

Unit II

Issue Management and Securitization

Issue Management

Existing as well as new companies raise funds through various sources for implementing their projects. One of the sources of raising funds is mobilising capital by issuing securities. This can be done in the following three ways: I Public Issue I Right Issue I Private Placement

Public Issue: The most common method of raising funds from public at large is called public issue. Public issue is made by a company through prospectus for a fixed number of shares at: (i) a stated price which may be at par or premium, and (ii) a rate determined by the issuer on the basis of market demand (book building mechanism).

Right Issue: Right issues are issues of new shares in which existing shareholders are given preemptive rights to subscribe to new issue of shares. Such additional shares are offered in proportion to the capital paid-up on the shares held by them at the date of such offer.

Private Placement: The direct sale of securities by a company to investors is called private placement. In private placement no prospectus is issued. Private placement covers shares, preference shares and debentures.

Issue management refers to managing issues of corporate securities like equity shares, preference shares and debentures or bonds. It involves marketing of capital issues, of existing companies including rights issues and dilution of shares by letter of offer. Management of issue also involves other issues. The decisions concerning size and timing of the public issue in the

light of the market conditions are advised by the merchant bankers. In addition to these, the merchant bankers also assist the corporate units on the designing of a sound capital structure acceptable to the financial institutions and determining the quantum and terms of the public issues of different forms of securities. Further, they also advise the issuing company whether to go for a fresh issue, additional issue, bonus issue, right issue or combination of these. In brief, managing public issue is a complicated and technical job. It involves various strategic decisions and coordination of various agencies.

The public issues are managed by the involvement of various agencies i.e., under writers, brokers, bankers, advertising agencies, printers, auditors, legal advisers, registrar to the issue and merchant bankers providing specialized services to make the issue a success. However, merchant bank is the agency at the apex level, who plans, coordinates and controls the entire issue activity and directs different agencies to contribute to the successful marketing of securities.

Issue management has tremendous scope and potential in a growing economy where capital market functions as catalyst for the funding needs of the industry. Issue managers in capital market parlance are known as Merchant Bankers or Lead Managers. Although, the term Merchant Banking, in generic terms, covers a wide range of services such as project counseling, portfolio management, investment counseling, mergers and acquisitions, etc. yet, Issue Management constitutes perhaps the most important and sizeable function within it. So much so, that very often, the terms merchant banking and Issue Management are almost used synonymously.

The significance of Issue Management for a Merchant Banker is succinctly displayed in the definition of 'Merchant Banker' as -contained in the Securities and Exchange Board of India (Merchant Banker) Rules & Regulations, 1992, viz., "any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management".

Merchant Bankers/ Lead Managers

"A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities

or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management”.

-Securities and Exchange Board of India (Merchant Bankers) Rules, 1992

Merchant Banking may be defined as an institution which covers a wide range of activities such as underwriting of shares, portfolio management, Project counseling, insurance etc. They all render these service for a fee. Both commercial and investment banks may engage in merchant banking activities. The original purpose of merchant banks was to facilitate and/or finance production and trade of commodities and hence the name "merchant“.

Who Is A Merchant Banker?

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

Functions of Merchant Banks

Promotional Activities – Merchant Banks helps the entrepreneur in conceiving an idea, identification of projects, preparing feasibility reports, obtaining Government approvals and incentives etc.

Issue Management - Management of issues refers to effective marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public.

Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

Credit Syndication - Credit Syndication refers to obtaining of loans from single development finance institution or a syndicate or consortium. Merchant Banks help corporate clients to raise syndicated loans from commercial bank.

Project Counseling- It includes preparation of projects reports, deciding upon the financing pattern, appraising the project relating to its technical, commercial and financial viability. It includes filling up of application forms for obtaining funds from financial institution.

Portfolio Management - It refers to the effective management of Securities i.e., the merchant banker helps the investor in matters pertaining to investment decisions. Taxation and inflation are taken into account while advising on investment in different securities. The merchant banker also undertakes the function of buying and selling of securities on behalf of their client companies. Investments are done in such a way that it ensures maximum returns and minimum risk.

Working capital Finance: Merchant bankers provide the following services as a part of working capital finance

- Assessment of working capital requirement
- Preparing the application for the sanction of appropriate credit facilities
- Providing assistance in negotiations with the banks.
- Advising on issue of debenture for augmenting long term requirement of working capital.

Acceptance credit and bill discounting: Activities relating to the acceptance and discounting of bills of exchange, besides advancement of loans to business concerns on strength of such instruments. In order that the bill accepting and discounting takes place it is imperative that the firms have a good reputation. Collecting credit information and credit rating is part of this function.

