



Directorate of Distance Education
CENTRE FOR DISTANCE AND ONLINE EDUCATION (CDOE)
NALSAR University of Law, Hyderabad

Reading Material

One Year Advanced Diploma in
Financial Services & Legislations

1.2.6 MERCHANT BANKING & INVESTMENT BANKING

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MODULE I: MERCHANT BANKING & ISSUE MANAGEMENT

Role of Merchant Bankers in the Economy

In modern terms, a merchant bank is a firm or financial institution that invests equity capital directly in businesses and often provides those businesses with advisory services. A merchant bank offers the same services as an investment bank, however, it typically services smaller clients and makes direct equity investments in them.

Merchant banks mainly work with small-scale enterprises that are unable to raise funds through an initial public offering (IPO) by providing mezzanine financing, bridge financing, equity financing, and corporate credit products. They also issue and sell securities on behalf of corporations through private placements to refined investors who require less regulatory disclosure. Large merchant banks place equity privately with other financial institutions by acquiring a considerable share of ownership from companies with a significant potential for high growth rate to seal the gap between venture capital and public stock.

History of Merchant Banks

The history of merchant banks can be traced back to Italy in the late medieval times as well in France in the 17th and 18th centuries. Merchant banks began operating as organized money markets consisting of merchants financing the transactions of other merchants. French merchant Marchand Banquier invested all his profits by integrating the banking business into his merchant activities and became a merchant banker.

In the United Kingdom, merchant banks started in the early 18th century. The oldest merchant bank in the United Kingdom is Barings Bank, which was established by a German-originated family of bankers and merchants. It was founded in 1762 and was the second oldest merchant bank in the world after Berenberg Bank. The bank was, at one time, referred to as the sixth great European power after Germany, Russia, United Kingdom, Austria, and France after it helped finance the US government during the 1812 war.

The growth of trade and industries in the 19th century led to the emergence of merchant banks in the United States. The first merchant banks in the United States were JP Morgan & Co and Citi Bank. The industry was mainly dominated by German-Jewish immigrant bankers and Yankee houses with close ties to expatriate Americans who settled in London as merchant bankers. However, with the growth of the financial world, corporations overshadowed family-owned businesses in the banking business. The corporations included merchant banking as one of their areas of interest, a characteristic that banks hold until today.

The Evolution of Merchant Banking in the Indian Scenario

With the advent of the industrial boom in India, there has been a growing need of Merchant Bankers. Businesses often require specialised banking services which are concentrated in nature. Hence, commercial bankers set up their merchant banking subsidiaries to cater financial services for the corporate sector.

The first Merchant Banker was set up in 1967 by Grindlay's Bank, after that there were a number of merchant banks incorporated. There are multiple factors that have accelerated the importance of Merchant Banking in the country. These could be enlisted in the following pointers:

Globalisation of Economy: Post the 1991 reforms, the Indian economy opened its gates to overseas organisations. This encouraged fundings coming in from abroad and thereby pivoting the importance of Merchant Bankers.

Increased Competition: With favourable business options and lucrative market scenarios, the Indian corporates buckled up their games and were on an expansion spree. This encouraged the Merchant Bankers to play substantial roles with their specialised services towards Corporates.

Change in Consumer Trends: With multiple foreign players setting shop on Indian soil, there has been a boost in the quality of products that were being offered to the Indian masses. This in turn transformed the strategies of the Indian counterparts. Financial products and instruments became more prominent in the prevailing environments.

Government Reforms: With reduction in Government intervention and privatisation, there was a boost in the private corporate sector. Also, increasing the limits on investments and reduction in direct interventions proved to be a lucrative proposition of foreign players.

These factors, along with the enhancement on the ease of doing business has paved the way for Merchant Bankers to gain a considerable position. In addition, SEBI has served to be an effective watchdog for **merchant banking** activities.

Functions of Merchant Banks

Merchant banks found its origin in the early periods in the country of Italy by the Italian merchants. The main function of the merchant banking services include providing financial advice and services to corporate as well as individuals. These banks act as a sort of intermediary between capital issuers and the buyers of the securities. These securities are issued by different companies in the stock markets to raise funds.

Fundamentally, **merchant bankers** are financial institutions. The main activities of merchant banker are like business loans as well as underwriting. They largely offer their services to large enterprises and individuals of high net worth.

The major functions that a merchant bank carries out are like

- Stock Underwriting: This is one of the most usual activities of a merchant bank.
- Issue Management: In this, a merchant Bank will assist the capital market to increase the supply of securities in the market.
- Portfolio Services is also essential function.

Underwriting is the process by which they raise and arrange to collect the fund from investors on behalf of corporations and governments issuing either equity or debt securities.

While acting as a banker to an issue, a **merchant banker** has to disclose full details to the Securities Exchange Board of India (SEBI) as it is the regulator for this entity.

Basically, merchant bankers are financial institutions. They do not undertake the activities of depositories or retail lender institutions.

They are, instead, intermediaries.

They undertake the activities of business loans as well as underwriting. They are a unique combination of consultancy and banking services. They provide consultancy on matters pertaining to the finances, marketing, management, and law. Such consultancy services assist starting of businesses, raise finance, modernise, expand or restructure an existing business, revival of sick units as well as provide assistance to companies in registering, buying and selling shares. They do not undertake the activities of depositories or retail lender institutions. They are, instead, intermediaries.

National Grindlays Bank introduced the concept of merchant banks in India somewhere in 1967. Similarly, the State Bank of India became the first Indian Commercial Bank to set up a separate Merchant Banking Division in the year 1972. Citibank setup its merchant banking division in 1970.

Role and activities of Merchant Bankers

Merchant bankers actively take up the following activities

1. Raising finance
2. Promotional activities
3. Brokers in stock exchanges
4. Project management
5. Advise on Modernisation and Expansion

Raising finance

Merchant Bankers(MB) assist their clients in fund raising by way of issue of a debenture, shares, bank loans, etc.

Promotional activities

In India, Activities of Merchant Banker play a very vital role of promoter of industrial enterprises. They assist entrepreneurs in the matter of conceiving ideas, identifying projects, preparation of feasibility reports, getting Government approvals as well as incentives, etc.

Brokers in stock exchanges

Merchant bankers also buy and sell shares in the stock exchange on behalf of their clients. They also additionally conduct researches on equity shares.

Project management

Merchant bankers offer their service to clients in several ways in the process of project management also.

Advise on Modernisation and Expansion

Further, Merchant bankers also advise on amalgamations, mergers, acquisitions, takeovers, foreign collaborations, diversification of business, technology up-gradation, joint-ventures, etc. to their clients.

Managing the ensuing public issue of the client is also very important service offered by the Merchant Bankers. In fact, it is prime function of Merchant Bankers.

They offer their following services for the above-mentioned purpose:

- the timing of the public issue to be fixed
- determining the size of the public issue
- the price of the share to be issued
- acting in the capacity of manager to the issue
- helping in receiving applications as well as allotment of securities
- appointment of brokers as well as underwriters for the issue
- lastly listing of the shares on the relevant stock exchange for the trading purpose

Credit Syndication

A merchant banker offers some specialized assistance in the phases of preparation of a project, the loan applications required for the raising of short-term and long-term credit from various banks and financial institutions, etc.

Handling Government Consent for Industrial Projects

A merchant banker fulfills all formalities for his client, to obtain government permission to expand and modernize business and starting new businesses.

Special Assistance to Entrepreneurs and Small Companies

Merchant banker counsels and explains the businessmen and small companies on availability and avenues of business opportunities, concessions, incentives and government policies and helps them to take advantage of this.

Services to PSU's

Merchant banker also offers several services to public sector undertakings and units and their public utilities.

The Revival of Sick Units

A merchant bank assists in reviving sick industrial units also. They negotiate with several agencies such as banks, long-term lending institutions, and the Board for Industrial and Financial Reconstruction (BIFR).

Portfolio Management of Sick Units

Merchant bankers help in offering revival services to companies issuing the securities. Thus, the Merchant Bankers offer a wide variety of services to the capital market in India.

The Necessity of Merchant Banking Services

The economy of the country is often afflicted with different unpredictable conditions like inflation, unemployment, stagnation and so forth. The need to sustain a steady growth is necessary for corporations and individuals which is possible only with a long term strategy and financial options. The merchant banking services provide solutions and financial options.

These banks provide advisor services to clients based on a particular fee. They also provide other financial services to mergers and clients. It is the only financial institute that invests its capital in the clients' company. It acts as an intermediary between those who possess capital and those who need capital.

To help their clients with a number of financial options, the merchant banking services operate in a number of countries all over the world. In this manner the clients have the opportunity to survey the different financial options to ensure better growth.

Difference between an Investment Bank and a Merchant Bank

Although there is somewhat a thin line between traditional merchant banks and investment banks, the financial institutions differ in several ways. First, merchant banks serve small-scale companies that may not be big enough to attract funding from venture capitalists and other large investors. Merchant banks offer such companies creative credit products such as bridge financing, equity financing, and mezzanine financing. They place equity with other financial institutions and take ownership of small but promising companies.

Investment banks, on the other hand, focus on underwriting and selling securities through initial public offerings (IPO) and share offerings. Unlike merchant banks that focus on small companies with potential for growth, investment's bank clientele comprises large companies with enough resources to finance the sale of securities to the public. Investment banks advise their clients on mergers and acquisitions, buyouts, and capital restructuring, among other services.

Traditional merchant banks mainly focus on international financing activities including trade finance, foreign corporate investing, and foreign real estate investment. Some of these activities may be shared with investment banks, but there are other functions like issuing letters of credit and international funds transfer that are predominantly carried out by merchant banks. Investment banks focus on raising funds for corporations and governments and issuing debt or equity on the market. This is a transition from their traditional roles of underwriting and selling securities. Investment banks also help in mergers and acquisitions as well as buying and selling large companies.

Difference Between Commercial Bank and Merchant Bank

Banks are termed as the financial institutions, which act as intermediaries between depositors and borrowers. Besides the usual function of accepting deposits and extending credit, many value added services are also provided by the banks. Indeed, there are different types of banks set up to perform different functions. Commercial banks are the banks that provide services to the general public and companies as well.

On the other hand, merchant banks are similar to investment banks as they do not provide regular banking services, rather deals with commercial loans and investment avenues. The article presents you the substantial differences between commercial bank and merchant bank, take a read.

Definition of Commercial Bank

A commercial bank may be described as the financial intermediary, that offers a number of monetary services to the general public and corporations as well. These are profit making companies, which are owned and controlled by the group of individuals.

The primary function of a commercial bank is taking deposits and granting loans, but it also serves the customers by providing services like:

1. Disbursement of payments
2. Collection funds

3. Providing working capital finance
4. Safeguarding valuables
5. Purchasing and selling securities
6. Bank overdraft
7. Cash credit
8. Discounting bill of exchange

Add to that; it offers a broad spectrum of products to the customers like the savings account, current account, fixed deposits, certificate of deposits, etc. Interest on the deposits is provided to the account holders, as well as the bank charges interest on a loan extended to the customer. The rate of interest on deposits or loans relies on the type of product opted by the customer.

Definition of Merchant Bank

A merchant bank refers to the banking company that provides both financial and consultancy services to the clients. It has got expertise in international finance, underwriting and business loans. It is also engaged in activities associated with the promotion and development of industrial projects such as:

1. Loan syndication
2. Portfolio management
3. Underwriting of capital issues
4. Project counselling
5. Issue management
6. Advisory services on mergers acquisitions and takeovers.
7. Corporate restructuring
8. Acceptance of bills

Merchant bank aims at fulfilling the advisory requirements of big business ventures and high net worth individuals. It provides financing services to multinational corporations and also looks after the management of currency exchange whenever the funds are transferred. It also assists companies in issuing securities using private placements, which do not require adherence to the legal formalities as in the case of initial public offering (IPO).

Key Differences Between Commercial Bank and Merchant Bank

The points given below are important, concerning the difference between commercial bank and merchant bank:

A commercial bank can be defined as the financial intermediary, set up by a group of individuals to offer basic banking services to the general public like accepting deposits and advancing credit. Conversely, merchant banks are the banking company that assist large enterprises in international trade and offer a number of products and services to its clients.

The commercial banks are governed by Banking Regulation Act, 1949. In contrast, the merchant banks follow the rules and regulations framed by SEBI, i.e. Securities and Exchange Board of India.

The main business of the commercial bank is related to regular banking services, whereas merchant banks excel in providing consultancy and advisory services to the clients.

Loan extended by the commercial bank is debt-related. Unlike equity related loans are granted by the merchant banks.

Commercial banks are less prone to risk, while merchant banks are highly exposed to risk. The role of a commercial bank resembles a financier. On the contrary, the merchant banks act as a financial advisor.

The commercial bank aims at fulfilling the needs of the general public, whereas big business houses that are operating in more than one nation and high net worth individuals are catered by merchant banks.

Comparison Chart

BASIS FOR COMPARISON	COMMERCIAL BANK	MERCHANT BANK
Meaning	Commercial bank is a banking company established by a number of people for providing the basic banking functions i.e. accepting deposits and lending money to general public.	Merchant bank refers to the financial institution, that specializes in international trade and provide an array of services to its clients.
Governing Act/body	Regulated by Banking Regulation Act, 1949.	Rules and regulations designed by SEBI.
Engaged in	General banking business	Consultancy type business
Nature of loan extended	Debt-related	Equity-related
Exposure to risk	Less	Comparatively more
Role	Financier	Financial Advisor
Caters	Needs of general public.	Needs of corporate firms.

As both the financial intermediaries cater varied needs of the customers, these are entirely different from one another. A merchant bank charges fees for the financial and consultancy services, commercial bank charges a fee for the facilities provided like ATM, mobile banking and net banking. While commercial bank plays the role of repository for the savings of the customer, merchant bank doesn't.

How to choose a merchant banker?

As per SEBI regulations in India, it is mandatory for a merchant banker to have a certificate of registration issued by SEBI, in order to offer merchant banking services. Besides this, tying up with a certified merchant banker, whose profile best suits the requirements of the enterprise can play a crucial role in the raising capital.

Here are some guidelines on what to look for in a merchant banker.

- Proven track record
- Good investor relations

- Industry focus
- Research skills
- Experience in market making

Proven track record:

Choosing a merchant banker that has experience in successfully managing at least one issue is essential as they will know all the regulatory and legal formalities that need to be taken care of for listing.

Good investor relations:

A merchant banker with good contacts with investors, venture capitalists and financial institutions, can help in mobilizing funds through successfully placing the company's shares.

Industry focus:

Opting for a merchant banking firm that has a strong focus in the industry in which the enterprise operates can make a difference as they are aware of the way the market works in a particular sector.

Research skills:

Since there are several aspects to be looked at before floating an IPO, the chosen merchant banker must have the capabilities of thoroughly researching essential information with regard to the company's capital structuring, financial viability and other elements that are important for the success of the issue.

Experience in market making:

The selected merchant banker should have the required skills and experience related to market making, including the process involved in trading, underwriting, buying, selling and marketing stocks.

Leading merchant bankers in India

In India, there are public sector, private sector as well as foreign players in the merchant banking industry. Some of the key players are listed below.

Public sector:

- SBI Capital Markets
- Punjab National bank
- IFCI Financial Services

Private sector:

- ICICI Securities,
- Axis Bank
- Bajaj Capital
- Tata Capital Markets
- Yes Bank
- Kotak Mahindra Capital Company
- Reliance Securities

Foreign merchant bankers:

- Goldman Sachs (India) Securities
- Morgan Stanley India
- Barclays Securities (India)
- Bank of America
- Citigroup Global Markets India

Leading merchant bankers in USA

The top merchant bankers in the USA include

- JP Morgan
- Merrill Lynch
- Deutsche Bank
- Goldman Sachs
- Morgan Stanley
- Citigroup
- Credit Suisse
- UBS
- Barclays and
- RBC Capital Markets.

Often, SMEs in India don't achieve their full potential due to lack of funding during the crucial stages of growth. With the BSE and NSE launching SME exchanges for helping small and medium industries tap the capital markets for additional funding, merchant bankers will have a key role to play by liaising between the enterprises and investors to make sure that public funds are put to the best use for the growth of the SME sector as well as the Indian economy as a whole.

Developments in Merchant Banking Establishment:

1. Setting up of Banks Subsidiaries
2. Re-organisation of Private Firms
3. Establishment of SUA
4. Securities and Exchange Board of India (SEBI)
5. Discount and Finance House of India (DFHI)
6. Credit Rating Information Services of India Ltd. (CRISIL)
7. Stock-Holding Corporation of India Ltd. (SHC)

Merchant Banking Establishment: Development # 1. Setting up of Banks Subsidiaries:

In order to meet the growing demand for broad-based financial services from the corporate sector more effectively, the merchant banking divisions of the nationalised Banks have started forming independent subsidiaries. These subsidiaries offer more specialised services with professional expertise and skills.

SBI Capital Markets Ltd., was incorporated as the first such subsidiary of SBI on 2nd July, 1986. Then Canbank Financial Services Ltd. was set up as wholly owned subsidiary of Canara Bank in 1987. PNB Capital Services Ltd. was promoted by PNB during mid-1988. Many more subsidiaries are being set up by other nationalised banks.

Merchant Banking Establishment: Development # 2. Re-organisation of Private Firms:

Expecting tough competition from growing number of merchant banking subsidiary companies of nationalised banks, private merchant bankers have also started reorganising their activities e.g., J.M. Financial & Investment Consultancy Ltd., 20th Century Finance Corporation Ltd., LKP Merchant Financing Ltd. etc. are some of the private sector firms of merchant bankers who have taken steps to reorganise their activities.

Merchant Banking Establishment: Development # 3. Establishment of SUA:

In order to educate and protect the interest of investors, to provide information about new issues of capital market, to evolve a code of conduct for underwriters and to render legal and other services to members and public, the Stockbroker Underwriters Association (SUA) was established in 1984. SUA works in co-ordination with merchant bankers and takes steps for promoting the activities of capital market.

Merchant Banking Establishment: Development # 4. Securities and Exchange Board of India (SEBI):

To develop and regulate securities market, investor protection and to formulate rules and guidelines for regulation of securities market, the Central Government constituted Securities and Exchange Board of India on April 4, 1988.

The Board carries out all functions as may be delegated to the Board/Chairman by Central Government for the development and regulation of securities market. Persons dealing in security market, merchant bankers, underwriters, sub-brokers, portfolio managers, mutual funds etc. have to seek authorisation from the Board.

Merchant Banking Establishment: Development # 5. Discount and Finance House of India (DFHI):

DFHI was incorporated as a company under the Companies Act, 1956 with an authorised and paid up capital of Rs. 100 crores. Out of this, Rs. 51 crores has been contributed by RBI, Rs. 16 crores by financial institutions and 33 crores by public sector banks.

It would also have lines of credit from public sector banks; refinance facility from the Reserve Bank of India in order to meet the working capital requirements. DFHI aims at providing liquidity in money market as it deals mainly in commercial bills.

Merchant Banking Establishment: Development # 6. Credit Rating Information Services of India Ltd. (CRISIL):

CRISIL has been set up in 1987 to provide help to investors, merchant bankers, underwriters, brokers, banks and financial institutions etc. CRISIL rates various types of instruments such as debt, equity and fixed return securities offered to the public. It helps the investors in taking investment decisions.

Merchant Banking Establishment: Development # 7. Stock-Holding Corporation of India Ltd. (SHC):

SHC was set up in 1986 by the All India Financial Institutions to take care of safe custody, delivery of shares and collection of sale proceeds of the securities. The setting up of SHC is bound to affect the capital market in future.

IPO Management

An IPO (initial public offering) is referred to a flotation, which an issuer or a company proposes to the public in the form of ordinary stock or shares. It is defined as the first sale of stock by a private company to the public. They are generally offered by new and medium-sized firms that are looking for funds to grow and expand their business.

It is also referred to as –public offering|

Basics of private and public:

Companies fall into two broad categories:

- Private
- public

A privately held company has fewer shareholders and its owners don't have to disclose much information about the company. Most small businesses are privately held, with no exceptions that large companies can be private too, like Domino's Pizza and Hallmark Cards being privately held. Shares of private companies can be reached through the owners only and that also at their discretion.

On the other hand, public companies have sold at least a portion of their business to the public and thereby trade on a stock exchange. This is why doing an IPO is referred to going public.

Why go public?

The main reason for going public is to raise the good amount of cash through the various financial avenues that are offered. Besides, the other factors include:

- Public companies usually get better rates when they issue debt due to increased scrutiny.
- As long as there is market demand, a public company can always issue more stock.
- Trading in the open markets means liquidity.
- Being Public makes it possible to implement things like employee stock ownership plans, which help to attract top talent of the industry.

Factors to be considered before applying for an IPO:

There are certain factors which need to be taken into consideration before applying for Initial Public Offerings in India:

- The historical record of the firm providing the Initial Public Offerings
- Promoters, their reliability, and past records
- Products offered by the firm and their potential going forward
- Whether the firm has entered into a collaboration with the technological firm
- Project value and various techniques of sponsoring the plan
- Productivity estimates of the project
- Risk aspects engaged in the execution of the plan

General Terms involved in IPO:

Primary market

It is the market in which investors have the first opportunity to buy a newly issued security as in an IPO.

Prospectus

A formal legal document describing the details of the company is created for a proposed IPO, also making the investors aware of the risks of an investment. It is also known as the offer document.

Book building

It is the process by which an attempt is made to determine the price at which the securities are to be offered based on the demand from investors.

Over-Subscription

A situation in which the demand for shares offered in an IPO exceeds the number of shares issued.

Green shoe option

It is referred to as an over-allotment option. It is a provision contained in an underwriting agreement whereby the underwriter gets the right to sell investors more shares than originally planned by the issuer in case the demand for a security issue proves higher than expected.

Price band

Price band refers to the band within which the investors can bid. The spread between the floor and the cap of the price band is not more than 20% i.e. the cap should not be more than 120% of the floor price. This is decided by the company and its merchant bankers. There is no cap or regulatory approval needed for determining the price of an IPO.

Listing

Shares offered in IPOs are required to be listed on stock exchanges for the purpose of trading. Listing means that the shares have been listed on the stock exchange and are available for trading in the secondary market.

Flipping

Flipping is reselling a hot IPO stock in the first few days to earn a quick profit. The reason behind this is that companies want long-term investors who hold their stock, not traders.

Advantages

The IPO is an exciting time for a company. It means it has become successful enough to require a lot more capital to continue to grow. It's often the only way for the company to get enough cash to fund a massive expansion. The funds allow the company to invest in new capital equipment and infrastructure. It may also pay off debt.

Stock shares are useful for mergers and acquisitions. If the company wants to acquire another business, it can offer shares as a form of payment.

The IPO also allows the company to attract top talent because it can offer stock options. They will enable the company to pay its executives fairly low wages up front. In return, they have the promise that they can cash out later with the IPO.

For the owners, it's finally time to cash in on all their hard work. These are either private equity investors or senior management. They usually award themselves a significant percentage of the

initial shares of stock. They stand to make millions the day the company goes public. Many also enjoy the prestige of being listed on the New York Stock Exchange or NASDAQ. For investors, it's called getting in on "the ground floor." That's because IPO shares can skyrocket in value when they are first made available on the stock market.

Disadvantages

The IPO process requires a lot of work. It can distract the company leaders from their business. That can hurt profits. They also must hire an investment bank, such as Goldman Sachs or Morgan Stanley. These investment firms are tasked with guiding the company as it goes through the complexities of the IPO process. Not surprisingly, these firms charge a hefty fee.

Second, the business owners may not be able to take many shares for themselves. In some cases, the original investors might require them to put all the money back into the company. Even if they take their shares, they may not be able to sell them for years. That's because they could hurt the stock price if they start selling large blocks and investors would see it as a lack of confidence in the business.

Third, business owners could lose ownership control of the business because the Board of Directors has the power to fire them.

Fourth, a public company faces intense scrutiny from regulators including the Securities and Exchange Commission. Its managers must also adhere to the Sarbanes-Oxley Act. A lot of details about the company's business and its owners become public. That could give valuable information to competitors.

What IPOs Mean to the Economy

The number of IPOs being issued is usually a sign of the stock market's and economy's health. During a recession, IPOs drop because they aren't worth the hassle when share prices are depressed. When the number of IPOs increase, it can mean the economy is getting back on its feet again.

The IPO Process

According to the Corporate Finance Institute,¹ there are five steps in the IPO process. First, the owners must select a lead investment bank. This beauty contest occurs six months before the IPO, according to CNBC. Applicant banks submit bids that detail how much the IPO will raise and the bank's fees. The company selects the bank based on its reputation, the quality of its research, and its expertise in the company's industry.

The company wants a bank that will sell the shares to as many banks, institutional investors, or individuals as possible. It's the bank's responsibility to put together the buyers. It selects a group of banks and investors to spread around the IPO's funding. The group also diversifies the risk. Banks charge a fee between 3% to 7% of the IPO's total sales price.

The process of an investment bank handling an IPO is called underwriting. Once selected, the company and its investment bank write the underwriting agreement. It details the amount of money to be raised, the type of securities to be issued, and all fees. Underwriters ensure³ that the company successfully issues the IPO and that the shares get sold at a certain price.

The second step is the due diligence and regulatory filings. It occurs three months before the IPO. This is prepared by the IPO team. It consists of the lead investment banker, lawyers, accountants, investor relations specialists, public relations professionals, and SEC experts.

The team assembles the financial information required. That includes identifying, then selling or writing off, unprofitable assets. The team must find areas where the company can improve cash flow. Some companies also look for new management and a new board of directors to run the newly public company.

The investment bank files the S-1 registration statement with the SEC. This statement has detailed information about the offering and company info. According to CNBC,⁴ the statement includes financial statements, management background, and any legal problems. It also specifies where the money is to be used, and who owns any stock before the company goes public. It discusses the firm's business model, its competition, and its risks. It also describes how the company is governed and executive compensation.

The SEC will investigate the company. It makes sure all the information submitted is correct and that all relevant financial data has been disclosed.

The third step is pricing. It depends on the value of the company. It also is affected by the success of the road shows and the condition of the market and economy.

After the SEC approves the offering, it will work with the company to set a date for the IPO. The underwriter must put together a prospectus that includes all financial information on the company. It circulates it to prospective buyers during the roadshow. The prospectus includes a three-year history of financial statements. Investors submit bids indicating how many shares they would like to buy.

After that, the company writes transition contracts for vendors. It must also complete financial statements for submission to auditors.

Three months before the IPO, the board meets and reviews the audit. The company joins the stock exchange that lists its IPO.

In the final month, the company files its prospectus with the SEC. It also issues a press release announcing the availability of shares to the public.

The day before the IPO, bidding investors find out how many shares they were able to buy.

On the day of the IPO, the CEO and senior managers assemble at either the New York Stock Exchange or NASDAQ for the first day of trading. They often ring the bell to open the exchange.

The fourth step is stabilization. It occurs immediately after the IPO. The underwriter creates a market for the stock after it's issued. It makes sure there are enough buyers to keep the stock price at a reasonable level. It only lasts for 25 days during the "quiet period."

The fifth step is the transition to market competition. It starts 25 days after the IPO, once the quiet period ends. The underwriters provide estimates about the company's earnings. That assists investors as they transition to relying on public information about the company.

Six months after the IPO, inside investors are free to sell their shares.

The Bottom Line

A private corporation becomes a public company through an IPO. It sells shares of ownership or stocks to the public market. Going public allows the company to gain any of four advantages:

- An expansion through a huge capital boost.
- Capacity to acquire or merge with another company.
- Facility to competitively attract talented management.
- Enormous increase of investment value for the original private investors.

The IPO process takes five steps:

- Selection of an investment bank
- Due diligence and filings
- Valuation
- Stabilization
- Transition to market competition.

The volume of issued stocks in the market could indicate the economy's health. A decrease may signal a recession, while an increase may express an economic upswing.

The Initial Public Offering IPO Process is where a previously unlisted company sells new or existing securities and offers them to the public for the first time.

Prior to an IPO, a company is considered to be private – with a smaller number of shareholders, limited to accredited investors (like angel investors/venture capitalists and high net worth individuals) and/or early investors (for instance, the founder, family, and friends).

After an IPO, the issuing company becomes a publicly listed company on a recognized stock exchange. Thus, an IPO is also commonly known as -going publicl.

Overview of the IPO Process

This guide will break down the steps involved in the process, which can take anywhere from six months to over a year to complete.

Below are the steps a company must undertake to go public via an IPO process:

1. Select a bank
2. Due diligence and filings
3. Pricing
4. Stabilization
5. Transition



Step 1: Select an investment bank

The first step in the IPO process is for the issuing company to choose an investment bank to advise the company on its IPO and to provide underwriting services. The investment bank is selected according to the following criteria:

- Reputation
- The quality of research
- Industry expertise
- Distribution i.e. if the investment bank can provide the issued securities to more institutional investors or to more individual investors.
- Prior relationship with the investment bank

Step 2: Due diligence and regulatory filings

Underwriting is the process through which an investment bank (the underwriter) acts as a broker between the issuing company and the investing public to help the issuing company sell its initial set of shares. The following underwriting arrangements are available to the issuing company:

- **Firm Commitment:** Under such an agreement, the underwriter purchases the whole offer and resells the shares to the investing public. The firm commitment underwriting arrangement guarantees the issuing company that a particular sum of money will be raised.
- **Best Efforts Agreement:** Under such an agreement, the underwriter does not guarantee the amount that they will raise for the issuing company. It only sells the securities on behalf of the company.
- **Syndicate of Underwriters:** Public offerings can be managed by one underwriter (sole managed) or by multiple managers. When there are multiple managers, one investment bank is selected as the lead or book-running manager. Under such an agreement, the lead investment bank forms a syndicate of underwriters by forming strategic alliances

with other banks, each of which then sells a part of the IPO. Such an agreement arises when the lead investment bank wants to diversify the risk of an IPO among multiple banks.

An underwriter must draft the following documents:

Engagement Letter: A letter of engagement typically includes:

1. **Reimbursement clause:** This clause mandates that the issuing company must cover all out-of-the-pocket expenses incurred by the underwriter, even if the IPO is withdrawn during the due diligence stage, the registration stage, or the marketing stage.
2. **Gross spread/underwriting discount:** Gross spread is arrived at by subtracting the price at which the underwriter purchases the issue from the price at which they sell the issue.

Gross spread = Sale price of the issue sold by the underwriter – Purchase price of the issue bought by the underwriter

Typically, the gross spread is fixed at 7% of the proceeds. The gross spread is used to pay a fee to the underwriter. If there is a syndicate of underwriters, the lead underwriter is paid 20% of the gross spread. 60% of the remaining spread, called –selling concessionl, is split between the syndicate underwriters in proportion to the number of issues sold by the underwriter. The remaining 20% of the gross spread is used for covering underwriting expenses (for instance, roadshow expenses, underwriting counsel, etc.).

Letter of Intent

A letter of intent typically contains the following information:

1. The underwriter's commitment to enter an underwriting agreement with the issuing company
2. A commitment by the issuing company to provide the underwriter with all relevant information and thus, fully co-operate in all due diligence efforts.
3. An agreement by the issuing company to provide the underwriter with a 15% overallotment option.

The letter of intent does not mention the final offering price.

Underwriting Agreement: The letter of intent remains in effect until the pricing of the securities, after which the Underwriting Agreement is executed. Thereafter, the underwriter is contractually bound to purchase the issue from the company at a specific price.

Registration Statement:

The registration statement consists of information regarding the IPO, the financial statements of the company, the background of the management, insider holdings, any legal problems faced by the company, and the ticker symbol to be used by the issuing company once listed on the stock exchange. The SEC requires that the issuing company and its underwriters file a registration statement after the details of the issue have been agreed upon.

The registration statement has two parts:

- **The Prospectus** – this is provided to every investor who buys the issued security
- **Private filings** – this is comprised of information which is provided to the SEC for inspection but is not necessarily made available to the public

The registration statement ensures that investors have adequate and reliable information about the securities. The SEC then carries out due diligence to ensure that all the required details have been disclosed correctly.

Red herring document

In the cooling-off period, the underwriter creates an initial prospectus which consists of the details of the issuing company, save the effective date and offer price. Once the red herring document has been created, the issuing company and the underwriters market the shares to public investors. Often, underwriters go on roadshows (called the dog and pony shows – lasting for 3 to 4 weeks) to market the shares to institutional investors and evaluate the demand for the shares.

Step 3: Pricing

After the IPO is approved by the SEC, the effective date is decided. On the day before the effective date, the issuing company and the underwriter decide the offer price (i.e. the price at which the shares will be sold by the issuing company) and the precise number of shares to be sold. Deciding the offer price is important because it is the price at which the issuing company raises capital for itself. However, after the stock starts trading on the secondary market, money raised through the sale of shares the company, not the underwriter. The following factors affect the offering price:

- the success/failure of the roadshows (as recorded in the order books)
- the company's goal
- condition of the market economy

IPOs are often underpriced to ensure that the issue is fully subscribed/ oversubscribed by the public investors, even if it results in the issuing company not receiving the full value of its shares.

If an IPO is underpriced, the investors of the IPO expect a rise in the price of the shares on the offer day. This increases the demand for the issue. Furthermore, underpricing compensates investors for the risk that they take by investing in the IPO. An offer that is oversubscribed 2 to 3 times is considered to be a –good IPOl.

Step 4: Stabilization

After the issue has been brought to the market, the underwriter has to provide analyst recommendations, after-market stabilization, and create a market for the stock issued.

The underwriter carries out after-market stabilization in the event of order imbalances by purchasing shares at the offering price or below it.

Stabilization activities can only be carried out for a short period of time – however, during this period of time, the underwriter has the freedom to trade and influence the price of the issue as prohibitions against price manipulation are suspended.

Step 5: Transition to Market Competition

The final stage of the IPO process, the transition to market competition, starts 25 days after the initial public offering, once the –quiet periodl mandated by the SEC ends.

During this period, investors transition from relying on the mandated disclosures and prospectus to relying on the market forces for information regarding their shares. After the 25-day period lapses, underwriters can provide estimates regarding the earning and valuation of

the issuing company. Thus, the underwriter assumes the roles of advisor and evaluator once the issue has been made.

Metrics for judging a successful IPO process

The following metrics are used for judging the performance of an IPO:

Market Capitalization: The IPO is considered to be successful if the company's market capitalization is equal to or greater than the market capitalization of industry competitors within 30 days of the initial public offering. Otherwise, the performance of the IPO is in question.

Market capitalization = Stock Price x Total Number of Company's Outstanding Shares

Market Pricing: The IPO is considered to be successful if the difference between the offering price and the market capitalization of the issuing company 30 days after the IPO is less than 20%. Otherwise, the performance of the IPO is in question.

IPO Lead Manager Performance 2019

At a great extent, the **success or failure of an IPO depends on a lead manager**. The lead manager decides the pricing, dates, size of IPO. They also help the company selling its IPO shares to public and institutional buyers. Most investors and IPO analysts check the profile of a lead manager before applying in an IPO.

The lead manager or merchant banker is a SEBI registered financial institutions. They play the most critical role in the IPO process. The book running lead manager work closely with the company from day one until the IPO shares get listed at the stock exchanges. They help companies preparing for IPO, write the DRHP / RHP documents and get them approved from the exchanges and SEBI. They decide the offer price, public issue dates and listing dates of the IPO in consultation with the company. They also take care of regulatory requirement and educate the company in for pre and post IPO compliances.

Below report shows the **performance of a lead manager for 2019 IPO's**. It tries to answers questions like:

- How many IPO's were managed by a lead manager?
- How many of these IPO gave listing gains to investors?
- How many IPO list at the exchange below their issue price?
- How much average gain/loss investors made on listing day?

