms and conditions.

Rights of Pledgee

1. Right of Retainer: As per Section 173 of the Indian Contract Act, the pawnee or pledge is entitled to the good pledged not only for non-payment of debt or non- performance of promise, but also for the interest on the debt and for all expense incurred for preservation of the goods pledged.
2. Right against Third Parties: A pledge has the same remedies against third persons, as the owner himself would have, if he is deprived of his goods.
3. No Right to Retain in case of Other Debts: In the absence of a contract to the contrary, the pledge cannot retain goods for a debt or a promise, other than the promise or debt for which the said goods are pledged.
4. Other rights: In case the Pledger makes default, then the Pledgee has three important rights:

(i) He may sue the pawnor upon the debt or promise

(ii) He may retain the pledged goods as collateral security

(iii) He may sell it after giving the pledger reasonable notice of the sale

Hypothecation over Securities

- The term “Hypothecation’ means a charge created on any movable asset/property, for a loan borrowed by the owner of goods/movable assets (existing or future) without transferring, either the property or the possession to the lender.
- Hypothecation – important features:

1. The charge hypothecation is applicable to movable assets.
2. The ownership and possession are held by the borrower of the assets (security).
3. The document (hypothecation agreement) provides for a covenant, whereby the borrower agrees to give possession of the goods (movable assets) when called upon to do so by the creditor. Upon taking over the possession of goods, the charge is treated as pledge.

Other important aspects of Hypothecation:

- (a) The possession of the goods/assets are held by the borrower, hence, it is always difficult for the creditor (lender) to have control over such goods.
- (b) The borrower may sell the hypothecated stocks, and pay other creditors.
- (c) The possibility of raising double finance against the same stock cannot be ruled out. For example the borrower may hypothecate the same stocks to another bank, the goods may be latter pledged to another creditor.
- (d) In case of default, the realization of assets may be difficult and costly

Lien

- Section 171 of the Indian Contract Act,1872 gives to the banker an absolute right of general lien on all goods and securities received by the banker. The banker has general lien on all deposits. If the deposit receipt is given as a security for raising a loan or discharging an obligation then the lien on such deposit receipt, is a particular lien, and it would exist till the debt is cleared or the obligation is fulfilled.
- Banker's General Lien:

This is applicable in the following situations: – when a banker receives goods and securities for a purpose – lien is applicable for the goods and/or securities which are belonging to a person who has delivered them to the banker – there is no contract to the contrary and the debt is not barred by limitation. A banker's lien is also called as an implied pledge. A banker has the right to retain and if necessary can also sell the goods and/or securities charged in his favour.

A banker cannot exercise his right of lien in following situations:

- 1. In case when goods and securities are not obtained by him in the ordinary course of business
- 2. In case of Safe Custody, when a banker accepts goods/securities of a customer to be kept in safe custody. In this case the relationship of banker and customer is that of the bailee and bailer. Here the banker acts as a trustee and not as a lender/creditor.
- 3. When the goods or security are left inadvertently or through oversight in the bank premises, the banker cannot exercise his right of lien on them.
- 4. When money is deposited by a customer with a request to transfer to another branch, the banker cannot exercise the right of lien. This is applicable even the applicant for the transfer of funds is a borrower as well.
- 5. The banker cannot have the right of lien and right of set off at the same time.

Mortgage

- Section 58(a) of the Transfer of Property Act, 1882 defines a mortgage as follows:
- ‘A mortgage is the transfer of interest in specific immoveable property, for the purpose of securing the payment of money advanced or to be advanced by way of loan, on existing or future debt or the performance of an engagement which may give rise to a pecuniary liability.’
- The transferor is called the ‘mortgagor’ and the transferee a ‘mortgagee’ the principal money and interest of which payment is secured is called mortgage money and the instrument by which the transfer is effected is called the ‘mortgage deed’.

Mortgage

- (a) Ingredients of Mortgage From the above definition of mortgage, the following are the requirements of a mortgage: (i) There should be transfer of interest in the property by the mortgagor (the owner or lessor). (ii) The transfer should be to secure the money paid or to be paid by way of loan.
- (b) Mortgage of Land – Various Types The Transfer of Property Act contemplates six different kinds of mortgages. They are:
- (i) Simple mortgage
- (ii) Mortgage by conditional sale
- (iii) Usufructuary mortgage
- (iv) English mortgage
- (v) Mortgage by deposit of title deeds (Equitable mortgage)
- (vi) Anomalous mortgage