Mergers and acquisitions: This is a specialized service provided by merchant bankers who arrange for negotiating acquisitions and mergers by offering expert valuation regarding the quantum and nature of consideration. The activities involved include

Undertaking management audits to identify the areas of strength and weakness in order to help formulate guidelines for future growth.

- Conducting exploratory studies on a global basis to locate overseas market, foreign collaborations, and JVs
- Obtaining approval from shareholders, depositors, creditors, government and other authorities.
- Identifying organizations with matching characteristics.

- Assisting in capital restructuring.
- Assisting in legal compliance.

Leasing and Finance – Many merchant bankers provide leasing and finance facilities. Some of them even maintain venture capital funds to assist the entrepreneurs. They also help companies in raising finance by way of public deposits.

Servicing Issues– Merchant Bankers helps in servicing the shareholders and debenture holders in distributing dividends, debenture interest.

Other Specialized Services – Merchant Banks also provide corporate advisory services on issues like mergers and amalgamations, tax matters, recruitment of executives and cost and management audit etc.

Merchant Banking In India

Need for merchant banking was felt with rapid growth in number and size of issues made in primary issue.

Merchant Banking services started by foreign banks, namely National Grindlays in 1967 followed by Citi Bank in 1970.

Merchant Banking services was offered along with other traditional banking services. SBI was first Indian bank to set up merchant banking division in 1972.

Later, the ICICI set up its merchant banking division in 1973.

It was followed by other commercial banks like Canara Bank, Bank of Baroda, Bank Of India, Syndicate Bank, Central Bank Of India, PNB, UCO Bank etc.

Merchant Banking Regulations

According to Securities and Exchange Board of India (Merchant Bankers) Rules, 1992, it is mandatory for a merchant banker to hold a certificate of registration granted by the Securities and Exchange Board of India.

If a person/ organization wants to carry or undertake any of the authorized activities, has to get registered under the regulations. To obtain the certificate of registration, one has to apply in the prescribed form and fulfill two set of norms (a) operational capabilities and (b) capital adequacy norms

Classification Of Merchant Banker

Category I – to carry on the activity of issue management i.e., the preparation of prospectus, determining the financial structure, tie-up of financiers ,financial allotment of securities and so on. To act as adviser, consultant, manager, underwriter, portfolio manager.

Category II - to act as adviser, consultant, co- manager, underwriter, and portfolio manager.

Category III - to act as underwriter, adviser and consultant to an issue.

Category IV – to act only as adviser or consultant to an issue of capital

Capital Adequacy Norms

The minimum net worth requirement for acting as merchant banker is given below:

Category I – Rs. 5 cores

Category II – Rs, 50 lakhs

Category III – Rs. 20 lakhs

Category IV – Nil

Code Of Conduct

- Should make all efforts to protect the interest of investors.
- Should maintain high standards of integrity, dignity and fairness in conduct of business.
- Should fulfill all obligations in a professional and ethical manner.
- Should not discriminate among the clients.
- Should endeavor to ensure that the inquiries, grievances are adequately dealt with in a timely and appropriate manner.
- Should ensure that prospectus/letter of offer is available to investors at the time of issue.
- Should render best possible advice to its clients.
- Any penal action taken by SEBI should be informed to its clients.
- Should inform the Board about legal proceedings initiated against it.

- Should abide by the rules of SEBI, 2003.
- Should ensure that any person it employs should have the capacity to be a merchant banker.
- Should not create false market.

Obligations And Responsibilities

- Merchant banker not to associate with any business other than that of the securities market.
- Maintenance of book of accounts, records, etc. Every merchant banker shall keep and maintain the following books of accounts, records and documents namely:
 - a. a copy of balance sheet at the end of each accounting period
 - b. A copy of profit and loss account for that period
 - c. A copy of auditor's report on the accounts of that period
 - d. a statement of financial position
- Submission of half-yearly results.
- Report on steps taken on auditor's report.
- Acquisition of shares prohibited.
- Information to the Board.
- Disclosure to the Board

Underwriter are important intermediary in the new issue /primary market who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed or subscribe to the issue themselves in the case of non subscription. Underwriters are appointed by the issuing companies in consultation with the lead managers/ merchant bankers to the issues

Registration

To act as underwriter,

- a) A certificate of registration must be obtained from SEBI. A SEBI registered merchant banker/ broker would not require a separate registration.
- b) The necessary infrastructure like adequate office space, equipment and manpower to

effectively discharge the activities

- c) Past experience in underwriting/ employment of at least two persons with experience in underwriting.
- d) Any person directly/indirectly connected with the applicant is not registered with SEBI as underwriter or previous application of any such person has been rejected or any disciplinary action has been taken against such person under the SEBI act regulations
- e) Capital adequacy requirement of not less than the net worth of Rs 20 lakh the capital adequacy requirement of broker underwriter would be specified by the stock exchange concerned
- f) The applicant/director/principal officer/partner has been convicted of offence involving moral turpitude or found guilty of any economic offence and is fit and proper person

Fee

The application fees for registration as underwriter since 1999 is Rs 5 lakh. To keep the registration in force renewal fees of Rs. 2 lakhs every 3 years from the date of initial registration is payable. Failure to pay the fee would result in the suspension of the certificate of registration.