The report only considers IPO which are listed on the stock exchanges. The IPO's which are in-progress or withdrawn are not considered in this report. This report shows the number of IPO handled by the lead manager in the calendar year 2019

IPO Merchant Banker performance 2019

Lead Manager	Total IPO	Positive Listing	Negative Listing	Average Gain
Aryaman Financial Services limited	6	5	1	-1.89%

Lead Manager	Total IPO	Positive Listing	Negative Listing	Average Gain
Axis Capital Limited	5	3	2	14.29%
Batlivala & Karani Securities India Private Limited	1	1	0	22.58%
BCB Brokerage Private Limited	1	1	0	1.25%
Beeline Broking Ltd	1	1	0	3.50%
Bonanza Portfolio Limited	1	1	0	0.28%
CapitalSquare Advisors Pvt. Ltd.	1	0	1	-1.17%
Citigroup Global Markets India Private Limited	1	1	0	21.75%
Credit Suisse Securities (India) Private Limited	2	1	1	1.02%
Deutsche Equities India Private Limited	1	0	1	-7.01%
Edelweiss Capital Limited	2	2	0	27.81%
Elara Capital (India) Private	1	1	0	0.26%
Equirus Capital Private Limited	1	0	1	-4.83%
Fast Track Finsec Pvt Ltd	3	2	1	3.18%
Fedex Securities Limited	5	5	0	6.34%
Finshore Management Services Limited	6	6	0	3.62%
First Overseas Capital Limited	1	1	0	0.63%
Goldman Sachs (India) Securities Private Limited	1	1	0	9.04%
Gretex Corporate Services Pvt Ltd	2	2	0	7.58%
Guinness Corporate Advisors Pvt Ltd	1	1	0	0.74%
HDFC Bank Limited	1	1	0	9.04%
Hem Securities Limited	4	2	2	-0.28%

Lead Manager	Total IPO	Positive Listing	Negative Listing	Average Gain
Holani Consultants Private limited	1	1	0	9.38%
ICICI Securities Limited	5	3	2	9.70%
IDBI Capital Market Services Limited	2	2	0	63.98%
IIFL Holdings Limited	5	3	2	23.77%
IndusInd Bank Limited	2	0	2	-3.95%
Inga Advisors Private Limited	1	1	0	22.58%
Inventure Merchant Banker Services Pvt Ltd	1	1	0	2.22%
ITI Capital Ltd	1	0	1	-9.32%
Jefferies India Private Limited	1	1	0	33.87%
JM Financial Consultants Private Limited	4	3	1	15.74%
Kotak Mahindra Capital Company Limited	3	3	0	27.29%
Mark Corporate Advisors Private Limited	1	1	0	0.52%
Monarch Network Capital Ltd	1	1	0	6.19%
Morgan Stanley India Company Pvt Ltd	1	1	0	3.71%
Navigant Corporate Advisors Ltd	3	3	0	1.69%
NEXGEN Capitals Ltd	1	0	1	-7.57%
Nomura Financial Advisory And Securities (India) Pvt Ltd	1	1	0	17.46%
Pantomath Capital Advisors Pvt Ltd	7	5	2	2.54%
SBI Capital Markets Limited	2	1	1	60.34%
Share India Capital Services Private Limited	2	2	0	4.40%

Lead Manager	Total IPO	Positive Listing	Negative Listing	Average Gain
SMC Capitals Limited	1	0	1	-4.92%
Swastika Investmart Ltd	1	1	0	1.76%
UTI Securities Ltd	2	1	1	12.94%
Vivro Financial Services Private Limited	1	1	0	1.63%
YES Bank Limited	1	1	0	0.26%
Yes Securities (India) Limited	4	2	2	35.39%

FPO Management

Follow-On Public Offering (FPO) is an issue of stocks that is released by a company that has previously issued an Initial Public Offering (IPO) and already listed on stock exchange. A company intending to offer additional shares to the public registers the offering with regulators, which includes releasing fresh prospectus of the investment.

But unlike an IPO, which includes a fixed or variable price range that the company is looking to sell its shares to the public, the price of a follow-on public offering (FPO) is market-driven.

As the company is already publicly listed in exchanges and its existing shares are consistently being valued by investors, its shares already having a defined valuation. Hence, any investment banks or underwriters working on the FPO of that company tends to focus on the current market price rather than doing the entire valuation.

Usually, the price of a follow-on public offering (FPO) is usually offered at a small discounted rate (lower price) from the closing market price on the day of the transaction.

Types of Follow-On Public Offer (FPO):

Typically there are two types of Follow-on Public Offers (FPO) that are released in the market. Those are:

- Dilutive
- Non-Dilutive

Dilutive FPO:

A dilutive Follow-on Public Offering (FPO) takes place when a company wants to raise additional funding from the public market. When this occurs, the company releases more shares (additional shares), but the value of the company remains effectively the same. Therefore this type of FPO decreased the per-share earnings (EPS) of the company. The money raised from a dilutive Follow-on Public Offering (FPO) is usually used to pay off outstanding debts and change a company's capital structure.

Non-Dilutive FPO:

A non-dilutive follow-on offering (FPO) occurs when company's founders, the board of directors, or other larger shareholders sell their privately held shares on the open market. This type of FPO is called non-dilutive FPO, as no additional shares of the company are sold.

The funds that are pulled from the market goes directly into the account of the shareholder selling those shares and not to the company itself. Since new shares are not being issued, the company's earnings per share (EPS) and capital structure remain unchanged.

Sometimes this type of offering is also referred to as —Secondary market offering

IPO Vs FPO

We have already learned what an IPO is and what an FPO is. But many beginner investors have doubts about the difference between IPO & FPO.

For a company to grow & run itself, it requires funds. Even well-established companies require funds in order to continue with their ongoing process and to expand their business. Oftentimes, it is not possible for the owner of the company to provide a continuous supply of funds. In that case, issuing share to the general public is the most convenient way for a company to raise capital.

IPO, a.k.a. Initial Public Offering is a way to raise funds by listing a company on the stock market for the first time. On the other hand, FPO (a.k.a. Follow-On Public Offering) are shares that are issued a company that has already been listed on the stock exchange and want to raise more money from the market by issuing subsequent shares of that company.

In IPO, the company gets listed in stock exchange for the first time via an institution (investment banks or underwriters). This allows the general public to purchase shares of the company. This way the company provides a part of ownership of the company to general public, in return for capital. This is by far the most common way for a private company to go public and raise money.

Now, once the company starts growing further, it may require more capital to properly run its business. The company may require further capital for business expansion or to pay off outstanding debts. This is when the requirement for releasing Follow-on Public Offering or FPO pops up. FPOs are additional shares that are offered after the company has already been listed on the stock exchange and has undergone the process of issuing IPOs.

IPO vs FPO - The Conclusion:

The difference between IPO and FPO can be summarized as follows:

IPO is the first public issue of the shares of a private company that is going public. On the other hand,

FPO is the second, third or subsequent public issue of the shares of an already listed company (public company).

IPO is released with an intention to raise capital through public investment. Unlike FPO, that is offered with an aim to inflow subsequent public investment.

IPO are relatively riskier than FPO. Since in IPO, an individual investor doesn't know of what is going to happen with the company in future.

But in the case of FPO the company is already listed on stock exchange, so investors can study the past performance of the company and make an assumption about the company's future growth prospects.

Difference between IPO and FPO - Comparison Chart:

The following table shows the differences between IPO and FPO in a clearer format.

Comparison	FPO	IPO
Full Form	Follow-on Public Offering	Initial Public Offering
Listing Status	Issued after the company gets listed on the stock exchange	Issued before company gets listed on the stock exchange
Issuer	Listed Company	Unlisted Company
Objective	Subsequent public investment.	Raising capital through public investment.
Raising Capital	Subsequent public contribution	First time from Public
Risk	Comparatively Low	High
Predictability	More Predictable	Less Predictable
Profit	Thought to be Lower than IPO	Thought to be Higher than FPO
Types	FPO	Equity and Preferred

Underwriting

Underwriting in the context of a company means undertaking a responsibility or giving a guarantee that the securities (shares and debentures) offered to the public will be subscribed for. The firms which undertake the guarantee are called ‘underwriters’. Underwriting is similar to insurance in the sense that it provides protection to the issuing company against the failure of an issue of capital to the public.

It ensures success of new issues of capital and if the shares or debentures are not subscribed by the public. Wholly, the underwriters will have to take them up and pay for them. Underwriting is, therefore, an act of undertaking the guarantee by an underwriter of buying the shares or debentures placed before the public in the event of non- subscription.

According to SEBI Rules 1993, underwriting means an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them. ‘Underwriter’ means

a person who engages in the business of underwriting of an issue of securities of a body corporate.

The underwriters, for providing this service to the issuing companies charge a commission generally calculated at an agreed specified rate on the issue price of whole of the shares or debentures under written. Such a commission is called underwriting commission which is payable on the whole of shares or debentures underwritten even if the public takes up all the shares or debentures offered.

The issuing company has, thus, to enter into an agreement with one or more underwriter/s who may be either an individual, a firm, bank or some financial institution.

In an English case, the learned Judge defined underwriting as –an agreement entered into before the shares are brought before the public that in the event of the public not taking up the whole of them or the number mentioned in the agreement, the underwriter will, for an agreed commission take an allotment of such part of the shares as the public has not applied for.

In India, the Companies Act, 1956 limits the underwriting commission on issue of shares at 5% of the issue price of shares and in case of debentures at 2½% of the issue price of debentures.

Need and Significance of Underwriting:

Whenever new issues of capital are made, there is always certain risk of non-subscription or under- subscription of securities by the public. The plans of the promoters of the companies remain unimplemented and their reputation adversely affected if the issues are not successful.

Underwriting is a safer way of marketing securities for new issues of capital. It is an insurance in the sense that it provides protection against such risks.

Thus, it is a very useful method of raising finance through issue of securities (shares and debentures). It is not only the issues of equity share capital that need be underwritten. The analysis of underwriting of issues indicates that almost 100 percent of the issues of preference share capital and debentures are underwritten in India.

Although, the need for underwriting of initial issues is more, especially in case of new un-experienced promoters; the further issues of capital are also underwritten. The extent of underwriting required depends upon the nature of the project, the state of the capital market, the general response of the investors and the reputation of the promoters.

Thus, underwriting plays a very significant role in corporate financing.

The importance of underwriting can further be highlighted from the following functions performed by the underwriters:

1. Assurance of Adequate Finance
2. Supplying Valuable information to Companies
3. Distribution of securities
4. Increase in Goodwill of the issuing company
5. Services to prospective investors
6. Service to the society

The brief description of each of these functions is given below

1. Assurance of Adequate Finance:

Underwriting is an act of undertaking guarantee by an underwriter to buy and pay for the shares or debentures placed before the public in the event of their non-subscription. Thus, through underwriting, an issuing company is assured of procuring the required funds from the issue of shares or debentures.

In the event of non-subscription by the public, underwriters purchase the unsubscribed part of the issue and provide finance to the company.

2. Supplying Valuable Information to Companies:

In addition to the protection of risk of the issuing companies with regard to the success of the issue, the underwriters supply valuable information in regard to capital market conditions, general response of the investors, etc. to the issuing companies. These companies are, usually, benefited from the expert-advice of the underwriters.

3. Distribution of Securities:

After purchasing securities, underwriters distribute the same to the real investors. The underwriters, through agents and others diffuse the issue over a large number of investors scattered in different part of the country. Thus, underwriting helps promoters to retain control over the management of the company.

4. Increase in Goodwill of the Issuing Company:

The underwriting of capital issues by prestigious institutions generates confidence among investors and improves their response to the issues. Investors in advanced countries are influenced more by the prestige of the underwriting agencies than by the prestige of the issuing company. Underwriting, thus, ultimately increases the goodwill of the issuing company.

5. Service to Prospective Investors:

Underwriters provide essential information about the issuing companies to the prospective investors and also advise them about various issues. They encourage people to save more and direct their savings in corporate securities. Thus, investors are also benefited through underwriting.

6. Service to the Society:

The pace of industrialisation of a country depends to a great extent upon the successful flotation of capital issues. By mobilising resources and providing adequate finance, underwriters play a very important role in setting up of new projects, increasing employment, production and per capita income. Thus, it is not only the corporate enterprises but also the society at large which is benefited by underwriting.

Forms of Underwriting:

The nature and form of underwriting transactions depend mainly upon the nature of the project, the state of the capital market, the general response of the investors to the new issues, the reputation of the promoters and capacity of the underwriters. It may be undertaken on a commission basis.

An issuing company may get underwriting from a single underwriter but where the size of the issue is so large that it is unmanageable by a single underwriter and the risk involved is also high, the company may approach a number of underwriters.

Thus, an underwriting agreement may take any of the following forms:

1. Full Underwriting
2. Partial Underwriting
3. Joint Underwriting
4. Syndicate Underwriting
5. Firm underwriting
6. Sub underwriting
7. Outright purchase of issues

Brief explanation of each underwriting form is mentioned below

1. Full Underwriting:

It is an agreement under which the underwriter undertakes the guarantee of buying the whole of shares or debentures placed before the public in the event of non-subscription. The liability of the underwriter is to buy and pay for the entire unsubscribed portion of the issue.

2. Partial Underwriting:

Under this type of agreement, the underwriter undertakes the guarantee for only part of the issue offered to the public and his liability is limited to the extent of unsubscribed portion of the issue underwritten by him.

3. Joint Underwriting:

In case of a large issue which is unmanageable by a single underwriter and where the risk involved is too high, the issuing company may enter into underwriting agreement with more than one underwriter. Each underwriter undertakes the guarantee for the issue of a certain portion of the whole issue offered to the public.

Thus, underwriters share the risk involved in the ratio of the number of shares or debentures underwritten by them. Sometimes the promoters of issuing company prefer joint underwriting from underwriters operating in different regions of the country so as to diffuse the issue over a number of investors scattered all over the country and retain control over management of the company.

4. Syndicate Underwriting:

Under this type of underwriting, a number of underwriting firms enter into an agreement among themselves to undertake the guarantee of buying shares or debentures of a large issue offered to the public involving huge funds and risk.

Syndicate underwriting is essentially different from joint underwriting so far as the agreement among the underwriters is concerned. Thus, in syndicate underwriting two types of separate agreements take place, one between the issuing company and the syndicate of underwriters, and the other among the underwriters who are members of the syndicate.

5. Firm Underwriting:

When an underwriter undertakes to buy or subscribe a certain number of shares or debentures irrespective of the subscription from the public, it is called firm underwriting.

The liability of underwriters in case of firm underwriting is both for shares underwritten as well as such part of the shares as the public has not applied for. Firm underwriting generates confidence among investors and increases the chances of success of the issue.

6. Sub-Underwriting:

Sometimes, the underwriter enters into agreement with some other underwriters to undertake guarantee for the issue of whole or part of the issue underwritten by him. Such an agreement between the underwriter and the other underwriters (called sub-underwriters) is known as sub-underwriting.

The sub-underwriters have no agreement with the issuing company and work under the main underwriter who pays them some commission out of his underwriting commission.

7. Outright Purchases of Issues:

In all the six forms of underwriting agreements discussed above, the underwriters provide the services on commission basis.

However, in some cases the underwriters, instead of undertaking guarantee to buy shares or debentures not subscribed by the public, may enter into an agreement to out-rightly purchase the issue (shares or debentures) at an agreed price and arrange to sell the same latter through their own arrangements.

Types of underwriters

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. The lead taken by public financial institutions has encouraged banks, insurance companies and stock brokers to underwrite on a regular basis.

The various types of underwriters differ in their approach and attitude towards underwriting. They can be classified into the following categories

1. Stock-brokers
2. Private Investment and insurance companies
3. Commercial Banks
4. Development banks and other Financial Institutions
5. Consortium Underwriting

A brief description of each category is given below

Agency # 1. Stock-brokers:

The private firms of stock brokers have been underwriting issues from very early times. But their participation has been on ad-hoc basis as they have refrained themselves from underwriting activities at times. Their primary emphasis is on market potentiality of issues rather than the viability of the issues. The brokers primarily help in placement of issues and seldom perform the real job of underwriting.

They usually do not assume risk or guarantee the buying of issue in case of non-subscription. Further, the private brokers are interested only in short-term gains and are not interested to retain securities for a long-period. Even in cases, where they have to buy shares or debentures

because of their underwriting obligations, they sell the same to promoters or others at the earliest opportunity.

Agency # 2. Private Investment and Insurance Companies:

There are many private investment companies, trust and insurance companies which also provide underwriting service in India. In the late thirties managing agents organised a number of companies and trusts like Industrial Investment Trust of Bombay and Birds Investment Ltd. Calcutta to underwrite mainly the issues of the companies managed by their managing agents.

As managing agency system was abolished in India in 1970, these companies and trusts are working as underwriters since then. The nature of underwriting services undertaken by private investment companies is very similar to that of brokers and they are the major sub-underwriters in the market.

Agency # 3. Commercial Banks:

Since 1955, commercial banks have also played an important role in the field of underwriting. But compared to their resources, their participation in underwriting business has not been substantial. Commercial banks are also, usually, not interested in holding for a long-period the underwritten shares or debentures.

Agency # 4. Development Banks and Other Financial Institutions:

Since 1995, development banks and a number of other lending direct financial institutions have emerged as a major group of underwriters. In addition to the direct finance to companies, they underwrite capital issues.

The nature and purpose of underwriting of capital issues by these institutions is quite different from other underwriters. Their emphasis is mainly on long term viability of the issuing company rather than marketability of securities. These institutions help the enterprises by holding the underwritten shares or debentures not taken up by public for a long period.

Agency # 5. Consortium Underwriting:

In the recent years, various financial institutions and banks have started underwriting of capital issues through consultations and collaborations of each other. Although there is no formal syndicate or consortium as such, yet it has become a very important form of underwriting of capital issues.

Underwriting regulations in India

The SEBI (Underwriters), Regulations, were framed to deal with the issues concerning registration of the underwriters, capital norms and adequacy, and obligations and responsibilities of the underwriters. And hence the regulations mentioned above were legislated and notified on October 8, 1993. Now, before we examine the key features of underwriter's regulations, we must have an insight into the background about the underwriters and why a need for the regulations arose.

Traditionally, the underwriting services were provided by the financial institutions, banks, members of the stock exchange and persons with adequate financial resources, the desired worth and experience. To do away with this abstract framework, Rule 3(1) of the Securities and Exchange Board of India (Underwriters) Rules, 1993 was introduced which laid down that

no person can act as underwriter unless he holds a certificate granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. As per Rule 3(2), an exemption in this regard was provided to the merchant banker or stock broker holding a valid certificate of registration under Section 12 of Securities and Exchange Board of India Act, 1992 to obtain a separate certificate for underwriting. Rule 4(b) of the Securities and Exchange Board of India (Underwriters), Rules, 1993 prescribes that the underwriter is required to enter into a valid agreement with the issuer entity which inter alia would define the allocation of duties and obligations between the underwriter and the issuer entity.

The need for adequate regulations was most felt for the reason that the capital markets were constantly evolving and hence the underwriting practices had to be in consonance with the market developments. Gone are the days when it was felt that an underwritten issue was a sign of weakness and hence had to be backed by an underwriting support. These days it is perceived as a sign of strength for the issue. There is an optimistic trend behind the underwritten issue which reflects that the intermediaries after assessing the risks are still backing the issue.

If we look into the definition of underwriting as defined in Rule 2(g) of the regulations, it is defined as –an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them. The definition, however, has not been exhaustive as it does not answer the practical needs which may arise in due course of capital market transactions. The existing definition restricts underwriting to –subscription to securities. It also restricts the underwriting to issues by a body corporate and excludes –offer for sale from its definition. In practice, however, the underwriter may not always subscribe by himself. Third party transactions are a common resort. However, this third party arrangement has not been provided in the current definition. The current definition can be modeled on the lines of the Companies Act which recognizes that commission may be paid in consideration of subscribing / procuring subscription.

The model underwriting agreement prescribed by SEBI also records underwriter's agreement to underwrite/procure subscription. To cater to the transactions carried out in due course of business, the definition may be remodeled to read as –an agreement to subscribe to or procure subscription for securities, issued or offered for sale, remaining unsubscribed. Underwriting includes sub-underwriting.

As mentioned earlier, the regulations were introduced to deal with the issues concerning capital adequacy as well. As per Regulation 7(1) of the SEBI regulations, the existing capital adequacy requires minimum net worth of Rs 20 lacs. This adequacy norm for the underwriter was prescribed on 8th October 1993. However as the time progressed, this ceiling limit has ballooned substantially as may be seen from the fact that minimum net worth for a merchant banker has gone up from Rs 100 lacs to Rs 500 lacs, while for a broker on The Stock Exchange Mumbai (BSE) it is Rs 50 lacs and on National Stock Exchange (NSE) it is Rs 200 lacs.

The increase in the minimum net worth demands a higher level of commitment on the part of the underwriter and is a positive step in the direction of making the capital market more conducive and a safer place, also a higher floor shall ensure committed and quality underwriters. Since underwriting is a financial gamble, it is obligatory on the underwriter to establish his worthiness and for him to have adequate finances to tackle the risk associated. It is

here that the role of chartered accountant assumes importance as he may grant the underwriter a certificate certifying his net worth.

The current worth shall be computed as per Regulation 7 which includes paid-up capital and free reserves. It cannot be denied that the liquidity of the underwriter at any point of time is more critical than net worth as on a particular date. The current definition does not give adequate importance to tangible and liquid assets of the underwriters. The auditors may be consulted for computing net tangible assets or obtaining the certificate of liquidity.

The regulations have prescribed a ceiling on the underwriting obligations. At present, the current limit of maximum 20 times net worth as per Regulation 15(2) of Regulations was believed to be high given the fact that net worth was not explicitly defined. As per the customary practice, underwriting commission is paid to the underwriters much after the issue closure and listing permissions are obtained. Surprisingly, there is no obligation on the issuer company to expedite the release of the commission to underwriters. The earliest obligation is while making an application to the regional stock exchange for the release of its 1% deposit after four months from the date of listing permission.

The commission/brokerage cannot be paid before listing permission, where one of the objects to the issue is to meet issue expenses since the funds in the issue account cannot be utilized unless the securities are listed on all stock exchanges where the listing is sought.

The regulations prescribe rules regarding registrations and other compliances thereto. As mentioned earlier rule 3(1) prescribes that no person shall act as an underwriter unless he holds a certificate granted by SEBI under the Regulations. One of the criteria for considering an application for registration as an underwriter, as per Regulation 6 and Form A of the Regulations, is necessary infrastructure and experience in underwriting. However, adequate infrastructure and experience are not clearly defined. Neither do these criteria ensure commitment towards underwriting. It is believed that underwriting involves a financial risk where adequate net worth is critical rather than adequate infrastructure and experience.

Most of the underwriters today are already registered with SEBI for some activity or the other. They may be merchant bankers, stock brokers, mutual funds, etc. They are already regulated by SEBI for their actions under different regulations. Seeking one more registration for the same entity, as an underwriter, adds to the administrative burden of SEBI. Such separate registration may be avoided. Furthermore, there have been instances of regulatory overlapping, especially in the cases of banks and financial institutions which makes the entire process quite cumbersome.

The regulations also prescribe a code of conduct to be followed by the underwriters. However, the existing code is quite generic and is on lines with Regulation 13 and Schedule 3.

The regulations may also provide for the protection of the interests of the underwriters providing that no material/adverse development including regulatory changes after executing the agreement which affects the marketability of the issue unless conveyed to the underwriter and accepted by him.

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI) . The certificate is granted by SEBI under the Securities and

Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. Under it, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

SEBI'S Guidelines on Underwriting:

(a) As per the original Guidelines issued by SEBI on 11.6.1992, underwriting was mandatory for full issue and minimum requirement of 90% subscription was also mandatory for each issue of capital to public. However, as per the Revised Guidelines issued by SEBI on 10.10.94, underwriting is not mandatory now and the issuers have the option of deciding whether the issue is to be underwritten or not.

Number of underwriters would also be decided by the issuers.

(b) If the issue is not underwritten and if the minimum subscription of 90% of the offer to the public is not received, the entire amount received as subscription would have to be returned in full.

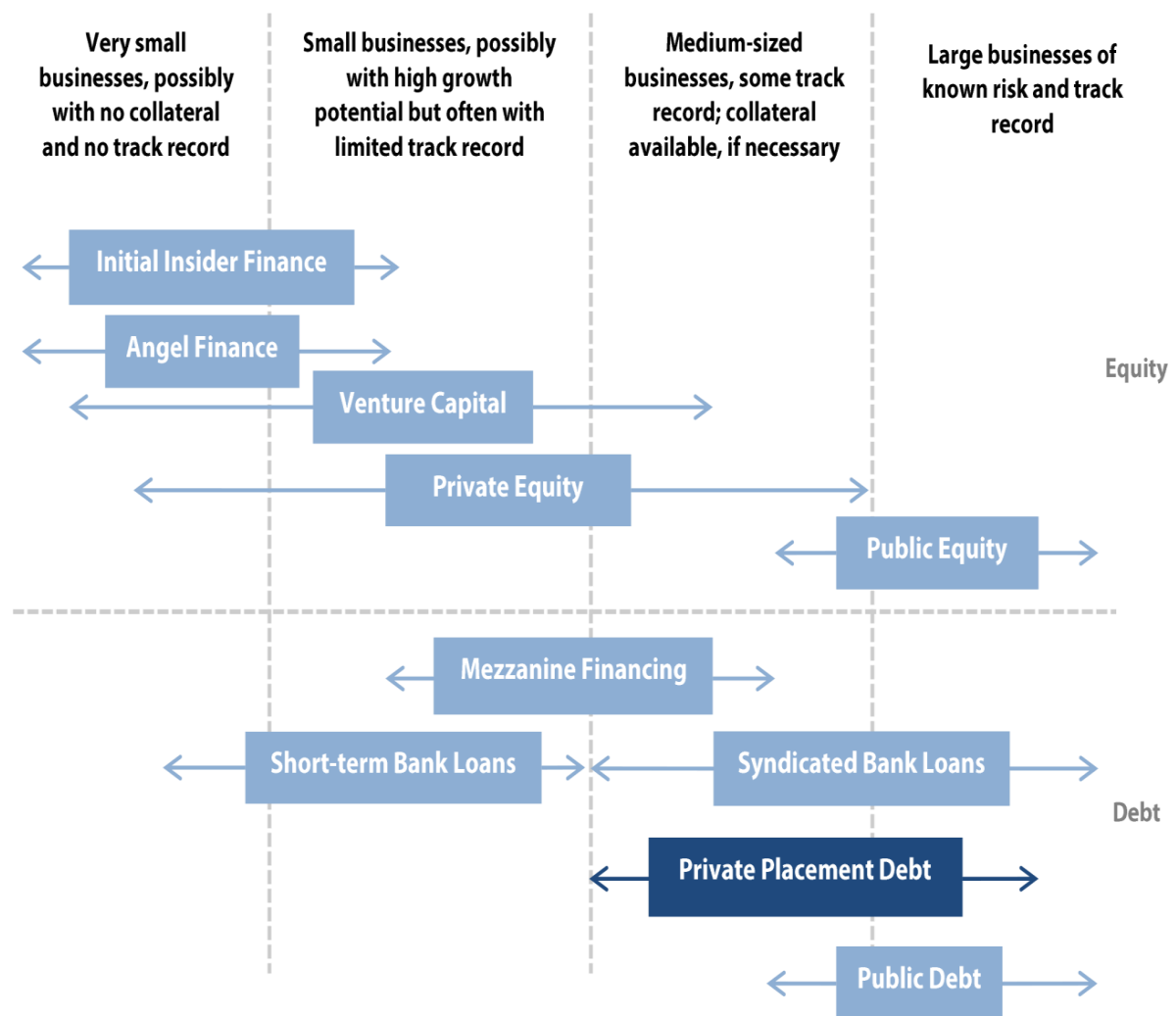
(c) If the issue is underwritten and if the company does not receive 90% of the issued amount from public subscription plus accepted development from underwriters, within 60 days of the opening of the issue, the company should refund the amount of subscription. In case of disputed devolvement, the company should refund the subscription if the above conditions are not met.

(d) The lead manager(s) must satisfy themselves about the net worth of the underwriters and the outstanding commitment and disclose the same to SEBI. A statement to this effect should be incorporated in the prospectus.

(e) The underwriting agreement may be filed to SEBI.

Private Placement

When businesses are started, they are often funded by the owners or a family loan. However, as they grow, many companies are unable to finance all needs solely from internal cash flows. When capital needs exceed cash-on-hand, businesses can utilize the following types of capital:



Private placement of shares is issuance of securities of a Company to a selected individual, group of individuals, corporates or group of corporates. The securities during this placement are not publicly offered. Thus, the Company raises capital by selling securities to a few selected investors whereas in a public offering the securities are open for sale in the market for all types of investors.

In this Placement, the securities are issued to a limited number of investors who are –accredited. An accredited investor is the one who: –

- Meets certain threshold of financial net worth and qualifications.
- Is more experienced in making investments and taking prudent financial decisions.
- Could afford taking risk and loss arising from such an investment.

Eg.: New York Life Insurance picked up 22.51% stake in Maxx ventures in January 2017 at Rs 78 per share by way of this placement

Differences Between Private Placement Program and Public Offering

A Private Placement is any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private

placement offer letter. Securities issued as private placements include debt, equity, and hybrid securities.

Private placement differs from public offering in the following manner

- The securities are sold to a group of investors in the Private placement of shares whereas in public offering the securities are offered to the public.
- Private placement of shares can be issued by both public and private Companies whereas in case of public offering the Company is either listed or will be listed after the offer is made.
- This placement deals may not be required to be registered with a regulator whereas the deals in which securities are offered publicly have to be registered with a regulator.

Features of Private placement

As the name suggests, a –private placement is a private alternative to issuing, or selling, a publicly offered security as a means for raising capital. In a private placement, both the offering and sale of debt or equity securities is made between a business, or issuer, and a select number of investors. There may be as few as one investor for any issue.

The three most important features that would classify a securities issue as a private placement are:

1. The securities are not publicly offered
2. The securities are not required to be registered with the SEC
3. The investors are limited in number and must be –accredited

Companies, both public and private, issue in the private placement market for a variety of reasons, including a desire to access long-term, fixed-rate capital, diversify financing sources, add additional financing capacity beyond existing investors (banks, private equity, etc.) or, in the case of privately held businesses, to maintain confidentiality.

Since private placements are offered only to a limited pool of accredited investors, they are exempt from registering with the Securities and Exchange Commission (SEC). This affords the issuer the opportunity to avoid certain costs associated with a public offering as well as allows for more flexibility regarding structure and terms.

"One of the key advantages of a private placement is its flexibility."

The most common type of private placement is long-term, fixed-rate senior debt, but there is an endless array of structuring alternatives. One of the key advantages of a private placement is its flexibility. Private placement debt securities are similar to bonds or bank loans and can either be secured, meaning they are backed by collateral, or unsecured, where collateral is not required.

In addition to senior debt, other types of private placement debt issuances include:

- Subordinated Debt
- Term Loans
- Revolving Loans

- Asset Backed Loans
- Leases
- Shelf Issues

Traditionally, middle-market companies have issued debt in the private placement market through two primary channels:

1. Directly with a private placement investor, such as a large insurance company or other institutional investor
2. Through an agent (most often an investment bank) on a best efforts basis who solicits bids from several potential investors - this is typically for larger transactions

A private placement issuance is a way for institutional investors to lend to companies in a similar fashion as banks, with a –buy-and-hold approach, and with no required trading or public disclosures. Historically, insurance companies refer to investments as purchasing –notes, while banks make –loans.

Uses of Private placement

Long-term capital is congruent with a company's long-term investments. Thus, capital raised from issuing a private placement is most commonly used to support long-term initiatives versus short-term needs, such as working capital.

Companies, both public and private, use the capital raised from private placements in the following ways:

- Debt refinancing
- Debt diversification
- Expansion/Growth capital
- Acquisitions
- Stock buyback/Recapitalization
- Taking a public company private
- Employee Stock Ownership Plan (ESOP)

Pricing and Payment Structure

Private placement debt is predominantly a fixed-income note that pays a set coupon, on a negotiated schedule. Private placements are priced similarly to public securities, where pricing is determined by the U.S. Treasury rate, with the addition of a credit risk premium.

Repayment of the principal can be accomplished in several ways, depending on the credit quality and needs of the issuer, such as sinking fund payments (amortization) or –bullets as well as tailored/bespoke amortization. Interest is typically paid quarterly or semi-annually.

A private placement allows for tailored terms and structures to meet the specific financing needs of the issuer.

Private Placement Market

Private Placement has evolved to be a preferred route for raising resources by both private and public sector companies.

In India, the route has gained importance during the last few years, in lieu of the prolonged subdued conditions in the new issues market. In terms of instruments, equity portion is more

often prescribed through preference shares while the debt portion is instrumented through bonds and debentures.

While the equity markets recover from economic and political concerns in the economy and gain buoyancy, private placement in bonds and debentures have caught attention of companies.

Companies Act, 2013 has brought about several changes with respect to Private Placements which are especially welcome from the point of view of investors. By introducing a defined process, timelines for issue and allotment, use of a separate/ escrow in bank account to maintain transparency and refund mechanisms with interest and strict penalties for violating regulations are some measures that will echo-well in the investor fraternity. Ofcourse, while measures have been taken to protect investors it shall certainly involve stiffer compliance and greater care on the part of companies.

Nevertheless, Private Placements as a means of raising capital shall continue to be used by companies. The Indian economy is certainly seen as a bright spot amidst the global economy and companies shall witness an investment interest from global as well as Indian investors.

Private Placements are expected to run bullish in years to come owing to the future business foray and the high leveraged financing structure of several sectors, compelling them to look for alternate capital raising options.

Private Placement will not only allow such companies to remain private and raise fund in lesser time and costs but also choose their own set of investors with like goals and enable them to make a return over a longer period of time.

How Does Private Placement Program Affect the Share Price of a Company?

The private placement of shares, if done by a private Company will not affect the share price because they are not listed. However, for a public listed Company, this placement will lead to a decline in share price at least in the near term.

This placement leads to dilution of the ownership of the existing shareholders to a proportion of the size of this placement. This is because new shares are issued and the holdings of the existing shareholders remain the same. Let us see an example:

Let the number of shares outstanding before the private placement of shares be 10 million and the Company has proposed to offer 1 million equity shares in the private placement. Thus, this would result in dilution of ownership of the existing shareholders by 10%.

This dilution of share normally leads to the decline of the share price; the impact of this placement can be considered as similar to that of stock split. However, such an impact can be seen only in short-term, a long-term effect on the price would take into account the utilization of funds by the Company raised during this placement.

If the Company does a private placement of shares to raise capital for a project which could provide better returns; extra profits and revenue from such a project will impact the share price thus pushing it higher.

Private Placement Program Advantages

Following are the top 6 private placement advantages

- Long Term Advantage
- Less Execution timeframe
- Diversification of Fundraising
- Lesser Regulatory Requirements
- Sell to Accredited Investors
- Privacy and control

Long Term Advantage

If it is a debt security, the Company issues private placement bonds which generally have a longer time to mature than a bank liability. Thus, the Company will have more time to pay back the investors. This is ideal for the situations where the Company is investing in new businesses which would require time to earn and grow. Further, if this placement is done on equity shares; they are generally done to strategic investors with –buy-and-hold strategy. These investors invest for longer duration and also provide strategic inputs on running the business. Thus, the Company benefits from having a long-time relationship with the investor.

Less Execution timeframe

As the market for this placement has matured this has increased standardization of documentation, better terms, and pricing and increased the size of raising funds. Further, the issuer does not have to register and market such a fundraising exercise with the regulator, hence it can be executed in lesser time and cost. If the issuer is issuing private placement bonds that will be privately held, he may not be required to get credit rating which will further reduce the cost to be paid to the credit agency.

Diversification of Fundraising

Fundraising by this placement helps the Company to diversify Company's funding sources and its capital structure. It aids the Company in raising capital when market liquidity conditions are not good. It helps the Company to organize the capital structure in terms of debt-equity structure and help it to manage its debt obligations. Since the terms can be customized, private placements can complement existing bank debt versus compete with it, and can allow a company to better manage its debt obligations. Diversification of funding sources is particularly important during market cycles when bank liquidity may be tight.

Private placements enable privately-held, middle-market companies and public companies to access capital just as they would with an underwritten public debt offering, but without certain requirements, such as ratings, registrations, or minimum size. And for public companies, private placements can offer superior execution relative to the public bond market for small issuance sizes as well as greater structural flexibility.

Lesser Regulatory Requirements

This placement requires limited public disclosures and is prone to less regulatory requirements than that would be needed in a public offering. Thus, the Company would negotiate the deal privately and offer the securities at a negotiated and fixed price.

Sell to Accredited Investors

This placement issuer can sell complex securities to the investors participating in the issue because such an issue will be limited to a select group of investors (accredited investors). Further, they would understand the potential risk and return on such securities.

Privacy and Control

Private placement transactions are negotiated confidentially. Also, public disclosure requirements are limited, compared to those found in the public market. Companies would not be beholden to public shareholders.

Private Placement Program Disadvantages

Following are the top 2 private placement disadvantages

- Difficulty in Finding a suitable investor
- Higher Returns Requirement

Difficulty in Finding a suitable investor

First and foremost, the disadvantage of a private placement of shares would be to find a suitable investor. Further, the investor may have a limited amount of funds to invest and may set certain targets to be achieved whereby he would invest the funds.

Higher Returns Requirement

The investors may require more return because of the risk they are taking by investing privately. If the investment is for private placement bonds, they may ask for higher interest rates or annual coupon because of the risk they take for unrated bond securities and illiquid securities. If investment in a private Company is by an issue of equity shares, they may ask for higher equity ownership or board positions because of the liquidity risk of their investment.

Further, even if the Company is publicly traded and it chooses to offer private placement shares, the investors would do a due diligence and some clauses on such an offer like annual dividends or shares to be issued at cheaper than market rates as they would have to lock-in their stake (not to be sold in open market) for a certain time period.

We have looked into advantages and disadvantages of private placements of shares. A Company may have a number of reasons to go for private placement like debt refinancing, expansion of business, capital diversification, strategic investor participation, Differences between mergers and acquisitions, share buyback, ESOP plan etc. However, the most important part of this placement is to find a suitable like-minded investor for the business.