Simple mortgage

- According to Section 58(b) of the Transfer of Property Act, a simple mortgage is a transaction whereby, ‘without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage money and agrees, expressly or impliedly, that in the event of his failing to pay according to his contract, the mortgagee shall have a right to cause the mortgaged property to be sold by a decree of the Court in a suit and the proceeds of the sale to be applied so far as may be necessary in payment of the mortgage money. Features of simple mortgage
- (i) The mortgagee has no power to sell the property without the intervention of the court In case there is shortfall in the amount recovered even after sale of the mortgaged property the mortgagor continues to be personally liable for the shortfall.
- (ii) The mortgagee has no right to get any payments out of the rents and produce of the mortgaged property
- (iii) The mortgagee is not put in possession of the property
- (iv) Registration is mandatory if the principal amount secured is ` 100 and above

Mortgage by conditional sale

- As per Section 58(c) of the Transfer of Property Act, a mortgage by way of a conditional sale of the property, is a transaction whereby, the mortgagor ostensibly sells the mortgaged property on the condition that:
- (a) on default of payment of the mortgage money on a certain date, the sale shall become absolute, or
- (b) on such payment being made the sale shall become void; or
- (c) on such payment being made, the buyer shall transfer the property to the seller.

Usufructuary mortgage

- According to Section 58(d) of the Transfer of Property Act, ‘a Usufructuary mortgage is a transaction in which (a) the mortgagor delivers possession expressly, or by implication and binds himself to deliver possession of the mortgaged property to the mortgagee, and
- (b) authorizes the mortgagee, to retain such possession until payment of the mortgage money and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage money, or partly in lieu of interest and partly in payment of the mortgage money.

English Mortgage

- According to Section 58(e) of the Transfer of Property Act, an ‘English Mortgage’ is a transaction in which, the mortgagor binds himself ‘to repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee, but subject to the provision that he will retransfer it to the mortgagor upon payment of the mortgage money as agreed’.
- Essential features of English Mortgage
- (i) It provides for a personal covenant to pay on a specified date notwithstanding the absolute transfer of the property to the mortgagee.
- (ii) There is an absolute transfer of the property in favour of the mortgagee. However, such absolute transfer is subject to a provision that the property shall be re-conveyed to the mortgagor in the event of the repayment of mortgage money.
- (iii) The mortgagee can sue the mortgagor for the recovery of the money and can obtain a decree for sale.

Anomalous mortgage

- According to Section 58(g) of the Transfer of Property Act, ‘a mortgage which is not a simple mortgage, a mortgage by conditional sale and usufructuary mortgage and English mortgage or a mortgage by deposit of title deeds within the meaning of this Section, is called an “Anomalous Mortgage.”
- Essential features Anomalous mortgage
- (i) It must be a mortgage as defined by Section 58 of the Transfer of Property Act.
- (ii) It is negatively defined and should not be anyone of the mortgages listed above.
- (iii) Anomalous mortgages are usually a combination of two mortgages.
- Examples of such mortgages are:
- (a) a simple and usufructuary mortgage, and
- (b) an usufructuary mortgage accompanied by conditional sale. There may be other forms, molded by custom and local usage.

Bank Guarantee

- As part of Non-fund based facilities, banks issue guarantees on behalf of their clients. A Bank Guarantee is a commitment given by a banker to a third party, assuring her/ him to honour the claim against the guarantee in the event of the non- performance by the bank's customer.

Types of Guarantee:

- Financial Guarantee: The banker issues guarantee in favour of a government department against caution deposit or earnest money to be deposited by bank's client.
- Performance Guarantee: Performance Guarantees are issued by banks on behalf of their clients
- Deferred Payment Guarantee: Under this guarantee, the banker guarantees payments of installments spread over a period of time

Letter of credit and bill of exchange

- https://www.youtube.com/watch?v=7gfg_LN6-YI
- https://www.youtube.com/watch?v=vDCoDg2o-yk
- Bill of Exchange - Explained in Hindi - YouTube

Letter of Credit

- A Letter of Credit is issued by a bank at the request of its customer (importer) in favour of the beneficiary (exporter). It is an undertaking/ commitment by the bank, advising/informing the beneficiary that the documents under a Letter of Credit would be honoured, if the beneficiary (exporter) submits all the required documents as per the terms and conditions of the Letter of Credit.

Letters of Credit – Parties

- Applicant (importer) requests the bank to issue the LC
- Issuing bank (importer's bank which issues the LC [also known as Opening banker of LC])
- Beneficiary (exporter)

Different types of banks: –

-Opening bank (a bank which issues the LC at the request of its customer [importer])

– Advising bank (the issuing banker's correspondent who advices the LC to beneficiary's banker and/ or beneficiary)

– Negotiating bank (the exporter's bank, which handles the documents submitted by the exporter. The bank also finances the exporter against the documents submitted under a LC)

– Confirming bank (the bank that confirms the credit) – Reimbursing bank (reimburses the LC amount to the negotiating/ confirming bank)

Types of Letter of Credit

- Sight Credit
- Acceptance Credit/ Time Credit
- Revocable and Irrevocable Credit
- Confirmed Credit
- Back-to-Back credit
- Transferable Credit
- Standby LC

Commercial Paper and Factoring

- Commercial papers are issued by companies with high credit ratings, in the form of promissory notes, at discount but repayable at par, to their holder at maturity. Commercial papers are money market instruments and issued as per the guidelines of the Reserve Bank of India.

