Financial market institutions

3. Financial Intermediaries

Lecturer: Sayyora Abdirahimova

Financial Intermediation:

A significant constituent of the organization of the financial system is an array of financial intermediaries which collect savings from others and issue in return claims against themselves and use the fund thus raised to purchase ownership or debt claim. The key intermediation businesses are:

1. Commercial Banking
2. Lease Financing
3. Hire Purchase
4. Venture Capital
5. Securitization

Commercial banks are the oldest, biggest and fastest growing financial intermediaries in India.

TYPES OF BANKS

Scheduled Banks **:** Scheduled Banks in India constitute those banks which have been included in the Second Scheduled of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide Section 42 (6) (a) of the Act.

TYPES OF BANKS

Non Scheduled Bank : “Non-scheduled bank in India” means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank.”

CLASSIFICATION

Commercial Banks

- Scheduled Commercial Banks
  - Public Sector Banks
    - Nationalized Banks
    - State Bank and its associates
  - Private Sector Banks
    - Old Private Banks
    - New Private Banks
  - Foreign Banks in India
  - Regional Rural Banks
- Unscheduled Commercial Banks

ROLE OF COMMERCIAL BANKS

- The most common services offered by commercial banks in India are as follows :
- **i) Bank accounts :** It is the most common service of the banking sector. An individual can open a bank account which can be either savings, current or term deposits.
- **ii) Loans :** You can approach all banks for different kinds of loans. It can be a home loan, car loan, and personal loan, loan against shares and educational loans.

- **iii) Money Transfer :** Banks can transfer money from one corner of the globe to the other by issuing demand drafts, money orders or cheques.
- **iv) Credit and debit cards :** Most banks offer credit cards to their customers which can be used to purchase products and services, or borrow money.
- **v) Lockers :** Most banks have safe deposit lockers which can be used by the customers for storing valuables, like important documents or jewellery.

Banking Services for NRIs in India

- Almost all the Indian Banks provide services to the NRIs. There are different types of accounts for them. They are :
- Non-Resident (Ordinary) Account – NRO A/c
- Non-Resident (External) Rupee Account – NRE A/c
- Non-Resident (Foreign Currency) Account – FCNR A/c

MAJOR REFORM INITIATIVES

1. Interest rate deregulation. Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates.
2. Adoption of prudential norms in terms of capital adequacy, asset classification, income recognition, provisioning, exposures limits, investment fluctuation reserve, etc.
3. Reduction in pre-emptions-lowering of reserve requirements (SLR and CRR), thus releasing more lendable resources which banks can deploy profitably.
4. Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.
5. Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater-flexibility.

6. New private sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up Offshore Banking Units in Special Economic Zones.

7. New areas have been opened up for bank financing : insurance, credit cards, infrastructure financing, leasing, gold banking, besides of course investment banking asset management, factoring etc.

8. New instruments have been introduced for greater flexibility and better risk management : e.g. interest rate swaps, forward rate agreements, cross currency forward contracts, forward cover to hedge inflows under foreign direct investment, liquidity adjustment facility for meeting day-to-day liquidity mismatch.

9. Several new institutions have been set up including the National Securities Depositories Ltd., Central Depositories Services Ltd., Clearing Corporation of India Ltd., Credit Information Bureau India Ltd.

10. Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.

11. Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer, Centralized Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.

12. Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc. are being adopted.

13. RBI guidelines have been issued for putting in place risk management systems in banks. Risk Management Committees in banks address credit risk, market risk and operational risk. Banks have specialized committees to measure and monitor various risks and have been upgrading their risk management skills and systems.

ASSET LIABILITY MANAGEMENT IN BANKS (ALM)

The ALM process rests on three pillars :

1. **ALM Information Systems :** The ALM Information System consists of the following
   - i. Management information systems
   - ii Information availability, accuracy, adequacy and expediency
2. **ALM organization :** It includes the following :
   - i. Structure and responsibilities
   - ii. Level of top management involvement
3. **ALM process :** The ALM process consists of the following steps
   - i. Risk parameters
   - ii. Risk identification
   - iii. Risk measurement
   - iv. Risk management
   - v. Risk policies and tolerance levels.