Selecting a Private Placement Investor

There are important considerations for a company when determining whether to issue a private placement. When choosing a private placement investor or lender, some key characteristics to look for are:

- They are relationship-oriented rather than transaction-orientated. It's important that they show interest in the businesses they finance as well as work to understand the needs of the business and how it functions.
- Because private placement debt is typically long-term, it is vital for the private placement investor to have the capacity to grow as a financial partner and have the knowledge and experience to help a company navigate during challenging times.
- They are fast-acting, responsive and have access to key decision-makers within their organization.
- The private placement investor demonstrates a constant appetite for private placement debt throughout market cycles and the calendar year.
- They follow through on their commitments.

Ultimately, it is most important to find a private placement investor who can offer financing best fitted for the goals of your business.

Conditions for Private Placement under the Companies Act, 2013

As per companies Act, 2013, following conditions should be met by the companies which are planning to make an offer for private placement.

- Maximum Number of Persons
- Minimum amount of offer for an individual
- Persons to whom an offer can be made
- Mode of Payment
- No advertisement of offer
- Bank Account
- Minimum gap between two offers

Maximum Number of Persons

- An offer for private placement can be made to not more than 200 people in a financial year. This limit excludes Qualified Institutional Buyers and Employees, as defined in the Issue of Capital and Disclosure Requirements, 2009, as amended from time to time and is calculated individually for each kind of security.
- In case of Non-Banking Financial Companies (NBFCs), in case of Private Placements of NCDs of maturity of more than 1 year, there are two separate categories
 - More than INR 1 crore per investor and
 - Less than INR 1 crore per investor.
- In case of NCDs issuances with less than INR 1 crore per investor there is a limit of 200 subscribers for each financial year and such subscriptions shall be fully secured. For issuances of INR 1 crore or more per subscriber, there is no limit on the number of subscribers.
- The option to create security in favour of the subscribers will be with the issuer. These provisions however do not apply to tax exempt bonds offered by NBFCs.

Minimum amount of offer for an individual:

The value of the Offer per person shall not be less than INR 20,000 of ‘face value’ of securities.

Persons to whom an offer can be made:

All offers shall be made only to those persons whose names are recorded by the company prior to the invitation to subscribe and allotments can be made only to such persons who have been addressed and the offer is made along with the Offer letter.

Mode of Payment:

All monies payable towards subscription of securities under this section shall be paid through cheque or demand draft or other banking channels but not by cash.

No advertisement of offer:

No company offering securities under private placement shall release any public advertisements or utilize any media, marketing or distribution channels or agents to inform the public at large about such an offer.

Bank Account:

The application money received from the private placement offer shall be deposited in a separate bank account in a scheduled bank.

Minimum gap between two offers:

A company can come with a new offer after completion of the earlier offer. However, no fresh offer or invitation shall be made unless the allotments with respect to any previous offer or invitation have been completed or been withdrawn or abandoned by the company.

It has also been laid that if a company makes an offer or accepts monies in contravention to the regulations under the Companies Act, the company, its promoters and directors shall be liable for a penalty up to the amount involved in the offer or invitation or Rs. 2 crore, whichever is higher, and the company will be liable to refund all monies to subscribers within a period of 30 days of the order imposing the penalty.

Procedure for Private Placement

The procedure for private placement has been laid down under section (1) (c) and is read with section 42 of Companies Act, 2013. A company must ensure that its articles of association authorize increase of share capital by private placement. If not, appropriate approvals from Board and the shareholders to be sought and resolutions to be passed.

Step by step process of private placement procedure is given below

1. Identification of Persons to whom the offer/invitation shall be made:
2. Preparation of the Private Placement Letter of Offer:
3. Special Resolution
4. Circulation of the Offer Letter
5. Prepare and Maintain a Record of Private Placement offers
6. ROC Filing – PAS 4 and PAS 5
7. Board Meeting and Allotment of Securities
8. ROC Filing PAS 3
9. Issue Share Certificates

Identification of Persons to whom the offer/invitation shall be made:

All Private Placement offers shall be made to only those persons whose names are recorded by the company prior to the invitation to subscribe and such persons shall receive the offer by name.

Preparation of the Private Placement Letter of Offer:

For every private placement an Offer Letter is to be prepared as per form PAS 4. The Letter of Offer shall contain such details including –

- General information about the company
- Management perception of risk factors
- Disclosures on the directors
- Litigations on the company as well as on the directors etc.,

It shall contain the complete particulars of the offer containing all terms and conditions as well as objects for making the private placement, amount to be raised, time schedule, details of any security etc. It shall also contain

- The Financial Position of the Company
- Capital Structure
- Profits
- Dividends
- Summary of financial position for past three years
- Audited cash flow statement
- Any change in accounting policies, etc.

Special Resolution

Prior approval of shareholders shall be taken by way of a Special Resolution for each offer/invitation for private placement. The explanatory statement attached to the notice to the general meeting shall include the justification of the price at which the offer is being made. In the case

of non-convertible debentures, prior approval of shareholders by a Special Resolution is required only once a year for all the offers of such debentures during the year.

Circulation of the Offer Letter

The offer letter along with the application form addressed specifically to the proposed allottees shall be sent either in writing or electronic form within 30 days of recording the names of such persons as specified above. Only the person to whom the application form is addressed shall be permitted to subscribe using that particular application form.

Prepare and Maintain a Record of Private Placement offers

The Company shall maintain a complete record under Form PAS 5 of the offer made under Private Placement. The details shall include name of the person, father's name, complete address, contact details, signature of the officer designated to maintain the records etc.

ROC Filing – PAS 4 and PAS 5

The Company shall file PAS 4 and PAS 5 within a period of 30 days with the Registrar of Companies in such manner as prescribed under the Act and Rules. The Company shall also file these forms with SEBI if the company is listed.

Board Meeting and Allotment of Securities

The Company shall call a Board meeting to consider the allotment of Privately Placed securities and make an allotment of securities under Private Placement within 60 days from the date of receipt of application money for such securities. If the company is unable to allot such securities within that period of time, it shall repay the application money to subscribers within 15 days from the date of completion of 60 days. If however the company fails to repay the allotment money within the 15 days period stated hereinabove, it shall be liable to repay that money with an interest rate of 12% p.a. from the expiry of the 60 day period mentioned hereinabove.

ROC Filing PAS 3

The Company is required to file with the ROC a return of allotment under form PAS 3 giving complete particulars of the list of allottees – full name, address, PAN, email address, class of security, date of becoming a security holder, number of securities, nominal value of securities, amount paid up and consideration received. The form shall also contain the requisite Board resolutions and valuation reports, if any.

Issue Share Certificates

Once the above mentioned process is completed, the Company shall issue share certificates to the respective allottees.

Regulations for Private Placement

The regulations for private placement of securities are codified under sections 42 and 62 of the Companies Act, 2013. The companies act 2013 has formally introduced the concept of Private Placement, which earlier was operating through practice and experience with support of certain provisions scattered over various sections. These regulations are more specifically laid down to address various parameters on which a private placement can be undertaken.

The government brought formal Private Placement regulations to address the issues which were brought up on account of the Sahara case. In the said matter, two Sahara group companies namely Sahara India Real Estate Corporation Limited (SIRECL) and Sahara Housing Investment Corporation Limited (SHICL) floated an issue of Optionally Fully Convertible Debentures (OFCDs) as a –Private Placement and collected investments of over INR 24,000 crores from over 2 crore investors.

When it came to the knowledge of SEBI that the OFCDs were issued to a large number of investors from the public, it issued a show cause notice to SIRECL and SHICL inter alia stating that the issuance of OFCDs are public issue and therefore liable to be listed u/s 73 of Act, 1956 and also directed to refund the money solicited and mobilized through the prospectus issued with respect to the OFCDs, since they had violated various other clauses of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 and also various provisions of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

It was urged by the Sahara Group that OFCDs were issued in the nature of –hybrid instruments as defined u/s 2(19A) the Companies Act, 1956 and SEBI did not have jurisdiction to administer those securities since hybrid securities were not included in the definition of ‘securities’ under the Securities and Exchange Board of India Act, 1992 (—SEBI Act), or the Securities Contract Regulation Act, 1956 (—SCRA), but would be governed by the Central Government under section 55A(c) of the Companies Act, 1956.

The Supreme Court held that OFCDs issued by Sahara Group were public issue of debentures, hence securities and once the number 49 is crossed, the proviso to Section 67(3) becomes effective and it is an issue to the public, which attracts Section 73(1) of the Companies Act, 1956 and application for listing becomes mandatory which falls under the administration of SEBI u/s 55A (1)(b) of the Act, 1956. The Court upheld the proceedings of the SEBI and Sahara Group was ordered to refund the amount to investors along with interest.

Institutional placement

It is a capital raising tool wherein a listed company can issue any security (other than warrants) It is a story that is true in every bull run—everyone wants a piece of it. During the bull run in 2007-08, there was a slew of initial public offerings (IPOs) and new fund offerings. This time, too, when the Sensex is trading around its all-time high of 25,000, there are a string of companies ready to use this window of opportunity to raise money through the qualified institutional placement (QIP) route. Many are slated to announce their issuances soon. According to data with Prime Database, a primary market tracker, in 2014 till May, four companies have raised money, a total of 11,454 crore, through QIPs. In all of 2013, 10 companies had raised 8,075 crore, and 12 companies (4,704 crore) in 2012.

What is a QIP?

A QIP is a capital raising tool wherein a listed company can issue equity shares, fully and partly convertible debentures, or any security (other than warrants) that is convertible to equity shares.

Apart from preferential allotment, this is the only other speedy method of private placement whereby a listed company can issue shares or convertible securities to a select group of investors. But unlike in an IPO or an FPO (further public offer), only institutions or qualified institutional buyers (QIBs) can participate in a QIP issuance. QIBs include mutual funds,

domestic financial institutions such as banks and insurance companies, venture capital funds, foreign institutional investors, and others.

There are a few rules to follow. The market regulator has stated that there should be at least two QIBs if the issue size is less than 250 crore, and at least five investors if the size is more than 250 crore. A single investor cannot be allotted more than 50% of the issue.

How is the price decided?

The QIP will be priced not less than the average of the weekly high and low of the closing prices of the equity shares during the two weeks preceding the –relevant" date. The –relevant" date will be the opening date of the issue, as decided by the company's board. In a rising market, such as now, the QIP price is set at an attractive rate.

Why QIP?

For the issuing company, QIPs are less cumbersome than IPOs and FPOs. It doesn't have to file a pre-issue document with the capital markets regulator, and only a placement document with the stock exchanges, which only has details of the issue.

QIP is also a less expensive mode of raising capital than, say, an IPO, FPO or rights issue.

For the QIBs, unlike in an IPO where an anchor investor has to stay invested for a month, there are no such restrictions with QIPs. With the new government, the sentiment towards our economy has changed. The revival has opened a welcome window for companies that have been struggling to raise funds, which is why companies are lining up to raise money.

Qualified institutional placement (QIP) is simply the means whereby a listed company can issue equity shares, fully and partly convertible debentures, or any securities other than warrants which are convertible to equity shares to a Qualified Institutional Buyer (QIB). Apart from preferential allotment, this is the only other method of private placement whereby a listed company can issue shares or convertible securities to a select group of persons. However, it scores over other methods, as it does not involve many of the common procedural requirements such as the submission of pre-issue filings to the market regulator.

Why was it introduced?

The Securities and Exchange Board of India (Sebi) introduced the QIP process in 2006, to prevent listed companies in India from developing an excessive dependence on foreign capital.

The complications associated with raising capital in the domestic markets had led many companies to look at tapping the overseas markets via Foreign Currency Convertible Bonds (FCCB) and Global Depository Receipts (GDR) to fulfil their needs. To keep a check on this process and to give a push to the domestic markets, QIPs were launched.

What are some of the regulations governing a QIP?

To be able to engage in a QIP, companies need to fulfil certain criteria such as being listed on an exchange which has trading terminals across the country and having the minimum public shareholding requirements which are specified in their listing agreement.

During the process of engaging in a QIP, the company needs to issue a minimum of 10% of the

securities issued under the scheme to mutual funds. Moreover, it is mandatory for the company to ensure that there are at least two allottee if the size of the issue is up to Rs 250 crore and at least five allottees if the company is issuing securities above Rs 250 crore.

No individual allottee is allowed to have more than 50% of the total amount issued. Also no issue is allowed to a QIB who is related to the promoters of the company.

Why have qualified institutional placements been in the news lately?

The latest company which adopted the QIP route to raising capital is the cash-strapped real estate major Unitech. While Unitech has managed to garner Rs 1620 crore through QIP, the promoter holding has now come down to 51%. There are also reports that LIC Housing Finance is mulling over a QIP where it is expected to issue shares of the value of up to 10% of its total paid up capital.

About Institutional Placement Programme (IPP)

The Securities & Exchange Board Of India (SEBI) has notified the amendment of ICDR (ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS) Chapter VIII A regarding Institutional Placement Programme (IPP). The details of the Institutional Placement Programme (IPP) are as listed below

Applicability:

The provisions of this Chapter shall apply to issuance of fresh shares and or offer for sale of shares in a listed issuer for the purpose of achieving minimum public shareholding in terms of Rule 19(2)(b) and 19A of the Securities Contracts (Regulation) Rules, 1957.

Definitions:

"eligible securities" shall mean equity shares of same class listed and traded in the stock exchange(s);

- "eligible seller" include listed issuer, promoter/promoter group of listed issuer;
- "institutional placement programme" means a further public offer of eligible securities by an eligible seller, in which the offer, allocation and allotment of such securities is made only to qualified institutional buyers in terms of this Chapter.

Conditions for institutional placement programme.

- An institutional placement programme may be made only after a special resolution approving the institutional placement programme has been passed by the shareholders of the issuer in terms of section 81(1A) of the Companies Act, 1956.
- No partly paid-up securities shall be offered.
- The issuer shall obtain an in-principle approval from the stock exchange(s).

Appointment of merchant banker.

An institutional placement programme shall be managed by merchant banker(s) registered with the Board who shall exercise due diligence.

Offer Document

- The institutional placement programme shall be made on the basis of the offer document which shall contain all material information, including those specified in Schedule XVIII.
- The issuer shall, simultaneously while registering the offer document with the Registrar of Companies, file a copy thereof with the Board and with the stock exchange(s) through the lead merchant banker.
- The issuer shall file the soft copy of the offer document with the Board as specified in Schedule V, along with the fee as specified in Schedule IV.
- The offer document shall also be placed on the website of the concerned stock exchange and of the issuer clearly stating that it is in connection with institutional placement programme and that the offer is being made only to the qualified institutional buyers.
- The merchant banker shall submit to the Board a due diligence certificate as per Form A of Schedule VI, stating that the eligible securities are being issued under institutional placement programme and that the issuer complies with requirements of this Chapter.

Pricing and allocation/allotment:

- The eligible seller shall announce a floor price or price band at least one day prior to the opening of institutional placement programme.
- The eligible seller shall have the option to make allocation/allotment as per any of the following methods –
 - proportionate basis;
 - price priority basis; or
 - criteria as mentioned in the offer document.
- The method chosen shall be disclosed in the offer document.
- Allocation/allotment shall be overseen by stock exchange before final allotment.

Restrictions:

The promoter or promoter group who are offering their eligible securities should not have purchased and/ or sold the eligible securities of the company in the twelve weeks period prior to the offer and they should undertake not to purchase and / or sell eligible securities of the company in the twelve weeks period after the offer.

- Allocation/allotment under the institutional placement programme shall be made subject to the following conditions:
 - Minimum of twenty five per cent. of eligible securities shall be allotted to mutual funds and insurance companies: Provided that if the mutual funds and insurance companies do not subscribe to said minimum percentage or any part thereof, such minimum portion or part thereof may be allotted to other qualified institutional buyers;
 - No allocation/allotment shall be made, either directly or indirectly, to any qualified institutional buyer who is a promoter or any person related to promoters of the issuer:

Provided that a qualified institutional buyer who does not hold any shares in the issuer and who has acquired the rights in the capacity of a lender shall not be deemed to be a person related to promoters.

- The issuer shall accept bids using ASBA facility only.

- The bids made by the applicants in institutional placement programme shall not be revised downwards or withdrawn.

Minimum number of allottees:

- The minimum number of allottees for each offer of eligible securities made under institutional placement programme shall not be less than ten:
 - Provided that no single allottee shall be allotted more than twenty five per cent of the offer size.
- The qualified institutional buyers belonging to the same group or who are under same control shall be deemed to be a single allottee.

Restrictions on size of the offer

- The aggregate of all the tranches of institutional placement programme made by the eligible seller shall not result in increase in public shareholding by more than ten per cent. or such lesser per cent. as is required to reach minimum public shareholding.
- Where the issue has been oversubscribed, an allotment of not more than ten per cent. of the offer size shall be made by the eligible seller.

Period of Subscription and display of demand

- The issue shall be kept open for a minimum of one day or maximum of two days.
- The aggregate demand schedule shall be displayed by stock exchange(s) without disclosing the price.

Withdrawal of offer

The eligible seller shall have the right to withdraw the offer in case it is not fully subscribed.

Transferability of eligible securities

The eligible securities allotted under institutional placement programme shall not be sold by the allottee for a period of one year from the date of allocation/allotment, except on a recognised stock exchange.

QIP Market in India

- State Bank of India's qualified institutional placement (QIP) for an amount of Rs 15,000 crore is the biggest ever. The size of top ten QIPs over the last ten years or so, including the ongoing issue of SBI, aggregates to Rs 60,651 crore.
- Banks and financial institutions accounted for three-fourths of these QIP issues. With benchmark indices rising to record highs and the sentiment on the Street, fund-raising through QIPs has gained the traction.
- So far in FY18, five companies have raised Rs 7,298 crore through the QIP route. SBI's placement was priced with a floor price of Rs 287.58 per share. This issue is nearly twice as large as the earlier one, which fetched the lender Rs 8,032 crore in January 2014.
- In January 2014, SBI had hoped to raise Rs 9,600 crore but ended up raising Rs 8,032 crore with the Life Insurance Corporation of India (LIC) picking up a big chunk of around 41% of the total shares sold.
- After SBI, private sector lender Kotak Mahindra Bank's QIP which raised Rs 5,803 crore in May 2017 is the biggest. Kotak Mahindra Bank sold 6.2 crore shares at Rs 936

per share. SBI's QIP will help the bank bolster its capital adequacy and expand its lending.

- Yes Bank raised Rs 4,906.65 through a QIP in April 2017, selling 3.27 crore shares at Rs 1,500 per piece. More than 60% of the shares were bought by global long-only funds, 20% by domestic long funds and another 20% by international hedge funds.

HDFC, Axis Bank, IndusInd Bank and India Bulls Housing Finance are the other companies from the banking and financial sector, which feature in the top ten QIPs. The non-banking firms who feature in the top ten issues include Reliance Communications and Adani Enterprises – both together raised Rs 8,808 crore. QIP is a capital-raising tool through which listed companies can issue equity shares, fully and partly convertible debentures, or any securities other than warrants that are convertible into equity shares to a qualified institutional buyer.

Role of Different types of Intermediaries

Intermediaries Associated with The Securities Markets

There are two types of intermediaries associated with the securities market. They are

- Primary market intermediaries
- Secondary market intermediaries

Primary Market Intermediaries

The new issue market / activity was regulated by the Controller of Capital Issues (CCI) under the provisions of the Capital Issues (Control) Act, 1947 and the exemption orders and rules made under it. With the repeal of the Act and the consequent abolition of the office of the CCI in 1992, the protection of the interest of the investors in securities market and promotion of the

development and regulation of the market/ activity became the responsibility of the SEBI. To tone up the operations of the new issues in the country, it has put in place rigorous measures. These cover both the major intermediaries as well as the activities. So, we will discuss here, various intermediaries, their regulation and SEBI guidelines related to them. The following intermediaries are part of Primary market

- Merchant bankers
- Underwriters
- Bankers to an Issue
- Portfolio managers
- Debenture trustees
- Registrars to an Issue and Share Transfer Agents

Merchant bankers

Merchant bankers play an important role in issue management process. Lead managers (category I merchant bankers) have to ensure correctness of the information furnished in the offer document. They have to ensure compliance with SEBI rules and regulations as also Guidelines for Disclosures and Investor Protection. To this effect, they are required to submit to SEBI a due diligence certificate confirming that the disclosures made in the draft prospectus or letter of offer are true, fair and adequate to enable the prospective investors to make a well informed investment decision.

The role of merchant bankers in performing their due diligence functions has become even more important with the strengthening of disclosure requirements and with SEBI giving up the vetting of prospectuses. SEBI's various operational guidelines issued during the year to merchant bankers primarily addressed the need to enhance the standard of disclosures.

It was felt that a further strengthening of the criteria for registration of merchant bankers was necessary, primarily through an increase in the net worth requirements, so that their capital would be commensurate with the level of activities undertaken by them. With this in view, the net worth requirement for category I merchant bankers was raised in 1995-96 to Rs. 5 crore. In 1996-97, the SEBI (Merchant Bankers) Regulations, 1992 were amended to require the payment of fees for each letter of offer or draft prospectus that is filed with SEBI. Part III gives further details of the registration of merchant bankers during 1996-97.

The salient features of the SEBI framework, related to merchant bankers are discussed as under.

Registration: Merchant bankers require compulsory registration with the SEBI to carry out their activities. Previously there were four categories of merchant bankers, depending upon the activities. Now, since Dec. 1997, there is only one category of registered merchant banker and they perform all activities.

Grant of Certificate: The SEBI grants a certificate of registration to applicant if it fulfills all the conditions like (i) it is a body corporate and is not a NBFC (ii) it has got necessary infrastructure to support the business activity (iii) it has appointed at least two qualified and experienced (in merchant banking) persons (iv) its registration is in the general interest of investors.

Capital Adequacy Requirement: A merchant banker must have adequate capital to support its business. Hence SEBI grants recognition to only those merchant bankers who have paid up capital and free reserves of minimum Rs. 1 crore. Fee: A merchant banker has to pay a registration fee of Rs. 5 lakh and renewal fees of Rs. 2.5 lakh every three years from the fourth year from the date of registration.

Code of Conduct: Every merchant banker has to abide by the code of conduct, so as to maintain highest standards of integrity and fairness, quality of services, due diligence and professional judgment in all his dealings with the clients and other people. A merchant banker has always to endeavor to (a) render the best possible advice to the clients regarding clients needs and requirements, and his own professional skill and (b) ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

Restriction on Business: No merchant banker, other than a bank/public financial institution is permitted to carry on business other than that in the securities market w.e.f. Dec.1997. However, a merchant banker who is registered with RBI as a primary dealer/satellite dealer may carry on such business as may be permitted by RBI w.e.f. Nov.1999.

Maximum number of lead managers: The maximum number of lead managers is related to the size of the issue. For an issue of size less than Rs. 50 crores, two lead managers are appointed. For size groups of 50 to 100 crores and 100 to 200 crores, the maximum permissible lead managers are three and four respectively. A company can appoint five and five or more (as approved by SEBI) lead managers in case of issue sizes between Rs.200 to 400 crores and above Rs.400 crores respectively.

Responsibilities of Lead Managers: Every lead manager has to enter into an agreement with the issuing companies setting out their mutual rights, liabilities and obligation relating to such issues and in particular to disclosure, allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. It is necessary for a lead manager to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakh whichever is less.

Due diligence certificate: The lead manager is responsible for the verification of the contents of a prospectus / letter of offer in respect of an issue and the reasonableness of the views expressed in them. He has to submit to the SEBI at least two weeks before the opening of the issue for subscription a due diligence certificate.

Submission of documents: The lead managers to an issue have to submit at least two weeks before the date of filing with the ROC/regional SE or both, particulars of the issue, draft prospectus/ letter of offer, other literature to be circulated to the investors / shareholders, and so on to the SEBI.

Underwriters

Underwriters are required to register with SEBI in terms of the SEBI (Underwriters) Rules and Regulations, 1993. In addition to underwriters registered with SEBI in terms of these regulations, all registered merchant bankers in categories I, II and III and stockbrokers and

mutual funds registered with SEBI can function as underwriters. Part III gives further details of registration of underwriters. In 1996-97, the SEBI (Underwriters) Regulations, 1993 were amended mainly pertaining to some procedural matters.

Though underwriting is not mandatory after April 1995, its organization is an important element of primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers / merchant bankers to the issues.

Registration: To act as underwriter, a certificate of registration must be obtained from SEBI. On application registration is granted to eligible body corporate with adequate infrastructure to support the business and with net worth not less than Rs. 20 lakhs.

Fee: Underwriters had to pay Rs. 5 lakh as registration fee and Rs. 2 lakh as renewal fee every three years from the fourth year from the date of initial registration. Failure to pay renewal fee leads to cancellation of certificate of registration.

Code of conduct: Every underwriter has at all times to abide by the code of conduct; he has to maintain a high standard of integrity, dignity and fairness in all his dealings. He must not make any written or oral statement to misrepresent (a) the services that he is capable of performing for the issuer or has rendered to other issues or (b) his underwriting commitment.

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

General responsibilities: An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all underwriting agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

Bankers to an Issue

Scheduled banks acting as bankers to an issue are required to be registered with SEBI in terms of the SEBI (Bankers to the Issue) Rules and Regulations, 1994. These regulations lay down eligibility criteria for bankers to an issue and require registrants to meet periodic reporting requirements. Part III gives further details of registration of bankers to an issue.

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

Registration: To carry on activity as a banker to issue, a person must obtain a certificate of registration from the SEBI. The applicant should be a scheduled bank. Every banker to an issue had to pay to the SEBI an annual fee of Rs. 5 lakh and renewal fee of Rs. 2.5 lakh every three years from the fourth year from the date of

initial registration. Non-payment of the prescribed fee may lead to the suspension of the registration certificate.

General Obligations and Responsibilities to Furnish Information: When required, a banker to an issue has to furnish to the SEBI the following information : (a) the number of issues for which he was engaged as banker to an issue (b) the number of applications / details of the applications money received (c) the dates on which applications from investors were forwarded to the issuing company / registrar to an issue (d) the dates / amount of refund to the investors.

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

Agreement with issuing companies: Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centers at which application/ application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the baker stating the number of applications and the amount of money received from the investor.

Code of Conduct: Every banker to an issue has to abide by a code of conduct. 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. A banker to an issue should always endeavor to render the best possible advice to his clients and ensure that all professional dealings are effected in a prompt, efficient and cost-effective manner.

Brokers to the Issue: Brokers are persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of brokers is not compulsory and the companies are free to appoint any number of brokers. The managers to the issue and the official brokers organize the preliminary distribution of securities and procure direct subscription from as large or as wide a circle of investors as possible. A copy of the consent letter from all the brokers to the issue, should be filed with the prospectus to the ROC. The brokerage applicable to all types of public issue of industrial securities is fixed at 1.5%, whether the issue is underwritten or not. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5%. Brokerage is not allowed in respect of promoters' quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders. Brokerage is not payable when the applications are made by the institutions/ bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the under subscription of the issues.

Portfolio managers

Portfolio manager are defined as persons who in pursuance of a contract with clients, advise, direct, undertake on their behalf the management/ administration of portfolio of securities/

funds of clients. The term portfolio means the total securities belonging to any person. The portfolio management can be

- (i) Discretionary or
- (ii) Non-discretionary.

The first type of portfolio management permits the exercise of discretion in regard to investment / management of the portfolio of the securities / funds. In order to carry on portfolio services, a certificate of registration from SEBI is mandatory. The certificate of registration for portfolio management services is granted to eligible applicants on payment of Rs.5 lakh as registration fee. Renewal may be granted by SEBI on payment of Rs. 2.5 lakh as renewal fee (every three years).

The registered portfolio managers exclusively carry on portfolio management activities. In addition all merchant bankers in categories I and II can act as portfolio managers with prior permission from SEBI. Part III gives further details of the registration of portfolio managers.

Debenture trustees

Debenture trustees are registered with SEBI in terms of the SEBI (Debenture Trustees) Rules and Regulations, 1993. Since 1995-96, SEBI has been monitoring the working of debenture trustees by calling for details regarding compliance by issuers of the terms of the debenture trust deed, creation of security, payment of interest, redemption of debentures and redressal of complaints of debenture holders regarding non-receipt of interest/redemption proceeds on due dates. Part III gives further details of the registration of debenture trustees.

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company. To act as a debenture trustee, a certificate from the SEBI is necessary. Only scheduled commercial banks, PFIs, Insurance companies and companies are entitled to act as a debenture trustees. The certificate of registration is granted to suitable applicants with adequate infrastructure, qualified manpower and requisite funds. Registration fee is Rs. 5 lakh and renewal fee is Rs. 2.5 lakh every three years.

Responsibilities and obligations: Before the issue of debentures for subscription, the consent in writing to the issuing company to act as a debenture trustee is obligatory. He has to accept the trust deed which contains matters pertaining to the different aspects of the debenture issue.

Duties: The main duties of a debenture trustee include the following:

- i. Call for periodical report from the company.
- ii. Inspection of books of accounts, records, registration of the company and the trust property to the extent necessary for discharging claims.
- iii. Take possession of trust property, in accordance with the provisions of the trust deed.
- iv. Enforce security in the interest of the debenture holders.
- v. Carry out all the necessary acts for the protection of the debenture holders and to the needful to resolve their grievances.

- vi. Ensure refund of money in accordance with the Companies Act and the stock exchange listing agreement.
- vii. Exercise due diligence to ascertain the availability of the assets of the company by way of security as well as their adequacy / sufficiency to discharge claims when they become due.
- viii. Take appropriate measure to protect the interest of the debenture holders as soon as any breach of trust deed/ law comes to notice.
- ix. Ascertain the conversion / redemption of debentures in accordance with the provisions / conditions under which they were offered to the holders.
- x. Inform the SEBI immediately of any breach of trust deed / provisions of law.

In addition, it is also the duty of trustees to call or ask the company to call a meeting of the debenture holders on a requisition in writing signed by debenture holders, holding at least one-tenth of the outstanding amount, or on the happening of an event which amounts to a default or which, in his opinion, affects their interest.

Registrars to an Issue and Share Transfer Agents

The registrars to an issue, as an intermediary in the primary market, carry on activities such as collecting applications from the investors, keeping a proper record of applications and money received from the investors or paid to the sellers of securities and assisting companies in determining the basis of allotment of securities in consultation with the stock exchanges, finalizing the allotment of securities and processing / dispatching allotment letters, refund orders, certificates and other related documents in respect of the issue of capital.

To carry on their business, the registrars must be registered with the SEBI. Registrars to an issue (RTI) and share transfer agents (STA) are registered with SEBI in terms of the SEBI (Registrar to the Issue and Share Transfer Agent) Rules and Regulations, 1993. Under these regulations, registration commenced in 1993-94 and is granted under two categories:

- category I - to act as both registrar to the issue and share transfer agent and
- category II - to act as either registrar to an issue or share transfer agent.
- Category I registrars must have minimum net worth of Rs. 6 lakhs and Category II, Rs. 3 lakhs
- Category I is required to pay a initial registration fee of Rs. 50,000 and renewal fee of Rs.40,000 every three years, where as Category II is required to pay Rs.30,000 and Rs. 25,000 respectively.

With the setting up of the depository and the expansion of the network of depositories, the traditional work of registrars is likely to undergo a change.

Code of Conduct: The registrars to an issue and the share transfer agents have to maintain high standards of integrity and fairness in all dealings with their clients and other registrars to the issue and share transfer agents in the conduct of the business. They should endeavor to ensure that

- (a) enquiries from investors are adequately dealt with, and
- (b) adequate steps are taken for proper allotment of securities and refund of application money without delay and as per law.

Also, they should not generally and particularly in respect of any dealings in securities to be a party to

- (a) creation of false market,
- (b) price rigging or manipulation
- (c) passing of unpublished price sensitive information to brokers, members of stock exchanges and other intermediaries in the securities market or take any other action which is not in the interest of the investors and
- (d) no registrar to an issue, share transfer agent or any of its directors, partners or managers managing all the affairs of the business is either on their respective accounts, or through their respective accounts, or through their associates or family members, relatives or friends indulges in any insider trading.

Secondary Market Intermediaries

There are two types of secondary market intermediaries

1. Stock brokers
2. Sub brokers

Stock brokers

All stock brokers dealing in securities are registered with SEBI in terms of SEBI (Stock Brokers and Sub Brokers) Regulation 1992. During 1996-97, 391 additional brokers were registered with SEBI making the total registered membership to 8,867 as on March 31, 1997.

Sub brokers

In many cases, individual investors transact in securities through sub brokers. It is therefore absolutely imperative to regulate this class of intermediary. As on March 31, 1997 only 1,798 sub brokers were registered with SEBI. The main reason for the limited success in registering large number of sub brokers is that brokers are reluctant to take responsibility of the acts of the sub-brokers. Measures initiated by SEBI for bringing sub-brokers more fully under the ambit of regulatory oversight have been described earlier in this Report.

Listing of Securities

Listing means the admission of securities of a company to trading on a stock exchange. Listing is not compulsory under the Companies Act. It becomes necessary when a public limited company desires to issue shares or debentures to the public. When securities are listed in a stock exchange, the company has to comply with the requirements of the exchange.

A company has to list its securities on the stock exchange for trading in the stock market. Listing of securities means a company is registered on the stock exchange. The company has to fulfill the conditions mentioned in companies act. To list its securities in stock exchange company has to offer its securities to the public for subscription. A company must have minimum equity capital of Rs. 5 crores and 60% of this amount are offered to the public, for Shares Listing on the stock exchange.

Objectives of Listing

The major objectives of listing are

1. To provide ready marketability and liquidity of a company's securities.
2. To provide free negotiability to stocks.
3. To protect shareholders and investors interests.
4. To provide a mechanism for effective control and supervision of trading.

Listing requirements

A company which desires to list its shares in a stock exchange has to comply with the following requirements:

1. Permission for listing should have been provided for in the Memorandum of Association and Articles of Association.
2. The company should have issued for public subscription at least the minimum prescribed percentage of its share capital (49 percent).
3. The prospectus should contain necessary information with regard to the opening of subscription list, receipt of share application etc.
4. Allotment of shares should be done in a fair and reasonable manner. In case of over subscription, the basis of allotment should be decided by the company in consultation with the recognized stock exchange where the shares are proposed to be listed.
5. The company must enter into a listing agreement with the stock exchange. The listing agreement contains the terms and conditions of listing. It also contains the disclosures that have to be made by the company on a continuous basis.

Minimum Public Offer

A company which desires to list its securities in a stock exchange, should offer at least sixty percent of its issued capital for public subscription. Out of this sixty percent, a maximum of eleven percent in the aggregate may be reserved for the Central government, State government, their investment agencies and public financial institutions.

The public offer should be made through a prospectus and through newspaper advertisements. The promoters might choose to take up the remaining forty percent for themselves, or allot a part of it to their associates.

Fair allotment

Allotment of shares should be made in a fair and transparent manner. In case of over subscription, allotment should be made in an equitable manner in consultation with the stock exchange where the shares are proposed to be listed.

In case, the company proposes to list its shares in more than one exchange, the basis of allotment should be decided in consultation with the stock exchange which is located in the place in which the company's registered office is located.

Shares Listing Procedure

According to Regulation 4(2) of **SEBI** (Issue of Capital and Disclosure Requirements) Regulations 2009, no issuer shall make a public issue or rights issue of securities unless they

make an application to one or more recognized stock exchanges and had chosen one of them as a designated stock exchange.

In the case of Initial Public offer, it is required for the issuer to make an application for Shares Listing in at least one recognized stock exchange having nationwide trading terminals.

Conditions

The company has to follow specified conditions before Shares listing in stock exchange:

- Shares of a company shall be offered to the public through the prospectus, and 25% of securities must be offered.
- Date of opening of subscription, receipt of the application and other details should be mentioned in the prospectus.
- The capital structure of the company should be wide and the securities of the company should be in public interest.
- The requirement for the Minimum issued is Rs. 3 Crores out of which 1.8 Crore must be offered to the public.
- There is a requirement of at least 5 public shareholders in respect of every Rs. 1 Lakh of fresh issue of capital and 10 shareholders for every Rs.1 lakh of the offer of existing capital.
- In the case of excess application money, the company has to pay interest within the range of 4% to 15% in case there is a delay in the refund and delay should not be more than 10 weeks from the date of closure of subscription list.
- The company has paid-up share capital of more than Rs. 5 crores should get itself registered in the recognized stock exchange and compulsorily on the regional stock exchange.
- The auditor or secretary of the company has to declare that share certificate has been stamped for listing so that shares belonging to promoter's quota cannot be sold or transferred for 5 years.

An article of Association must contain the following provisions:

1. A common form for transfer shall be used;
2. Fully paid shares shall be utilized;
3. No lien on fully paid shares;
4. Calls paid in advance will not carry the right to dividend and cannot be forfeited before claims become time-barred.
5. Only after the sanction by the general meeting, option to call off shares shall be given;
 - Letter of allotment, Letter of regret and letter of a right shall be issued.
 - Receipts for all securities deposited either by way of registration or split.
 - Consolidation and renewal certificates will be issued for a certificate of the division, letter of allotment, transfer, and letter of rights, etc.
 - The company has to notify stock exchange regarding the board meeting, change in the composition of a board of directors and the case of the new issue of securities in place of a reissue of forfeited shares.
 - Due notice should be given to stock exchange, for closing transfer books for a declaration of dividend, rights issue or bonus issue.
 - After the annual general meeting, the annual return is required to be filed.
 - The company is required to comply with the conditions imposed by the stock exchange for the listing of security.