Features of Commercial Paper:

- **Borrower**
- **Lenders**
- **Networth of Issuing Company:** The networth of the company (capital + reserves) should not be less than Rs.4 crore. The working capital limit of the company should also be not less than Rs.4 crore.
- **Denomination of CPs:** The minimum denomination for a single investor is Rs.25 lakh. Thereafter, it should be in multiples of Rs.5 lakh.
- **Issue Price**
- **Tenure:** CPs are issued for periods ranging between 15 days to 1 year.
- **Negotiability**
- **Credit Rating:** Credit rating should be obtained from any of the credit rating agencies. The rating should not be less than P2 from CRISIL and A2 from ICRA.
- **Format**

Advantages

- The advantage of commercial paper lies in its simplicity. It involves hardly any documentation between the issuer and investor.
- The issuer can issue commercial paper with the maturities tailored to match the cash flow of the company.
- A well-rated company can diversify its sources of finance from banks to short-term money markets at somewhat cheaper cost.
- The companies which are able to raise funds through commercial paper become better known in the financial world and are thereby placed in a more favourable positions for raising such long-term capital as they may, from time, require. Thus there is an in-built incentive for companies to remain financially strong.
- The commercial paper provides investors with returns than they could get from the banking system.
- Commercial paper facilitates securitization of loans resulting in creation of secondary market for the paper and efficient movement of funds providing cash surplus to cash deficit entities.