Agreement with clients

Underwriter

Every underwriter has to enter into an agreement with the issuing company. The agreement among other provides for the period during which the agreement is in force, the amount of underwriter obligations the period within which the underwriter has to be subscribe to the issue after being intimated by/ on behalf of the issuer, the amount of commission / brokerage, and details of arrangements if any made by the underwriter for fulfilling the underwriting obligations.

General Responsibilities

- An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than the underwriter commission .
- The maximum obligation under all under writer agreements of an underwriter cannot exceed 20 times his net worth .
- Underwriters have to subscribe for securities under the agreement within 45 days of

the receipt of intimation from the issuers.

Bankers to an issue

- The bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investors in respect of issues of capital and refund of application money.

Registration

To carry on the activities as a banker to an issue, a person must obtain a certificate of registration from the SEBI.

The SEBI grants registration on the basis of all the activities relating to banker to an issue in particular with reference to the following requirements:

- (1) The applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities,
- (2) The applicant/any of the directors of the applicant is not involved in any litigation connected with the securities market/has not been convicted of any economic offence;
- (3) Is a scheduled bank and
- (4) Grant of a certificate is in the interest of the investors.
- (5) A banker to an issue can apply for renewal of his registration three months before the expiry of the certificate.

Fee

Every banker to an issue has to pay to the SEBI an annual fee of Rs 2.5 lakh for the first two years from the date of initial registration, and Rs 1 lakh for the third year to keep his registration in force. The renewal fee to be paid by him annually for the first two years is Rs 1 lakh and Rs 20,000 for the third year. Non-payment of the prescribed fee may lead to suspension of the registration certificate.

General Obligations and Responsibilities

When required a banker to an issue has to furnish to the SEBI the following information:

- (1) The number of issues for which he was engaged as a banker to an issue;
- (2) The number of applications/details of applications' money received;
- (3) The dates on which applications from investors were forwarded to the issuing company/ registrar to an issue;
- (4) The dates/ amount of refund to the investors.

Books of Account / Record / Documents

A banker to an issue is required to maintain books of account/records/ documents for a minimum period of three years in respect of, inter alia, the number of application received, the names of the investors, the times within which the applications received were forwarded to the issuing company/ registrar to the issue, and dates and amounts of refund money to investors

Agreement with Issuing Companies

- Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centres at which applications/application money received is forwarded to the registrar, for issuance and submission of daily statement by the designated controlling branch of the banker, stating the number of applications and the amount of money received from the investors
- Disciplinary Action by the RBI If the RBI takes any disciplinary action against a banker to an issue in relation to issue payment, the latter should immediately inform the SEBI. If the banker is prohibited from carrying on his activities as result of the disciplinary action, the SEBI registration is deemed as suspended/ cancelled.

Code of Conduct

In the conduct of his business, he should observe high standards of integrity and fairness in all his dealings with clients/ investors / other members of the profession. He should exercise due diligence and ensure proper care.

- He should not make any statement/indulge in any act, practice/ unfair competition harmful to the interest of other bankers or likely to place the latter in a disadvantageous position.

- Further, he should not make exaggerated oral/written statements to his clients about his qualification / capability to render services or his earlier achievements in this regard.
- Moreover, a banker to an issue should always endeavour to render the best possible advice to his clients and ensure that all professional dealings are affected in a prompt, efficient and cost effective manner.
- He should not divulge to other clients/press/any other party any confidential information in his knowledge about his client. He should also not allow blank applications forms bearing brokers' stamp to be kept at the bank premises / near the entrance of the premises and accept applications after office hours / or after the date of closure of the issue/or o bank holidays.
- Finally, he should not act at any time in collusion with other agents in a manner that is detrimental to small investors. He has to abide by all acts, rules, regulations, guidelines, resolutions, notification, directions, circulars and instructions issued by the Government /RBI/ Indian Banks Association / SEBI relevant to his activities as a banker to an issue.

Brokers to the issue

- Brokers are the persons mainly concerned with the procurement of subscription to the issue from the prospective investors.
- The appointment of a broker is not compulsory
- The issuing company is free to appoint any number of brokers.
- The manager to the issue and the official broker to the issue organize the preliminary distribution of securities and procure direct subscription from as large number of investors as possible.
- The broker has to get a letter of consent from the respective exchange to act as broker to an issue.
- Brokerage must be paid according to the agreement between the broker and the company.