Different Types of Listing of Securities

Listing of securities happens in any of the following cases

1. Initial Listing
2. Public issue
3. Right Issue
4. Bonus Shares
5. Listing for merger or amalgamation

Initial Listing

In case shares of the company are listed for the first time in the stock exchange.

Public issue

The company who has listed its shares on a stock market comes out with a public issue.

Right Issue

The company who has listed its shares in a stock exchange issues shares to its existing shareholders.

Bonus Shares

When a listed company issue bonus shares to its existing shareholders for capitalizing its profits.

Listing for merger or amalgamation

The amalgamated company issues new shares to the shareholders of the merged company, and these new shares are listed.

Procedure for Listing Requirements

The following are the steps to be followed in listing of a company's securities in a stock exchange:

1. The promoters should first decide on the stock exchange or exchanges where they want the shares to be listed.
2. They should contact the authorities to the respective stock exchange/ exchanges where they propose to list.
3. They should discuss with the stock exchange authorities the requirements and eligibility for listing.
4. The proposed Memorandum of Association, Articles of Association and Prospectus should be submitted for necessary examination to the stock exchange authorities
5. The company then finalizes the Memorandum, Articles and Prospectus
6. Securities are issued and allotted.
7. The company enters into a listing agreement by paying the prescribed fees and submitting the necessary documents and particulars.
8. Shares are then and are available for trading.

Public Company has to submit the following documents to Shares Listing in stock exchange:

- Certified copy of Memorandum & Article of Association;
- Prospectus & agreement with underwriters;

- Details of Capital Structure;
- Copies of an advertisement offering securities during the last 5 years;
- Copies of financial statement & auditor's report for the last 5 years;
- Copy of shares & debentures, letter of allotment and letter of regret;
- Details of the company since incorporation including changes in the capital structure, borrowings, etc.;
- Details of shares or debentures issued for consideration other than cash;
- A statement defining the distribution of shares and other details related to the commission, brokerage, discounts, or terms related to issue of shares;
- Agreement with a financial institution, if any;
- Details of shares forfeited;
- Details of securities about which permission to deal with are applied for;
- A copy of consent from SEBI.

Procedure

The application is made to the listing committee of the stock exchange by the company, and then the listing committee will scrutinize the application form of the company.

Stock Exchange will ensure the following:

- Whether the financial position of the company is sound or not;
- Solvency & liquidity positions of the company;

In case the application for listing is accepted then the listing company will have to execute a listing agreement with the stock exchange.

Obligations required to be followed by the company:

- It is required to treat all application with equal fairness.
- In the case of oversubscription, the process of allotment will be decided in consultation with stock exchanges.

In the case of a change in management, capital structure or bonus or right issue of shares.

MODULE II: OVERSEAS CAPITAL MARKET ISSUES

Introduction to International Financial and Capital Markets

International Financial Markets

International financial markets consist of mainly international banking services and international money market. The banking services include the services such as trade financing, foreign exchange, foreign investment, hedging instruments such as forwards and options, etc. All these banking services are provided by international banks. International money market includes the Eurocurrency markets, Euro credits, Euro notes, Euro commercial Paper etc.

International financial markets, as we saw, can broadly be classified into international banking and international money market. International markets are accessed by multinational corporations more than anybody else. Traders or businesses having import and export transaction also have frequent access to these markets.

INTERNATIONAL BANKING

International banking is quite different from the domestic banking as there are several services which are required only in an international environment and are provided by international banks. Following are such services:

TRADE FINANCING

Several trade financing services are required by importers and exporters. An importer importing goods from outside may wish to open a *letter of credit* to be given to the exporter from another country. The importer is not known to the exporter and therefore the deal is routed through the banks.

Documentary collection is another in which the exporter of goods provides the bank with all the documents required for releasing the goods under shipment. They are handed over to the importer only after the payment is made to the bank.

A trader who is not a place invest a lot of money into his debtors can avail *factoring and forfeiting* services. Under this service, the trader hands over his accounts receivables into a bank or third party's hand for collection. The trader effectively sells his debtors at a discount and frees his money.

FOREIGN EXCHANGE

International businesses have frequent transactions in foreign currencies and therefore have payables or receivables in those currencies. To close such transactions the businesses need foreign exchange which is provided by international banks and institutions. These institutions have their bid and ask rates for such currency buying and deposits. They buy or accept currencies at a bid price which is less than their ask price at which they sell. These banks have the privilege to trade foreign exchange in international markets.

FOREIGN INVESTMENTS

We all know that the banks are no more doing traditional banking. They have a gamut of services to be provided to their clients both domestic and international. Foreign investment is one of such services being provided by multinational banks to their clients. Since these banks

have the presence in many countries; they are better positioned to provide consulting services to their clients for their investing requirements.

HEDGING EXCHANGE RATE RISK

It is known fact that the dealing in foreign currency is risky. The risk is assumed because the prices of currencies are very fluctuating. The price at which a deal is struck may not remain constant till all the transactions are over. Here is where the hedging plays an important role. With the help of hedging instruments such as forwards and options, such risk can be mitigated and planned profits may be attained. Such instruments are the contracts which lock the prices of currency on a particular day in future.

INTERNATIONAL MONEY MARKET

International money market mainly deals in Eurocurrency deposits, Euro credits, Euro notes, Euro commercial Papers etc. All these involve foreign currencies. Eurocurrency deposits are deposits of foreign currency in a bank situated in a country which is different from the country of that foreign currency. An Indian depositing US dollars in Chinese bank situated in China is called Eurocurrency deposit.

Euro credits are a kind of loan extended to corporations in a currency other than the home currencies. These are normally short term to the medium term loan and are extended by a syndicate of banks because the quantum of loan is too big and the risk cannot be assumed just by one bank.

Likewise, the other money market instruments include euro notes, euro commercial papers etc.

In essence, the international financial market is even bigger a market available for multinational and other domestic companies. A growing business when reaches international heights also has a lot of services to be offered by international banks and financial institutions. These markets provide a business with a platform to take their businesses to a different height.

International Capital Markets

What Are International Capital Markets?

A capital market is basically a system in which people, companies, and governments with an excess of funds transfer those funds to people, companies, and governments that have a shortage of funds. This transfer mechanism provides an efficient way for those who wish to borrow or invest money to do so. For example, every time someone takes out a loan to buy a car or a house, they are accessing the capital markets. Capital markets carry out the desirable economic function of directing capital to productive uses.

There are two main ways that someone accesses the capital markets—either as debt or equity. While there are many forms of each, very simply, debt is money that's borrowed and must be repaid, and equity is money that is invested in return for a percentage of ownership but is not guaranteed in terms of repayment.

In essence, governments, businesses, and people that save some portion of their income invest their money in capital markets such as stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments through the capital markets. When savers make investments, they convert risk-free assets such as cash or savings into risky assets with the hopes of receiving a future benefit. Since all

investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Basically, a higher rate of return means a higher risk.

For example, let's imagine a beverage company that makes \$1 million in gross sales. If the company spends \$900,000, including taxes and all expenses, then it has \$100,000 in profits. The company can invest the \$100,000 in a mutual fund (which are pools of money managed by an investment company), investing in stocks and bonds all over the world. Making such an investment is riskier than keeping the \$100,000 in a savings account. The financial officer hopes that over the long term the investment will yield greater returns than cash holdings or interest on a savings account. This is an example of a form of direct finance. In other words, the beverage company bought a security issued by another company through the capital markets. In contrast, indirect finance involves a financial intermediary between the borrower and the saver. For example, if the company deposited the money in a savings account, and then the savings bank lends the money to a company (or a person), the bank is an intermediary. Financial intermediaries are very important in the capital marketplace. Banks lend money to many people, and in so doing create economies of scale. This is one of the primary purposes of the capital markets.

Capital markets promote economic efficiency. In the example, the beverage company wants to invest its \$100,000 productively. There might be a number of firms around the world eager to borrow funds by issuing a debt security or an equity security so that it can implement a great business idea. Without issuing the security, the borrowing firm has no funds to implement its plans. By shifting the funds from the beverage company to other firms through the capital markets, the funds are employed to their maximum extent. If there were no capital markets, the beverage company might have kept its \$100,000 in cash or in a low-yield savings account. The other firms would also have had to put off or cancel their business plans.

International capital markets are the same mechanism but in the global sphere, in which governments, companies, and people borrow and invest across national boundaries. In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following benefits:

Higher returns and cheaper borrowing costs.

These allow companies and governments to tap into foreign markets and access new sources of funds. Many domestic markets are too small or too costly for companies to borrow in. By using the international capital markets, companies, governments, and even individuals can borrow or invest in other countries for either higher rates of return or lower borrowing costs.

Diversifying risk.

The international capital markets allow individuals, companies, and governments to access more opportunities in different countries to borrow or invest, which in turn reduces risk. The theory is that not all markets will experience contractions at the same time.

The structure of the capital markets falls into two components—primary and secondary. The primary market is where new securities (stocks and bonds are the most common) are issued. If a corporation or government agency needs funds, it issues (sells) securities to purchasers in the primary market. Big investment banks assist in this issuing process as

intermediaries. Since the primary market is limited to issuing only new securities, it is valuable but less important than the secondary market.

The vast majority of capital transactions take place in the secondary market. The secondary market includes stock exchanges (the New York Stock Exchange, the London Stock Exchange, and the Tokyo Nikkei), bond markets, and futures and options markets, among others. All these secondary markets deal in the trade of securities. The term securities includes a wide range of financial instruments. You're probably most familiar with stocks and bonds. Investors have essentially two broad categories of securities available to them: equity securities, which represent ownership of a part of a company, and debt securities, which represent a loan from the investor to a company or government entity.

Creditors, or debt holders, purchase debt securities and receive future income or assets in return for their investment. The most common example of a debt instrument is the bond. When investors buy bonds, they are lending the issuers of the bonds their money. In return, they will receive interest payments usually at a fixed rate for the life of the bond and receive the principal when the bond expires. All types of organizations can issue bonds.

Stocks are the type of equity security with which most people are familiar. When investors buy stock, they become owners of a share of a company's assets and earnings. If a company is successful, the price that investors are willing to pay for its stock will often rise; shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. Stock prices are also subject to both general economic and industry-specific market factors.

The key to remember with either debt or equity securities is that the issuing entity, a company or government, only receives the cash in the primary market issuance. Once the security is issued, it is traded; but the company receives no more financial benefit from that security. Companies are motivated to maintain the value of their equity securities or to repay their bonds in a timely manner so that when they want to borrow funds from or sell more shares in the market, they have the credibility to do so.

For companies, the global financial, including the currency, markets

- (1) provide stability and predictability,
- (2) help reduce risk, and
- (3) provide access to more resources.

One of the fundamental purposes of the capital markets, both domestic and international, is the concept of liquidity, which basically means being able to convert a noncash asset into cash without losing any of the principal value. In the case of global capital markets, liquidity refers to the ease and speed by which shareholders and bondholders can buy and sell their securities and convert their investment into cash when necessary. Liquidity is also essential for foreign exchange, as companies don't want their profits locked into an illiquid currency.

Major Components of the International Capital Markets

International Equity Markets

Companies sell their stock in the equity markets. International equity markets consists of all the stock traded outside the issuing company's home country. Many large global companies seek

to take advantage of the global financial centers and issue stock in major markets to support local and regional operations.

For example, ArcelorMittal is a global steel company headquartered in Luxembourg; it is listed on the stock exchanges of New York, Amsterdam, Paris, Brussels, Luxembourg, Madrid, Barcelona, Bilbao, and Valencia. While the daily value of the global markets changes, in the past decade the international equity markets have expanded considerably, offering global firms increased options for financing their global operations. The key factors for the increased growth in the international equity markets are the following:

- Growth of developing markets.
- Drive to privatize.
- Investment banks.
- Technology advancements.

Growth of developing markets.

As developing countries experience growth, their domestic firms seek to expand into global markets and take advantage of cheaper and more flexible financial markets.

Drive to privatize. In the past two decades, the general trend in developing and emerging markets has been to privatize formerly state-owned enterprises. These entities tend to be large, and when they sell some or all of their shares, it infuses billions of dollars of new equity into local and global markets. Domestic and global investors, eager to participate in the growth of the local economy, buy these shares.

Investment banks.

With the increased opportunities in new emerging markets and the need to simply expand their own businesses, investment banks often lead the way in the expansion of global equity markets. These specialized banks seek to be retained by large companies in developing countries or the governments pursuing privatization to issue and sell the stocks to investors with deep pockets outside the local country.

Technology advancements.

The expansion of technology into global finance has opened new opportunities to investors and companies around the world. Technology and the Internet have provided more efficient and cheaper means of trading stocks and, in some cases, issuing shares by smaller companies.

International Bond Markets

Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond. The international bond market consists of all the bonds sold by an issuing company, government, or entity outside their home country. Companies that do not want to issue more equity shares and dilute the ownership interests of existing shareholders prefer using bonds or debt to raise capital (i.e., money). Companies might access the international bond markets for a variety of reasons, including funding a new production facility or expanding its operations in one or more countries. There are several types of international bonds, which are detailed in the next sections.

Foreign Bond

A foreign bond is a bond sold by a company, government, or entity in another country and issued in the currency of the country in which it is being sold. There are foreign exchange,

economic, and political risks associated with foreign bonds, and many sophisticated buyers and issuers of these bonds use complex hedging strategies to reduce the risks. For example, the bonds issued by global companies in Japan denominated in yen are called *samurai bonds*. As you might expect, there are other names for similar bond structures. Foreign bonds sold in the United States and denominated in US dollars are called *Yankee bonds*. In the United Kingdom, these foreign bonds are called *bulldog bonds*. Foreign bonds issued and traded throughout Asia except Japan, are called *dragon bonds*, which are typically denominated in US dollars. Foreign bonds are typically subject to the same rules and guidelines as domestic bonds in the country in which they are issued. There are also regulatory and reporting requirements, which make them a slightly more expensive bond than the Eurobond. The requirements add small costs that can add up given the size of the bond issues by many companies.

Eurobond

A Eurobond is a bond issued outside the country in whose currency it is denominated. Eurobonds are not regulated by the governments of the countries in which they are sold, and as a result, Eurobonds are the most popular form of international bond. A bond issued by a Japanese company, denominated in US dollars, and sold only in the United Kingdom and France is an example of a Eurobond.

Global Bond

A global bond is a bond that is sold simultaneously in several global financial centers. It is denominated in one currency, usually US dollars or Euros. By offering the bond in several markets at the same time, the company can reduce its issuing costs. This option is usually reserved for higher rated, creditworthy, and typically very large firms.

Did You Know?

As the international bond market has grown, so too have the creative variations of bonds, in some cases to meet the specific needs of a buyer and issuer community. Sukuk, an Arabic word, is a type of financing instrument that is in essence an Islamic bond. The religious law of Islam, Sharia, does not permit the charging or paying of interest, so Sukuk securities are structured to comply with the Islamic law. —An IMF study released in 2007 noted that the Issuance of Islamic securities (sukuk) rose fourfold to \$27 billion during 2004–06. While 14 types of sukuk are recognized by the Accounting and Auditing Organization of Islamic Finance Institutions, their structure relies on one of the three basic forms of legitimate Islamic finance, murabahah (synthetic loans/purchase orders), musharakah/mudharabah (profit-sharing arrangements), and ijara (sale-leasebacks), or a combination thereof.‖

The Economist notes —that by 2000, there were more than 200 Islamic banks...and today \$700 billion of global assets are said to comply with sharia law. Even so, traditional finance houses rather than Islamic institutions continue to handle most Gulf oil money and other Muslim wealth.‖

—More worrying still, the rules for Islamic finance are not uniform around the world. A Kuwaiti Muslim cannot buy a Malaysian sukuk (sharia-compliant bond) because of differing definitions of what constitutes usury (interest). Indeed, a respected Islamic jurist recently denounced most sukuk as godless. Nor are banking licenses granted easily in most Muslim countries. That is why big Islamic banks are so weak. Often they are little more than loose collections of subsidiaries. They also lack home-grown talent: most senior staff are poached from multinationals.‖ But in 2009, one entrepreneur, Adnan Yousif, made headlines as he tried

to change that and create the world's biggest Islamic bank. While his efforts are still in progress, it's clear that Islamic banking is a growing and profitable industry niche.

Eurocurrency Markets

The Eurocurrency markets originated in the 1950s when communist governments in Eastern Europe became concerned that any deposits of their dollars in US banks might be confiscated or blocked for political reasons by the US government. These communist governments addressed their concerns by depositing their dollars into European banks, which were willing to maintain dollar accounts for them. This created what is known as the Eurodollar—US dollars deposited in European banks. Over the years, banks in other countries, including Japan and Canada, also began to hold US dollar deposits and now Eurodollars are any dollar deposits in a bank outside the United States. (The prefix *Euro-* is now only a historical reference to its early days.) An extension of the Eurodollar is the Eurocurrency, which is a currency on deposit outside its country of issue. While Eurocurrencies can be in any denominations, almost half of world deposits are in the form of Eurodollars.

The Euro-loan market is also a growing part of the Eurocurrency market. The Euroloan market is one of the least costly for large, creditworthy borrowers, including governments and large global firms. Euro-loans are quoted on the basis of LIBOR, the London Interbank Offer Rate, which is the interest rate at which banks in London charge each other for short-term Eurocurrency loans.

The primary appeal of the Eurocurrency market is that there are no regulations, which results in lower costs. The participants in the Eurocurrency markets are very large global firms, banks, governments, and extremely wealthy individuals. As a result, the transaction sizes tend to be large, which provides an economy of scale and nets overall lower transaction costs. The Eurocurrency markets are relatively cheap, short-term financing options for Eurocurrency loans; they are also a short-term investing option for entities with excess funds in the form of Eurocurrency deposits.

Offshore Centers

The first tier of centers in the world are the world financial centers, which are in essence central points for business and finance. They are usually home to major corporations and banks or at least regional headquarters for global firms. They all have at least one globally active stock exchange. While their actual order of importance may differ both on the ranking format and the year, the following cities rank as global financial centers: New York, London, Tokyo, Hong Kong, Singapore, Chicago, Zurich, Geneva, and Sydney.

Did You Know?

The Economist reported in December 2009 that a —poll of Bloomberg subscribers in October found that Britain had dropped behind Singapore into third place as the city most likely to be the best financial hub two years from now. A survey of executives...by Eversheds, a law firm, found that Shanghai could overtake London within the next ten years.‖—Foul-Weather Friends,‖ Economist, December 17, 2009, accessed February 2, 2011, <http://www.economist.com/node/15127550>. Many of these changes in rank are due to local costs, taxes, and regulations. London has become expensive for financial professionals, and changes in the regulatory and political environment have also lessened the city's immediate popularity. However, London has remained a premier financial center for more than two centuries, and it would be too soon to assume its days as one of the global financial hubs is over.

In addition to the global financial centers are a group of countries and territories that constitute offshore financial centers. An offshore financial center is a country or territory where there are few rules governing the financial sector as a whole and low overall taxes. As a result, many offshore centers are called tax havens. Most of these countries or territories are politically and economically stable, and in most cases, the local government has determined that becoming an offshore financial center is its main industry. As a result, they invest in the technology and infrastructure to remain globally linked and competitive in the global finance marketplace.

Examples of well-known offshore financial centers include Anguilla, the Bahamas, the Cayman Islands, Bermuda, the Netherlands, the Antilles, Bahrain, and Singapore. They tend to be small countries or territories, and while global businesses may not locate any of their operations in these locations, they sometimes incorporate in these offshore centers to escape the higher taxes they would have to pay in their home countries and to take advantage of the efficiencies of these financial centers. Many global firms may house financing subsidiaries in offshore centers for the same benefits. For example, Bacardi, the spirits manufacturer, has \$6 billion in revenues, more than 6,000 employees worldwide, and twenty-seven global production facilities. The firm is headquartered in Bermuda, enabling it to take advantage of the lower tax rates and financial efficiencies for managing its global operations.

As a result of the size of financial transactions that flow through these offshore centers, they have been increasingly important in the global capital markets.

Ethics in Action

Offshore financial centers have also come under criticism. Many people criticize these countries because corporations and individuals hide wealth there to avoid paying taxes on it. Many offshore centers are countries that have a zero-tax basis, which has earned them the title of tax havens.

The Economist notes that offshore financial centers are typically small jurisdictions, such as Macau, Bermuda, Liechtenstein or Guernsey, that make their living mainly by attracting overseas financial capital. What they offer foreign businesses and well-heeled individuals is low or no taxes, political stability, business-friendly regulation and laws, and above all discretion. Big, rich countries see OFCs as the weak link in the global financial chain...

The most obvious use of OFCs is to avoid taxes. Many successful offshore jurisdictions keep on the right side of the law, and many of the world's richest people and its biggest and most reputable companies use them quite legally to minimise their tax liability. But the onshore world takes a hostile view of them. Offshore tax havens have —declared economic war on honest US taxpayers,‡ says Carl Levin, an American senator. He points to a study suggesting that America loses up to \$70 billion a year to tax havens...

Business in OFCs is booming, and as a group these jurisdictions no longer sit at the fringes of the global economy. Offshore holdings now run to \$5 trillion–7 trillion, five times as much as two decades ago, and make up perhaps 6–8 percent of worldwide wealth under management, according to Jeffrey Owens, head of fiscal affairs at the OECD. Cayman, a trio of islands in the Caribbean, is the world's fifth-largest banking centre, with \$1.4 trillion in assets. The British Virgin Islands (BVI) are home to almost 700,000 offshore companies.

All this has been very good for the OFCs' economies. Between 1982 and 2003 they grew at an annual average rate per person of 2.8 percent, over twice as fast as the world as a whole (1.2 percent), according to a study by James Hines of the University of Michigan. Individual OFCs have done even better. Bermuda is the richest country in the world, with a GDP per person estimated at almost \$70,000, compared with \$43,500 for America...On average, the citizens of Cayman, Jersey, Guernsey and the BVI are richer than those in most of Europe, Canada and Japan. This has encouraged other countries with small domestic markets to set up financial centres of their own to pull in offshore money—most spectacularly Dubai but also Kuwait, Saudi Arabia, Shanghai and even Sudan's Khartoum, not so far from war-ravaged Darfur.

Globalisation has vastly increased the opportunities for such business. As companies become ever more multinational, they find it easier to shift their activities and profits across borders and into OFCs. As the well-to-do lead increasingly peripatetic lives, with jobs far from home, mansions scattered across continents and investments around the world, they can keep and manage their wealth anywhere. Financial liberalisation—the elimination of capital controls and the like—has made all of this easier. So has the internet, which allows money to be shifted around the world quickly, cheaply and anonymously.

The Role of International Banks, Investment Banks, Securities Firms, and Global Financial Firms

The role of international banks, investment banks, and securities firms has evolved in the past few decades. Let's take a look at the primary purpose of each of these institutions and how it has changed, as many have merged to become global financial powerhouses.

Traditionally, international banks extended their domestic role to the global arena by servicing the needs of multinational corporations (MNC). These banks not only received deposits and made loans but also provided tools to finance exports and imports and offered sophisticated cash-management tools, including foreign exchange. For example, a company purchasing products from another country may need short-term financing of the purchase; electronic funds transfers (also called wires); and foreign exchange transactions. International banks provide all these services and more.

In broad strokes, there are different types of banks, and they may be divided into several groups on the basis of their activities. Retail banks deal directly with consumers and usually focus on mass-market products such as checking and savings accounts, mortgages and other loans, and credit cards. By contrast, private banks normally provide wealth-management services to families and individuals of high net worth. Business banks provide services to businesses and other organizations that are medium sized, whereas the clients of corporate banks are usually major business entities. Lastly, investment banks provide services related to financial markets, such as mergers and acquisitions. Investment banks also focused primarily on the creation and sale of securities (e.g., debt and equity) to help companies, governments, and large institutions achieve their financing objectives. Retail, private, business, corporate, and investment banks have traditionally been separate entities. All can operate on the global level. In many cases, these separate institutions have recently merged, or were acquired by another institution, to create global financial powerhouses that now have all types of banks under one giant, global corporate umbrella.

However the merger of all of these types of banking firms has created global economic challenges. In the United States, for example, these two types—retail and investment banks—

were barred from being under the same corporate umbrella by the Glass-Steagall Act. Enacted in 1932 during the Great Depression, the Glass-Steagall Act, officially called the Banking Reform Act of 1933, created the Federal Deposit Insurance Corporations (FDIC) and implemented bank reforms, beginning in 1932 and continuing through 1933. These reforms are credited with providing stability and reduced risk in the banking industry for decades. Among other things, it prohibited bank-holding companies from owning other financial companies. This served to ensure that investment banks and banks would remain separate—until 1999, when Glass-Steagall was repealed. Some analysts have criticized the repeal of Glass-Steagall as one cause of the 2007–8 financial crisis.

Because of the size, scope, and reach of US financial firms, this historical reference point is important in understanding the impact of US firms on global businesses. In 1999, once bank-holding companies were able to own other financial services firms, the trend toward creating global financial powerhouses increased, blurring the line between which services were conducted on behalf of clients and which business was being managed for the benefit of the financial company itself. Global businesses were also part of this trend, as they sought the largest and strongest financial players in multiple markets to service their global financial needs. If a company has operations in twenty countries, it prefers two or three large, global banking relationships for a more cost-effective and lower-risk approach. For example, one large bank can provide services more cheaply and better manage the company's currency exposure across multiple markets. One large financial company can offer more sophisticated risk-management options and products. The challenge has become that in some cases, the party on the opposite side of the transaction from the global firm has turned out to be the global financial powerhouse itself, creating a conflict of interest that many feel would not exist if Glass-Steagall had not been repealed. The issue remains a point of ongoing discussion between companies, financial firms, and policymakers around the world. Meanwhile, global businesses have benefited from the expanded services and capabilities of the global financial powerhouses.

For example, US-based Citigroup is the world's largest financial services network, with 16,000 offices in 160 countries and jurisdictions, holding 200 million customer accounts. It's a financial powerhouse with operations in retail, private, business, and investment banking, as well as asset management. Citibank's global reach make it a good banking partner for large global firms that want to be able to manage the financial needs of their employees and the company's operations around the world.

In fact this strength is a core part of its marketing message to global companies and is even posted on its website (<http://www.citigroup.com/citi/products/invest.htm>): –Citi puts the world's largest financial network to work for you and your organization.¶

Ethics in Action

Outsourcing Day Trading to China

American and Canadian trading firms are hiring Chinese workers to —day trade¶ from China during the hours the American stock market is open. In essence, day trading or speculative trading occurs when a trader buys and sells stock quickly throughout the day in the hopes of making quick profits. The New York Times reported that as many as 10,000 Chinese, mainly young men, are busy working the night shift in Chinese cities from 9:30 p.m. to 4 a.m., which are the hours that the New York Stock Exchange is open in New York.

The motivation is severalfold. First, American and Canadian firms are looking to access wealthy Chinese clients who are technically not allowed to use Chinese currency to buy and sell shares on a foreign stock exchange. However, there are no restrictions for trading stocks in accounts owned by a foreign entity, which in this case usually belongs to the trading firms. Chinese traders also get paid less than their American and Canadian counterparts.

There are ethical concerns over this arrangement because it isn't clear whether the use of traders in China violates American and Canadian securities laws. In a New York Times article quotes Thomas J. Rice, an expert in securities law at Baker & McKenzie, who states, —This is a jurisdictional mess for the U.S. regulators. Are these Chinese traders essentially acting as brokers? If they are, they would need to be registered in the U.S. While the regulatory issues may not be clear, the trading firms are doing well and growing: —many Chinese day traders see this as an opportunity to quickly gain new riches. Some American and Canadian trading firms see the opportunity to get —profit from trading operations in China through a combination of cheap overhead, rebates and other financial incentives from the major stock exchanges, and pent-up demand for broader investment options among China's elite. David Barboza, —Day Trading, Conducted Overnight, Grows in China, New York Times, December 10, 2010.

KEY TAKEAWAYS

- Capital markets provide an efficient mechanism for people, companies, and governments with more funds than they need to transfer those funds to people, companies, or governments who have a shortage of funds.
- The international equity and bond markets have expanded exponentially in recent decades. This expansion has been fueled by the growth of developing markets, the drive to privatize, the emergence of global financial powerhouses including investment banks, and technology advancements.
- The international bond market consists of major categories of bonds—including foreign bonds, Eurobonds, and global bonds—all of which help companies borrow funds to invest and grow their global businesses.

The International Bond Market

International bonds are bonds issued by a country or company that is not domestic for the investor. The international bond market is quickly expanding as companies continue to look for the cheapest way to borrow. By issuing debt on an international scale, a company can reach more investors. It also potentially help decrease regulatory constraints.

Three Categories of International Bonds

There are three general categories for international bonds:

- domestic,
- euro
- foreign.
-

The categories are based on the country (domicile) of the issuer, country of the buyer, and currencies used.

Domestic bonds

Issued, underwritten and then traded with the currency and regulations of the borrower's country.

Example: A British company issues debt in the United Kingdom with the principal and interest payments based or denominated in British pounds.

Eurobonds

Underwritten by an international company using domestic currency and then traded outside of the country's domestic market.

Example: A British company issues debt in the United States with the principal and interest payments denominated in pounds.

Foreign bonds

Issued in a domestic country by a foreign company using the regulations and currency of the domestic country.

Example: A British company issues debt in the United States with the principal and interest payments denominated in dollars.

Dollar-denominated Bonds

Dollar-denominated bonds are issued in US dollars and offer investors more choices to increase diversity. The two types of dollar-denominated bonds are Eurodollar bonds and Yankee bonds. The difference between the two bonds is that Eurodollar bonds are traded outside of the domestic market while Yankee bonds are issued and traded in the US.

1. Eurodollar bonds

Eurodollar bonds are the largest component of the Eurobond market. A Eurodollar bond must be denominated in U.S. dollars and written by an international company. Since the Eurodollar bonds are not registered with the SEC, it can not be sold to the U.S. public. However, it can be traded on the secondary market. Even though many portfolios do include Eurodollar bonds in U.S. portfolios, U.S. investors do not participate in the primary market. Therefore, the primary market is dominated by foreign investors.

2. Yankee bonds

Yankee bonds are another type of dollar-denominated bonds. However, unlike the Eurodollar bonds, Yankee bonds' target market is within the U.S. These bonds are issued by a foreign company or country that has registered with the Securities and Exchange Commission (SEC). Since Yankee bonds are meant to be purchased by U.S. citizens in the primary market, they must follow regulations set by the SEC. For example, the company issuing the bond needs to be financially stable and capable of making payments throughout the period of the bond.

Non-dollar-denominated Bonds

Non-dollar-denominated international bonds are all the issues denominated in currencies that are not the dollar. Since there is currency volatility, U.S. investors face the question of whether to hedge currency exposure. The different types of non-dollar-denominated bonds depend on the domicile of the issuer and the location of the primary trading market. The three major types are the domestic market, the foreign market, and the Euro market.

1. Domestic market

The domestic market includes bonds that are issued by a borrower in their home country using the country's currency. Domestic markets have seen significant growth for several reasons.

First of all, for companies, issuing debt in the domestic currency allows them to better match liabilities with assets. By doing so, they also don't need to worry about the currency exchange risk. Also, by issuing debt in dollar-denominated markets and the domestic market, companies gain access to more investors. This allows them to gain access to a better borrowing rate.

2. Foreign market

The foreign bond market includes the bonds that are sold in a country using that country's currency but issued by a non-domestic borrower. For example, the Yankee bond market is the U.S. dollar version of the market. This is because it is sold in the U.S. using the dollar, but is issued by a syndicate outside of the U.S. Other examples include the Samurai market and the Bulldog market. The Samurai market is Yen-denominated bonds issued in Japan but by non-Japanese borrowers. The Bulldog market is pound-denominated bonds issued in the U.K. by non-British groups.

3. Euro market

Securities that are issued into the international market are called Eurobonds. This market encompasses all the bonds that are not issued in a domestic market and can be issued in any currency. Eurodollar bonds are an example of a U.S. dollar-denominated version of a Eurobond as they are sold into the international markets.

Most of the time, the bonds are written by an international syndicate and sold in several national markets simultaneously. Issuers of Eurobonds include international corporations, supranational, and countries.

Products of Overseas Capital Markets

The following points highlight the top four international capital market instruments. They are:

1. Global Depository Receipts
2. Foreign Currency Convertible Bonds
3. American Depository Receipts
4. External Commercial Borrowing.

Instrument # 1. Global Depository Receipts:

Global Depository Receipt (GDR) is an instrument which allows Indian Corporate, Banks, Non-banking Financial Companies etc. to raise funds through equity issues abroad to augment their resources for domestic operations.

As per the recent guidelines on issue of GDR, a corporate entity can issue any number of GDR issues in a year and the corporate involved in infrastructure projects need not have a past track record of financial performance.

A GDR is a dollar denominated instrument of a company, traded in stock exchanges outside the country of origin i.e., in European and South Asian Markets. It represents a certain number of underlying equity shares.

Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees only. Instead of issuing in the names of individual shareholders, the shares are issued by the company to an intermediary called the 'depository', usually in Overseas Depository Bank, in whose name the shares are registered.

It is the depository, which subsequently issues the GDR to the subscribing public. The physical possession of the equity shares will be with another intermediary called the ‘custodian’, who is an agent of the depository. Though the GDR represents the company’s shares, it has a distinct identity and does not figure in the books of the company.