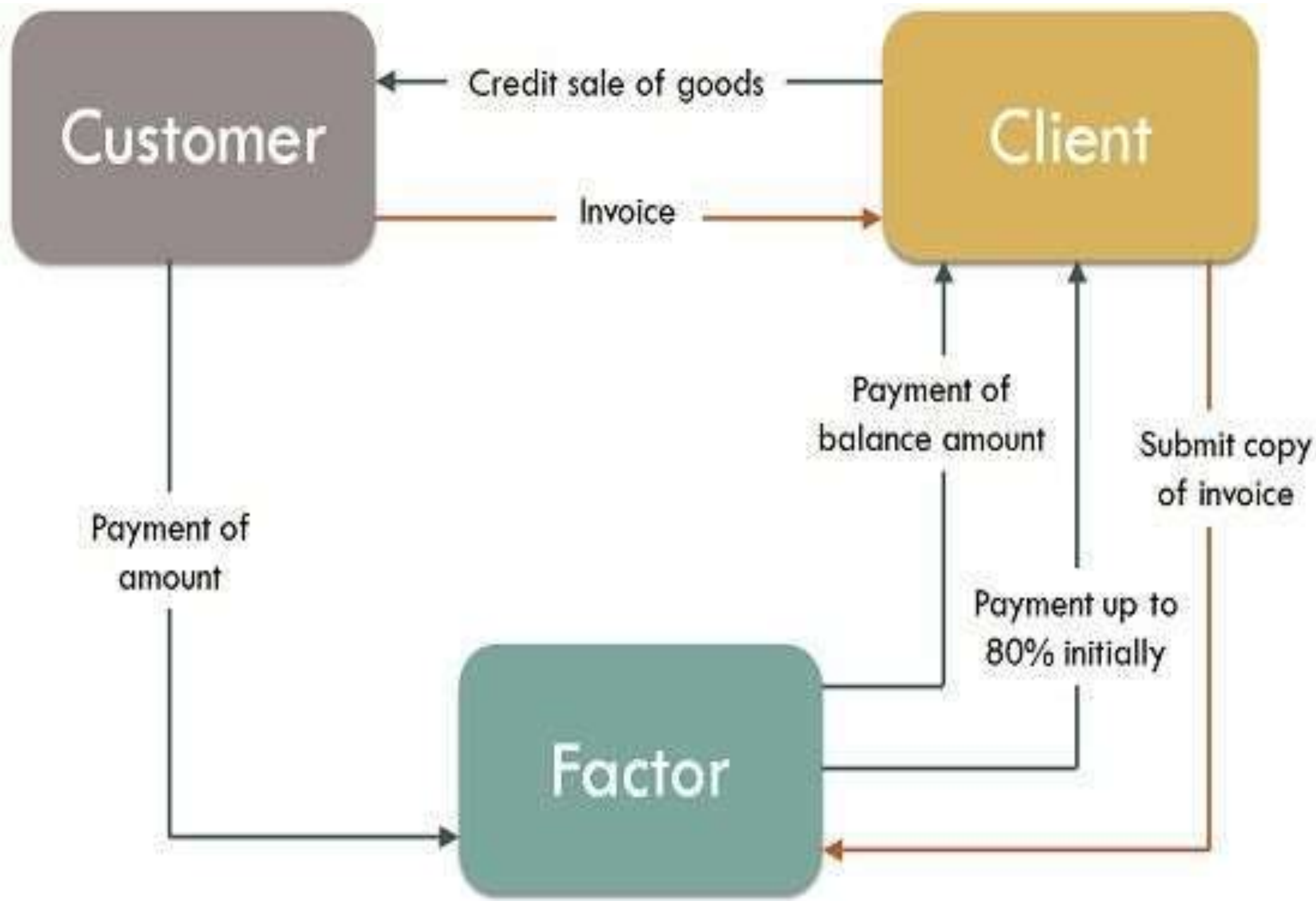
Disadvantages

- Its usage is limited to only blue-chip companies.
- Issuance of CP bring down the bank credit limits.
- A high degree of control is exercised on issue of CP.
- Standby credit may become necessary.

Factoring

- Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in respect of account receivables. The factor undertakes the responsibility of collecting the account receivables.

Process of Factoring



Types of factoring

- Recourse and Non-recourse Factoring
- Disclosed and Undisclosed Factoring
- Domestic and Export Factoring

Presentation of BLP Unit -3

Presentation By
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FINANCIAL ANALYSIS

- The performance of a company or business enterprise can be measured by looking into the financial results of the company over a period of time. A comparative study of the financial statements would assist the analyst to assess the results.
- Two important financial statements commonly used for financial analysis are P & L account, and balance sheet.

Advantages of analysis of financial statements:

- The financial results in the form of P&L accounts and balance sheets are readily available.
- These financial statements are drawn as per the accounting standards and as per the regulatory and legal frame work.
- Depending upon the requirement of the analyst (investors, bankers, credit rating agencies etc.,) the figures and data available on these statements can be easily grouped and interpreted.

Limitations of analysis of financial statements

- The balance sheet numbers are available as on a particular date hence may not reveal the correct position of the financial health for over a period of one year.
- Since both profit and loss account and balance sheet are in the form of numerical statements, these statements would not reveal the overall picture about the performance of the concern or business unit.
- The methods of valuation of assets, writing off depreciation, amortization of costs, large expenses etc. may vary from business unit to business unit.
- Further, these financial statements depict the performance of the business enterprise. Therefore, any meaningful interpretation of these statements, will depend upon the projections of the future trend.

P&L Account

- A profit and loss account is an account into which all income and expenses are collected, in order to ascertain the excess of gains over the losses or vice-versa.

- Need
  - To ascertain the Net Profit and Net Loss
  - Comparison with previous years profits
  - Control on expenses
  - Helpful in the preparation of Balance Sheet

Preparation of P&L Acount

- Items written in debit side P&L Account
  - Gross Loss
  - Office & Administrative Expenses
  - Selling and Distribution Expenses
  - Miscellaneous Expenses

Items written in credit side P&L Account
  - Gross Profit
  - Other Incomes and Gains

- **In case of Gross Loss**

Profit and Loss A/c Dr.
To Trading A/c

- **In case of Gross Profit**

Trading A/c Dr.
To Profit and Loss A/c

Balance Sheet

Liabilities	Assets
Current Liabilities Bank Overdraft Bills Payable Sundry Creditors Outstanding Expenses Unearned Income **Non current liabilities** Long Term Loans **Reserves** **Capital** *Add*: Net Profit *Less*: Drawings *Less*: Income Tax *Less*: Life Insurance Premium	**Current Assets** Cash in Hand Cash at Bank Bills Receivable Short Term Investments Sundry Debtors Closing Stock Prepaid Expenses Accrual Income **Non Current Assets:** Furniture Loose Tools Motor Vehicles Long term Investments Plant and Machinery Land and Buildings Patents Goodwill

TECHNIQUES USED IN ANALYSIS OF FINANCIAL STATEMENTS

- Funds Flow Analysis:

The total sources of funds are categorized as ‘Long term’ and ‘Short term’. Similarly, the total uses are also categorized as ‘Long term’ and ‘Short term’. If the short term sources are more than the short uses, it indicates diversion of working capital funds and needs to be probed further. Sometimes, it may be a desirable thing e.g., in case of companies with very high current ratio, it may be desirable to use the idle funds for creating additional capacity. The guiding principle is that this diversion should not affect the liquidity position of the company to unacceptable level.