Conditions for Grant Of Certificate Of Registration as broker

- He holds the membership of any stock exchange
- He shall abide by rules, regulation and bye-laws of stock exchange of which he is a member.

- He shall pay the fees for registration in the manner provided in the regulations
- He shall take adequate steps for redressal of grievances of the investors within one month of the date of receipt of complaints

Stock Brokers

A stock broker is a member of a recognized stock exchange, who buys, sells or deals in securities. A certificate of registration from SEBI, is mandatory to act as a broker. SEBI is empowered to impose conditions while granting the Certificate.

As a member of the Stock Exchange

- He will have to abide by its rules, regulations and bye laws,
- Pay the prescribed fee
- Take adequate steps for redressal of investor grievances within one month of the receipt of the complaint
- Keep SEBI informed about the number, nature and other particulars of such complaints.

Registration

- Has to apply through the stock exchange of which he is a member.
- The application must be forwarded by the exchange to SEBI within 30 days from the date of receipt.
- The exchange should also include a statement to the effect that no complaints/arbitration cases are pending against the applicant.

For granting Registration

- SEBI checks whether or not he is eligible to be member of a stock exchange
- Has the necessary infrastructure including manpower to discharge his activities
- Has past experience in the business of buying, selling or dealing in securities
- Whether there are any disciplinary proceedings against him by the stock exchange.

Payment of Fees: Rs 5000 plus 0.0001 per cent of his turnover in excess of Rs 1 Crore.

Code of Conduct

Registered stock brokers have to abide by a code of conduct.

Appointment of a compliance officer: Every stock broker should appoint a compliance officer to monitor the compliance of SEBI regulations etc. He should immediately and independently report any non-compliance observed by him to the SEBI.

Not to deal with unregistered sub- broker. A stock broker should not deal with any person as a sub broker unless he has obtained a certificate of registration from the SEBI.

Inspection and Penalties: SEBI is empowered to inspect the books of accounts and documents of the stockbroker. A stock broker or sub broker who contravenes any of the provisions of SEBI Act, rules or Regulations is liable for penalty.

Capital Adequacy Norms

1. Base Minimum Capital
2. Additional/Optional Capital

Base Minimum Capital: An absolute minimum of Rs 5 lakhs should be maintained as deposit with the stock exchange by member brokers of Mumbai and Kolkata stock exchanges. Rs 3.5 lakhs by those of Delhi and Ahmedabad exchanges Rs 2 lakhs – Minimum requirement for other stock exchanges

Additional/Optional Capital: Not less than 8 per cent of the gross outstanding business in the stock exchange defined as the aggregate of up to date sales and purchase by member broker in all the securities put together. On the outstanding Business reaching 10 times the base and additional capital, a broker has responsibility to intimate the stock exchange. If the outstanding business reaches 12.5 times the base and additional capital, the member should not increase his outstanding business until additional capital has been brought into his business and the stock exchange is satisfied that the member could be allowed to trade further.

Clients and Brokers: All brokers must keep their own money and money of the clients in separate accounts. Brokers have to make payment to their clients / deliver the securities purchased within two working days of payout unless the client desires otherwise. They can buy securities for clients only on receipt of 20 per cent margin on the price of the securities proposed to be purchased. The

broker must issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract.

Trading and Clearing/Self Clearing Members A sub broker acts on behalf of a stock broker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers, but is not a member of the stock exchange. Sub Brokers wanting to do Business with more than one broker need to be separately registered with the SEBI for each broker.

.A sub-broker is an entity who is not a member of Stock Exchange but who acts on behalf of a trading member or Stock Broker as an agent for assisting the investors in buying, selling or dealing in securities all the way through such trading member or Stock Broker with whom he is connected. Sub-brokers assist in increasing the reach of brokers to a larger number of investors. Trades have to be routed only through the trading terminals of registered brokers of an exchange, to be accepted and executed on the electronic system. Sub-brokers in remote locations who do not have electronic facilities offer trading services to their customers through phone or physical orders formats. The main broker to whom they are affiliated then enters these trades into the system.

Foreign Broker

A foreign Broker can operate only on behalf of Registered FIIs. He cannot deal in securities on his own account as principal.

A forex broker is a financial services company that provides traders access to a platform for buying and selling foreign currencies. Forex is short for foreign exchange. Transactions in the forex market are always between a pair of two different currencies.

A forex broker may also be known as a retail forex broker or a currency trading broker.