The Complete List of Indian GDRs

The complete list of Indian GDRs trading in the London, Singapore and Luxembourg exchanges and on the Portal as of Oct, 2018 are shown in the table below:

S.No	Company	Ticker	Stock Exchange	Ratio DR:ORD	Industry
1	Ambuja Cements - Reg. S	--	Luxembourg Stock Exchange	1:1	Construction & Materials
2	Aptech (Lux Listed) - Reg. S	--	Luxembourg Stock Exchange	1:4	Software & Computer Services
3	Aqua Logistics - Reg. S	--	Luxembourg Stock Exchange	1:23	Support Services
4	Axis Bank - 144A	AXBA	London Stock Exchange	1:5	Banks
5	Axis Bank - Reg. S	AXB	London Stock Exchange	1:5	Banks
6	Bajaj Holdings & Investment - Reg S	BAUD	London Stock Exchange	1:1	Automobiles & Parts
7	Bharat Forge - 144A	--	Luxembourg Stock Exchange	1:1	Industries, Metals & Mining
8	Bharat Hotels - Reg. S	--	Luxembourg Stock Exchange	1:2	Travel & Leisure
9	Bombay Dyeing & Manufacturing - Reg. S	--	Luxembourg Stock Exchange	1:1	Personal Goods
10	CG Power and Industrial Solutions-144A	CGVA	London Stock Exchange	1:5	Electronic & Electric Equipment

S.No .	Company	Ticker	Stock Exchange	Ratio DR:OR D	Industry
11	CG Power and Industrial Solutions-Reg. S	CGVD	London Stock Exchange	1:5	Electronic & Electric Equipment
12	Dish TV India - Reg. S	--	Luxembourg Stock Exchange	1:1000	Electronic & Electric Equipment
13	Federal Bank - 144A	FEDA	London Stock Exchange	1:1	Banks
14	Federal Bank - Reg. S	FEDS	London Stock Exchange	1:1	Banks
15	Finolex Cables - 144A	--	Luxembourg Stock Exchange	1:1	Electronic & Electric Equipment
16	GAIL India - 144A	GAIA	London Stock Exchange	1:6	Oil & Gas Producers
17	GAIL India - Reg. S	GAID	London Stock Exchange	1:6	Oil & Gas Producers
18	Grasim Industries - Reg. S	--	Luxembourg Stock Exchange	1:1	Construction & Materials
19	Great Eastern Energy - Reg. S	GEEC	London Stock Exchange	2:1	Mining
20	HDFC Bank - Reg. S	--	Luxembourg Stock Exchange	2:1	Banks
21	Hindalco Industries - 144A	--	Luxembourg Stock Exchange	1:1	Industries, Metals & Mining
22	Indiabulls Housing Finance - Reg. S	--	Luxembourg Stock Exchange	1:1	Financial Services
23	Indiabulls Real Estate - 144A	--	Luxembourg Stock Exchange	1:1	Real Estate Investments & Services

S.No .	Company	Ticker	Stock Exchange	Ratio DR:OR D	Industry
24	Indiabulls Real Estate - Reg. S	--	Luxembourg Stock Exchange	1:1	Real Estate Investments & Services
25	Indiabulls Securities - Reg. S	--	Luxembourg Stock Exchange	1:1	Financial Services
26	Industrial Investment Trust - Reg. S	--	Luxembourg Stock Exchange	1:2	Financial Services
27	ITC - Reg. S	--	Luxembourg Stock Exchange	1:1	Food Producers
28	Jindal Stainless (Hisar) - Reg. S	--	Luxembourg Stock Exchange	1:2	General Industrials
29	Jindal Stainless - Reg. S	--	Luxembourg Stock Exchange	2:1	Industries, Metals & Mining
30	Kesoram Industries - Reg. S	--	Luxembourg Stock Exchange	1:1	Construction & Materials
31	Larsen & Toubro - Reg. S	LTOD	London Stock Exchange	1:1	Construction & Materials
32	Mascon Global - Reg. S	--	Luxembourg Stock Exchange	1:4	Financial Services
33	NCC - Reg. S	--	Luxembourg Stock Exchange	1:1	Construction & Materials
34	Noida Toll Bridge - Reg. S	NTBC	London Stock Exchange	1:5	Industrial Engineer.
35	Orchid Chemicals & Pharmaceuticals - 144A	OCPA	London Stock Exchange	1:1	HealthCare Equipment & Services
36	Orchid Chemicals & Pharmaceuticals - Reg. S	OCP	London Stock Exchange	1:1	HealthCare Equipment & Services

S.No .	Company	Ticker	Stock Exchange	Ratio DR:ORD	Industry
37	Oriental Hotels - Reg. S	--	Luxembourg Stock Exchange	1:1	Travel & Leisure
38	Panama Petrochem - Reg. S	--	Luxembourg Stock Exchange	1:5	Oil & Gas Producers
39	RattanIndia Infrastructure Limited - Reg. S	--	Luxembourg Stock Exchange	1:1	Industrial Engineer.
40	Raymond - Reg. S	--	Luxembourg Stock Exchange	1:2	House Goods & Home Const
41	Reliance Capital - Reg. S	--	Luxembourg Stock Exchange	1:1	Financial Services
42	Reliance Communications - Reg. S	--	Luxembourg Stock Exchange	1:1	Mobile Telecom.
43	Reliance Infrastructure - 144A	RIFA	London Stock Exchange	1:3	Electricity
44	Reliance Infrastructure - Reg. S	RIFS	London Stock Exchange	1:3	Electricity
45	Reliance Power - Reg. S	--	Luxembourg Stock Exchange	1:1	Electricity
46	SREI Infrastructure Finance - 144A	SRIA	London Stock Exchange	1:4	Financial Services
47	SREI Infrastructure Finance - Reg. S	SRI	London Stock Exchange	1:4	Financial Services
48	State Bank of India - 144A	SBIA	London Stock Exchange	1:10	Banks
49	State Bank of India - Reg. S	SBID	London Stock Exchange	1:10	Banks
50	Steel Authority of India - 144A	SAUA	London Stock Exchange	1:15	Industries, Metals & Mining
51	Steel Authority of India -	SAUD	London Stock	1:15	Industries,

S.No .	Company	Ticker	Stock Exchange	Ratio DR:OR D	Industry
	Reg. S		Exchange		Metals & Mining
52	Subex - Reg. S	SUBX	London Stock Exchange	1:1	Software & Computer Services
53	Suzlon Energy - Reg. S	--	Luxembourg Stock Exchange	1:4	Electronic & Electric Equipment
54	Tata Global Beverages - 144A	TGBA	London Stock Exchange	1:1	Beverages
55	Tata Global Beverages - Reg. S	--	Luxembourg Stock Exchange	1:1	Beverages
56	Tata Power - Reg. S	--	Luxembourg Stock Exchange	1:90	Electricity
57	Tata Steel - Reg. S	--	Luxembourg Stock Exchange	1:1	Industries, Metals & Mining
58	Tata Steel - Reg. S	TTST	London Stock Exchange	1:1	Industries, Metals & Mining
59	Ultratech Cemco - 144A	--	Luxembourg Stock Exchange	1:2	Construction & Materials
60	Ultratech Cemco - Reg. S	--	Luxembourg Stock Exchange	1:2	Construction & Materials
61	Uniphos Enterprises - Reg. S	--	Luxembourg Stock Exchange	1:1	Chemicals
62	United Spirits - Reg. S	--	Luxembourg Stock Exchange	2:1	Beverages
63	UPL - Reg. S	UPL	Singapore Exchange	1:2	Chemicals

S.No .	Company	Ticker	Stock Exchange	Ratio DR:OR D	Industry
64	Usha Martin - Reg. S	--	Luxembourg Stock Exchange	1:5	Fixed Line Telecom.
65	Usha Martin Education & Solutions - Reg. S	--	Luxembourg Stock Exchange	1:1	Software & Computer Services
66	Videocon Industries - Reg. S	--	Luxembourg Stock Exchange	1:1	Oil & Gas Producers
67	Wockhardt - Reg. S	--	Luxembourg Stock Exchange	1:1	Pharma. & Biotech.
68	Zee Learn - Reg. S	--	Luxembourg Stock Exchange	1:10	Personal Goods

Instrument # 2. Foreign Currency Convertible Bonds:

Foreign Currency Convertible Bonds (FCCBs) are issued in accordance with the scheme and subscribed by a non-resident in foreign currency and convertible into ordinary share of the issuing company in any manner, either in whole or in part on the basis of only equity related warrants attached to debt instrument. The FCCB is almost like the convertible debentures issued in India.

The Bond has a fixed interest or coupon rate and is convertible into certain number of shares at a prefixed price. The bonds are listed and traded on one or more stock exchanges abroad. Till conversion the company has to pay interest on FCCBs in dollars (or in some other foreign currency) and if the conversion option is not exercised, the redemption also has to be done in foreign currency. The bonds are generally unsecured.

Foreign Currency Convertible Bonds Issued By Indian Companies

Following the sustained liberalisation programme undertaken by the Indian Government to integrate with the global economy, the foreign currency convertible bond (FCCB) market took a quantum leap during the bull run of 2005– 2008. Reports state that 201 Indian companies raised approximately US\$16bn through FCCBs during that period.

Companies issued FCCBs to reduce their borrowing costs. They issued the bonds at very low coupon rates; some were even zero coupon. However, they fixed the conversion prices between 25 per cent and 150 per cent higher than the prevailing market prices in expectation of an increase in share prices. This theory fell flat with the subsequent crash in global equity markets. It is estimated that two thirds of the FCCBs due to mature before March 2013 will not be converted into equity shares.

Most of the FCCBs that will mature in 2012 were issued in the years 2007–2008, when the foreign exchange rate was approximately 42 Indian rupees (INR) to a US dollar. The INR has

since lost more than 30 per cent against the US dollar. This has added approximately US\$2bn to the value of FCCB maturities in 2012.

In cases where the current price is trading at a significant discount to the conversion price, it appears that the companies will need to adopt other alternatives to pay back their investors. Although a number of companies have managed to convert their FCCBs to equity, low investor appetite and the expensive debt market are making it difficult for further conversions to take place. In the present market, companies have the following options.

Injecting equity

A company may raise equity to finance redemption/repayment of the FCCBs. However, it may be difficult to find new investors considering the present liquidity crunch and the FCCB repayment liability in the books of the issuer company. Further, the present shareholders may not agree to dilute their equity by inducting new shareholders. The present shareholders will probably be required to bring in the capital. This may not be feasible in the current market.

Raising domestic debt

Interest rates in India are generally far higher than interest rates overseas. Considering the present credit crunch and high interest rates, raising new domestic debt to service cheaper FCCB debt may prove expensive and unfeasible.

Redemption of FCCBs by refinancing

The FCCB Guidelines were issued in 1993 by the Ministry of Finance under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (the 'Scheme'). The right to approve FCCB borrowings was delegated to the central bank, the Reserve Bank of India (RBI) pursuant to the Foreign Exchange Management Act, 2000 (FEMA). The RBI issues guidelines for External Commercial Borrowings (ECBs) from time to time, which are also applicable to FCCBs.

Envisaging the difficulties that Indian companies may face in arranging funds for redemption of the FCCBs, on 4 July 2011 the RBI permitted companies to raise fresh ECBs/FCCBs under the automatic route (ie, without the requirement to obtain prior written permission from the RBI) to facilitate the refinancing of existing FCCBs on the following conditions:

- the amount of the new ECB/FCCB cannot exceed the outstanding redemption value at the maturity of the FCCBs;
- the new ECB must be raised within a period of six months prior to the FCCB maturity date;
- a new ECB/FCCB in excess of US\$500m will require prior RBI approval;
- where the new ECB is co-terminus with the outstanding maturity of the original FCCB, it can have a term of less than three years (which is generally the minimum term for an ECB); and
- the FCCB Guidelines prohibit a change in the conversion price. However, an FCCB may be restructured by changing the maturity period and interest rates.

Refinancing entails settlement of debt by the issuer and mandates funds at the disposal of the issuer company to redeem the bonds. Several large Indian companies have been able to refinance their FCCBs, but this route is not viable for companies that do not have a strong

credit profile. Reports estimate that Indian companies may have to pay additional interest of US\$700m per annum to refinance the US\$5bn of FCCB debt maturing in 2012.

Buy-back of FCCBs

The RBI has, from time to time, permitted Indian companies to buy back their FCCBs, including for a period ending March 2012, on the following terms:

- category 1 authorised dealers were allowed, pursuant to delegated authority from the RBI, to approve the buy-back under the automatic route, where the funds used were from existing foreign currency funds or from a new ECB;
- where the buy-back was under the automatic route, prepayment was permitted at a minimum discount of eight per cent to the book value;
- if a new ECB was raised, co-terminus with the FCCB to be prepaid, the borrowing cost was not to exceed the London Interbank Offered Rate (LIBOR) + 200 basis points;
- where RBI approval was obtained for a buy-back funded from the internal accruals of the issuer company, the minimum discount mandated ranged from ten per cent to 20 per cent depending on the amount prepaid; and
- all other terms of the ECB policy were to be complied with.

Some companies availed of this opportunity. In a buy-back of FCCBs, the company has an opportunity to reduce its debt. From the perspective of the Indian Government, this option potentially reduces the higher foreign exchange outflow.

Restructuring the FCCBs

Indian companies may restructure the terms of their FCCBs with the agreement of the bond-holders. Obviously, this presupposes the acceptance of the bond-holders. Proposals for restructuring FCCBs that do not involve a change in the conversion price will be considered by the RBI under the approval route, on a case-by-case basis. Prior approval of the RBI is required to change the conversion price. Reports estimate that approximately half of the FCCBs due to mature in the second half of 2012 will need to be restructured, as it will prove difficult for companies to refinance the FCCBs in the current debt market.

In February 2009, the Ministry of Finance permitted companies to change the conversion price of FCCBs issued prior to 27 November 2008, based on the market price prevailing on the date of the Board meeting of the company approving the price revision. Several companies availed of the opportunity to reset the conversion prices of their FCCBs falling due in 2011–2012.

Enforcement of bond-holders' rights

In the event of a dispute between an Indian company and its bond-holders in respect of redemption of FCCBs, the bond-holder may seek recourse to the contractual dispute resolution mechanism prescribed in the FCCB transaction documents – typically arbitration.

The (Indian) Companies Act, 1956 provides a statutory remedy for failure to pay an admitted debt (such as the FCCB): the creditor may file a petition seeking that the debtor company be wound up so that its assets may be liquidated and the creditor repaid.

Generally, FCCBs are unsecured and therefore rank lower in terms of repayment of debt; FCCB-holders receive their payment only after the secured creditors and statutory dues of the liquidated company are paid.

However, filing a winding-up petition currently appears to be the preferred route for bond-holders. The bond-holders of Wockhardt Ltd have had some success in Indian courts. They filed a petition seeking to wind up the affairs of the company so that they could be repaid. The court directed the company to repay its bond-holders first, prior to the secured creditors of the company.

Given the current liquidity and equity market conditions, companies have little choice but to borrow monies at high interest rates and redeem the FCCBs on the due dates. The credit squeeze in global and local markets has made it difficult for Indian companies to find willing lenders.

The Indian regulator is attempting to provide a cordial and practical approach. The RBI tried to prevent further defaults by extending the deadline for the buy-back of FCCBs from June 2011 to March 2012. Further, it imposed a minimum discount as a condition for the buy-back of FCCBs.

The global economic crisis has slowed the revenue and profit growth of Indian companies, dragged down their stock prices and left them less able to service debt. However, the regulator and the courts continue to work towards creating a climate that facilitates redemption of FCCBs in India.

Regulation of FCCBs in India

FCCBs, currently governed by the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 have been amended from time to time by the Government of India with a view to liberalize the FCCB guidelines in order to enhance the infrastructure, development and expansion plan of corporate India world.

The Government of India has adopted few measures by passing various notifications in order to liberalize the FCCB regime, such as:

- Indian companies have been permitted to raise fresh External Commercial Borrowing (ECB)/FCCB as per the extant ECB guidelines under the automatic route to refinance their outstanding FCCBs. However, restructuring of FCCBs involving change in the existing conversion price are not held to be permissible. Also that the proposals for restructuring of FCCBs not involving change in conversion price will, however, be considered under the approval route depending on the merits of the proposal.
- ECB borrowers have been permitted to change the recognized lender, subject to however, the ensuring certain conditions such as the new lender is a recognized lender as per the extant ECB norms; there is no change in the other terms and conditions of the ECB; and the ECB is in compliance with the extant guidelines.
- Indian companies in the infrastructure sector, have been permitted to utilise 25 per cent of the fresh ECB raised by the corporate towards refinancing of the Rupee loan/s availed by them from the domestic banking system, under the approval route, subject to certain conditions as stipulated by RBI.
- Indian companies in the infrastructure sector have been allowed, to import capital goods by availing of short term credit (including buyers' / suppliers' credit) in the nature of 'bridge finance', under the approval route, subject to certain conditions as stipulated by RBI.

- ECB borrowing limit for eligible borrowers in real sector-industrial sector-infrastructure sector has been enhanced from USD 500 million to USD 750 million or equivalent per financial year under the automatic route.
- Corporates in specified service sectors viz. hotel, hospital and software, can avail of ECB up to USD 200 million or equivalent during a financial year as against the present limit of USD 100 million or equivalent per financial year subject to the condition that the proceeds of the ECBs should not be used for acquisition of land.
- All eligible borrowers have been permitted to avail of ECBs designated in INR from foreign equity holders under the automatic/ approval route, as the case may be.
- Direct foreign equity holders, holding minimum of 25 per cent of the paid up capital and indirect foreign equity holders, holding atleast 51% of the paid-up capital, have been permitted under the automatic route to provide credit enhancement to Indian companies engaged exclusively in the development of infrastructure, on ECB and by the Infrastructure Finance Companies (IFCs) been classified as such by the Reserve Bank.
- The term 'debt' in the debt-equity ratio will be replaced with 'ECB liability' and the ratio will be known as 'ECB liability'-equity ratio to make the term signify true position as other borrowings/debt are not considered in working out this ratio.

However, in the interest of the investors, soon RBI realized mistreatment of liberalization of the FCCB regime by the Indian companies especially many companies being restless and attempting default in redemption of FCCBs. As per the reports, one such company being the Leela Group – which raised US\$110 million through FCCBs and is nearing redemption found itself on a sticky wicket due to its adverse debt equity ratio. Thus, the Indian banking regulator – RBI in light of fear of companies being restless to redeem the FCCBs issued due to consequence of the rickety economy behavior and in the interest of the investors is now eyeing on the FCCB regime and proposing certain checks and balances to be maintained.

As per the latest reports, the Indian banking regulator is exploring two options – first being that the firms will be directed to create an FCCB redemption reserve by setting aside money from their profits, which is proposed to be done in phases, over a period of time, to cushion any impact of the redemption on their balance sheets and thus ensuring a healthy and investor friendly FCCB regime. The other option being explored is capping the exposure of companies to such instruments, which is to be done after taking into account their debt-equity ratio, among other things.

Instrument # 3. American Depository Receipts:

A foreign company might make issue in U.S. by issuing securities through appointment of Bank as depository. By keeping the securities issued by the foreign company, the U.S. Bank will issue receipts called American Depository Receipts (ADRs) to the investors.

It is a negotiable instrument recognizing a claim on foreign security. The holder of the ADRs can transfer the instrument as in the case of domestic instrument and also entitled for dividends as and when declared.

The ADR holder can ask the bank for the original foreign security by exchanging the ADR. The Bank will act as a custodian for the investors. An ADR can be described as a negotiable instrument denominated in US dollars, representing a non-US Company's local currency equity shares or known as depository receipts.

These are created when the local currency shares of an Indian Company are delivered to an overseas depository bank's domestic custodian bank, against which depository receipts in US dollars are issued. Each depository receipt may represent one or more underlying shares. These depository receipts can be listed and traded as any other dollar denominated security.

The disclosures as required under the Securities Exchange Commission's (SEC) regulations are stringent and onerous. In order to protect the investor, the SEC places the onus on the issuer company, its officers and directors to ensure that the prospectus does not contain any misstatement or omissions which are material in nature.

Benefits:

To Indian Company:

- (a) Better corporate image both in India and abroad which is useful for strengthening the business operations in the overseas market.
- (b) Exposure to international markets and hence stock prices in line with international trends.
- (c) Means of raising capital abroad in foreign exchange.
- (d) Use of the foreign exchange proceeds for activities like overseas acquisitions, setting up offices abroad and other capital expenditure.
- (e) Increased recognition internationally by bankers, customers, suppliers etc.
- (f) No risk of foreign exchange fluctuations as the company will be paying the interest and dividends in Indian rupees to the domestic depository bank.

To Overseas Investors:

- (a) Assured liquidity due to presence of market makers.
- (b) Convenience to investors as ADRs are quoted and pay dividends in U.S. dollars, and they trade exactly like other U.S. securities.
- (c) Cost-effectiveness due to elimination of the need to customize underlying securities in India.
- (d) Overseas investors will not be taxed in India in respect of capital gains on transfer of ADRs to another non-resident outside India.

The Complete List of Indian ADRs trading on the US Exchanges as of Dec 25, 2019 are listed below:

S.No.	Company	Ticker	Exchange	Industry
1	Dr. Reddy's Laboratories	<u>RDY</u>	NYSE	Pharma. & Biotech.
2	HDFC Bank	<u>HDB</u>	NYSE	Banks
3	ICICI Bank	<u>IBN</u>	NYSE	Banks
4	Infosys	<u>INFY</u>	NYSE	Software & Computer

S.No.	Company	Ticker	Exchange	Industry
				Services
5	SIFY Technologies	<u>SIFY</u>	NASDAQ	Software & Computer Services
6	Tata Motors	<u>TTM</u>	NYSE	Industrial Engineer.
7	Vedanta	<u>VEDL</u>	NYSE	Construct.& Materials
8	Videocon d2h	<u>VDTH</u>	NASDAQ	Media
9	Wipro	<u>WIT</u>	NYSE	Software & Computer Services
10	WNS Holdings	<u>WNS</u>	NYSE	Support Services

The Complete List of Indian ADRs trading on the US OTC Markets as of Dec 25,2019 are listed below:

S.No.	Company	Ticker	Industry
1	Grasim Industries	<u>GRSXY</u>	Construct. & Materials
2	Mahanagar Telephone Nigam	<u>MTENY</u>	Fixed Line Telecom.
3	Rediff.com India	<u>REDFY</u>	Software & Computer Services

Instrument # 4. External Commercial Borrowing:

External Commercial Borrowings (ECBs) is a borrowing of over 180 days. ECB is the borrowing by corporate and financial institutions from international markets. ECBs include commercial bank loans, buyers credit, suppliers credit, security instruments such as floating rate notes and fixed rate bonds, credit from export-credit agencies, borrowings from international financial institutions such as IFC etc.

The incentive available for such loans is the relative lower financing cost. ECB's can be taken in any major currency and for various maturities. ECBs are being permitted by the Government

for providing an additional source of funds to Indian corporate and PSU's for financing expansion of existing capacity as well as for fresh investment to augment the resources available domestically.

ECBs are approved with an overall annual ceiling. Consistent with prudent debt-management keeping in view the balance of payments position and level of foreign exchange reserves.

External Commercial Borrowing aids Indian organizations raise funds in foreign currencies from outside India. This can be used to bring in fresh investments. They can be availed through the automatic or the approval route.

ECB, or External Commercial Borrowing as it is known in its extended form, is an instrument that helps Indian firms and organisations raise funds from outside India in foreign currencies. Indian corporates are permitted by the Indian government to raise funds using External Commercial Borrowing in an effort to help the companies expand their current capacity. External Commercial Borrowing can also be used to bring in fresh investments.

The sources similar to ECBs include Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs). While the main purpose for the issuance of FCCBs is to raise capital, External Commercial Borrowing is applicable to commercial loans that can include securitised instruments, bank loans, suppliers' credit, buyers' credit, and bonds that are availed from lenders that are not Indian residents. The minimum maturity of these instruments, on average, is three years.

How to Avail External Commercial Borrowing

Funds can be raised using External Commercial Borrowing either through the approval route or the automatic route. There are certain eligibility regulations created by the government for availing finance under the automatic route. These regulations relate to amounts, industry, the end-use of the funds, etc. Companies that wish to raise finance through ECB will have to meet these eligibility criteria and funds can be raised without the need for approval.

The approval route, on the other hand, requires companies that fall under certain pre-specified sectors to get the RBI's or the government's explicit permission before raising funds through External Commercial Borrowing. Circulars and formal guidelines have been issued by the Reserve Bank of India for the specification of norms for borrowing.

Benefits of External Commercial Borrowing

The following are some of the main benefits of raising funds using ECB:

- The value of funds is generally lower when borrowed from external sources. For instance, there are economies that have a lower interest rate, and Indian firms and organisations can borrow money at lower interest rates from the Eurozone and the United States as the rates are comparatively low.
- Since the markets are larger when raising funds through ECB, companies can meet larger requirements from international players in comparison with what can be achieved through domestic players.
- External Commercial Borrowing is basically just a way to take a loan. It does not necessarily have to be of equity nature, and therefore the company's stakes will not be

diluted. Borrowers can essentially raise funds without relinquishing control as debtors will not have any voting rights in the company.

- The investor base can be diversified by the borrower.
- ECB offers access to global markets so that borrowers have greater exposure to worldwide opportunities.
- ECB offers benefits to the economy as well. Inflows can be directed into the sector by the government of India, thereby increasing its potential for growth. For instance, a greater percentage of funding through ECB can be allowed by the government for the SME and infrastructure industry. This aids significantly in the overall growth of the country.
- Companies can become increasingly profitable through ECB.

Disadvantages of External Commercial Borrowing

The following are the main disadvantages of raising funds through ECB:

- The company could develop a lax attitude as the funds are available at lower rates. Companies could borrow excessively due to this and it could eventually lead to higher debt on the company's balance sheet, thereby adversely affecting financial ratios.
- Rating agencies see companies with higher debt on their balance sheets in a negative light, which could lead to a potential downgrade of such companies. Eventually, this could enhance the company's cost of debt, thereby destroying the image of the company in the market. Furthermore, the shares of the company could also be subject to a decline in market value over a period of time.
- Considering the fact that raising funds through External Commercial Borrowing is done in foreign currencies, the principal as well as the interest will have to be paid in foreign currencies. As such, the company is exposed to risks associated with exchange rates. Hedging costs may have to be incurred by the company, thereby leading the company to incur heavy losses.

Despite the fact that ECBs can be availed at lower rates, there are a number of guidelines and restrictions that must be followed. Restrictions mainly apply to the amount that can be borrowed and the maturity of the External Commercial Borrowing. Amounts in excess of \$20 million will have maturity periods of at least five years. Amounts under \$20 million will have maturity periods of at least three years on average. The manner in which the funds are used will also be subject to certain restrictions.

The funds borrowed through External Commercial Borrowing can be used for the expansion of companies, but borrowers cannot use the funds for onward lending, repaying existing loans, or investing in real estate. External Commercial Borrowings are among the most commonly available sources of funding, but companies are advised to exercise caution regarding the impact the borrowing can have on their balance sheets and the risks associated with exchange risks if they are to use the funds in an effective manner.

Trends in External Commercial Borrowings in India

When it comes to borrowing external funds, there are no signs of corporate India facing any kind of slowdown. India Inc's debt fundraising through overseas loans touched \$25 billion in the first half of the current fiscal year, which is an all-time-high borrowing for a half-yearly period. External commercial borrowings (ECB) of Indian companies jumped nearly 50% in the six months ended 30 September from a year ago, thanks to cheaper overseas funds, easier overseas borrowing norms and weakened local banks.

According to Reserve Bank of India (RBI) data, India Inc raised External Commercial Borrowing(ECBs)/Foreign Currency Convertible Bonds (FCCBs) worth \$25.17 billion (both under the Approval and Automatic routes) in the April-September period. The borrowing is 53 per cent higher than the \$16.48 billion that Indian entities raised during the comparable period last year.

Corporates borrowed \$24.3 billion from overseas markets in the first six months of FY20, showed data from the Reserve Bank of India (RBI) compiled by Bloomberg. This compares with \$16.46 billion and \$9.68 billion raised in the first six months of FY19 and FY18, respectively.

To be sure, despite this shift, banks are still the single-largest source of funds for businesses, and ECBs made up just 12% of their total borrowings in FY19. However, bank credit growth has been subdued so far this year, with outstanding non-food credit growing 8.8% year-on-year (y-o-y) to ₹97.68 trillion in the fortnight ended 25 October.

According to a 6 November report by CARE Ratings, it needs to be seen if bank credit picks up in the rest of FY20 when economic activity generally tends to be higher, to ascertain the extent of substitution, if any, in the sources of external funds of businesses.

-The constrained and relatively high-cost lending of domestic banks and financial institutions on account of stressed asset quality, heightened risk aversion and strained liquidity conditions has, in part, been counterbalanced by the low interest rate regime in the international markets," said Kavita Chacko, senior economist, CARE Ratings.

The CARE report said companies from the financial services sector continue to dominate external borrowings, accounting for nearly 47% of the value of ECB in the first six months of the current fiscal, up from 35% a year ago.

Recent instances include HDB Financial Services Ltd (\$300 million), L&T Housing Finance Ltd (\$60 million), Bajaj Finance Ltd (\$575 million) and Home Credit India Finance Pvt. Ltd (\$112 million) in September 2019.

Another interesting trend is that companies are mostly using this route for their working capital requirements. In September alone, of the 117 entities that raised money, 45 needed working capital.

-The primary reason for corporates to seek funding from ECB is the better pricing they are getting. With the currency becoming slightly strong and the hedging costs becoming cheaper, the all-inclusive cost is still lower than raising money in India," said Ajay Manglunia, managing director and head of institutional fixed income at JM Financial.

The CARE report said that of the total ECBs raised during April-September 2019, nearly 65% fell in the 3-5 years maturity bracket and less than 10% of borrowings were for tenures of over 10 years, indicating ECBs are not relied upon for financing longer duration projects.

Others believe that an RBI regulation that aims to de-risk the banking sector for concentrated corporate exposure could be limiting banks' ability to fund large businesses.

According to Soumya Kanti Ghosh, group chief economic adviser, State Bank of India (SBI), the large exposure framework may be acting as a constraining factor in bank lending to such entities and hence they are tapping the ECB route. The RBI regulations, which came into effect on 1 April, mandate that banks limit their exposure to 25% of their capital for connected parties.

-As far as the non-banking financial companies (NBFC) sector is concerned, though the banks expanded their lending in the first half of FY20, the markets seemed to have lost appetite in funding of NBFCs, even the commercial papers (CPs). Subsequently, a large part of NBFCs are tapping the ECB route mostly for onlending," Ghosh wrote in a report on 16 October.

Borrowing binge

External commercial borrowing (ECB) between FY14 and FY20

(in \$ billion)



Data includes Approval and Automatic routes

In FY19, India Inc's ECB fund-raising touched a historical high of \$42 billion. The spurt in ECBs in the previous year is attributed to a liquidity crunch and high interest rates in the domestic market against stable exchange rates and attractive borrowing costs in the overseas market, and a host of rationalisation measures by the RBI, which enabled many corporates to access overseas funding.

Currently, the RBI's cap on the ECB lending rate is LIBOR plus 450 basis points, which means companies can borrow at an interest rate anywhere between 2 to 6.5 per cent, which is much lower than the domestic bank lending rates.

Impact of RBI easing norms

-Liberalisation of ECB guidelines, and prudent and tighter single-group exposure norms by the RBI have possibly resulted in higher ECB volumes. The risk aversion of the Indian banking sector is also one of the major factors, said Rajesh Parthasarathy, Managing Director of Mumbai-based GrowTrust Ventures Consultancy Pvt Ltd. The company offers business and advisory solutions on corporate finance, banking and treasury.

In July, the RBI permitted ECBs with minimum average maturity of 10 years from recognised lenders other than overseas branches or subsidiaries of Indian banks for working capital and general corporate purposes. It also allowed Non-banking financial companies (NBFCs) to use this route to raise external funds for on-lending for these purposes, which also contributed to the growth in overseas borrowing.

Among the sectors, financial services, which includes non-banking financial companies (NBFCs), housing finance companies (HFCs) and micro finance institutions (NBFC-MFIs), continues to be a major borrower this financial year. The sector, which has been hit by the liquidity crisis, accounted for 47 per cent of the total borrowings in the first half of this financial year.

Default impact

–The debt capital market in India does not have a large appetite for NBFCs anymore due to black swan kind of default events in the recent past. Risk aversion despite strong liquidity has led well-rated NBFCs to tap foreign currency bonds and ECB loans, Parthasarathy said, adding that he is seeing more interest from NBFCs to explore overseas borrowing.

A black swan is a rare event with very severe consequences. While it cannot be predicted beforehand, many believe it becomes obvious in hindsight.

The RBI's October monetary policy report revealed that financial flows to the commercial sector have declined sharply, by around 88 per cent, in the first six months of FY20. The RBI's recent report on scheduled commercial banks also showed that bank credit growth continues to be in single digits (8.9 per cent) for the fortnight ended October 25, against 14.6 per cent recorded for the comparable period last year.

In its recent report titled, 'Resurgence in External Commercial Borrowings', CARE Ratings said: –The rising trend of external commercial borrowings is likely to be sustained for the remainder of the current fiscal year. The favourable external conditions — in terms of low overseas interest rates and liquidity, are expected to prevail for the foreseeable future and could lead to higher borrowings by corporates from this source.

Risks Associated with External Commercial Borrowings

Former RBI governor Raghuram Rajan highlighted the perils of the 2019 budget announcement of GoI's plan to start raising a part of its gross borrowing programme in external currencies.

There are two issues regarding India's foreign borrowing. One, the quantum of borrowing and debt.

While multilateral and bilateral debt is welcomed, India has been conservative in the matter of external commercial borrowing (ECB) ever since the balance of payment (BoP) crisis of 1991-92. After that, annual caps were imposed on additional borrowing, particularly on short-term debt, and the end use of external commercial borrowings was restricted. What that experience taught was that short-term debt could not be rolled over, since panic gripped the markets, aggravating the crisis of liquidity.

ECB policy has been liberalised over the years, although RBI is, by instinct, conservative. India's external debt remains within prudent levels, at 21% of GDP and 150% of foreign currency reserves in 2018-19. Nirmala Sitharaman's budget speech does not propose relaxing quantitative limits on ECB.

Two, ECB raised directly by GoI as sovereign debt. GoI has in the past pushed public sector utilities (PSUs) to borrow from external markets for fiscal and BoP support, and foreign

portfolio investors (FPIs) are allowed to buy domestic government bonds denominated in rupees. But it has so far avoided borrowing directly on its own books from international financial markets. The budget announcement marks a structural shift in policy.

So, should GoI borrow directly from external financial markets? Another former RBI governor, C Rangarajan, doesn't think so — and for good reasons. –The proposal... does not appear to be correct. This essentially means the exchange risk is borne by GoI, unlike the situation in which foreign investors are allowed to invest in government bonds in rupees,|| .

–Second, there is certainly no need for government to borrow as the foreign inflows are adequate.||

There are, however, four compelling arguments for the proposal. One, global interest rates are at historic lows. This has intensified what former chair of the US Federal Reserve Ben Bernanke called a ‘global savings glut’. India, with a deficit of savings over investment, could tap into this glut. The cost of hedging against forex risk would be counterbalanced by the saving in the coupon rate.

Two, direct borrowing by the sovereign is always cheaper than for any other entity. As long as the policy shift simply means that overall ECB limits remain unchanged, with GoI borrowing more and the corporates less in international financial markets, there would be net welfare gains for the economy.

Three, the sovereign is the best credit in the country. As such, sovereign bonds set the lowest possible benchmark for Indian borrowers in international financial markets. Instead of relying on the sovereign bond yields of other similarly rated developing countries, they would now borrow at spreads above Indian sovereign bonds, controlling for tenure of the loan and credit rating. GoI can lower the yields on its own sovereign bonds through good macroeconomic management.

Four, India has a huge infrastructure deficit. Global experience is that most of this investment would need to come directly or indirectly from government. Private enterprise can play only a marginal role, in view of the higher risks, lower returns and longer gestation periods of the underlying investment. Such investments generate large externalities, indirectly benefitting the larger economy much more than the investor directly. As the case of China illustrates, first-class infrastructure lowers the cost of overheads, making the economy more efficient, productive and hence more internationally competitive.

GoI would need to scale up its borrowings on the margin to scale up investment in infrastructure.

The unpleasant arithmetic arising from this could raise interest rates and crowd out private investment. India's savings have declined, but so has private investment, as a result the deficit — the current account deficit — has remained more or less constant. As and when the animal spirits of private investors revive, it would be a good thing to have an enabling provision to avoid such crowding out in the domestic debt market. As long as extant borrowing limits are not breached, direct borrowing by the sovereign in external commercial markets may not be a bad idea. The provision needs to be, of course, used judiciously. Without this caveat, India's demographic dividend can well turn into a demographic nightmare.

Bottom line

The government wants to diversify its borrowing, which has so far been limited to the domestic market, and create a benchmark for future bond sales. With global interest rates low and falling, officials see the timing as favorable too. This move aims at reducing public sector borrowings in the domestic market, thus creating space for the private sector.

Although the step would integrate the Indian economy in global markets, it is debated that there is high risk involved. The interest rate on the coupon depends primarily on India's sovereign credit rating, external and internal risk factors, and the rates that our peers currently pay.

Presently, global money markets are inundated with liquidity, which is the reason for many emerging economies' ability to borrow at low interest rates. Indian government borrows a mere 5% of its GDP in foreign currency, which makes room for the government to borrow more.

However, borrowing abroad also makes the country far more vulnerable to currency volatility. If the Indian rupee suddenly drops in value because of an unforeseen event, repaying the debt in dollar terms would become much more expensive for the government. Since GoI will have to pay the interest and principal in rupee terms, depreciation against the dollar amounts to an additional interest charge on the loan.

E.g., if the rupee were to depreciate by 3% post fundraising, and if the interest rate offered was 3.5%, the effective cost would be 6.5%.

Thus, to go the ECB route, the government will need to be prudent to ensure that external risks are kept to the minimum. Also, it is best if the government thinks of this as a rare instance to take advantage of low global interest-rate levels in a bid to ease pressure of domestic borrowings, and not make this a regular practice.

FREQUENTLY ASKED QUESTIONS (FAQs) on External Commercial Borrowings (ECB) (As on May 29, 2019)

A. BASIC QUERIES

1. Where can one get the details of extant External Commercial Borrowings (ECB) and Trade Credits (TC) framework?

Master Direction No. 5 on External Commercial Borrowings, Trade Credits and Structured Obligations dated March 26, 2019 may be referred to for guidance on the extant framework on ECB and TC. ECBs and TCs raised under the prior frameworks should continue to be in compliance with the corresponding guidelines applicable at the time of availing the ECBs and TCs.

2. Do FCNR (B) loans given by AD Category I banks come under the ECB framework?

No, foreign currency loans given domestically by AD Category I banks out of the proceeds of FCNR (B) deposits do not come under the ECB framework.

3. What precautions have to be taken before raising loan from non-residents?

Borrowings from overseas have to be in compliance with the applicable ECB guidelines / provisions contained in the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018 issued vide Notification No. FEMA 3 (R)/2018-RB dated December 17, 2018, as amended from time to time.

4. Whose responsibility is it to ensure compliance with ECB guidelines?

The primary responsibility for ensuring that the borrowing is in compliance with the applicable ECB guidelines is that of the borrower concerned. Structures which bypass/ circumvent ECB guidelines in any manner and / or raising borrowings in any other manner which is not permitted / disguising borrowing under the wrap of other kind of transactions and / or contravening provisions of Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018 would also invite penal action under FEMA.

B. ELIGIBILITY FOR RAISING ECB

5. Are LLPs eligible to raise ECBs?

As LLPs are not eligible to receive FDI, they cannot raise ECBs.

C. CURRENCY OF ECB

6. Can INR denominated ECB be converted into foreign currency ECB?

Any entity raising INR denominated ECB is not permitted to convert the liability arising out of INR ECB into foreign currency liability in any manner or assuming foreign currency risk in any manner by either entering into a derivative contract or otherwise.

D. RECOGNISED LENDERS/ INVESTORS

7. Is the minimum equity holding requirement of foreign equity holder (direct/indirect) applicable where the end uses is other than general corporate purpose/working capital/repayment of Rupee loans?

The foreign equity holders as defined at Paragraph 1.11 of the Master Direction No. 5 on External Commercial Borrowings, Trade Credits and Structured Obligations dated March 26, 2019 (MD) are eligible to lend for the end-uses given at Paragraph 2.1.viii(d), 2.1.viii(e) and 2.1.viii(f) of the MD. For end-uses, other than those in the negative list, recognised lenders are given at Paragraph 2.1.iv of the MD.