Trend Analysis

- (a) The items, for which trend is required to be seen, are arranged in horizontal form and percentage increase (decrease) from the previous year's fig is indicated below it. Generally, this is used to see the trends of sales, operating profit, PBT, PAT etc. from P& L account. Similarly, the balance sheets, arranged in horizontal order give the trends of increase or decrease of various items.
- (b) Common size statements are prepared to express the relationship of various items to one item in percentage terms. For example, consumption of raw materials is expressed as a percentage of sales for different years and comparison of these figures gives indication of trend of operating efficiency.

Ratio Analysis

- Liquidity ratio: Current Ratio and quick Ratio
- Profitability Ratio
- Leverage Ratio
- Efficiency ratio
- Market Valuation ratio
- https://corporatefinanceinstitute.com/resources/knowledge/finance/financial-ratios/

https://hbr.org/1982/03/how-to-negotiate-a-term-loan

DU PONT MODEL

- The Du Pont identifies that the earning power of a firm is represented by (Return on Capital Employed) ROCE. ROCE shows the **combined effect** of the **profit margin and the capital turn over**. A change in any of these ratios would change the company's earning power.
- ROCE = Turn Over x Profit Margin =Net Profit/Capital Employed
- Turn over = Sales/ Capital Employed
- Capital Employed = Working Capital + Fixed Assets
- Working Capital = Stock + Bills Receivable + Debtors + Cash
- Profit Margin= Net Profit/ Sales
- Net Profit = Sales – (Manufacturing costs + Selling costs + Administrative costs)

Special issues in financial analysis – Banking Industry

- Safety and security is the concern of a lending and investing banker, since he also acts as trustee for the depositor's money.
- While lending as well as investing, banks are exposed to many a risks.
- Banks needs to balance their assets and liabilities, and also ensure proper liquidity management.
- Banks should carefully handle their assets portfolio to ensure that their NPA levels remain at minimum possible levels.

FINANCIAL ANALYSIS BY BANK AS A LENDER

- Net Worth of the borrower
- Viability
- Repayment Capacity
- Assessment of Performance and Financial Position
- Financial Health Indicators
- Assessment of Credit Requirements
- Cross Verification

BANKERS AS INVESTOR

- These investments are made by banks for the following reasons:
- To comply with SLR requirements
- To optimally deploy surplus funds
- To manage the gap between assets and liabilities (mismatch)
- To diversify risks

While investing funds in Non–SLR securities, the following need to be taken into account:

- They should adhere to exposure limits and counter-party limits.
- The financial statements of banks and corporate clients, where the funds would be invested, need to be properly analyzed.
- Like a lending banker, the investing banker also needs to verify all the important parameters to cover various risks.
- If the investments are in market related instruments, banks also need to do a proper analysis of the market risks and their impact
- Banks should ensure that all such investments are properly valued by practicing the mark-to-market concept.
- Apart from trend ratio and other analysis, banks should also carry out PESTEL analysis (Political, Economic, Social, Technological, Environmental and Legal) and impact of the PESTEL factors on their investments

- Sales/Revenue
- - VC
- Contribution
- -Fixed Cost
- PBDIT (Gross Profit)
- -Dept.
- PBIT (Operating Profit)
- -I
- PBT
- -T
- PAT (Net Profit)

-Div Preference shares
EATESH

Unit 4
Banking Laws and Practice

Presented by –
Sarita Yadav

International Banking

- "International Banking" can be defined as a sub-set of commercial banking transactions and activity having a cross-border and/or cross currency element. Multinational banking refers to the location and ownership of banking facilities in a large number of countries and geographic regions.
- International banking comprises a range of transactions that can be distinguished from purely domestic operations by (a) the currency of denomination of the transaction, (b) the residence of the bank customer and (c) the location of the booking office.

International Banking – features

- Expansion
- Legal and Regulatory framework
- Cost of Capital
- Current account and Capital account transactions
- Risks

Evolution of International Banking

- Gold Standard System
- Gold Specie Standard
- Gold Bullion Standard
- Gold Exchange Standard

Bretton Woods Conference

- The main objectives of the new monetary order were: –
- To establish an international monetary system with stable exchange rates
- To eliminate existing exchange controls
- To aim to bring convertibility of all currencies

The Bretton Woods Conference, created a new system popularly called as “Bretton Woods System” Bretton Woods System paved the way for the formation of three important multilateral International institutions viz.,

– International Monetary Fund (IMF)

-International Bank for Reconstruction and Development (IBRD) – popularly known as “World Bank”

– International Trade Organization

International Monetary Fund (IMF)