The Role of a Forex Broker

Most foreign exchange transactions are between pairs of the currencies of the 10 nations that make up the G10. The nations and their currencies include the U.S. dollar (USD), the Euro (EUR), the pound sterling (GBP), the Japanese yen (JPY), the Australian dollar (AUD), the New Zealand dollar (NZD), the Canadian dollar (CAD), and the Swiss franc (CHF).

Most brokers allow customers to trade in other currencies, including those of emerging markets. Using a forex broker, a trader opens a trade by buying a currency pair and closes the trade by selling the same pair. For example, a trader who wants to exchange euros for U.S. dollars buys the EUR/USD pair. This amounts to buying euros using U.S. dollars.

To close the trade, the trader sells the pair, which is equivalent to buying U.S. dollars with euros. If the exchange rate is higher when the trader closes the trade, the trader makes a profit. If not, the trader takes a loss.

Trading and Clearing/Self Clearing Members

A self-clearing member means a member of a clearing corporation or clearing house of the derivatives exchange or derivatives segment of a stock exchange who may clear and settle transactions on his own account or on behalf of his clients. The member shall not, however, clear transactions of any other trading member.

Clearing is the second part of the process which will come after the execution of the trade and before the settlement of the transaction. Settlement is the last stage of the process where the clearing house will transfer the ownership of the securities bought to the buyer and transfer funds in payment to the seller.

Clearing Member means a member of the Clearing Corporation who clears and settles deals through the Clearing Corporation. The Clearing Member clears and settles deals for a segment in a manner and mode and subject to such terms and conditions and procedures prescribed for them. Further, a Clearing Member may clear and settle deals either on their own account or on behalf of their clients subject to the terms and conditions prescribed by the Clearing Corporation.

In the Capital market Segment, all trading members of the Exchange are required to become the Clearing Member of the Clearing Corporation.

Stock Market (Cash/Normal) trading through NSE.)

India has a history of stock exchanges limited in their operating jurisdiction to the cities in which they were set up. The NSE represented an attempt to overcome the fragmentation of regional markets by providing a screen based system that transcends geographical barriers.

Objective: To set up a nationwide trading facility for equities, debt instruments and hybrids.

The NSE has three segments for cash trading in securities:

- The Wholesale Debt Market
- Capital Market
- Trading in Central Government Securities.

Wholesale Debt Market Segment: Provides a facility for institutions/body corporates (institutional Investors) to enter into High value transactions in instruments such as Government Securities, T-Bills, PSU Bonds, units of mutual funds, Certificates of Deposits, Commercial Papers and so on.

Capital Market Segments: Provides an efficient and transparent platform for trading of equity and Preference shares, debentures, warrants, coupons and exchange traded funds. This segment started trading in November, 1994.

Trading Mechanism: The trading system is known as the National Exchange for Automated Trading (NEAT). Online, fully automated, order driven, screen based trading system where a member can punch into the system quantities of securities and the prices at which he likes to transact and the transaction is executed as soon as it finds a matching sale or buy order from a counterparty.

Derivatives trading

- The SEBI set up LC Gupta committee on November 18, 1996 to develop appropriate regulatory for derivatives trading in India.
- The committee submitted its report on March 17, 1998.
- The Securities Contracts Regulations Act was amended in December, 1999 to include Derivatives within the ambit of Securities.
- Derivatives Trading commenced in India in June, 2000 after SEBI granted the final approval to this effect in May, 2001.
- It permitted the derivative segment of two stock exchanges, NSE and BSE and their clearing house/corporation to commence trading and settlement in the derivative segment of two stock exchanges.
- To begin with, it approved trading in index futures contracts based on NIFTY and Sensex.
- The trading in Index options commenced in June 2001 and in options on individual securities commenced in July, 2001.

- Futures contracts on Individual stocks was launched in November, 2001.
- Exchange traded interest derivatives contracts have been introduced with effect from June, 2003.

DERIVATIVES

A derivative is a contract or product that derives its value from an underlying asset. Derivatives can include a wide range of such assets including indices, currencies, exchange rates, commodities, stocks or the rate of interest. The buyer and seller of such contracts have opposite estimations of the future trading price. Both the parties bet on the future value of the underlying assets to make a profit. Derivative trading is similar to a regular buy and sell process. But instead of paying the whole amount up front, a trader pays only an initial margin to a stockbroker.