8. A foreign equity holder holding minimum 25% direct equity holding in the borrowing entity or minimum indirect equity holding of 51% in the borrowing entity is a recognised lender. Can the foreign equity holder dispose-off the holding once ECB is contracted?

No, all ECB guidelines including those related to minimum equity holding, are to be fulfilled during the whole tenure of the ECB and not only at the time of contracting of ECB.

9. Can Indian banks participate in the process of issuance of Rupee denominated bonds overseas in any other manner?

Indian banks cannot subscribe to RDBs issued overseas in primary market but can be arrangers/ underwriters/ market makers/ traders subject to compliance with prudential norms.

10. Can persons resident in India subscribe to bonds (foreign currency/INR) issued by eligible ECB borrowers in overseas centres or IFSCs as permitted in the ECB framework?

No. AD banks should ensure that persons resident in India do not have any exposure to borrowings by eligible entities under this framework either directly or indirectly except foreign branches/ subsidiaries of Indian banks abroad or any other permitted entities. Further, establishing borrowing structures/modalities which contravene the guidelines shall render themselves liable for penal action as prescribed under FEMA.

11. Individuals can be recognised lenders if they are foreign equity holders or for subscription to bonds/debentures listed abroad. Should such lenders also be from FATF/IOSCO compliant jurisdictions?

Yes.

E. AVERAGE MATURITY PERIOD

12. How is average maturity period calculated?

You may refer to https://rbidocs.rbi.org.in/rdocs/Content/PDFs/12EC160712_A6.pdf for illustration purposes.

13. Can door-to-door maturity be used in lieu of average maturity?

No.

14. In case of an ECB raised from foreign equity holder and utilized for general corporate purpose/working capital/repayment of Rupee loans, can repayment of principal of ECB start before the completion of 5 years?

Yes, however, the ECB should have minimum average maturity period of 5 years.

F. LEVERAGE CRITERIA AND BORROWING LIMIT

15. Should the proposed ECB be added to all outstanding ECBs for the purpose of ECB liability to equity ratio?

Yes, apart from ECB raised for refinancing where the proposed ECB amount may not be taken into account to avoid double counting.

16. Does the equity in –ECB liability to Equity ratio include non-convertible preference capital?

No.

17. Should the proposed ECB be added to all outstanding ECBs for arriving at the individual limit for raising of ECBs?

The individual limit for raising ECB under the automatic route will take into account all ECBs raised in the financial year including the proposed one. However, refinancing of ECB amount

will not be considered for arriving at individual limit per financial year. Also, the limit will be restored at the beginning of new financial year.

18. Is the debit balance in the profit and loss account for losses incurred by the Eligible Borrower, if any, required to be deducted from the free reserve while calculating the ECB liability-equity ratio?

Yes. Any debit balance in the profit and loss account as per the latest audited balance sheet of the Eligible Borrower should be deducted from the equity for computing the ECB liability-equity ratio.

19. Can an eligible borrower simultaneously raise both Foreign Currency and INR denominated ECBs?

Yes, as long as the ECBs are in compliance with the ECB guidelines for the respective currencies as per RBI guidelines. The individual limit will include all ECBs raised, whether in foreign currency or INR.

20. Is the enhancement of ECB amount permitted under the delegated powers?

Yes, provided the enhanced amount does not breach the applicable annual limit for the automatic route for the current financial year and the other parameters of the ECB are in compliance with the existing ECB guidelines also. Since this would be considered as change in terms for the same ECB, no separate LRN is required for the enhanced amount.

G. ALL-IN-COST

21. Does all-in-cost ceiling apply on a continuous basis or can it be calculated even on an average basis?

All-in-cost should be within the applicable ceiling at all times, e.g., breach of all-in-cost ceiling in the first year and a much lower all-in-cost in the second year so as to comply on an average, is not permitted.

22. Can interest during construction stage be paid out of ECB borrowings?

The definition of all-in-cost prohibiting use of ECB proceeds for payment of interest/charges is not applicable to ECBs raised for project finance and utilised for payment of guarantee fees (like ECA Premium) and interest during construction, provided the said components are part of project cost and capitalised by the borrower.

G. END-USES

23. Is the reimbursement of expenditure incurred in the past a permissible end-use under the ECB framework?

The reimbursement of expenditure incurred in the past is not a permissible end-use under the ECB framework.

24. Can ECB be availed of for making equity investment domestically or buying goodwill?

No. Equity investment either directly or indirectly (through purchase of goodwill) is not permitted.

25. Can ECB be availed of for making contribution in an LLP?

No, it is not permitted.

26. Can an eligible borrower raise fresh foreign currency ECB for repayment of existing Rupee denominated ECB?

Refinancing of Rupee denominated ECB with Foreign Currency denominated ECB is not permitted.

27. Can ECB proceeds be used by eligible resident borrowers for investment in their overseas JV/WOS as per the extant overseas investment guidelines?

Yes. ECB proceeds can be utilized for overseas investment as permitted under the overseas investment guidelines.

28. Is on-lending treated as working capital for borrowers who are engaged in the business of on-lending?

For the purpose of ECB, on-lending by borrowers who are engaged in the business of on-lending is not treated as working capital. Additionally, the borrowers shall need to adhere to the guidelines issued by the concerned sectoral or prudential regulator in this regard.

29. Can the housing finance companies raise ECB for on-lending to individual borrowers exclusively for flats/units in the affordable housing projects as defined in Harmonised Master List of Infrastructure Sub-sectors notified by Government of India?

Yes.

H. REFINANCING OF ECB

30. Can ECB raised under the earlier ECB framework be refinanced/ partially refinanced through an ECB raised under extant ECB framework?

Yes, provided that the borrower continues to be eligible to raise ECB under the extant ECB framework, all-in-cost is lower than the all-in-cost of existing ECB, residual maturity is not reduced and the new ECB is in compliance with the extant ECB framework as well.

31. Can refinancing/ partial refinancing be undertaken under auto route even for ECBs raised under approval route, subject to compliance with guidelines?

Yes.

32. Is refinancing of ECBs raised from foreign equity holders and utilised for working capital/ general corporate purpose/ repayment of Rupee loans permitted?

Yes. However, the new ECB lenders should also be foreign equity holders as defined in the ECB framework and subject to applicable refinancing guidelines.

I. HEDGING UNDER ECB FRAMEWORK

33. Can an entity raising INR ECB including issuance of Rupee denominated bonds overseas, assume foreign currency risk on account of liabilities arising out of such ECBs?

Any entity raising INR ECB (including issuance of Rupee denominated bonds overseas) is not permitted to convert the liability arising out of such ECBs into a foreign currency liability in any manner or assume foreign currency risk in any manner by either entering into a derivative contract or otherwise.

34. Can the existing hedge(s) for ECBs be rolled over to the extent of 100 per cent of outstanding ECB exposure?

Yes. The prescription is that of a minimum mandatory hedge.

35. What are the permitted derivative products for hedging of ECB?

Users may refer to Master Direction on Risk Management and Inter-bank dealings dated July 5, 2016, as amended from time to time.

J. Reporting

36. What precautions have to be taken at the time of filing of Form ECB in respect of an ECB?

Any draw-down in respect of an ECB should happen only after obtaining the Loan Registration Number (LRN) from RBI by filing duly certified Form ECB to the Director, External Commercial Borrowings Division, Department of Statistics and Information Management (DSIM), Reserve Bank of India, Bandra-Kurla Complex, Mumbai – 400 051. It should be ensured that all terms and conditions of the ECB are reported correctly in Form ECB and none of the columns are left blank (such columns which are not applicable for the borrowing or against which ‘_nil’ information has to be given, should be suitably covered). Changes in ECB parameters, whether under the automatic route with the approval of Authorised Dealer Category –I banks or under the approval route with prior approval of the RBI, should also be reported to the DSIM through revised Form ECB at the earliest, in any case not later than 7 days from the changes effected. While submitting revised Form ECB, the changes should be specifically mentioned in the communication. Any failure to comply with reporting guidelines in respect of Form ECB for an ECB may invite penal action under FEMA.

37. How are actual transactions of an ECB reported to RBI?

The borrowers are required to report actual ECB transactions, correctly and fully, through duly certified Form ECB 2 through the Authorised Dealer Category-I bank to DSIM as per the periodicity specified by the RBI. None of the columns in Form ECB 2 should be left blank (such columns which are not applicable for the borrowing or against which ‘_nil’ information has to be given, should be suitably covered). The Form ECB 2 should reach DSIM within seven working days from the close of month to which it relates. Changes, if any, in ECB parameters should also be incorporated in Form ECB 2 suitably. Any failure to comply with reporting

guidelines in respect of Form ECB 2, including failure to adhere to periodicity of reporting, may invite penal action under FEMA.

38. In light of the New ECB framework, does the borrower need to file revised Form ECB?

No, in case no changes are made in terms and conditions of ECB, there is no need to file revised Form ECB (erstwhile Form 83).

39. Is LSF applicable to old ECB 2 returns also?

No. LSF provisions will be applicable to ECB 2 returns submitted from February 2019 onwards i.e. Form ECB 2 submitted in the month of February for transactions conducted in the month of January 2019.

40. Is LSF applicable for each Form ECB 2 and to nil returns as well?

Yes. LSF is applicable for non-submission of each Form ECB 2, including Nil returns.

K. MISCELLANEOUS

41. Can the interest accrued on ECB be converted into Equity under the extant norms?

Yes. Extant norms permit both ECB principal and interest to be converted into equity subject to applicable conditions as given under Paragraph 7.4 of the Master Direction No. 5 on External Commercial Borrowings, Trade Credits and Structured Obligations dated March 26, 2019.

42. When ECB is partially converted into equity, should the remaining ECB amount comply with all the ECB guidelines?

Yes. The part conversion of ECB into equity will be freely permitted only when the part amount remaining as ECB complies with all the applicable ECB norms.

43. Can fixed deposits created out of ECB proceeds, pending utilization, be renewed after completion of maximum permitted period?

No.

Depository Receipt Mechanism of Equity Offers

Depository receipt is a source of raising foreign capital. It enables an already listed company (in most cases) to raise further capital from international markets. Also, the individual investors get an opportunity to invest in foreign markets without hassle. A depository receipt is a negotiable instrument. The local bank of a country issues a depository receipt. The exchange of the issuing country lists the depository receipts. However, it represents shares, usually equity, of a foreign company as its underlying.

The most prevalent depository receipts traded today include ADR's and GDR's.

DRs constitute an important mechanism through which issuers can raise funds outside their home jurisdiction. DRs are issued for tapping foreign investors who otherwise may not be able to participate directly in the domestic market. It is perceived as the beginning point of connecting with the foreign investors (i.e. a stage before the actual listing the shares /securities

in a foreign stock exchange) or a way of introducing the company to a foreign investor. For investors, depository receipt is a way of diversifying the risk, by getting exposure to a foreign market, but without the exchange rate risk as they are foreign currency denominated. Further, they feel more safe to invest from their home location.

Depending on the location in which these receipts are issued they are called as **ADRs** or American Depository Receipts (if they are issued in USA on the basis of the shares/securities of the domestic (say Indian) company), **IDR** or Indian Depository Receipts (if they are issued in India on the basis of the shares/securities of the foreign company; Standard Chartered issued the first IDR in India) or in general as **GDR** or Global Depository Receipt.

Thus, ADR or GDR are issued outside India by a foreign depository on the back of an Indian security deposited with a domestic Indian custodian in India (means a custodian or keeper of securities- an Indian depository, a depository participant, or a bank- and having permission from the securities market regulator, SEBI, to provide services as custodian).

Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) (Seventeenth Amendment) Regulations, 2014 and as per the Scheme issued in this regard by the Ministry of Finance in December 2014, a depository receipt is defined as follows:

‘Depository Receipt’ means a foreign currency denominated instrument, whether listed on an international exchange or not, issued by a foreign depository in a permissible jurisdiction on the back of eligible securities issued or transferred to that foreign depository and deposited with a domestic custodian and includes ‘global depository receipt’ as defined in section 2(44) of the Companies Act, 2013.

As per the Companies Act, 2013 "Global Depository receipt" means any instrument in the form of a depository receipt created by a foreign depository outside India and authorised by a company making an issue of such depository receipts while the "Indian Depository Receipt" means any instrument in the form of a depository receipt created by a domestic depository in India and authorised by a company incorporated outside India;

In India any company - whether private limited or public limited or listed or unlisted - can issue DRs. However listed DRs enjoy some tax benefits.

ADR /GDR issues based on shares of a company are considered as part of Foreign Direct Investment (FDI) in India, though it is an indirect way of holding shares. As per a Cabinet decision dated 16 July 2015, DRs having underlying of instruments which can be issued under Schedule 5 of FEMA Regulations, being in the nature of debt, will not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement will be reckoned as foreign investment.

Types of DRs

DRs are generally classified as under:

1. Sponsored
2. Un-sponsored

Sponsored

Where the Indian issuer enters into a formal agreement with the foreign depository for creation or issue of DRs. A sponsored DR issue can be further classified as:

1. Capital Raising
2. Non-Capital Raising

Capital Raising

The issuer issues new securities which are deposited with a domestic custodian. The foreign depository then creates DRs abroad for sale to foreign investors. This constitutes a capital raising exercise, as the proceeds of the sale of DRs go to the Indian issuer.

Non-Capital Raising

In a non-capital raising issue, no fresh underlying securities are issued. Rather, the issuer gets holders of its existing securities to deposit these securities with a domestic custodian, so that DRs can be issued abroad by the foreign depository. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

Un-sponsored

Un-sponsored DRs are where there is no formal agreement between the foreign depository and the Indian issuer. Any person other than the Indian issuer may, without any involvement of the issuer, deposit the securities with a domestic custodian in India. A foreign depository then issues DRs abroad on the back of such deposited securities. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

Based on whether a DR is traded in an organised market or in the over the counter (OTC) market, the DRs can be classified as listed or unlisted.

Listed

Listed DRs are traded on organised exchanges. The most common example of this are American Depositary Receipts (ADRs) which are traded on the New York Stock Exchange (NYSE).

Unlisted

Unlisted DRs are traded over the counter (OTC) between parties. Such DRs are not listed on any formal exchange.

International experience

The most common DR programs internationally are:

ADRs

DRs issued in United States of America (US) by foreign firms are usually referred to as ADRs. These are further classified based on the detailed rules under the US securities laws. The classification is based on applicable disclosure norms and consists of:

- Level 1: These programs establish a trading presence in the US but cannot be used for capital raising. They may only be traded on OTC markets, and can be unsponsored.
- Level 2: These programs establish a trading presence on a national securities exchange in the US but cannot be used for capital raising.
- Level 3: These programs can not only establish a trading presence on a national securities exchange in the US but also help raise capital for the foreign issuer.
- Rule 144A: This involves sale of securities by a non-US issuer only to Qualified Institutional Buyers (QIBs) in the US.

Global Depository Receipts (GDRs)

GDR is a collective term for DRs issued in non-US jurisdictions and includes the DRs traded in London, Luxembourg, Hong Kong, Singapore.

DEPOSITORY RECEIPT ISSUANCE: PROCESS

The process of issuance of a depository receipt involves several steps. The following example seeks to clarify and explain the process in a simplified manner.

Say, a Japanese Automobile company wishes to raise funds from the American capital market. It, therefore, proceeds to initiate the issue for ADR's to be listed on the NYSE. It satisfies the preliminary requirements to qualify for an ADR issue.

PARTIES INVOLVED

DEPOSITORY BANK

Located in the country of ADR issuance. (Here, USA). The depository bank is the ultimate issuer of the DR's on a local exchange.

CUSTODIAN BANK

Located in the country from where the shares have originated. (Here, Japan). The depository bank, sitting in the USA chooses the custodian bank.

BROKER

A broker undertakes to oversee the entire process from inception to issuance. He is usually located in the country of ADR issuance.

FOREIGN STOCK EXCHANGE

The exchange ultimately listing the ADR's. (Here, NYSE).

PROCESS

Step 1:

The US broker purchases the shares of the Japanese company through his international branch situated in Japan. He then has these shares delivered to the custodian bank (Japan).

Step 2:

The depository bank (USA) confirms the delivery and receipt of the underlying shares with the custodian bank. Its a signal from Custodian Bank to the depository bank that the shares are deposited with it and ADRs in lieu of them can now be issued.

Step 3:

ADRs are issued upon confirmation. A predetermined number of underlying shares are consolidated to constitute an ADR. The ADR ratio is decided upon after considering several economic factors including the existing exchange rate of the Japanese Yen to USD as on that date.

Step 4:

The broker receives the so formulated ADR's. The broker is an intermediary between the Japanese company and the American Exchange. He then proceeds to conclude the process of listing of the ADR's on the NYSE.

CHARACTERISTICS OF DEPOSITORY RECEIPT**GLOBAL ACCESSIBILITY**

The first and foremost reason why a company issues depository receipts is global exposure. By issuing DR's, a company can invite capital from across borders. This is a particularly helpful tool when a business has exhausted equity capital sources from its own country.

Investors too reap great benefits from being able to invest in depository receipts. For an individual investor, wanting to invest in foreign capital markets spells trouble. There are so many countless hurdles of compliances and procedures to cross that the desire to invest abroad is a nip in the bud. With a depository receipt, the investor can successfully take a position in international markets and not worry about multiple compliances.

DIVERSIFICATION

Elaborating on the aforementioned point, depository receipts allow investors to participate in markets beyond their borders. Consequently, investors from the developed economy can participate in the high yielding economies of developing countries. For example, ICICI Bank, India has issued ADR's listed on the NYSE. Investing in DR's escalates one's portfolio to capture global movements. The investor can diversify away the risk specific to his own country by investing into depository receipts.

FOREIGN EXCHANGE EXPOSURES

The investors are also able to generate foreign exchange income. Dollars or Euros denominate most depository receipts. These are amongst the strongest currencies today. Naturally, apart from the anticipated capital gain income, the investors make a considerable profit while converting their income back to that of the home country. However, like two sides of a coin, this upside can quickly turn to a downside should the foreign currency take any hits owing to economic and other factors. Therefore, an investor of DR's is equally exposed to positive as well as negative currency fluctuations.

EASE OF OPERATIONS

A remarkable aspect in the workings of a depository receipt is that they replicate any other existing stock on the exchange. They are denominated in the currency of the country they are issued. For example, ADR's are listed in dollars and even pay out dividends in dollars. Since they are expected to comply with the statutory requirements of the issuing country, they behave almost identically with shares of that country.

The willing investors are not required to go any extra effort for obtaining depository receipts than they have to for purchasing local shares of that country. And local brokerage or trading

account will easily make available the DR's. This has greatly benefited the individual and small investors who wish to invest in the foreign market but do not possess the extravagant means to do so.

DERIVED VALUE

Though the depository receipts are issued in the currency of the country of issuance, that currency has little or no significance in determining its value. This is because the DR's, in essence, is a consolidated bunch of the underlying shares. These shares continue to be denominated in the currency of its originating country. The underlying shares determine the value of a depository receipt. It is the business performance of parent company and market sentiment for the stock in its country of origin that has a considerable bearing in deciding the price of a depository receipt.

STATUTORY COMPLIANCE

Issuance of a depository receipt requires heavy compliances from the issuing company. It is required to obtain umpteen number of sanctions and approvals before proceeding with a DR issue. It does not end there. After satisfying the legal requirements of own country, the issuer must also ensure that the issue agrees with the compliance requirements of the target country. The issuing company is also subjected to stringent examination of books of accounts and credit evaluations. It is only on –getting an okay! in all respects can the company finally roll out its issue.

COST OF ISSUE

Owing to its complicated and intermingling nature, depository receipts are undoubtedly a very expensive source of finance. Corporations cannot resort to it as a routine means of raising funds. Issuing depository receipts is not as simple an affair as merely issuing fresh equity shares. In fact, most organizations go a lifetime without having to raise funds through DR's. Several investment banking professionals and financial service institutions have to be hired who charge a very hefty amount for such an issue. Additionally, government approvals and sanctions also entail a significant amount of fees.

Indian Regulatory Regime for Global Market Floats

In India, the issue of Depository receipts were regulated by the –The Issue of Foreign Currency Convertible Bonds and Ordinary Share (through Depository Receipt Mechanism) Scheme 1993 issued by the Ministry of Finance. The 1993 Scheme was formulated at a time when India's capital markets were substantially closed to foreign capital and the domestic financial system was not well developed. In the last two decades, the equity market has developed sophisticated market infrastructure with active participation by both domestic and foreign investors and capital controls have been eased substantially. In this period many aspects of the Indian legal and regulatory system have evolved with substantial changes. These developments warranted a fresh look at the Scheme governing the issue of Depository Receipts (DRs). Accordingly, based on the recommendations of the MS Sahoo committee, Hon'ble Finance Minister had announced in the 2014-15 Budget Speech that he propose to –Liberalize the ADR/GDR regime to allow issuance of depository receipts on all permissible securities!. Accordingly –The Depository Receipts Scheme, 2014" was formulated and implemented from December 15, 2014.

Detailed comparison of the 1993 Scheme and the 2014 scheme

Sl. No.	Parameter	1993 Scheme	2014 Scheme
1	Approval for issue of DRs from authorities	Required from MoF	Not required
2	Issuer of DRs (foreign depository)	A bank authorized by issuer of underlying securities	A regulated person having legal capacity to issue DRs
3	Custodian of DRs (domestic custodian)	A bank which acts as a custodian	A regulated entity having legal capacity to act as custodian for underlying securities
4	Jurisdictions for issue of DRs	Anywhere for listed companies; FATF/ IOSCO jurisdiction for unlisted companies	FATF and IOSCO compliant jurisdictions
5	Purpose of issue of DRs	Capital raising and non-capital raising	No change
6	Quantity / Limit on issue of DRs	No limit	No change
7	Kind of issue of DRs	Sponsored	Both sponsored and unsponsored
8	Mode of issue of DRs	Public offer, private placement or any other manner prevalent	No change
9	Listing of DRs	Not required	No change
10	End Use	Restricted	No restriction
11	Securities underlying DRs	Equity shares and FCCB	Any securities which are available to persons resident outside India and in demat form
12	Subscribers of DRs	Any person	No change
13	Mode of issue of underlying shares	Any mode permissible under law	No change
14	Mode of transfer of underlying securities to foreign depository	Not applicable	On Exchange, Off Exchange and tender process
15	Pricing of underlying securities at issue	Listed shares as per SEBI rules; Unlisted shares as per discounted cash flow method	Listed shares as per SEBI rules; No restriction on other securities
16	Issuer of underlying	Any company- listed or unlisted	Any issuer - listed or

	securities		unlisted
17	Whether underlying shares form part of public holding	No	Yes subject to certain conditions
18	Conversion from underlying securities to DRs and vice versa	Permissible	No change
19	Voting rights associated with underlying securities	Foreign depository	No change
20	Obligations	No explicit provision	Custodian, depository, issuer and transferor of underlying securities, holders of DRs
21	Market Abuse	No explicit provision	To be dealt by SEBI
22	Oversight on Prevention on money laundering	FIU, Enforcement Directorate and SEBI	No change

Process Flow of International offering

1). Introduction

SEBI, through its circular dated October 10, 2019 has laid down a framework for issue of depository receipts ("**DRs**") by listed companies and to be listed companies in order to provide increased access to foreign funds (the "**SEBI DR Circular**"). The framework comes shortly after Finance Minister Nirmala Sitharaman's statement in August that the markets regulator would soon implement the Depository Receipt Scheme, 2014 notified by the Ministry of Finance in 2014 (the "**MoF Scheme**").

DRs are foreign currency denominated instruments, issued by a foreign depository backed by securities of an issuer, issued or transferred to a domestic custodian and are listed on an international exchange.

The MoF Scheme, though a generously liberalized scheme for Indian companies, was never fully operationalized, resulting in unavailability of DRs as a fund-raising option. Additionally, identification of beneficial ownership norms for the longest time kept the route unattractive for foreign investors and depositories. However recently, the amendment to the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (the "**PML Rules**") on September 18, 2019 on the identification of beneficial owners paved the way for DRs (the "**Amendment**").

2. REGULATORY BACKGROUND

Issue of DRs is primarily governed by the Companies Act, 2013 (the "**Companies Act**") read with the Companies (Issue of Global Depository Receipts) Rules, 2014 (the "**GDR Rules**"), the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (the "**FEMA Rules**"), and the MoF Scheme.

Initially, the issue of DRs were regulated by the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (the "**1993 Scheme**"), which has been repealed (except for issue of FCCBs) by the MoF Scheme. However, unlike the SEBI DR Circular, the 1993 Scheme was largely unregulated by SEBI.

3. SEBI DR CIRCULAR: ANALYSIS

3.1. Key tenets of DRs

(a) *International exchanges and jurisdictions*

DRs are allowed to list on international exchanges in permissible jurisdictions. A list of permissible jurisdictions and international exchanges therein are notified by Ministry of Finance and SEBI, respectively, through their notifications dated November 28, 2019.

List of permissible jurisdictions and international exchanges are as:

Sl. No.	Permissible Jurisdiction	International Stock Exchange
1.	United States of America	NASDAQ Stock Market The New York Stock Exchange
2.	Japan	Tokyo Stock Exchange
3.	South Korea	Korea Exchange Inc.
4.	United Kingdom <i>excluding British Overseas Territories</i>	London Stock Exchange
5.	France	Euronext Paris
6.	Germany	Frankfurt Stock Exchange
7.	Canada	Toronto Stock Exchange
8.	International Financial Services Centre in India	India International Exchange NSE International Exchange.

Further, within the specified international exchanges, only the highest level of DR programs are permitted (for example Level III ADR program on NASDAQ or NYSE) which require highest level of disclosure. Accordingly, Level I and II ADR programs which contains lesser amount of compliance and regulatory oversight have been disallowed. This could act as a disincentive given that lower disclosure and compliance standards are permitted in those jurisdictions and are acceptable to foreign investors.

Also, while the MoF Scheme mandated compulsory listing of DRs in case of unsponsored DRs (defined below), the SEBI DR Circular has made listing for all DR issuances by listed and to be listed issuers compulsory.

(b) *Permissible securities*

The SEBI DR Circular only allows equity shares and debt securities listed on an Indian stock exchange to be the underlying securities for DRs. This is in contrast to the MoF Scheme, which gave a more expansive definition of securities, including units of real estate investment trusts (REITs) and infrastructure investment trusts (InvITs).

3.2 Eligibility

Under the SEBI DR Circular, any issuers, its promoters, promoter group, directors and selling shareholders who are debarred from accessing capital markets and are declared as willful defaulters or fugitive economic offender are ineligible to undertake a DR issue. This is stricter than the eligibility criteria prescribed under the MoF Scheme. For example, the debarment test is only applicable to issuers and selling shareholders under the MoF Scheme, compared to the wider net of individuals and entities captured under the SEBI DR Circular.

Further, the eligibility conditions in case of fast track rights issues and public offers provide for a look back period of three years and excludes imposition of monetary fines by stock exchanges, while seeking compliance with SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (the "**LODR**"). However, similar concessions have not been provided in the eligibility conditions prescribed under the SEBI DR Circular.

3.3 Compliance with Minimum Public Shareholding ("**MPS**") norms

As an eligibility condition, a listed issuer proposing to issue DRs should be in compliance with the LODR in relation to the MPS requirement of 25% of the post issue capital, as given under the Securities Contract Regulation Rules, 1957 (the "**SCRR**"). Under the SEBI DR Circular, DRs are excluded from computing towards public shareholding, a departure from the MoF Scheme and the SCRR, wherein DRs were included. This could pose a significant challenge for companies intending to list DRs through fresh issuance, or DRs through secondary sale by non-promoter group, which could lead to higher than expected dilution to public by an issuer. Further, it needs to be seen if stock exchanges are agreeable to issuing in-principle approvals to issuers who have made a public offer of only 10% of the post issue capital to public (in accordance with SCRR) and are yet to increase it to the mandatory 25% of the post issue capital.

3.4 DR issuances

The issue of DRs can be offered through fresh issue or through transfer by existing security holders, as long as it complies with the foreign investment limits imposed under the FEMA Rules.¹ In case of issue and listing of DRs pursuant to transfer by existing holders, the issuer must provide an option to all existing security holders to take part in the process by tendering their securities – however, no procedure has been laid out under the SEBI DR Circular.

Further, an unsponsored DR as per the MoF Scheme is a program where DRs are issued without specific approval of the issuer. Thus, unsponsored DRs provide an additional avenue for investors on the back on underlying securities by creating a market overseas. However, the SEBI DR Circular has removed such flexibility.

3.5 Identification of beneficial owner

A permissible holder of a DR includes a beneficial owner, who is neither a person resident in India nor an NRI. Identification of beneficial owner will now be governed by the norms of the jurisdiction where the DRs will be listed, i.e. to say a foreign investor can acquire a DR based on the KYC checks it has undergone with the notified international exchange. However, the identification of beneficial owners under the Companies Act is at divergence when compared with the identification pursuant to the Amendment. To that extent, policy alignment is still a much-needed request.

3.6 Simultaneous listing outside and within India

The SEBI DR Circular permits simultaneous listing of DRs and permissible securities on Indian stock exchanges wherein the issue or transfer of the DRs can only happen after trading approval has been received from the Indian stock exchange for the public offer.

This may however pose a challenge in case of a secondary DR issue with respect to the pre-IPO shares locked in under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (the "**ICDR Regulations**"). Also, in case of further issue of permissible securities for issue of DRs, the capital structure of the issuer will remain fluid, which will require obtaining necessary clearance from SEBI both in terms of disclosures as well as restriction on further issue of capital under the ICDR Regulations.

3.7 Filing of offer documents for DRs

For issue of DRs, the preliminary offer document needs to be filed with SEBI and the Indian stock exchanges for their comments, along with filing of the final offer documents. This is in contrast to the MoF Scheme, which mandated mere filing of the offer documents with SEBI. Additional review requirements imposed under the SEBI DR Circular seems to be excessive legislation impacting the timelines for launch.

Filing of offer document seems to be a varied practice when compared to the external commercial borrowings raised by an issuer through international capital markets, and foreign currency convertible bonds.

3.8 Disclosures on Indian stock exchange

All public disclosures made on the international exchange to comply with the norms of the permissible jurisdiction where the DRs will be listed, are also required to be filed on the Indian stock exchange as per the SEBI DR Circular.

3.9 Voting Rights

While all DR holders are allowed to vote through foreign depository, the discretion provided to foreign depository under the MoF Scheme to vote on such matters irrespective of instructions received from DR holders has been taken away under the SEBI DR Circular. This seems to be a step in the right direction, as it now prevents the foreign depository to vote on the instructions of the promoters, or management of an issuer.

3.10 Pricing

Under the SEBI DR Circular, the price of issue of DRs should not be less than the price for the public offer/ preferential allotment/ QIP that has been made to the domestic investors. In case permissible securities are transferred for the issue of DRs, the same should be issued at a price not less than the price of a corresponding mode of issue of permissible securities to domestic investors under the applicable laws. With lack of clarity on what would constitute a corresponding mode of issue, it could affect the manner in which the pricing occurs, especially in case of issue of DRs from existing security holders.

4. CONCLUSION

Overall, the SEBI DR Circular is a welcome step by SEBI to operationalize the MoF Scheme for listed and to be listed companies. In addition, clarity on beneficial ownership was a longstanding roadblock which has been eased through the Amendment. However, the SEBI DR Circular in its current state still requires certain modifications to offer DRs as a lucrative

fund-raising option. Further, clarity in relation to the fungibility of DRs is still awaited and will be reviewed with much interest, given the lessons learnt with the fungibility of IDRs in the past. However, a major roadblock for the complete operationalization of the MoF Scheme is a framework for unlisted companies, constituting a majority of active fund seekers (esp. start-ups) who are eagerly awaiting to tap this route, for which a regulatory framework by Ministry of Corporate Affairs is awaited.

MODULE III: INVESTMENT BANKING

Evolution of Investment Banking

The history of investment banking in India traces back to when European merchant banks first established trading houses in the region in the 19th century. Since then, foreign banks (non-Indian) have dominated investment and merchant banking activities in the country.

In the 1970's, the State bank of India entered the business by creating the Bureau of Merchant Banking and ICICI Securities became the first Indian financial institution to offer merchant banking services.

By 1980, the number of merchant banks had risen to more than 30. This growth in the financial services industry included rapid expansion of commercial banks and other financial institutions.

Association of Investment Bankers of India

According to the Association of Investment Bankers of India (AIBI), the merchant banking industry started to take off in the 1990's with over 1,500 merchant bankers registering with the Securities and Exchange Board of India (SEBI). To regulate and govern the new wave of banks that opened up, the Association of Investment Bankers of India (AIBI) was created to ensure members were in compliance with banking regulations and that their activities were kept in check.

AIBI's purpose is to ensure members institutions follow its ethical and legal practices, as well as to promote the industry of investment banking in India and the business interests of its members.

Investment Banking in India – List of AIBI Member Investment Banks:

- A.K. Capital Services Ltd.
- Ambit Corporate Finance Pvt.Ltd.
- Anand Rathi Advisors Ltd.
- Ashika Capital Ltd.
- Avendus Capital Pvt.Ltd.
- Axis Bank Ltd.
- Axis Capital Ltd.
- Barclays Bank Plc
- Bcb Brokerage Pvt.Ltd.
- Birla Capital & Financial Services Ltd.
- Bnp Paribas
- Bob Capital Markets Ltd.
- Boi Merchant Bankers Ltd.
- Canara Bank
- Central Bank Of India
- Centrum Capital Ltd.
- Chartered Finance Management Ltd.
- Choice Capital Advisors Pvt.Ltd.
- Citigroup Global Markets India Pvt.Ltd.
- Credit Suisse Securities (India) Pvt.Ltd.
- Deutsche Equities India Pvt.Ltd.
- DSP Merrill Lynch Ltd.

- Edelweiss Financial Services Ltd.
- Ernst & Young Merchant Banking Services Pvt.Ltd.
- HDFC Bank Ltd.
- HSBC Securities & Capital Markets (India) Pvt.Ltd.
- ICICI Securities Ltd.
- IDBI Capital Market Services Ltd.
- IDFC Securities Ltd.
- LIFL Holdings Ltd.
- Il&Fs Capital Advisors Ltd.
- Indian Overseas Bank
- Inga Capital Pvt.Ltd.
- Jefferies India Pvt.Ltd.
- JM Financial Institutional Securities Ltd.
- JP Morgan India Pvt.Ltd.
- Karvy Investor Services Ltd.
- Keynote Corporate Services Ltd.
- KJMC Corporate Advisors (India) Ltd.
- Kotak Mahindra Capital Co.Ltd.
- Lazard India Pvt.Ltd.
- Morgan Stanley India Co.Pvt.Ltd.
- Motilal Oswal Investment Advisors Pvt. Ltd.
- Munoth Financial Services Ltd.
- Pantomath Capital Advisors Pvt.Ltd.
- Religare Capital Markets Ltd.
- Rothschild (India) Pvt.Ltd.
- Saffron Capital Advisors Pvt.Ltd.
- SBI Capital Markets Ltd.
- SMC Capitals Ltd.
- Trust Investment Advisors Pvt.Ltd.
- UBS Securities India Pvt.Ltd.
- Union Bank Of India
- Vivro Financial Services Pvt.Ltd.
- Yes Bank Ltd.

List of Top Investment Banks in India

There are many investment banks in India which offer excellent services and have been gradually expanding their reach. But among all of them, here is the list of top 10 Indian investment banks as per the deal volume (these deals are purely based on M&A deals) –

Name of the Investment Bank	No. of Deals (2016)
Ernst & Young Private Ltd.	26
Price Water House Coopers, Investment Banking Arm	11
Deloitte Touche Tohmatsu India, LLP	11
O3 Capital Global Advisory Private Ltd.	8

KPMG India Private Ltd.	8
Axis Capital Ltd.	7
Standard Chartered Bank, Investment Banking Division	6
Avendus Capital Private Ltd.	6
JM Financial Institutional Securities Ltd.	6
KPMG Corporate Finance LLC	6

Now, let's have a look at the list of top 10 investment banks as per deal value (M&A) in 2016

–

Rank	Name of the Investment Bank	Deal Value (in \$ millions)	No. of Deals
1	Arpwood Capital Private Ltd.	21,891.71	4
2	JM Financial Institutional Securities Ltd.	13,599.77	6
3	Morgan Stanley	11,950.00	4
4	Ernst & Young Global Ltd.	10,898.72	4
5	Kotak Mahindra Capital Co. Ltd.	10,149.96	4
6	Ambit Private Ltd.	9,730.00	3
7	DH Consultants Private Ltd.	9,730.00	1
7	Citigroup Global Markets India Private Ltd.	9,730.00	1
8	Lazard Ltd.	9,407.42	4
9	J.P. Morgan Securities LLC	8,000.00	1
9	Evercore Partners Inc.	8,000.00	1
10	Standard Chartered Bank, Investment Banking Division	3,667.80	6

Now, let's look at the list of investment banks that have topped the list in 2016 in terms of IPO in the domestic market –

Rank	Name of the Investment Bank
1	ICICI Securities
2	Edelweiss Financial Services

3	Axis Bank
4	HSBC
5	Kotak Mahindra Bank
6	IIFL Securities
7	IDFC Bank
8	State Bank of India
9	JM Financial Institutional Securities Ltd.
10	Elara Capital

The best part of this list is that only one foreign bank has been included in the list, i.e. HSBC. Remaining all 9 banks belong to India. That means, the reign of foreign investment banking has been declining and more and more Indian investment banks are coming up on the top.