- It was created in 1945 and presently has 188 members. Its Objectives are:
- To promote international monetary cooperation,
- To strive for stable exchange rates
- To facilitate the balanced growth of international trade and creation of employment opportunities
- To assist in establishment of a multilateral payment system
- To assist member countries in case of balance of payments crisis

Bank for International Settlement (BIS)

- BIS offers a wide range of financial services specifically designed to assist the central banks and the other official monetary institutions in management of their foreign exchange reserves. It is headquartered at Basel and has 140 customers including various international financial institutions who currently make use of these services. It provides Asset Management services in sovereign securities or high grade assets. It also extends short term credits to central banks, usually on a collateralized basis. It does not provide services to private individuals or private entities/corporate...
- – Since 1930, the BIS have the legal form of a corporation. Its Board of Directors consists of 19 members out of which the Governors of central banks of Belgium, France, Germany, Italy, UK and US Fed chairman are the ex-officio members.
- – The objective of BIS :: ‘The objects of the bank are to promote the cooperation of central banks and to provide additional facilities for international financial operations, and to act as trustee or an agent in regard to international financial settlements entrusted to it under agreements with the parties concerned

FEMA 1999

- 1. FEMA 1999 was enacted as part of liberalization process
- 2. The main objective of FEMA is to consolidate and amend the law relating to foreign exchange to facilitate external trade and payments and also to develop foreign exchange markets in India.
- FEMA – Important aspects:
  - FEMA allows free flow of transactions on current account subject to certain reasonable restrictions
  - FEMA has control over realization of export proceeds
  - FEMA allows RBI to have control over capital account transactions
  - FEMA provides for dealing in foreign exchange through ‘Authorised Persons’ like authorized dealer/money changer/ off-shore banking unit;

LEGAL AND REGULATORY FRAME WORK

FOREIGN EXCHANGE REGULATION ACT 1973	FOREIGN EXCHANGE MANAGEMENT ACT 1999
To conserve foreign exchange and to prevent its misuse	To facilitate external trade and payments and also to develop foreign exchange markets in India
Violation of FERA was a criminal offence	Violation of FEMA is a civil offence
While many restrictions were part of FERA in respect of transfer of funds	Almost all current account transactions are free except a few
FERA was criminal law	FEMA is a civil law

Legal Issues in International Banking Transactions

- Legal issues associated with international banking transactions arise due to involvement of more than one law/ s of different countries. Due to various reasons, even in a simple two party loan agreement a number of different legal systems may be involved. The objects of private international law are:
- To ascertain whether a court has jurisdiction to determine the case
- To identify which system of law the court will apply to the determine fact of the case
- To determine whether the court will recognize or enforce a judgment obtained in a foreign court

The important aspects of the international loan agreement/s are:

- Clarity
- Clearance/s
- Condition/s: (i)The loan agreement should specify the procedure for the drawdown of the loan, the commitment period, method of draw down etc., (ii) Repayment schedule should be clearly indicated, and the pre payment option should also be clearly incorporated in the agreement
- Commitment fee/s
- Confirmation
- Cross-Default, Jurisdiction and Sovereign Immunity
- Jurisdiction: The loan agreement should specify the place (jurisdiction) whose laws are applicable to the interpretation of the rights and obligations under it.
- Cross-default: Cross-default clause allows the lenders the right to accelerate recovery of the loan in the event of default by the borrower or the guarantor/s under any other loan agreement
- Sovereign immunity: An express waiver of sovereign immunity, is obtained from the borrower or guarantor as the case may be

INTERNATIONAL LAWS – APPLICATION IN INTERNATIONAL BANKING SCENARIO

- Choice of Laws: it is imperative to choose a particular law which would protect the rights and obligations of the parties involved.
- Proper Law: The selection of choice of legal clause is very important to ensure that a proper law is selected, to protect the rights and obligations of the parties concerned.
- Language: English is preferred as an international language; therefore there is a preference for either English Law or New York Law

Continue....

- Legal Issues - Trade Disputes:
  - Buyers and sellers, investors, lenders, borrowers rarely meet each other
  - On account of locations at different time zones, long distances(proximity), culture, political setup, languages, currency, systems and procedures, legal frame work, interpretations etc., invariably international commercial and financial markets face lot of differences and issues in dealing with different types of clients/ banks.
  - The international trade takes place basically with the support of relevant documents and legal papers. Some of the important documents used are: Letters of Credit, Guarantees, Bills of Exchanges, Trade and loan agreements and other supporting commercial (Commercial Invoice) transportation (Bills of Lading), risk covering (Insurance Policy) and regulatory documents.
  - The International Chamber of Commerce (ICC) Paris, publishes the UCPDC (Uniform Customs and Practices for Documentary Credits) and international trade related guidelines.