Different Types of Derivatives

Depending upon the conditions of a contract, derivatives can be of the following types –

- **Futures** – A futures contract is a legal agreement between two parties to buy or sell the underlying asset at a predetermined future date and price. The contract is executed directly through a regulated and organised exchange.
- **Forwards** – Forward contracts are similar to futures except the deal is not made through an organised or regulated exchange. Since these are Over-The-Counter (OTC) contracts, they carry more counterparty risk for both parties involved.
- **Options** – An options contract gives a trader the right but not an obligation to buy or sell an underlying asset at a predetermined future date and price.
- **Swaps** – A swap is a contractual agreement between two parties to exchange cash flows at a future date based on a pre-planned formula. Similar to forwards, they are OTC contracts and consequently not traded on exchanges.

Although forwards and futures may seem similar to each other, there are some key differences to them:

Point of Difference	Futures	Forwards
Nature of contract	These are standardised contracts.	These types of contracts are tailor-made to suit the requirements of both the parties; These are not standardised.
Settlement date	These are settled on a daily basis.	These are settled on the date of maturity.
Risk involved	The risk associated with a futures contract is low.	The level of risk associated with forwards is high.
Collateral requirement	An initial margin is required as collateral for the credit risk.	No collateral is required for forwards.
Method of transaction	These are traded on regulated and organised stock exchanges such as BSE and NSE.	These are Over-The-Counter (OTC) contracts, negotiated directly between a buyer and a seller. They're not traded on a regulated and organised exchange.

Participants in a Derivatives Market

There are four participants involved in derivative trading. They are as follows –

- **Hedgers** – These participants invest in the derivatives market to eliminate the risks associated with future price changes.
- **Traders and speculators** – They predict future changes in the price of an underlying asset. Based on these predictions, they take a certain position (long or short) in a derivative

contract.

- **Arbitrageurs** – Arbitrage is a practice often adopted by traders to exploit the price differences in two or more markets. For example, a trader purchases stock in one market and simultaneously sells it off at a higher price in another. It is a common practice in financial markets.
- **Margin traders** – In derivative trading, a margin is an initial amount an investor has to pay to the stockbroker. It is only a percentage of the total value of the investor's position. Margin traders use this distinct payment feature to buy more stocks than they can afford.

Advantages of Derivative Trading

- **Low transaction costs** – Derivative contracts play a part in reducing market transaction costs since they work as risk management tools. Thus, the cost of transaction in derivative stock trading is lower as compared to other securities like debentures and shares.
- **Used in risk management** – The value of a derivative contract has a direct relation with the price of its underlying asset. Hence, derivatives are used to hedge the risks associated with changing price levels of the underlying asset. For example, Mr A buys a derivative contract, the value of which moves in the opposite direction to the price of the asset he possesses. He'll be able to use the profits in the derivatives to offset losses in the underlying asset.
- **Market efficiency** – **Derivative trading** involves the practice of arbitrage which plays a vital role in ensuring that the market reaches equilibrium and the prices of the underlying assets are correct.
- **Determines the price of an underlying asset** – Derivative contracts are often used to ascertain the price of an underlying asset.
- **Risk is transferable** – Derivatives allow investors, businesses and others to transfer the risk to other parties.

Disadvantages of Derivative Trading

After knowing what is derivative trading, it's imperative to be familiarised with its disadvantages as well.

- **Involves high risk** – Derivative contracts are highly volatile as the value of underlying assets like shares keeps fluctuating rapidly. Thus, traders are exposed to the risk of

incurring huge losses.

- **Counterparty risk** – Derivative contracts like futures that are traded on the exchanges like BSE and NSE are organised and regulated. But, OTC derivative contracts like forwards, are not standardised. Hence, there's always a risk of counterparty default.
- **Speculative in nature** – Derivative contracts are commonly used as tools for speculation. Due to the high risk associated with them and their unpredictable fluctuations in value, baseless speculations often lead to huge losses.

Derivative trading requires in-depth knowledge about the products and a great deal of expertise. All investors need to conduct thorough research regarding this process and formulate effective strategies to minimise losses and optimise profits.

Clearing and Settlement

The National Securities Clearing Corporation Limited undertakes clearing and settlement of all trades executed on the F&O segment of the NSE. It also acts as a legal counterparty to all trades and guarantees their final settlement. All futures and Options contracts are cash settled.

SECURITIZATION

As business expands the need for various types for finance also increases. Financial institutions throughout the world are raising their resources, in the money market, capital market and debt instrument market. Governments are raising their finances by issuing various types of instruments. Thus, Securitization is a new concept by which financial institutions are able to acquire additional resources by using their existing long-term assets.

Securitization is the method of converting the receivables of the financial institutions, i.e., loans and advances, into bonds which are then sold to the investors. In simple terms, it is the means of turning the illiquid assets into liquid assets to free up the blocked capital.

The receivables on debts against collateral assets like property, land, building and other real estate, become exchangeable financial instruments in this process of securitization.

Definition:

A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities.