RBI Guidelines

As per RBI guidelines, commercial banks are to distribute the outflows/inflows in different residual maturity period known as time buckets. The Assets and Liabilities were earlier divided into 8 maturity buckets (1-14 days; 15-28 days; 29-90 days; 91-180 days; 181-365 days, 1-3 years and 3-5 years and above 5 years), based on the remaining period to their maturity (also called residual maturity). All the liability figures are outflows while the asset figures are inflows. In September, 2007, having regard to the international practices, the level of sophistication of banks in India, the need for a sharper assessment of the efficacy of liquidity management and with a view to providing a stimulus for development of the term-money market, RBJ revised these guidelines and it was provided that

a. The banks may adopt a more granular approach to measurement of liquidity risk by splitting the first time bucket (1-14 days at present) in the Statement of Structural Liquidity into three time buckets viz., next day, 2-7 days and 8-14 days. Thus, now we have 10 time buckets. After such an exercise, each bucket of assets is matched with the corresponding bucket of the liability. When in a particular maturity bucket, the amount of maturing liabilities or assets does not match, such position is called a mismatch position, which creates liquidity surplus or liquidity crunch position and depending upon the interest rate movement, such situation may turnout to be risky for the bank. Banks are required to monitor such mismatches and take appropriate steps so that bank is not exposed to risks due to the interest rate movements during that period.

b. The net cumulative negative mismatches during the Next day, 2-7 days, 8-14 days and 15-28 days buckets should not exceed 5%, 10%, 15% and 20% of the cumulative cash outflows in the respective time buckets in order to recognize the cumulative impact on liquidity.

Lease Financing

Conceptually, a lease is a contractual arrangement/transaction:

- In which the owner of an asset/ equipment (lessor) provides the asset for use to another/transfers the right to use the asset to the user (lessee) for an agreed period of time in return for periodic payment (rental)
- At the end of the lease period the asset reverts back to the owner. Leasing essentially involves the divorce of ownership from the economic use of an equipment/asset

Classification:

(i) Finance and operating lease

(ii) Direct lease and sale and lease back lease

(iii) Single investor and leveraged lease and

(iv) Domestic lease and international lease which can be further sub-classified as cross-border and import lease

Finance & Operating Lease:

the classification of lease into finance and operating is of fundamental importance. The distinction between the two types of leases is based on the extent to which the risks and rewards of ownership are transferred from the lessor to the lessee

- Risk means the possibility of loss arising out of under-utilization or technological obsolescence of the leased asset
- Reward refers to the incremental net cash flows generated by the usage of the equipment over its economic life and the realization of the anticipated residual value on the expiry of the economic life

If a lease transfers a substantial part of the risks and rewards, it is called finance lease; otherwise it is operating lease

Major Players:

The major players in leasing in India are:

- Independent leasing companies
- Other finance and investment companies
- Manufacturer-lessors
- Development finance institutions
- In-house lessors and banks

Product Profile:

As far as the product profile of leasing in India is concerned, by and large leases are of finance type and operating leases are not very popular:-

- The lease rentals are payable generally in equated monthly installments at the beginning of every month
- The rental structures are related to the requirements of the lessee and projected cash flow pattern. They are structured so as to recover the entire investment during the primary period
- Most of the transactions are direct lease; sale and lease back type are rare. Equipment leasing covers a wide range of assets and equipment but project leasing and cross-border leasing are not popular

Advantages:

The significance of lease financing is based on several advantages both to the lessors and the lessees such as:

- Flexibility
- User-orientation
- Tax-based benefits
- Convenience
- Expeditious disbursements of funds
- Hundred per cent financing and better utilization of own funds and so on.

However, the advantages of off-balance sheet financing in the sense that it does not affect the debt capacity of the firm is not real

Law/ Legislation:

- There is no law/legislation/act/direction which exclusively applies to equipment leasing. Such transactions are governed by the relevant provisions of number of acts/laws/directions and so on. Some of these are quite intricate involving fine points of law.

- Since the features of an equipment lease transaction closely resemble the features of bailment

  The provision of Contract Act in general and those relating to contracts of bailment in particular apply to equipment lease transactions. The implied obligations of the bailor (lessor) and bailee (lessee) are defined by this enactment. However, one implied obligation of lessor, namely, fitness of the bailed goods is inapplicable. As in a typical equipment lease transaction, the lessor plays the role of a financier, the implied obligation of the lessor (bailor) relating to fitness of the goods/assets is expressly negative by the lease agreement.

- Some provisions of Motor Vehicle Act and Stamp Act also apply to equipment leasing

Regulatory Authority:

With a view to coordinate, regulate and control the functioning of all the NBFCs, RBI has issued directions under the RBI Act. These also apply to leasing companies

Documentation:

- The lease documentation process is fairly simple. It starts with the submission of a proposal by the lessee. On approval, the lessor issues a letter of offer detailing the terms and conditions of the lease. The letter of offer is accepted by the lessee by passing a Board resolution. This is followed by the lessor and lessee entering into a formal lease agreement.