To mitigate the Legal Risk

- Some of the important standardized legal documents used in international banking system are:
- Master Agreements (Documentation)
- International Swap and Derivatives Association Master Agreement (ISDA)
- International Currency Options Master Agreement (ICOM)
- International Foreign Exchange Master Agreement (IFEM)

INTERNATIONAL BANKING OPERATIONS MANAGEMENT

- In view of the large scale expansion of international banking, with more cross border transactions, international banks have to face many issues like
- Cross border risks
- International legal and regulatory framework
- Money laundering activities – Volatile international markets due to various factors including PESTEL factors

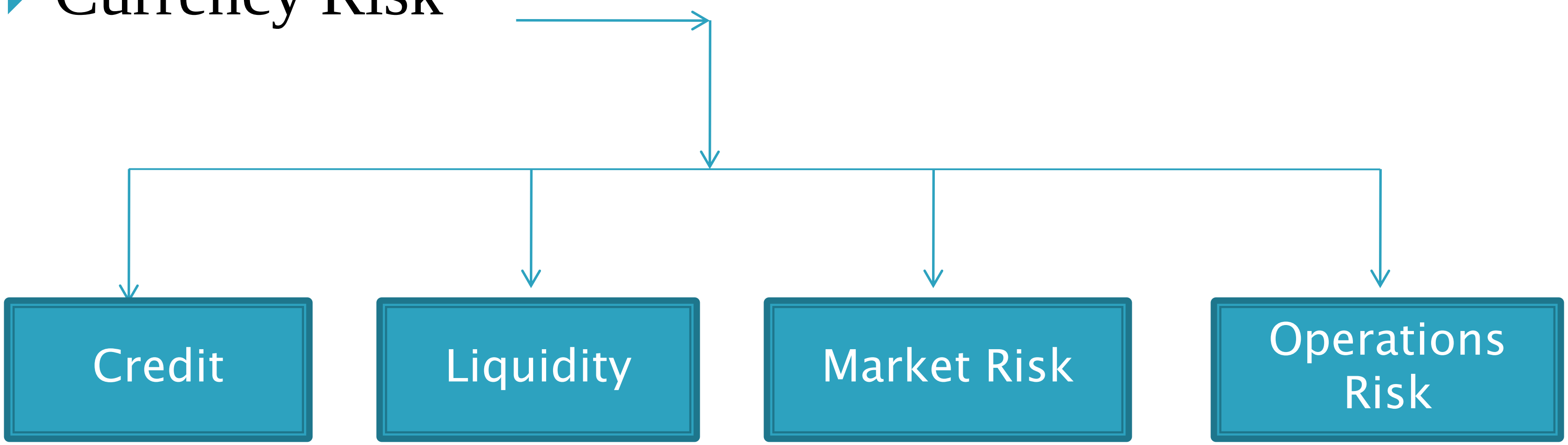
INTERNATIONAL BANKING OPERATIONS MANAGEMENT

- Expansion of business: International banks are linked together in various ways;
- (i) Correspondent banks
- (ii) Foreign branches
- (iii) Foreign subsidiaries and affiliates
- (iv) Off shore Banking Units

RISK MANAGEMENT IN INTERNATIONAL BANKING

- https://www.youtube.com/watch?v=ZKDB64uYIIo

- Cross Border Risk
- Currency Risk



Mitigation of Risk

- Mitigation of Credit Risk
- Mitigation of Operation Risk
- Adherence to systems and procedures

SPECIAL ISSUES: TECHNOLOGY AND INTERNATIONAL BANKING

- Clearing House Interbank Payment System (CHIPS)
- SWIFT
- Technological innovations

GLOBALIZATION AND INTERNATIONAL BANKING

- Integration of global economies created more opportunities for expansion of trade and financial investments.
- International markets operate virtually on 24 x7 basis, on account of their geographical locations
- International legal frame work and regulatory compliance is another important aspect which make the operations of international banks more complicated and difficult as well.
- International Accounting Standards
- Bank for International Settlement (BIS)
- Technological innovations
- International Financial Markets: ADR (American Depository Receipt) and GDR (Global Depository Receipt) through Banks

FINANCIAL INNOVATIONS IN INTERNATIONAL BANKING

- Forward Exchange Contract: Foreign Exchange Rate Risk
- Forward Rate Agreement (FRA)
- Interest Rate Swap (IRS)
- Currency Swap
- Options

Unit 5
Banking Laws and Practice

Presented By-
Ms Sarita Yadav

RISK MANAGEMENT – AN OVERVIEW

- As per the Basel norms, these risks are broadly classified into three:
- 1) Credit Risk
- 2) Operational Risk
- 3) Market Risk
- Operational Risk: Apart from credit and market risks, other risks can be recognized as part of operational risk. Operational risk mainly arises out of non adherence to the regulatory directives, guidelines, non compliance of legal frame work, on account of human and system errors, natural disasters, and also on account of frauds, misappropriation of funds, weak internal control systems etc.