- Securitization is the transformation of illiquid assets into a security, that is, an instrument that is issued and can be traded in a capital market.
- Assets that have been transformed in this manner include residential mortgages, auto loans, credit card receivables, leases and utility payments.
- The term asset-backed security (ABS) is generally applied to issues backed by non-mortgage assets.
- Asset Backed Security (ABS): Financial securities issued to the public market that are backed (securitized) by pledging specific assets, for example:
 - Mortgage Backed Securities (MBS)
 - Auto Loans (CARS)
 - Credit Card Receivables (CARDS)
 - Home Equity Loans (HELs)
 - Royalties (eg David Bowie Bonds)
 - Student Loans

How do banks securitize assets?

- ABS securities are created by removing assets from the balance sheet of the bank
- It sells pledged assets to a special purpose vehicle (SPV). The SPV is not owned by the bank
- The SPV issues debt to the public market, using the pledged assets to securitize the offering
- The yield on the issue is based on the quality of the pledged assets and not the bank from which they came. A higher credit rating results in lower yield (more

valuable bonds)

Securitization v/s Factoring

While both factoring and securitization involves capitalizing the receivables of the company, however there are many differences between factoring and securitization.

1. While factoring is arrangement between the banks and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables whereas Securitization is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows.
2. Under factoring there are two parties that is the bank and the company while under securitization there are many investors involved who invest in the securitized asset.
3. While factoring is done for short term account receivables ranging from 1 month to 6 months whereas securitization is done for long term receivables of the company.
4. While factoring is of many types and can be with or without recourse while securitization is done without recourse.
5. Since factoring involves only bank and the company there is no need for any credit rating while securitization involves many investors and therefore it is necessary to take credit rating before going for securitization of receivables

Pass Through Certificate

A pass through certificate (PTC) is a certificate that is given to an investor against certain mortgaged-backed securities that lie with the issuer. The certificate can be compared to securities (like bonds and debentures) that may be issued by banks and other companies to investors.

The only difference being that they are issued against underlying securities. The interest that is paid to the issuer on these securities comes to the investor in the form of a fixed income.

Many banks and private organizations have incomes or receivables that are due to them in lieu of loans or services that they have offered in the past. Securitisation involves the conversion of these incomes or receivables into debt instruments which are then sold to investors. For this purpose, the parent organization sets up a Special Purpose Vehicle (SPV) which issues these debt instruments.

All the PTCs in the market are rated by agencies like Crisil or Fitch ratings, among others. The ratings tell the investor about the quality of the underlying securities.

Parties involved:

1. Debtor (Borrowers/Loan takers)
2. Originator (Bank/Financial Institution)
3. SPV (Special Purpose Vehicle)
4. Investors (Public)
5. Other Parties: Credit Rating Agencies, Agents, Trustees, Administrators, etc. [SEBI]

Mechanism of Securitization

(i) The process of securitization starts with identification by the company (the originator) the loans or bills receivable in its portfolio, to prepare a basket or pool of assets to be securitized. The package usually forms an optimum mix so as to ensure fair marketability of the instrument to be issued.

Further, the maturities are also so chosen that the package represents one homogeneous lot. The pool of receivables is backed by the underlying securities held by the originator (in the form of mortgage, pledge, charge, etc.).

The pool of assets so identified is then sold to a specific purpose vehicle (SPV) or trust. Usually an investment banker performs the task of an SPV, which is also called an issuer, as it ultimately issues the securities to investors.

(ii) Once the assets are acquired by SPV, the same are split into individual shares/securities which are reimbursed by selling them to investors. These securities are called 'Pay or Pass Through Certificates' (PTC) which are so structured as to synchronize for redemption with the maturity of the securitized loans or bills.

A PTC thus represents a sale of an undivided interest to the extent of the face value of the PTC in the aggregate pool of assets acquired by the SPV from the originator.

(iii) Repayments under the securitized loans or bills keep on being received by the originator and passed on to the SPV. To this end, the contractual relationship between the originator and the borrowers/obligates is allowed to subsist in terms of the pass through transaction; alternatively a separate agency arrangement is made between the SPV (Principal) and the originator (agent).

(iv) Although a PTC could be with recourse to its originator, the usual practice has been to make it without recourse. Accordingly, a PTC holder takes recourse to the SPV and not the originator for payment to the principal and interest on the PTCs held by him. However, a part of the credit risk, as perceived (and not interest risk), can be absorbed by the originator, by transferring the assets at a discount, enabling the SPV to issue the PTCs at a discount to face value.

(v) The debt to be securitized and the PTC issues are got rated by rating agencies on the eve of the securitization. The issues by the SPV could also be guaranteed by external guarantor- institutions to enhance creditability of the issues. The PTCs, before maturity, are tradable in a secondary market to ensure liquidity for the investors.