- The lease agreements provide for a number of obligations on the part of the lessee which do not form part of his implied obligations under the Contract Act. While the exact contents of the lease contract differ from case to case, a typical lease contract provides:

I. Nature of lease
II. Description of the equipment
III. Delivery and re-delivery
IV. Period, lease rentals
V. Repairs and maintenance
VI. Alteration, peaceful possession
VII. Charges
VIII. Indemnity clause
IX. Inspection prohibition of sub-leasing
X. Defaults and remedies and so on

Tax Aspects:

The tax aspects of leasing pertain to both income tax and sales tax

The income tax considerations for the lessees are claims for lease rentals and the operating costs of the leased assets being treated as deductible expenses from taxable income. The lease rentals and the incidental expenses such as repairs and maintenance, insurance and finance charge are treated as normal business expenditure

- A lease transaction attracts sales tax at three stages:

I. Purchase of equipment by the lessor

II. Transfer of the right to a lessee to use the equipment for a lease rental

III. Sale of asset by the lessor at the end of the lease period

Hire Purchase:

Hire-purchase is a mode of financing the price of goods to be sold on a future date. It is an agreement relating to a transaction in which:

- Goods are let on hire
- The purchase price is to be paid in installments
- Hirer is allowed the option to purchase the goods paying all the installments

Though the option to purchase the goods/assets is allowed in the very beginning, it can be exercised only at the end of the agreement

Essence of the Agreement

The essence of the agreement is that:

- The property in the goods does not pass at the time of the agreement but remains in the intending seller (hire-vendor) and only passes when the option is exercised by the hirer (intending hire-purchaser). In contrast, in installment sale the ownership in the goods passes onto the purchaser simultaneously with the payment of the initial/first installment
- The hire-purchase also differs from the installment sale in terms of the call option and right of termination in the former but not in the latter
- Similarly, hire-purchase and leasing as modes of financing are also differentiated in several respects such as ownership of the asset/equipment, its capitalization, depreciation charge, extent of financing and accounting and reporting

Under the down payment plan of hire-purchase, the hirer has to make a down payment of 20-25 per cent of the cost and pay the balance in equated monthly installments (EMIs). As an alternative, under a deposit-linked plan the hirer has to invest a specified amount in the fixed deposit of the finance company which is returned together with interest after the payment of the last EMI by the hirer.

The hire-purchase installment has two components: (i) interest/finance charge and (ii) recovery of principal. The interest component is based on a flat rate of interest while effective rate is applied to the declining balance of the original amount to determine the interest component of each installment

During the hire-period, the hirer can opt for early repayment/purchase of the equipment/asset by paying the remaining installments minus an interest rebate. The hirer has the right to terminate the contract after giving due notice

Legislation/ Law:

There is no exclusive legislation dealing with hire purchase transactions in India. The Hire-Purchase Act was passed in 1972. A bill was introduced in 1989 to amend some of the provisions of the Act. However, the Act has not been enforced so far.

- In the absence of any specific law, the hire-purchase transactions are governed by the general laws. The hire-purchase transaction has two aspects:

(i) An aspect of bailment of goods which is covered by the Indian Contract Act

(ii) An element of sale when the option to purchase is exercised by the hirer which is covered by the Indian Sales of Goods Act. The hire-purchase agreements also contain provisions for the regulation of hire-purchase deals

Taxation:

There are three aspects of taxation of hire-purchase deals:

(i) Income-tax
(ii) Sales tax
(iii) Interest tax

- Though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price.
- He can also claim deduction on account of consideration for hire, that is, finance charge. The amount of finance charge to be deducted each year is to be spread evenly over the term of the agreement on the basis of a method chosen from amongst the alternatives: SOYD, ERI, SLM. The consideration is viewed as a rental charge rather than interest and no deduction of tax at source is made.

REFERENCE AND SOURCE

1. Financial Markets and Institutions by Anthony Saunders and Marcia Cornett | Feb 7, 2018
2. Financial Institutions, Markets, and Money, Twelfth Edition by David S. Kidwell, David W. Blackwell, et al. | Nov 7, 2016
3. Foundations of Global Financial Markets and Institutions, fifth edition (The MIT Press) by Frank J. Fabozzi, Frank J. Jones, et al. | Apr 30, 2019
4. Corporate and Investment Banking: Preparing for a Career in Sales, Trading, and Research in Global Markets by Fidelio Tata | Jul 20, 2020
5. Money, Banking, Financial Markets & Institutions (MindTap Course List) by Michael Brandl | Jan 1, 2020
6. Financial Institutions, Markets, and Money by David S. Kidwell, David W. Blackwell, et al. | Nov 1, 2011