Characteristics and Structure of Indian Investment Banking Industry

For more than three decades, the investment banking activity was mainly confined to merchant banking services. The foreign banks were the forerunners of merchant banking in India. The erstwhile Grindlays Bank began its merchant banking operations in 1967 after obtaining the required license from RBI. Soon after Citibank followed through. Both the banks focused on syndication of loans and raising of equity apart from other advisory services. In 1972, the Banking Commission report asserted the need for merchant banking activities in India and recommended a separate structure for merchant banks totally different from commercial banks structure. The merchant banks were meant to manage investments and provide advisory services. The SBI set up its merchant banking division in 1972 and the other banks followed suit. ICICI was the first financial institution to set up its merchant banking division in 1973.

The advent of SEBI in 1992 was a major boost to the merchant banking activities in India and the activities were further propelled by the subsequent introduction of free pricing of primary market equity issues in 1992. Post-1992, there was lot of fluctuations in the issue market affecting the merchant banking industry. SEBI started regulating the merchant banking activities in 1992 and a majority of the merchant bankers were registered with it. The number of merchant bankers registered with SEBI began to dwindle after the mid nineties due to the inactivity in the primary market. Many of the merchant bankers were into issue management or associated activity such as underwriting or advisory. Many merchant bankers succumbed to the downturn in the primary market because of the over-dependence on issue management activity in the initial years. Also not all the merchant bankers were able to transform themselves into full-fledged investment banks. Currently bigger industry players who are in investment banking are dominating the industry.

Major Constraints for Investment Banking in India

The major constraints for investment banking in India were:

1. The Indian investment banks depended on issue management to a greater extent and so some of them had to perish due to the primary market downturn in the 90's.
2. The bigger industry players were the only ones to survive because of a general lack of institutional financing in a big way to fund capital market activity, which would have otherwise paved way for other smaller players.
3. The lack of depth in the secondary market, especially in the corporate debt market could not supplement the primary market for any major development.

Characteristics of Indian Investment Banking Industry

Till the 1980s, the Indian financial services industry was characterized by debt services in the form of term lending by financial institutions and working capital financing by banks and non-banking financial companies. Capital markets was still an unorganized industry and was mostly restricted to stock broking activity. In the early nineties, when the capital markets opened up, merchant banking and asset management services flourished. Many banks, NBFCs and financial institutions entered the merchant banking, underwriting and advisory services driven by the boom in the primary market.

Over the subsequent years, the merchant banking industry had faced a huge downturn due to recession in the capital markets. Also, the capital markets and investment banking activities came under lot of regulatory developments that required separate registration, licensing and capital controls. This proved to be an impediment for the growth of the investment banking industry.

Structure of Investment Banking in India

The Indian investment banking industry has a heterogeneous structure for the following reasons:

1. The regulations do not permit all investment banking functions to be performed by a single entity for two reasons:
 1. To prevent excessive exposure to business risk.
 2. To prescribe and monitor capital adequacy and risk mitigation mechanisms.
2. The commercial banks are prohibited from getting exposed to stock market investments and lending against stocks beyond certain specified limits under the provisions of RBI and Banking Regulation Act.
3. Merchant banking activities can be carried out only after obtaining a merchant-banking license from SEBI.
4. Merchant bankers other than banks and financial institutions are not authorized to carry out any business other than merchant banking.
5. The Equity research activity has to be carried out independent of the merchant banking activity to avoid conflict of interest.
6. Stock broking business has to be separated into a different company

Regulatory Framework for Investment Banking in India

An overview of the regulatory framework is furnished below:

1. All investment banks incorporated under the Companies Act, 1956 are governed by the provisions of that Act.
2. Those investment banks that are incorporated under a separate statute are regulated by their respective statute. Ex: SBI, IDBI.
3. Universal banks that function as investment banks are regulated by RBI under the RBI Act, 1934.
4. All Non-banking Finance Companies that function as investment banks are regulated by RBI under RBI Act, 1934.
5. SEBI governs the functional aspects of Investment banking under the Securities and Exchange Board of India Act, 1992.
6. Those investment banks that carry foreign direct investment either through joint ventures or as fully owned subsidiaries are governed by Foreign Exchange Management Act, 1999 with respect to foreign investment.

The present state of Investment Banking in India

Competition is undoubtedly a challenge for banks in any country, but it is absolutely fierce in India, where the infamous one rupee token fee — equivalent to about 1.5 US cents — for investment banking mandates for state-owned companies is a reality.

In such a tough environment, how can international banks make ends meet? And more importantly, is it even worth trying? For while Indian banks have no option but to stay in India, international banks have a choice – and some of them have quit already.

–The very interesting story in India over the last 10 years has been the steady replacement of foreign capital with domestic capital, and as a result the steady displacement of foreign banks by domestic banks,|| says Mumbai-based Saurabh Mukherjea, chief executive of domestic investment bank Ambit Capital. —The two stories are linked to each other.||

Mukherjea is not alone in detecting a shift in the foreign banks' operations, particularly in Indian investment banking.

Economic growth, with per-capita income rising from \$500 about 20 years ago to \$1,600 today, has paved the way for the financial services industry to open up and expand. But banks, especially the international ones, are finding the rewards elusive.

International banks have –undoubtedly scaled back||, says a head of investment banking at a private-sector lender, giving firms like his more opportunities.

One founder of a domestic wealth management practice says foreign banks don't have –much of an impact|| anymore as far as his business is concerned.

The head of a family office at a local firm reckons global banks –have vacated|| India. Foreign bankers dispute this, but the numbers tell an important tale.

In 2007, eight of the top 10 investment banking revenue leaders in India were international banks, alongside Kotak Mahindra Bank and Axis Bank.

Bank of America Merrill Lynch led the way with net revenues of \$83.4 million, followed by Citi with \$80.2 million and UBS and Deutsche Bank with \$63.2 million and \$47.1 million, respectively, according to Dealogic.

Kotak was fifth with \$39.8 million in revenues, followed by JPMorgan, Axis, Morgan Stanley, Nomura and NatWest Markets, with each earning between \$25 million and \$35 million.

Fee pools in investment banking in 2007 were between \$750 million and \$1 billion for a market that everyone thought was just about to take off, say bankers.

But it didn't. Activity slowed after the global financial crisis and did not come back.

Core investment banking revenues in India for the top 10 banks had fallen to \$344 million by 2016, before rebounding to \$456 million last year, Dealogic data shows. Last year was a relatively good one thanks to a pick-up in equity markets. India's benchmark Nifty 50 Index soared nearly 30% in 2017, propped up by hopes of economic reform and strong earnings growth – and driving a bumper crop of share offerings worth \$30.7 billion, including a record \$11.7 billion in IPOs, according to Dealogic.

–What has happened in the past five to seven years is that we've seen a backtracking of globalization of banking, not just in India but overall, says Rashesh Shah, chairman, managing director and chief executive of Edelweiss Group, a financial services conglomerate.

–The rules of every country are different and the context of every country is different. So, what worked until 2008, which is being a large global bank in 180 countries in the world, became very complex. Because of that complexity and compliance, we've seen global banks shrinking in India and in other emerging markets, Shah says.

–The large global banking days are over, he adds, –and largely because local rules have changed and the local markets have evolved a lot. Especially in India, where you have to be very sensitive to the local cost structure.

Does Shah have a point? Are international banks in India losing steam?

KVS Manian, president of corporate, institutional and investment banking at Kotak Mahindra Bank, agrees that foreign banks have retreated from the country.

–Most of them have not had a consistent enough strategy, he tells from the lender's headquarters in Mumbai's Bandra Kurla Complex, which houses many of the country's leading banks. –They come (into) products and go (from) products. It's the result of a combination of regulatory constraints and their own strategy.

–Plus, many [banks] have had to shrink their international balance sheets to take care of regulations in their domestic market. This has meant foreign banks have not expanded as much as one would have thought they would.

And yet, international banks still feature among the top earners: last year, JPMorgan led the way for investment banking revenues with \$72.9 million, followed by Citi with \$30.1 million and Axis Bank with \$27 million, according to Dealogic.

ICICI Bank and Morgan Stanley were fourth and fifth, respectively, with net revenues of \$20.5 million and \$19.6 million. The next five banks all earned between \$11 million and \$20 million.

This suggests the problem is one that affects all investment banks in India, whether they are local or international.

Client base

One senior investment banker puts foreign banks operating in the country into three categories. The first are the monoline banks, which only cover select clients, have limited on-the-ground resources and are willing to be patient for the business to come through from their chosen client base.

He puts firms like BAML, Goldman Sachs, Morgan Stanley and to some extent JPMorgan in this group.

In the second bucket are firms that have realized over time that India is not meaningful to their business in the Asian context and have therefore reduced their focus from the country. The third, he adds, are the ones that are pretty much mainstream banks and have a large presence in India.

In the latter category, most bankers in India – whether local or international – rate Citi's Indian operations across wholesale banking as the best of the foreign banks and a real competitor to the local players. KVS Manian, Kotak Mahindra Bank

League tables only capture a small proportion of the revenues available in Indian wholesale banking, which includes global banking and markets, treasury and trade solutions, securities and fund services and research.

Ravi Kapoor, head of corporate and investment banking at Citi India, says: –As a mainstream foreign investment bank, competing with other full-scale banks, we need to do many deals for our coverage clients across the board to maintain our leadership and league table dominance, as well as to defend our wallet share. That has been our business philosophy.¶

However, even Citi's investment banking franchise has seen better days. In 2007, it had core investment banking net revenues of \$80.2 million, giving it a market share of almost 11%. In 2012, this slipped to \$26 million and a 7.7% market share. Last year, that market share was 6.6%, according to Dealogic.

While the bank has consistently been among the top three investment banking revenue earners in India over the last few years, the market dynamics have undoubtedly changed. Standard Chartered, another example, earned revenues of \$11.5 million last year and a market share of 2.5%. Five years earlier, it had \$18.1 million in revenues and a 5.3% share.

Does that mean investment banking revenues and fees will be in continual decline? That depends who you ask.

Kapoor is optimistic that both the fee pools and volumes will expand.

–But while volumes expand, we will witness further contractions in gross margins,¶ he says. –At present, deal sizes, particularly in the ECM space, are relatively small, barring a few. Typical ECM deal sizes are still \$100 million to \$200 million. Therefore, banks will have to do

a combination of a few large deals and a reasonable share of the mid-sized deals to meet their plan numbers and maintain wallet shares.¶

Another senior investment banker at a foreign firm adds: –Some Muppet offered me 50 lakhs [equivalent to Rs5 million, or \$77,000] the other day and I turned it down. I’d like to believe that 2% on M&A is a good fee to get. But an entrepreneur or corporation might think differently.

–But why should the entrepreneur or the corporation be willing to give you more? Even in the private-sector space, as long as the competition remains as strong as it is, plus the entrepreneur thinks he’s strong, why will they pay more?¶ he asks. –Some of the fee levels you see in Hong Kong or China are pretty much unheard-of in India and will remain so.¶

That has naturally had some impact over the years. In the middle of 2016, Royal Bank of Scotland decided to wind up its corporate, retail and institutional operations in India — part of its efforts to steadily sell non-core businesses globally as it retreated after its ill-fated expansion spree before the financial crisis. ING Bank, which in India operated through ING Vysya Bank after its merger with Vysya Bank in 2002, completed the sale of ING Vysya Bank to Kotak in April 2015. Barclays shut its cash equities business across all Asian countries in early 2016, including in India, while Standard Chartered closed most of its equities operations in the country in 2015.

Despite the upheavals, some international firms strongly believe that India is core to their operations, notwithstanding the decline in revenues and intense competition for business.

Capital markets

Mihir Doshi, chief executive of Credit Suisse’s India business, says he is seeing positive momentum in the financing business, an important aspect of the investment banking and capital markets franchise in addition to ECM, DCM and M&A.

–We are differentiated due to our ability to provide bespoke and creative financing solutions that use our balance sheet smartly,¶ he says. –We have been successful in combining our financing and traditional IB platforms.¶ He adds that the fee pool is large enough when you combine financing, ECM, DCM and M&A, and the private placement business.

The bank has stepped up its game. Last year, Credit Suisse completed nine ECM transactions in India for credits of \$715 million, Dealogic data shows, up from \$215 million in 2016. On the DCM front, its market share in international public dollar bond issuance was 2.8% last year, rising from around 2% in 2016.

But revenues have been declining. Credit Suisse earned \$18.9 million in investment banking revenues last year and had a market share of 4.1%, down from \$27.8 million in revenues and an 8.1% market share in 2016. But in 2015, it had a 4.1% market share, and the year before that 5.5%.

Anuj Kapoor, head of corporate client solutions for India at UBS, says the Indian banking industry is so dynamic that business strategies need to be constantly rethought.

–It is clear that after the global financial crisis, banks needed to redefine their strategy — whether in terms of geography, products or people, he reckons. –For banks in India and the region, the key metrics over the last few years have been costs and headcount, but the focus now seems to be coming back to revenues. They are accurate near- to medium-term indicators of commitment and a safe barometer as to who will or will not retreat from the country.

A chief executive of a domestic bank, however, reckons cost structures for international banks will remain key when deciding whether or not to bulk up in the region.

–If they have just one snazzy office in Mumbai, then they get restricted to the top Nifty 50 index companies and to the big equity raises and M&A, he says. –But it’s the mid-market companies that will become bigger and bigger over the years and will provide business later. If you don’t start building relationships with them now, you’ll lose out later.

–I haven’t seen any single foreign bank that is betting big in India and looking to spread its wings, he adds. –It’s not easy of course to build a big business here, but it’s a burgeoning economy.

A Mumbai-based banker at a large foreign firm admits: –Many of us are going back to an old model that foreign banks used to have 10 to 15 years ago: to focus on our home market while playing in niches. That’s what we are trying to do in India.

Paying fees

What niches do foreign banks have in India? It is a difficult market to muscle into. –Most corporations don’t like to pay for advice – they’ll pay for balance sheet but not for advice, moans one banker in Mumbai.

–Large Indian corporations are notorious for not paying fees, mutters another. –We always look at the US market and think how well they are getting paid.

The story of how State Bank of India paid its bankers a token fee of one rupee for arranging a \$2.3 billion follow-on share offering last year is the stuff of financiers' nightmares – even though the concept of the one rupee fee has been around for many years.

Bankers reckon fees for India last year averaged less than 1% of deal proceeds, compared with 2% in Hong Kong and more than 3% in New York. Bankers say the low fees on offer in India mean underwriting deals don't make any commercial sense.

According to Ambit Capital's Mukherjee, there are two areas where the displacement of foreign firms has already happened – in private banking and fund management.

For now, he adds, if ECM deals are worth \$1 billion or more, foreign banks play an important role. They are also relevant when it comes to big-ticket inbound M&A. But he reckons that in the next few years, India's per-capita income will rise from \$1,600 to \$5,000. In line with that, –the ECM piece will become entirely Indian investment bank-dominated, because the local savings pot will be so deep that the need for foreign capital will go away, he says.

But Credit Suisse's Doshi is sceptical: were this hypothesis true, then global banks should have all but disappeared from countries like Australia, Japan and South Korea, he says – places where international houses still play a large role in the investment banking landscape.

–Issuers do not tend to differentiate simply between foreign versus domestic banks, he says.
–They differentiate based on quality, because ultimately it is about the quality of research, sales, distribution and relationships.

–In terms of banking business models, one can have a focused, niche offering within a bulge bracket firm, with a lower cost base, or have a broader offering across all investment banking product categories, which of course means a higher cost base, says Doshi. –For a country of this size, having a niche offering is not as viable. However, a boutique model with a focus on M&A or certain products can offer some value add.

Kotak's Manian says foreign banks are not a –big threat to private-sector banks. –There is a niche available for them, and some of them are playing that niche, he says.

–But finally it is niche, so their market share cannot dramatically improve. One of the senior bankers at an international firm admits that is the case – which makes the clout shift to the domestic banks.

–Part of the reason why people are worried about international investment banks' sustainability in this country is because they play in narrow and niche products, he says.

–To take advantage of the India story, the commercial banks have seen lending, retail and the whole corporate banking growth, which undoubtedly is a big part of it. That's why they have done well. Domestic banks all stand out. I'm jealous of them, in a nice manner, because there is more power to them.

Alternative Investment Funds

In India, alternative investment funds (AIFs) are defined in Regulation 2(1) (b) of Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. It refers to any privately pooled investment fund, (whether from Indian or foreign sources), in the form of

a trust or a company or a body corporate or a Limited Liability Partnership (LLP). Hence, in India, AIFs are private funds which are otherwise not coming under the jurisdiction of any regulatory agency in India.

Categories of Alternative Investment Funds (AIFs)

As per Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 Alternative Investment Funds shall seek registration in one of the three categories

- Category I: Mainly invests in start-ups, SME's or any other sector which Govt. considers economically and socially viable.
- Category II: These include Alternative Investment Funds such as private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator
- Category III : Alternative Investment Funds such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator.

Tenure and Listing of Alternative Investment Funds / Schemes

For AIF scheme launched under Category I & II shall be close ended, the tenure shall be determined at the time of application and shall be for minimum three years.

Category III Alternative Investment Fund may be open ended or close ended.

Extension of the tenure of the close ended Alternative Investment Fund may be permitted up to two years subject to approval of two-thirds of the unit holders by value of their investment in the Alternative Investment Fund. In the absence of consent of unit holders, the Alternative Investment Fund shall fully liquidate within one year following expiration of the fund tenure or extended tenure.

Units of close ended Alternative Investment Fund may be listed on stock exchange subject to a minimum tradable lot of one crore rupees. Such listing shall be permitted only after final close of the fund or scheme. However, listing on stock Exchanges is purely voluntary.

Process and Documentation required for Listing and Trading Alternative Investment Fund on BSE

Process

Documentation:

A. List of documents to be submitted for seeking In-principle approval for listing units of AIF scheme

Certified true copy of the following Agreements / documents:

- Draft Information / Placement memorandum. Hard as well as soft copy.
- Investment Management Agreement. **(In case of 1st Listing)**
- Certification of registration of Alternative Investment Fund issued by SEBI. **(In case of 1st Listing)**
- Custodian Agreement. **(In case of 1st Listing)**
- R & T Agreement. **(In case of 1st Listing)**
- Trust Deed (if applicable)
- Memorandum & Articles of Association of the issuer **(in case of 1st listing)**
- Resolution passed by trustee in case of AIF is established as trust or Board of directors in case AIF is established as Company or by partners in case AIF is established as a Limited Liability partnership at their meeting approving listing of units of close ended AIF on the BSE Ltd.
- An undertaking from the CEO/ compliance officer that AIF is in compliance with Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 as amended and all the other applicable laws.

[Click here for \(Check list and Annexures\)](#)

Note:

- The Exchange reserves the right to ask for documents other than those mentioned above

Non- Refundable Processing fees as follows

Particulars	Fees Amount
Per Placement Memorandum / Information Memorandum	Rs. 50,000/-

- Goods and Service Tax (GST) is payable on the Processing fees at the applicable rate
- BSE reserves the right to revise the above fee structure

B. List of documents to be submitted for Listing of units of AIF (Post allotment of units)

Certified true copy of the following Agreements / documents:

- Letter of Application for listing of units of Scheme.
- Details of the applicant (In case of 1st Issue/Listing) and Issue Details.
- Certified True Copy of observations / comments received from SEBI on the / placement Memorandum / Scheme Information Document (SID)

- Certified true copy of the Final Placement Memorandum / Scheme Information Document (SID) (soft copy also required)
- Unit holding pattern of Unit holders of the Scheme (As per format)
- Confirmation from the CEO / Compliance officer regarding allotment of units and the actual no. of units allotted.
- Statement of Collection details.
- Listing Agreement (In case of 1st Listing) as per SEBI LODR Regulations. (The format would be made available soon)
- Confirmation from CEO / Compliance officer regarding compliance with the provisions of Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 including subsequent amendments thereof and SEBI circulars issued in this respect.
- Confirmation from NSDL and CDSL (ISIN activation)
- Confirmation from RTA on the final number of units to be allotted with NSDL, to be allotted with CDSL and to be issued under physical form.
- Undertaking from the RTA on the units considered under switches that they have debited the units from the respective schemes and credited the applicable units in this scheme(if applicable).
- Confirmation received from NSDL / CDSL for credit.
- Confirmation from RTA regarding dispatch of Certificates / Account statement/refund order.
- Annual listing fees plus Applicable Taxes
- The Exchange would reserve the right to ask for documents other than those mentioned above

BSE would have the right to add, modify, delete, revise any or all the above requirements as deem fit.

Submission of documents and fees would not amount to listing of units or grant of approval by BSE.

**For Listing of units of Schemes under AIF (Post allotment of units)
Non- Refundable Alternative Investment Scheme Annual Listing Fees to be paid year on year**

Sr. No.	Particulars	Fees Amount
1	Initial Listing Fees	Nil
2	Annual Listing Fee- for tenure of the scheme	Payable per annum or part thereof
A	Issue size up to Rs.250 Crores	Rs. 2,50,000/-
B	Above Rs.250 Crores. and up to Rs.500 Crores.	Rs. 3,75,000/-
C	Above Rs.500 Crores. and up to Rs.750 Crores,	Rs. 5,00,000/-
D	Above Rs.750 Crores and up to Rs.1000 Crores	Rs. 7,50,000/-
E	Above Rs 1000 Crores	Rs. 10,00,000/-

Year-end would mean March 31.

Note:

Goods & Service Tax (GST) would be payable on the listing fees at the applicable rate

- BSE reserves the right to revise the above fee structure

AIFs are a class of pooled-in vehicles for investing in real estate, private equity and hedge funds. While the regulations for AIFs were formulated just over six years ago by the Securities and Exchange Board of India (SEBI), they have evidently gained acceptance among India's ultra-rich as strong investible platforms. In fact, the capital pumped in by AIFs rose to nearly Rs. 1.1 trillion in the Jan-Mar quarter of 2019, which is nearly 79% higher than it was in the same period a year ago.

While AIFs are currently not covered by the current jurisdiction of any regulatory body in India, they have been described and classified in detail in Regulation 2 (1) (b) SEBI (Alternative Investment Funds) Regulation, 2012. As per the current definition, AIFs are privately held and managed pool of investment fund of either domestic or foreign origin, organised in the form of an LLP (limited liability partnership), corporate body, company or trust. For all intents and purposes, AIFs are seen as private investment funds, and therefore, are not available through IPOs (initial public offerings) or other forms of a public issue which are applicable to Collective Investment Schemes and Mutual Funds that are registered with SEBI.

Types of AIF

As per existing SEBI classification, these private investment funds have been divided into 3 unique categories – Category I, Category II and Category III, with the minimum qualifying corpus amount for these schemes being Rs. 20 Crores. The only exception to this rule is an angel fund, which is a subcategory of Category I AIFs, as they have lower qualifying criteria

in terms of fund corpus at Rs. 10 crores. Let's discuss them in a little more detail to gain a clear understanding of each category:

1. **Category I:** Venture Capital Funds, Startup / Early stage funds, Infrastructure funds – These are those AIFs which are positive and beneficial to the Indian economy and enhance growth. Hence, these funds receive incentives or concessions by SEBI or the government of India. Such funds generally invest in start-ups or early-stage ventures, social ventures, SMEs, infrastructure or other sectors which are considered socially or economically important for the country.
2. **Category II:** Private equity funds – Private equity (PE) funds, especially Real Estate PE funds, typically reduce the risk profile by offering diversified investment portfolios managed by experienced fund managers. Thus, it provides the dual benefit of a defensive investment alternative as well as a hedging mechanism by offering an alternative investment asset class.
3. **Category III:** Hedge funds – Category III AIFs are a unique class of privately pooled funds that employ a range of complicated trading strategies including but not limited to arbitrage, margin trading, futures and derivatives trading, etc. to generate returns. This category of AIF is also allowed to utilise leverage in order to make investments in both unlisted and listed derivatives as specified by SEBI (Alternative Investment Funds) Regulation, 2012. Leading examples under this alternative investment fund category include PIPE Funds and Hedge Funds.

Alternative investments continue to grow in popularity and are making their way into the portfolios of well-off individual investors. So, if you are one of them, you must understand the advantages and limitations of investing in Alternative Investment Funds in India. Alternative investments typically do not correlate to the stock market, which means they add diversification to a portfolio and help mitigate volatility. While, just like any other investment, the rate of return for AIFs is not guaranteed, there is potential for it to be higher than that of traditional investments through inflation hedging and robust diversification. However, alternative investments are more complex and have higher fees associated with them than traditional investment vehicles. Moreover, the majority of AIFs are invested in illiquid investments, making them difficult to exit and price on a regular basis. And as with any investment, the potential for a higher return also means higher risk.

Andhra Pradesh Urban Development Fund (APUDF), a state government-backed AIF aiming at high socio-economic impact while delivering sustainable returns to investors, is a very good example of alternative investment in India. APUDF is a SEBI registered Category-II AIF that is mandated to invest in companies or projects or urban local bodies or other urban development agencies operating in Andhra Pradesh. The strategic objective of APUDF is to build a scalable and sustainable investment framework, which can be leveraged to support socio-economic development while generating reasonable returns to its contributors by investing in commercially viable and bankable projects in the state.

As discussed above, AIFs in India are regulated by Regulation 2 (1) (b) SEBI (Alternative Investment Funds) Regulation, 2012. To set up an AIF, an investor needs to submit a required application form and a bank draft of Rs. 1 Lakh to SEBI. Thereafter, SEBI will evaluate the application and will notify about its success to the investor within 21 days. In case, the investor

receives the letter from SEBI notifying that its application has been successful, it must prepare for paying a registration fee of Rs. 5 Lakh for getting the status of AIF in India. After getting the certification of registration of AIF issued by SEBI, the AIF may approach the exchanges for listing by submitting a draft information/placement memorandum, an investment management agreement, a custodian agreement, a trust deed, memorandum & articles of association of the issuer and an undertaking from the CEO/ compliance officer that AIF is in compliance with Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 as amended and all the other applicable laws. In order to invest in an AIF, you need to submit your identity proof, pan card and proof of income.

Pros & Cons of AIF

Alternative investments are becoming more popular for investors. These non-traditional investments allow investors with access to assets not correlated to the stock market, offering diversification and potentially higher returns when compared to mutual funds, stocks and bonds. Alternative investment funds are complex and often higher risk than traditional investments to which most high net-worth individual investors are already accustomed. Even the Finance Minister Arun Jaitley, in his 2018 Union Budget speech, spoke about measures to improve and strengthen investments into AIFs — particularly venture capital funds and angel investors—sending out a signal that India is ready to look beyond the usual when it comes to investments.

MODULE IV: PROJECT FINANCE

Introduction to Project Finance

Project Financing by Financial Institutions in India assumes significance in context of the fact that India is world's second fastest growing economy. In order to maintain the tempo of growth in the years to come, it is imperative to have an un-interrupted flow of funds to industrial and infrastructure sectors. In the present scenario, the socio-economic development of any State can only be ensured by the adequacy and timely availability of funds, efficient and reliable financial system. Currently, Indian economy is flourishing at the rate of about 8 per cent per year and needs to be sustained over the next twenty five years, if it is to eradicate poverty and achieve human development goals. To deliver a sustained growth rate of 8 percent through 2031-32, India needs to increase the project finance flow.

Traditionally companies have been using various methods for funding their capital expenditure requirements viz. corporate bonds, term loans, asset-based security funding, security funding, equipment leasing, venture capital and most common of all initial public offerings or subsequent offerings of equity capital. Over the years Project Financing has emerged as a prominent method of financing by FIs throughout the world.

Meaning of Project Financing

Project Financing is generally used to refer to a non-recourse or limited recourse financing structure in which debt, equity, and credit enhancement are combined for -30- construction and operation, or the refinancing, of a particular facility in a capital intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue producing contracts and other cash flow generated by the facility, as collateral for the debt (Hoffman, 2001). The concept of project finance is very simple, as it involves a capital investment on the merits of the asset's returns, but despite the simplicity of the concept, there is no definite definition agreed upon by the financial community.

According to Finnerty (1996), -.....the raising of funds to finance an economically separable capital investment project in which the providers of the funds look primarily to the cash flow from the project as the source of funds to service their loans and provide the return on their equity invested in the project.¶

According to Nevitt & Fabozzi (2000), -A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flow and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.¶ According to Pacelle et al (2001), -It is a term that typically refers to money lent to build power plants or oil refineries.¶

According to Esty & Sesia (2005), -It involves the creation of a legally independent project company financed with equity and non-recourse debt for the purpose of financing a single purpose capital asset, usually with a limited life.¶

According to Standard & Poor's Risk Solutions (2002), -A project company is a group of agreements and contracts between lenders, project sponsors, and other interested parties that creates a form business organisation that will issue a finite amount of debt on inception; will

operate in a focused line of business; and will ask that lenders look only to a specific asset to generate cash flow as the sole source of principal and interest payments and collateral. In general, it may be inferred that project finance is the financing of longterm infrastructure and industrial projects based upon a complex financial structure.

All these definitions of project finance highlight some basic characteristics of the project financing method, which may be explained as follows:

a) Creation of Separate Entity - Project financing involves a creation of separate entity popularly known as Special Purpose Entity/Vehicle (SPE/SPV). The SPV has a defined objective and definite life. -31 –

b) Equity Holding Pattern - The project financing structure is a highly concentrated ownership structure. It normally an outcome of partnership or joint venture between 3 or 4 equity sponsors. This format is similar to the venture-backed companies with the only exception that equity sponsors are not the managers.

c) Non re-course debt - The debt component provided by lenders is of nonrecourse nature and the lenders have no claim on the equity sponsors for the repayment of debt service but fully rely on the project cash flows for the debt service.

d) Leverage - The project financing deals are highly leveraged deals typically involving a leverage of 70% and at times going up to 80% or more.

e) Contractual Structure - The project financing because of definite life and objective is a highly contractual entity and the operations are highly structured by entering into various contracts.

Project finance is finance for a particular project, such as a mine, toll road, railway, pipeline, power station, hospital, which is repaid from the cash-flow of that project. Project finance is different from traditional forms of finance because the financier principally looks to the assets and revenue of the project in order to secure and service the loan. In contrast to an ordinary borrowing situation, in a project financing the financier usually has little or no recourse to the non-project assets of the borrower or the sponsors of the project. In this situation, the credit risk associated with the borrower is not as important as in an ordinary loan transaction; what is most important is the identification, analysis, allocation and management of every risk associated with the project.

Certain Accepted Indian Project Finance Structures

Following are the some prominent Project Finance Structures generally accepted in our country:

1. Public-Private Partnerships Finance Model & General Structures

Public-Private Partnership (PPP) is increasingly becoming an accepted model for developing and financing infrastructure projects in India. While the public sector faces the budgetary constraints and lacks required expertise, the private sector faces -32- problems in land acquisitions, obtaining environment pollution, forests permits and other clearances from govt, offices, securing approvals from local authorities and overcoming inordinate delays caused by

the central/state/local govt, authorities. Both public and private sector complement each other in facing these often daunting project impediments.

Some of the structures under the PPP Finance model include, but these are not limited to, the following:

- BOO (Build Own and Operate i.e. without any obligation to transfer) e.g. The Bangalore International Airport Limited is a good illustration of this model.
- BOT (Build Own and Transfer) Large scale Indian Infrastructure projects, such as those under National Highway Development Program (NHDP) use BOT model to access direct private sector funds.
- BOOT (Build Own Operate and Transfer)
- BOR (Build Operate and Renewal of concession)
- BLT/BRT (Build Lease/Rent and Transfer)
- BT (Build and Transfer)
- BTO (Build Transfer and Operate)
- DBFO (Design Building Finance and Operate)
- DCMF (Design Construct Manage and Finance)
- MOT (Modernize Own/Operate and Transfer)
- ROO (Rehabilitate Own and Operate)
- ROT (Rehabilitate Own and Transfer)

2. Take-Out Finance

It is an innovative technique which refers to the transfer of the project loan liability from one lending agency to another in order to receive better financial benefits and a suitable allocation of risks between different lenders.

3. Bond Finance Sponsors and Developers have begun approaching the Indian bond markets for their borrowing needs. As the Indian capital markets mature, bond Financing mechanisms could lower the cost of capital by creating the desired financing flexibility through different debt instruments.

4. Securitisation

Securitisation is a significant financing tool in the future in India. However, as of now, it is still not a common method for the mobilisation of financial resources. Nevertheless, companies are beginning to realise its potential benefits.

5. Viability Gap Funding

In a recent initiative, the Gol has established a special financing facility, called –Viability Gap Funding under the Department of Economic Affairs, Ministry of Finance, to provide support to PPP infrastructure projects that have at least 40% private equity committed to each such project. Viability Gap Funding can take various forms such as capital grants, subordinated loans, O&M support grants and interest subsidies.

6. Infrastructure SPV

The Gol very recently provided for the establishment of a SPV to finance infrastructure projects in specified sectors such as roads, ports, airports and tourism. The projects will be appraised by an inter-institutional group of banks and financial institutions. The SPV will lend funds, especially long-term debt, to eligible projects.

Project financing is now a well recognised financing technique through out the world. Chen et al (1989) documented more than \$ 3 billion worth of project financings between 1987 and 1989 and identified 168 projects being financed on this format, including 102 projects for power production. Project financing can be used to finance the infrastructure requirement of the countries (financing the future, 1993; Forrester et al, 1994, Chrisney, 1995). Project financing has long been used to fund large scale natural resource projects. The use of project finance is primarily focused on the development of infrastructural requirements like roads, electricity generation and telecommunication etc. The use of project finance is not a new concept in India but it has yet to spread its wings in the country stage. The use of project finance in our country goes back to the 19th century as the development of railways in 1880 was principally financed by private entities whose investments took the form of project finance (Benouaich, 2000). In the recent years the Indian government has realised that to develop the infrastructure in the country, they have to embrace the private sector through the Public-Private-Partnership (PPP). In the recent past the use of project finance has increased in India and it is not only used for infrastructural financing as for Dabhol Power Company (now Ratnagiri Gas and Power Private Ltd.), Noida Toll Bridge Company, but is being used by many corporate for financing their requirements as Reliance Petro Investments, the SPV formed by Reliance Capital and Reliance Industries to bid for IPCL, Global Steel Holdings (GSHL), an SPV controlled by Pramod and Vinod Mittal of Ispat group, has acquired the Turkish Electric Arc Furnace (EAF) steel maker, etc

Project Finance is one of the key focus areas in today's world because of continuous growth and expansion of the industries at a rapid rate. Project finance is a centuries-old form of financing high-risk, development-oriented projects.

Project finance is the long-term financing of infrastructure and industrial projects based upon non-recourse or limited alternative of financial structure where project debt and equity used to finance the project are paid back from the cash flow engendered by the project.

They are most ordinarily non-recourse loans, which are fortified by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors, a decision in part braced by financial modeling.

Methods of Project Financing

A survey said that 90% of respondents identified money as the greatest obstacle to implementation of any project.

The various sources of finance can be broadly divided into two categories, viz. equity capital and debt capital (borrowed capital). The combination of equity and debt should be judiciously chosen, and it will vary according to the nature of the project. The project manager can choose any one or a combination of two or more of these methods to finance the project.

1. Share capital – equity capital and preference capital.
2. Term loan
3. Debenture capital
4. Commercial banks
5. Bills discounting

Some more types of financing available are

Seed Capital

In consonance with the Government policy which boosts a new class of entrepreneurs and also aims wider spreading of ownership and control of manufacturing units, a distinct scheme to complement the resource of an entrepreneur has been presented by the Government. Assistance in this scheme is accessible in the nature of seed capital which is generally given by way of long term interest free loan. Seed capital aid is provided to small as well as medium scale units promoted by eligible entrepreneurs.

Framework and Guidelines

The list of major contracts for project consist of Concession agreement, license or mineral lease, construction contract or a development management agreement, supply agreement, sales agreement, operating agreement, other major contracts may occur in any specific project depending on the structure accepted.

The borrower may have to get certain statutory and non – statutory clearances essential for the projects like techno economic clearance, pollution, environment and forest clearance, company registrations, financing and land availability/ concessions etc.

The promoter while making the application to the financial institutions records the copies of documents most vital of which are:

- i) copy of letter of allotment of plot/ sale deed in good turn of the borrower of the plot.
- ii) Detailed plan of project approved by the local body.
- iii) Partnership deeds/ articles of association in case of a company.

Boom of Project Financing in India

A study placed India on top in the global project finance market in 2009, ahead of Australia, Spain and the US. The key market for project finance in 2009 was the domestic Indian market, which rose up \$30 billion (Rs 1.38 lakh crore), accounting for 21.5 per cent of the global project finance market. This was up from \$19 billion in 2008.