From the above, it is evident that the primary participants involved in the issuance of securitization transaction are the originator, obligors, the SPV, the servicer and the credit enhancer. The originator has the assets which are sold or used as collateral for the assets backed securities. Originators are generally manufacturing companies, financial institutions, banks and non-banking finance companies.

The term obligors' refers to borrowers who have taken loans from the originators resulting in the creation of the underlying asset. The SPV or trust raises funds to buy assets from the originator by selling securities to investors. It uses the cash flow generated by the financial assets in the pool to

pay interest and principal to investors and covers its own costs. The servicer/receiving and paying agent is responsible for collecting principal and interest payments on assets when due and for pursuing the collection from delinquent accounts.

The service is usually the originator or an associate of the originator. The credit enhancer provides the required amount of credit support to reduce the overall credit risk of a security issue. Credit enhancement is provided by the originator in the form of senior- subordinate structure over collateralisation or through a cash collateral. Third party credit enhancement generally takes the form of a letter of credit or a surety bond.

Special Purpose Vehicle (SPV)

A Special Purpose Vehicle (SPV) is a separate legal entity created by an organization. The SPV is a distinct company with its own assets and liabilities, as well as its own legal status. Usually, they are created for a specific objective, often to isolate financial risk. As it is a separate legal entity, if the parent company goes bankrupt, the special purpose vehicle can carry on.

A special purpose vehicle can be a “bankruptcy-remote entity” because the operations of the entity are restricted to the purchase and financing of specific assets or projects.

The typical legal forms of special purpose vehicles are partnerships, limited partnerships, or joint ventures. Moreover, in some cases, it is required that the SPV should not be owned by the company on whose behalf the entity is created.

Uses of Special Purpose Vehicles

The following are the most common reasons for creating SPVs:

1. Risk sharing

A corporation’s project may entail significant risks. Creating an SPV enables the corporation to legally isolate the risks of the project and then share this risk with other investors.

2. Securitization

Securitization of loans is a common reason to create an SPV. For example, when

issuing mortgage-backed securities from a pool of mortgages, a bank can separate the loans from its other obligations by creating an SPV. The SPV allows investors in the mortgage-backed securities to receive payments for these loans before other creditors of the bank.

3. Asset transfer

Certain types of assets can be hard to transfer. Thus, a company may create an SPV to own these assets. When they want to transfer the assets, they can simply sell the SPV as part of a merger and acquisition (M&A) process.

4. Property sale

If the taxes on property sales are higher than the capital gain realized from the sale, a company may create an SPV that will own the properties for sale. It can then sell the SPV instead of the properties and pay tax on the capital gain from the sale instead of having to pay the property sales tax.

Securitisable Assets

Any company with assets that generate relatively predictable cash may be securitized. The most common asset types include corporate receivables, credit card receivables, auto loans and leases, mortgages, student loans and equipment loans and leases. Generally, any diverse pool of accounts receivable can be securitized. Eligibility criteria generally require that the receivables not be delinquent, not be subject to offset, be fully earned with no future performance required by the company and not be due from an affiliate of the company or the federal government.

Benefits of Securitization

TO THE ORIGINATOR

The originator derives maximum benefit from securitization since the purpose is to get the blocked funds released to take up other alluring opportunities. Let us discuss each one of these:

1. **Unblocks Capital:** Through securitization, the originator can recover the amount lent, much earlier than the prescribed period.
2. **Provides Liquidity:** The illiquid assets, such as the receivables on loans sanctioned by the bank, are converted into liquid assets.
3. **Lowers Funding Cost:** With the help of securitization, even the BB grade companies can benefit by availing AAA rates if it has an AAA-rated cash flow.
4. **Risk Management:** The financial institution lending the funds can transfer the risk of bad debts by securitizing its receivables.
5. **Overcoming Profit Uncertainty:** When the recovery of debts is uncertain, its profitability, in the long run, is equally doubtful. Thus, securitization of such obligations is a suitable option to avoid loss.
6. **Reduces Need for Financial Leverage:** Securitization releases the blocked capital to maintain liquidity; therefore, the originator need not seek to financial leverage in case of any immediate requirement.

TO THE INVESTOR

The investor's aim is to accelerate the return on investment. Following are the different ways in which securitization is worth investing:

1. **Quality Investment:** The purchase of MBS and ABS are considered to be a wise investment option due to their feasibility and reliability.

2. **Less Credit Risk:** The securitized assets have higher creditworthiness since these are treated separately from their parent entity.

3. **Better Returns:** Securitization is a means of making a superior return on their investment; however, it depends more on the investor's risk-taking ability.