RISK MANAGEMENT – IMPORTANT FEATURES

- 1. Risk management policies should be approved by the board. It should cover all the required guidelines and directives of the regulators and applicable legal frame work
- 2. There should be a good support from the Information Technology wing for creating an integrated system whereby an effective and efficient MIS would be an integral part of the risk management
- 3. There should be clear demarcation of functions and authority levels to ensure better internal control systems (ex: front office, mid office and back office of an integrated treasury)
- 4. An effective communication system coupled with the training programs
- 5. One of the risk mitigation measures is to setup appropriate limits for various aspects like counter party limit, country limit, currency limit, over night and intraday limits, stop loss limit, individual and group exposure limits etc.
- 6. Inbuilt checking and balancing systems, such as input and output controls, access control to the computer systems, and sensitive areas of the banks
- 7. Apart from review by the ALCO members, a periodical review and evaluation system should be in place

Risk Management

- Identify
- Analyze: Analyzing the factors e.g. PESTEL
- Evaluate
- Monitor and Review
- Mitigation of Risk

Risk Management Structure

- Risk Management under Basel I: Capital Risk to Weighted Asset Ratio minimum 9%
- Risk Management under Basel II
  - Pillar I: Minimum Capital Requirements
  - Pillar II: Supervisory Review Process
  - Pillar III – Market Discipline

CREDIT RISK MANAGEMENT

- Mitigation of Credit Risk
- Adherence to KYC norms
- Credit Appraisal
- Standardized Approach (SA)
- Internal Rating Based Approach (IRB)
  - Foundation
  - Advanced

Market Risk

- Interest Rate Risk
- Exchange Rate Risk
- Trading book and banking transactions
- Stress Analysis
- Market Risk – Basel II norms

Country Risk Management System (CRMS)

- Strict adherence to the "Know Your Customer" (KYC) principle in international transactions
- Country risk factor should be given special attention while evaluating the counterparty risk
- All exposures funded, non funded from domestic as well as international centers needs to be included while determining the country limits.
- Direct Exposure – funded:
  - (i) Cash balances
  - (ii) Bank balances and deposit placements: Covers the bank balances and placements with banks incorporated outside India
  - (iii) Loans and Advances: Loans against NRI deposits exceeding the deposit amount, Travellers' cheques purchased
  - (iv) Overdrafts in Vostro accounts etc.
- Direct Exposure – non funded:
  - (i) Letters of Credit: Exposures on account of Letters of credit issued by branches on behalf of constituents resident outside of India
  - (ii) Guarantees: Exposures on account of guarantees issued by branches on behalf of entities resident outside India
  - iii Confirmed LCs issued by foreign banks etc

OPERATIONAL RISK

- The limits (single borrower limit, group wise limit, counter party limit, country limits, overnight and day light limit, stop loss limit, gap limit etc.) are respected and they operate within the limits.
- All activities, operations are as per approved policies, systems and procedures and with proper approvals, authorizations.
- A proper reporting system should be in place for better management review and control and risk identification. To this end the Management Information System should not only be accurate, but also user friendly.
- There should be proper co-ordination between different divisions of the banks for a better result.
- A fair Performance Appraisal System is one of the key factors and this aspect needs to be given proper weights.
- (vi) Big ticket deals, transactions and legal documentation should be properly designed and vetted to protect the banks, especially in one-off transactions and structured deals.
- (vii) International banking is part of the international markets, which operate on 24 x 7 Basis, in different time zones covering various international centers.

LEGAL RISK

- The Basic Indicator Approach (BIA): This approach sets a charge for operational risk as a fixed percentage (“alpha factor”) of a single indicator, such as the banks’ gross annual revenue.
- The Standardized Approach (SA): This approach requires that the bank separate its operations into eight standard business lines, such as trade finance, corporate banking and others. The capital charge for each business line is calculated by multiplying gross income of that business line by a factor (“beta”) assigned to that business line.
- Advanced Measurement Approach (AMA): Under this approach, the regulatory capital requirement will equal the risk measure generated by the banks’ internal operational risk measurement system.

REPORTING OF BANKING RISK

- Accuracy
- Comprehensiveness
- Clarity and usefulness
- Frequency
- Distribution

RISK ADJUSTED PERFORMANCE EVALUATION: IMPORTANT ASPECTS

- Breaking down asset returns
- The Sharpe ratio
- Treynor ratio
- Jensen’s alpha
- Expected Return=a+Rf+$\underbrace{\text{B(Rm-Rf)}}_{\text{Risk Premium}}$
-
- The Information Ratio