The global project finance market was buttressed up in 2009 by government-linked projects such as social infrastructure and renewables and by the detail that 20 per cent of the market is in India, which poured to become the biggest and busiest market last year, knocking down Australia from the previous year's top position

Given the credit crunch and the collapse of major banks in the West, the global Project Finance figures were not as strong as in the previous couple of years. According to PFI data, globally, the Project Finance loan figure positions at \$139.2 billion in 2009 compared to the overwhelming \$250 billion in 2008 and \$220 billion in 2007. Totaling the figures for project bonds at \$8.2 billion, down from \$11.9 billion in 2008, the global Project Finance market volume stood at \$147.4 billion. That was a descent of 44 per cent from 2008, but to put it in framework, the overall global Project Finance market set upright at \$114.5 billion in 2004 and at \$166 billion in 2005.

SBI settled 36 deals amounting to \$20 billion of debt – 35.2 per cent of the total volume for the Asia-Pacific region. This comprised some major contracts such as financing for the Sasan ultra mega power project, projects of Adani Power and Sterlite Energy, and resources for Vodafone and Unitech in the telecom sector.

The power sector sustained to decree lending and generated a record volume. More than \$22.3-billion loans in 53 transactions in the sector were signed globally all through the year, accounting for almost 40 per cent of the entire PF market. Also, a major contribution came from social infrastructure development patterns launched by the government lately.

In all, 224 financial institutions were ranked. Only prime arranger mandates are credited for the league table, while involvement in syndications is not credited. Also, PFI tables do not include property or real estate sector transactions. In addition, the Project Finance tables do not comprise corporate loans and those guaranteed by sponsors or governments.

2013 Project Finance volume by top 15 nations

Rank	Nationality	Value (US \$m)	Deals	% change
1	India	26,129	75	7%
2	United states	22,145	34	28%
3	Australia	14,116	30	-52%
4	Saudi Arabia	13,520	6	88%
5	United Kingdom	13,166	28	13%
6	Vietnam	9,000	1	1263%
7	Brazil	8,098	34	-4%
8	UAE	6,371	5	957%
9	Nigeria	6,120	9	700%
10	Canada	4,421	11	47%
11	Germany	3,637	6	-5%
12	Belgium	2,843	2	104%
13	Italy	2,780	11	-18%
14	South Korea	2,761	6	-28%
15	Malaysia	2,753	5	-70%
	Total	1,73,131	389	-11%

An Example of Project Financing

The World Bank has hurred consultations with the ministries of finance and new and renewable energy for financing solar projects in phase II of the National Solar Mission. The World Bank is really enthralled with the performance of phase I of the National Solar Mission in which, the mounted capacity has increased to 2,000 Mw from 30 Mw.

The World Bank was tied up with the ministry of new and renewable energy during phase I in working out the policy and positioning in place essential guidelines but had not provided funds. Though, in the course of phase II, the World Bank is quite ardent to finance solar projects. The total prerequisite of funds is of the directive of Rs 80,000 crore (\$13 billion) of which, as high as Rs 54,000 crore (\$9 billion) will be debt based on a 70:30 debt equity ratio. The World Bank has conveyed that it was profound to a degree finance debt requirement. The total debt

prerequisite of Rs 54,000 crore, is much necessary to come from the scheduled commercial banks.

In the course of the first phase, commercial banks had lent \$700 million and they need to scale up to the levels foreseen. In order to make investment in solar power more striking for scheduled commercial banks, the government will need to tactically use limited public resources to leverage commercial financing, report structural barriers that preclude commercial banks from contributing and expedite appropriate technology deployment.

The role of enabling public funding in leveraging commercial lending on a constant basis through risk plummeting instruments as well as innovations in financing is important and authoritative for moving solar development to a largely non-recourse financing mode in India. The World Bank in its report titled, –Paving the way for a Transformational Future: Lessons from Jawaharlal Nehru National Solar Mission Phase II, recommends that the government could offer multiple financial way out involving viability gap fund, generation-based incentives, credit guarantees, credit lines to banks at a concession to cut interest rates and secondary public finance to spread the tenor of loans. According to the World Bank, by means of public financing for lengthening the tenor of a loan and providing subordinated debt is least expensive amid all other options, with the objective of decreasing the solar tariff to Rs 5.50 per unit.

Conclusion

India required an investment of over \$1 Trillion for infrastructure development in the 12th Five year plan which goes from 2012-2017. Government is putting a better prominence on infrastructure development and the successive need for much advanced levels of capital to fund these projects. However the knowledge & skill sets essential in these areas is absent and as a outcome there has been a rebirth of interest in PFI and PPP project finance deals.

The need for vigorous knowledge with respects to structuring and re-financing projects is greater now than ever before.

Project Financing Process

For whom is it important to understand project finance?

- a. Financial managers.
- b. Sponsors.
- c. Lenders.
- d. Consultants and practitioners.
- e. Project managers.
- f. Builders.
- g. Suppliers.
- h. Engineers.
- i. Researchers
- j. Students.

Why is it important to understand project finance?

The people involved in a project are used to find financing deal for major construction projects such as mining, transportation and public utility industries, that may result such risks and

compensation for repayment of loan, insurance and assets in process. That's why they need to learn about project finance in order to manage project cash flow for ensuring profits so it can be distributed among multiple parties, such as investors, lenders and other parties.

Definition of Project:

Organizations perform work continuously. These works include operations or projects though some works may overlap with each other. For the organizations, projects are important elements of change. They are considered to be the leading edge of change in organizations. A project consists of a combination of organizational resources pulled together to create something that did not previously exist and that will provide a performance capability in the design and execution of organizational strategies. Projects are conceptualized, designed, engineered and produced (or constructed); something is created that did not previously exist. An organizational strategy has been executed to facilitate the support of ongoing organizational life. Projects therefore support the ongoing activities of a going concern.

Project Finance

Project finance is a method of financing very large capital intensive projects, with long gestation period, where the lenders rely on the assets created for the project as security and the cash flow generated by the project as source of funds for repaying their dues.

Simply put, project finance is essentially financing on the security of the project itself, with limited or no recourse against the sponsors of the project or other parties involved in the development and implementation of the project. Due to such characteristics of project finance, the loans sought by the borrowers are always approved by the lenders on the basis of strong in-house appraisal of the cost and viability of the ventures as well as the credit standing of project promoters.

Project finance generally covers green-field industrial projects, capacity expansion at existing manufacturing units, construction ventures or other infrastructure projects. The term 'infrastructure projects' is used here in its general and wide meaning to describe physical structures (such as roads, highways, ports, airports etc.) or systems (such as electricity transmission system, pipeline distribution systems) that are designed, built, operated and maintained to provide for certain physical facilities (such as roads, railways, airports, urban mass rapid transit systems) or commodities (such as natural gas, petroleum, electricity) or for the due utilization of natural resources (water, crude oil, minerals) or provision of services (telecommunications, broadcasting, air transport services, waste handling and treatment) through the general public within the specified geographical area. Capital intensive business expansion and diversification as well as replacement of equipment may also be covered under project finance.

An understanding of the possible money streams into a particular project and the possible expenditure streams out of the same is essential to structure the finance. Such understanding would be based on an analysis of the legal framework governing the project, all of the project's documentation including all government approvals with regard to the implementation and financing of the project and the finance documentations.

Project finance is quite often channeled through a project company known as special purpose vehicle or project development vehicle. Internationally, in addition to a private limited

company, a limited company, a partnership and an unincorporated entity structure are all recognized as suitable project development vehicle. However, in India, a private limited company is regarded to be an appropriate project development vehicle as it ensures limited liability for the developers of the project, enables the shareholders to incorporate the various terms and conditions agreed to between them in the articles of association of the project company, thereby binding not only the shareholders themselves but also the company to such agreed terms. Besides, a private limited company also has greater avenues open for equity and loan financing.

Some Jargons:

1. Full Recourse Loan: A loan in which the lender can claim more than the collateral as repayment in the event that the loan is enforced. Thus a full recourse loan places the Sponsor's assets at risk.

2. Non Recourse Loan: A loan in which the lender cannot claim more than the collateral as repayment in the event that the loan is enforced.

3. Limited Recourse Loan: A loan in which the lender can claim more than the collateral, subject to some restrictions, as repayment in the event that the loan is enforced.

Project Financing Participants and Agreements

Sponsor/Developer: The sponsor(s) or developer(s) of a project financing is the party that organizes all of the other parties and typically controls, and makes an equity investment in, the company or other entity that owns the project. If there is more than one sponsor, the sponsors typically will form a corporation or enter into a partnership or other arrangement pursuant to which the sponsors will form a "project company" to own the project and establish their respective rights and responsibilities regarding the project.

Additional Equity Investors: In addition to the sponsor(s), there frequently are additional equity investors in the project company. These additional investors may include one or more of the other project participants.

Construction Contractor: The construction contractor enters into a contract with the project company for the design, engineering, and construction of the project.

Operator: The project operator enters into a long-term agreement with the project company for the day-to-day operation and maintenance of the project.

Feedstock Supplier: The feedstock supplier(s) enters into a long-term agreement with the project company for the supply of feedstock (i.e., energy, raw materials or other resources) to the project (e.g., for a power plant, the feedstock supplier will supply fuel; for a paper mill, the feedstock supplier will supply wood pulp).

Product Off taker: The product off taker(s) enters into a long-term agreement with the project company for the purchase of all of the energy, goods or other product produced at the project.

Lender: The lender in a project financing is a financial institution or group of financial institutions that provide a loan to the project company to develop and construct the project and that take a security interest in all of the project assets.

Principle advantages and disadvantages of Project financing:

Advantages:

1. **Non-Recourse:** The typical project financing involves a loan to enable the sponsor to construct a project where the loan is completely non-recourse to the sponsor, i.e., the sponsor has no obligation to make payments on the project loan if revenues generated by the project is insufficient to cover the principal and interest payments on the loan. In order to minimize the risks associated with a non-recourse loan, a lender typically will require indirect credit supports in the form of guarantees, warranties and other covenants from the sponsor, its affiliates and third parties involved with the project.

2. **Maximise Leverage:** In a project financing, the sponsor typically seeks to finance the cost of development and construction of the project on a highly leveraged basis. Frequently, such costs are financed using 80 to 100 percent debt. High leverage in a non-recourse project financing permits a sponsor to put less in funds at risk, permits a sponsor to finance the project without diluting its equity investment in the project and, in certain circumstances, also may permit reductions in the cost of capital by substituting lower-cost, tax-deductible interest for higher-cost, taxable returns on equity.

3. **Off-Balance-Sheet Treatment:** Depending upon the structure of project financing, the project sponsor may not be required to report any of the project debt on its balance sheet because such debt is non-recourse to the sponsor. Off-balance-sheet treatment can have the added practical benefit of helping the sponsor comply with covenants and restrictions relating to borrowing funds contained in other indentures and credit agreements to which the sponsor is a party.

4. **Maximize tax benefit:** Project financings should be structured to maximize tax benefits and to assure that all possible tax benefits are used by the sponsor or transferred, to the extent permissible, to another party through a partnership, lease or other vehicle.

Disadvantages:

Project financings are extremely complex. It may take much longer period of time to structure, negotiate and document a project financing than a traditional financing, and the legal fees and related costs associated with a project financing can be very high. Because the risks assumed by lenders may be greater in a non-recourse project financing than in a more traditional financing, the cost of capital may be greater than with a traditional financing.

Stages in Project Financing

Project identification	Pre Financing Stage
Risk identification & minimizing	
Technical and financial feasibility	
Equity arrangement	Financing Stage
Negotiation and syndication	
Commitments and documentation	
Disbursement	
Monitoring and review	Post Financing Stage
Financial Closure / Project Closure	
Repayments & Subsequent monitoring	

Preparation of Project Report

A project report is essential before a decision for setting-up of any project is taken. The most important thing in any project financing is preparation of Detailed Project Report (DPR) which should be made beautifully for getting the project approved from banks/financial institutions. After preparation of DPR the proposal is moved to the banks/financial institutions for processing of the file.

Project Report must include the followings:

A. Technical Feasibility

All the factors relating to infrastructure needs, technology, availability of machine, material etc. are required to be scrutinized under this head.

Broadly speaking the factors that are covered under this aspect include:

1. Availability of basic infrastructure- It includes the land and its location as per present and future needs, lay out and building plan including finalization of structure, availability of water and power, availability of cheap labour in abundant supply.
2. Licensing/ registration requirements
3. Selection of technology/ technical process- The technical process/technology selected for the project must be readily available either indigenously or necessary arrangements for foreign collaboration must be finalized. Further the selected technology must find a successful application in Indian environment and the management shall be capable of fully absorbing the technology.
4. Availability of suitable machinery/raw material/ skilled labour etc- After selection of technical process, the availability of suitable kind of machinery is most important factor which needs to be considered. It should be ensured that the suppliers are capable to supply the plant and machinery timely along with all spare parts

B. Managerial Competence

The ultimate success of even well conceived and viable project may depend on how competently it is managed. The promoters of the project have to provide necessary leadership and their qualification, experience and track record will be closely examined by lending institution. The detail of other projects successfully implemented by the same promoters may provide the necessary confidence of these institutions and help final approval of the project.

The reputation of the promoters group in the market is also very important factor which the banks/ financial institutions consider while lending to the companies. Also the bank/ financial institutions check the payment history of past loan raised by the companies in which the promoters are directors which shows their willingness of repayment of the loans. CIBIL is a very strong tool in the hand of banks/ financial institutions to verify the payment history and the number of loans raised by the companies from the date of existence.

C. Commercial Viability

Any project can be commercially viable only if it is able to sell its product at profit. For this purpose it would be necessary to study demand and supply pattern of that particular product to determine its marketability. Various methods such as trend method, regression method for estimation of demand are employed which is then to be matched with the available supply of a particular product.

D. Financial Viability

Factors need to consider for financial viability:

1. Cost of project: A realistic assessment of cost of project is necessary to determine the source for its availability and to properly evaluate the financial viability of the projects. For this purpose, the various items of cost may be sub-divided as many sub-heads as possible so that all factor are taken into consideration for arriving at the total cost.

Cost includes the following:

- a. Land Cost- Acquisition of project land, registry charges, and charges for other clearance.
- b. Site Development Cost- to make the project easily accessible it is necessary to build roads, water tank, boundary walls, arranging electricity, levelling the site, demarcation of site, making available the basic amenities etc.
- c. Buildings Cost- it includes lay out and building plan along with the structure cost, building the site office, factory sheds, godowns, residential flats for staff etc.
- d. Plant and Machinery- cost of plant and machinery, any foreign assistance for installation, salary of technical staff, transportation cost, foreign currency fluctuations (if any), bank commissions, L/C Charges etc.
- e. Miscellaneous Fixed Assets
- f. Preliminary Expenses- licence required to start commercial production from the local authorities along with other clearances etc.
- g. Contingencies- normally 5% extra cost is taken as contingency to avoid any kind of cost over-run at the end of implementation of project.
- h. Margin for Working Capital- for running a project it is necessary to fuel it with the working capital. It works like a lubricant for any kind of business. It is financed against receivables and stock. A proper assessment of the same should be done. Banks now generally require that 25% of the total current assets (working capital) shall be the margin to be provided from the long term resources and 75% shall be financed by them.

2. **Means of Finance:** After estimation of the cost of the project, the next step will be to find out the source of funds by means of which the project will be financed. The project will be financed by contribution of funds by the promoter himself and also by raising loans from others including term loans from banks and financial institutions.

The means of financing will include:

1. Issue of share capital including ordinary/preference shares.
2. Issue of secured debentures.
3. Secured long-term and medium-term loans (including the loans for which the application is being put up to term lending institutions).
4. Unsecured loans and deposits from promoters, directors etc.
5. Deferred payments.
6. Capital subsidy from Central/State Government.

3. **Security Coverage and Promoters Contribution:** In today scenario and being to play safe, the bankers wants that at least the promoters should contribute 40% of the total project cost. The long term sources of funds are utilized for acquisition of land, procuring the fixed assets and construction of building etc. But for day to day expenses, payment of staff salary, purchasing the stocks etc. the project require short term loan or working capital loans. Hence

the financing for a project is the mix of both long term and short term loans. In project funding the bank has charge on the land, building, any super structure thereof and hypothecation of stocks & receivables and all the current assets relating to project. It is considered as primary security but the bankers may ask for collaterals also in addition to the primary security.

4. Profitability Analysis: After determine the cost of the project and means of financing, the viability of the project will depend on its capacity to earn profits to service the debts and capital. To undertake the profitability analysis, it will be necessary to draw estimates of the cost of production and working results. These estimates are made for a period which should at least cover the moratorium and repayment periods. Generally in case of project loans repayment begins after 2-3 years, the time gap between the disbursement of loan and repayment of first installment is called moratorium period. Further repayment should start in that quarter or month when it is assured that the project will have sufficient cash profit to service the same in that particular quarter or month. Also, the moratorium and repayment period is decided while submitting the proposal to the banks hence while selecting these periods' accurate calculations should be done.

5. Projected Balance Sheet, Profit and Loss Account and Projected Cash Flow: The projected financials of the project is prepared for the entire tenure as estimated above.

6. Break-Even Point: Estimations of working results pre-suppose a definite level of production and sales and all calculations are based on that level. The minimum level of production and sales at which the unit will run on -no profit no loss is known as break-even point and the first goal of any project would be to reach that level. The break-even point can be expressed in terms of volume of production or as a percentage of plant capacity utilization. Break-even in terms of volume of production = $\text{Total Fixed Cost} / \text{Contribution per unit}$

7. Debt Service Coverage Ratio (DSCR):

Debt Service Coverage Ratio is calculated to find out the capacity of the project servicing its debt i.e. in repayment of the term loan borrowings and interest. The DSCR is worked out in the following manner: $\text{D.S.C.R} = (\text{PAT} + \text{Depreciation} + \text{Interest on Long Term Borrowings}) / (\text{Repayments of Term Borrowings during the year} + \text{Interest on long-term borrowings})$ The higher D.S.C.R. would impart intrinsic strength to the project to repay its term borrowings and interest as per the schedule even if some of the projections are not fully realized. Normally a minimum D.S.C.R. of 2:1 is insisted upon by the term lending institutions and repayment is fixed on that basis.

8. Sensitivity Analysis: While evaluating profitability projections, the sensitivity analysis may be carried in relation to changes in the sale price and raw material costs, i.e. sale price may reduce by 5% to 10% and raw material costs may be increased by 5% to 10% and the impact of these changes on DSCR shall be analyzed. If the new DSCR, so calculated after changes, still proves that the project is viable, the financial institution may go ahead in funding the project.

9. Internal Rate of Return: This is an indicator of earning capacity of the project and a higher IRR indicates better prospects for the project. The present investment in the cash flow which is assumed to be negative cash flow and the return (cash inflow) are assumed to be positive cash flows. Normally bankers want that internal rate of return should be at least 18% because it

depicts the strength of the project and its earning and repayment capacity at the same time. Better the IRR better rating to the project.

E. Environmental, Political and Economic Viability

The performance of the project is also influenced by the external factors also such as existing government policies regarding particular sector, easiness in getting the licence to operate in a particular region or state, effects of the project on the environment, tax exemptions for particular region etc. Hence while compiling the project report it is important to study the industry scenario, government policies etc and these should be covered in the project report.

Project Appraisal

Project Appraisal is a process of detailed examination of several aspects of a given project before recommending the same. The lending institution has to ensure that the investment on the proposed project will generate sufficient returns on the investments made and that loan amount disbursed for the implementation of the project will be recovered along with interest within a reasonable period of time.

The various aspects of Project appraisal are:

1. Technical Appraisal
2. Commercial Appraisal or Market Appraisal (Demand of the product, supply of the product, distribution channels, pricing of the product and government policies.
3. Economic Appraisal
4. Management Appraisal (assessing the willingness of the borrower to repay the loan)
5. Financial Appraisal

Methods of the Project Financing

There are three methods in Project Financing:

1. Cost Share Financing or Low interest loan financing.
2. Debts Financing.
3. Equity Financing.

Sources for Financing Fixed Assets

The type of funds required for acquiring fixed assets have to be of longer duration and these would normally comprise of borrowed funds and own funds. There are several types of long-term loans and credit facilities available which a company may utilise to acquire the desired fixed assets. These are briefly explained as under.

1. Term Loan :-

(a) Rupee loan- Rupee loan is available from financial institutions and banks for setting up new projects as, well as for expansion, modernisation or rehabilitation of existing units. The rupee term loan can be utilised for incurring expenditure in rupees for purchase of land, building, plant and machinery, electric fittings, etc. The duration of such loan varies from 5 to 10 years including a moratorium of up to a period of 3 years. Projects costing up to Rs. 500 lakhs are eligible for refinance from all India financial institutions and are financed by the State level financial institutions in participation with commercial banks. Projects with a cost of over Rs. 500 lakhs are considered for financing by all India financial institutions. They entertain

applications for foreign currency loan assistance for smaller amounts also irrespective of whether the machinery to be financed is being procured by way of balancing equipment, modernisation or as a composite part of a new project. For the convenience of entrepreneurs, the financial institutions have devised a standard application form. All projects whether in the nature of new, expansion, diversification, modernisation or rehabilitation with a capital cost upto 5 crores can be financed by the financial institution either on its own or in participation with State level financial institutions and banks.

(b) Foreign Currency term loan. Assistance in the nature of foreign currency loan is available for incurring foreign currency expenditure towards import of plant and machinery, for payment of remuneration and expenses in foreign currency to foreign technicians for obtaining technical know-how. Foreign currency loans are sanctioned by term lending institutions and commercial banks under the various lines of credits already procured by them from the international markets. The liability of the borrower under the foreign currency loan remains in the foreign currency in which the borrowing has been made. The currency allocation is made by the lending financial institution on the basis of the available lines of credit and the time duration within which the entire line of credit has to be, fully utilised.

2. Deferred payment guarantee (DPG) - Assistance in the nature of Deferred Payment Guarantee is available for purchase of indigenous as well as imported plant and, machinery. Under this scheme guarantee is given by concerned bank/financial institutions about repayment of the principal along with interest and deferred instalments. This is a very important type of assistance particularly useful for existing profit-making companies who can acquire additional plant and machinery without much loss of time. Even the banks and financial institutions grant assistance under Deferred Payment Guarantee more easily than term loan as there is no immediate outflow of cash.

3. Soft loan - This is available under special scheme operated through all India financial institutions. Under this scheme assistance is granted for modernisation and rehabilitation of industrial units. The loans are extended at a lower rate of interest and assistance is also provided in respect of promoters contribution, debt-equity ratio, repayment period as well as initial moratorium.

4. Supplier's line of credit - Under this scheme non-revolving line of credit is extended to the seller to be utilised within a stipulated period. Assistance is provided to manufacturers for promoting sale of their industrial equipments on deferred payment basis. While on the other hand this credit facility can be availed of by actual users for purchase of plant/equipment for replacement or modernisation schemes only.

5. Buyer's credit - Under a buyer's credit arrangement, a specific long-term loan is granted by a designated lending agency in the exporter's country to the buyer in the import, country against a guarantee by an acceptable bank or financial institution. The supplier receives payment for the exports on his delivering to the lending agency the requisite documents specified in the loan agreement and the relative commercial contract. The lending agency realises the payment from the buy (importer) in instalments as and when they fall due. Ordinarily, the supplier of his obligation reckons the period credit as the duration from the date of completion.

6. Debentures - Long - term funds can also be raised through debenture with the objective of financing new undertakings, expansion, diversification and also for augmenting the long-term resources of the company for working capital requirements. Debenture holders are long term creditors of the company. As a secured instrument, it is a promise to pay interest and repay principal at stipulated times. In the contrast to equity capital which is a variable income (dividend/ security, the debenture / notes are fixed income (interest) security).

7. Leasing - Leasing is a general contract between the owner and user of the assets over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee company) which pays a specified rent at periodical intervals. The ownership of the asset lies with the lessor while the lessee only acquires possession and right to use the assets subject to the agreement. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.

8. Public deposits - Deposits from public is a valuable source of finance particularly for well established large companies with a huge capital base. As the amount of deposits that can be accepted by a company is restricted to 25 per cent of the paid up share capital and free reserves, smaller companies find this source less attractive. Moreover, the period of deposits is restricted to a maximum of 3 years at a time. Consequently, this source can provide finance only for short to medium term, which could be more useful for meeting working capital requirements. In other words, public deposits as a source of finance cannot be utilised for project financing or for buying capital goods unless the payback period is very short or the company uses it as a means of bridge finance to be replaced by a regular term loan. Before accepting deposits a company has to comply with the requirements of section 58A of the Companies Act, 1956 and Companies (Acceptance of Deposits) Rules, 1975 that lay down the various conditions applicable in this regard.

9. Own Fund:

a. Equity: Promoters of a project have to involve themselves in the financing of the project by providing adequate equity base. From the bankers/financial institutions' point of view the level of equity proposed by the promoters is an important indicator about the seriousness and capacity of the promoters. Moreover, the amount of equity that ought to be subscribed by the promoters will also depend upon the debt: equity norms, stock exchange regulations and the level of investment, which will be adequate to ensure control of the company. The total equity amount may be either contributed by the promoters themselves or they may partly raise the equity from the public. So far as the promoters stake in the equity is concerned, it may be raised from the directors, their relatives and friends.

Equity may also be raised from associate companies in the group who have surplus funds available with them. Besides, equity participation may be obtained from State financial corporation/industrial development corporations. Another important source for equity could be the foreign collaborations. Of course, the participation of foreign collaborators will depend upon the terms of collaboration agreement and the investment would be subject to approval from Government and Reserve Bank of India. Normally, the Government has been granting approvals for equity investment by foreign collaborators as per the prevailing policy.

The equity participation by foreign collaborators may be by way of direct payment in foreign currency or supply of technical know-how/ plant and machinery. Amongst the various

participants in the equity, the most important group would be the general investing public. The existence of giant corporations would be impossible but for the investment by small shareholders. In fact, it would be no exaggeration to say that the real foundation of the corporate sector are the small shareholders who contribute the bulk of equity funds. The equity capital raised from the public will depend upon several factors viz. prevailing market conditions, investors' psychology, promoters track record, nature of industry, government policy, listing requirements, etc.

The promoters will have to undertake an exercise to ascertain the maximum amount that may have to be raised by way of equity from the public after taking into account the investment in equity by the promoters, their associates and from various sources mentioned earlier. Besides, some equity may also be possible through private placement. Hence, only the remaining gap will have to be filled by making an issue to the public.

b. Preference share: Though preference shares constitute an independent source of finance, unfortunately, over the years preference shares have lost the ground to equity and as a result today preference shares enjoy limited patronage. Due to fixed dividend, no voting rights except under certain circumstances and lack of participation in the profitability of the company, fewer shareholders are interested to invest monies in preference shares. However, section of the investors who prefer low risks fixed income securities do invest in preference shares. Nevertheless, as a source of finance it is of limited import and much reliance cannot be placed on it.

Compliance with Different Laws & Regulations In this context it would be pertinent to note that while initiating the process for making a public issue of equity /preference shares, the promoters will have to comply with the requirements of different laws and regulations including Securities Contracts (Regulation) Act, 1956, Companies Act, 1956 and SEBI guidelines etc., and various rules, administrative guidelines, circulars, notifications and clarifications issued there under by the concerned authorities from time to time.

c. Retained earnings: Plough back of profits or generated surplus constitutes one of the major sources of finance. However, this source is available only to existing successful companies with good internal generation. The quantum and availability of retained earnings depends upon several factors including the market conditions, dividend distribution policy of the company, profitability, Government policy, etc. Hence, retained earnings as a source plays an important role in expansion, diversification or modernisation of an existing successful company. There are several companies who believe in financing growth through internal generation as this enables them to further consolidate their financial position. In fact, retained earnings play a much greater role in the financing of working capital requirements.

d. Unsecured Loans: If there is some shortfall in the means-of-finance, the promoters/ directors can mobilize funds from their friends, relatives and well-wishers. Such loans are always unsecured i.e., the lenders cannot have any charge over the assets of the company. Banks and financial institutions stipulate the following conditions if unsecured loan is to form part of the means-of-finance. - The promoters shall not repay the unsecured loan till the term loan persists. - Interest if any payable on unsecured loan shall be paid only after meeting the term loan repayment commitments. -The rate of interest payable on unsecured loan shall not be higher than the rate of interest applicable for term loans. Normally unsecured loan component is expected not to exceed 50% of the equity capital.

10. Bridge Loans: This is a temporary loan meant for tying up the capital cost of the project. The necessity for bridge finance arises in situations where finance from particular source is being delayed. However, the availability of finance from that source is certain.

11. Seed Capital: In consonance with the Government policy which encourages a new class of entrepreneurs and also intends wider dispersal of ownership and control of manufacturing units, a special scheme to supplement the resource & of an entrepreneur has been introduced by the Government. Assistance under this scheme is available in the nature of seed capital which is normally given by way of long term interest free loan. Seed capital assistance is provided to small as well as medium scale units promoted by eligible entrepreneurs.

12. Government subsidies: Subsidies extended by the Central as well as State Government form a very important type of funds available to a company for implementing its project. Subsidies may be available in the nature of outright cash grant or long - term interest free loan. In fact, while finalising the mean of finance, Government subsidy forms an important source having a vital bearing on the implementation of many a project.

Conclusion

The key to any project finance is to use a right mix of debt and equity. Further, there should be a right mix of foreign currency and rupee loans. It is also essential that there should be flexibility in respect of switching from foreign currency to rupee loan and vice versa. There are a number of issues highlighted herein above which need to be considered for the purpose of financing of the project. Besides, it is important that due care is taken in drafting the documents concerning the financing of the project. The companies should adopt the project financing structures so that the objective of shareholder's wealth maximization can be achieved. As the world is heading towards a global integrated market and the failure of governments as well as the demand for private capital in infrastructure assets is increasing, project finance will continue to play an important role in both developed and developing markets.

Debt Syndication

In India, the debt market is several times smaller than the equity market, while elsewhere it is just a multiple of the latter. One of the complex tools that have helped lessen this gap over the years is **debt syndication**. Be it SMEs, mid-corporates or large corporates, all those looking for customised financing solutions for capital intensive projects opt for it.

Benefits in Store for All

Debt syndication is not only beneficial for the borrowers, who get the required money for their working capital and growth finance needs, but also for the lenders and other people involved. The biggest benefit for the lenders is that the risk gets spread out across the board. On the other hand, it saves time and effort of borrowers as they only need to meet the arranging bank or the key agent and not every individual lender. Besides, the diversification of loan terms and types of interest make it flexible for the borrowers. They can even opt for different currencies as this protects them against inflation, changes in government laws or policies by RBI and other external factors.

Effect on the Market

Positive reputation reinforcement is another advantage of borrowing through debt syndication. Anybody that has paid syndicated loan successfully in the past automatically garners a good image in the market. In addition, it helps borrowers in networking and making new contacts with the group of lenders and not just the key lender; thus, increasing their visibility in the market. All these and more have made debt syndication a sensible choice for businesses.

Statistics Speak – The Way Forward!

In the last one year, around 49.5% of the investment banking revenues was contributed by debt syndication. 2 years ago, in the month of August in the year 2016, a committee that was headed by former RBI Deputy Governor, Mr. H R Khan made some recommendations for the Indian debt market, which included some changes in the policies, regulations, market infrastructure, as well as innovation as the prerequisite towards its deepening. With all these recommendations to be implemented, the impact began to show: between the month of March 2016 and the year 2018, wherein, corporate bonds outstanding had risen to around 1.36 times. If we talk of liquidity, then on an average, the daily trading has nearly doubled in the last 5 years or so, with an exception to the CDs (the certificates of deposit), where it is decreased due to low supply. Growth fuelled by a cycle of decreasing interest rate and also due to demonetisation; it led to a liquidity-surfeit. However, still we have many miles to go, if we talk of the footprint on our Indian economy. Structurally speaking, the domestic debt market still firmly remains skewed towards the G-secs (the Government securities). If our country has to have a rapid economic growth in the long run, which is in fact an absolute societal necessity, then the corporate bond market is to play a very pivotal role as the major funding source. As per the CRISIL report, over the 5 fiscals through the year 2023, it is expected that the corporate-bond outstanding to over double to Rs. 55 lakh to 60 lakh crore, as compared with to 27 lakh crore rupees at the end of the fiscal year 2018 largely driven by big infrastructural investment needs, growth of most of the non-banking financial institutions, the regulatory force that will push, and the inability of our banks for cranking up corporate lending due to the capital constraints. We need a slew of some mandatory measures for bridging this gap, and for ensuring a healthy dynamics of demand & supply. Though the reforms that have been done thus far are progressive in nature, but still we need much more of it, and also need some more fine-tuning.

Business enterprises need capital in the form of equity or debt to meet various requirements. Depending on the business fundamentals, finance managers evaluate funding options and decide on an appropriate debt/ equity mix and composition. Consistency and predictability of earnings typically determine the ability of a business to service the cost of funding, be it equity or debt. An entity with proven earnings track record and a robust business model would find it more attractive to leverage financially and generate higher returns for its shareholders.

Providers of debt financing find it quite comforting to lend money to an entity where they have experienced consistency in servicing interest and timely repayment of principal. Their appetite for risk-reward trade off typically determines the cost of debt that the lender is usually willing to charge.

Alternate debt financing options

Depending on the deployment needs and the duration of funding, debt financing could comprise of term loans, working capital loans, receivables financing, bonds, commercial paper, debentures, deposits etc.

Foreign currency borrowings in the form of external commercial loans, buyers' credit, suppliers' credit, floating or fixed rate bonds are also available. External commercial borrowings are generally cheaper in terms of cost since interest rates on these borrowings tend to be linked with LIBOR. However, true cost comparison for external commercial borrowings is best done on a fully hedged basis to alleviate currency depreciation risk for the borrower.

Need for debt syndication

One of the mechanism for raising borrowings is through the **debt syndication** platform. Syndicated loans are now steadily finding favour with many Indian firms who need large sums of money to finance new projects but may not wish to raise funds through equity for strategic reasons. Some may not be able to raise money through bonds for lack of a suitable credit rating.

Loan syndication is the process of involving several different lenders in providing various portions of a loan. Loan syndication most often occurs in situations where a borrower requires a large sum of capital that may be outside the lending appetite for one single lender or outside the scope of a lender's risk exposure levels.

A syndicated loan is by a group of lenders (called a syndicate) who work together to provide funds for a single borrower. The loan may involve fixed amounts, a credit line, or a combination of the two.

Debt syndication categories

Globally, there are three types of debt syndication: an underwritten deal, best-efforts syndication, and a club deal.

An underwritten deal is one for which the arrangers guarantee the entire commitment, then syndicate the loan. If the arrangers cannot fully subscribe the loan, they are forced to absorb the difference, which they may later try to sell to investors.

A best-efforts syndication is one for which the arranger group commits to underwrite less than or equal to the entire amount of the loan.

A club loan is a form of multi-bank financing whereby several banks lend to the same borrower on materially the same terms (other than pricing), but there is no bank syndicate or facility agent, and the participant financiers are usually self-arranged by the borrower.

Consortium banking is one form of debt syndication.

Why go for debt syndication?

Syndicated loans are win-win for both lender and the borrower. For example, some of the large financing deals in India in last one decade were syndicated – project financing for large power plants, large refineries, steel plants and funds raised for acquisition financing. Some large debt syndication have been done in the recent past by Bharti, Essar and Tata Groups.

Financing these deals would have been a nightmare for single lender considering the quantum and risk associated. Equally, it would be cumbersome and long drawn process for borrower to individually approach multiple lenders.

Income generated from arranging syndicated loans now account for almost half of the country's investment banking revenue, unlike in major economies where debt capital market and mergers and acquisitions account for bulk of the fees.

Using debt syndication to expand corporate debt market in India

Traditionally, the equity market in India has been quite active and the size of corporate debt market is very small in comparison with developed markets and also emerging market economies in Asia. A liquid corporate debt market can play a critical role by supplementing the banking system to meet the requirements of the corporate sector for long-term capital investment and asset creation as well.

According to Securities and Exchange Board of India database, outstanding corporate bonds amounted to Rs. 19 trillion, around 14% of GDP. In contrast, outstanding corporate bonds are close to 90% of the GDP in the US where the corporate debt market is most developed and bond market financing has long replaced bank financing as a funding source for the corporates; around 34% in Japan and close to 60% in South Korea.

Development of the domestic corporate debt market in India is thwarted by a number of factors, the prominent ones being low primary issuance of corporate bonds leading to illiquidity in the secondary market, narrow investor base, high costs of issuance, lack of debt market accessibility to small and medium enterprises, dearth of a well-functioning derivatives market that could have absorbed risks emanating from interest rate fluctuations and default possibilities, excessive regulatory restrictions on the investment mandate of financial institutions, large fiscal deficit, high interest rates and the dominance of issuances through private placements, which in turn also prevent retail participation and aggravate the dependence on bank financing.

Indian corporate debt market potential is vastly untapped and debt syndication mechanism can take care of a number of these challenges and play a vital role in bridging the gap and contributing to India's GDP growth and development.

Role of DFIs in Project Finance

A Development Financial institution (DFI) is defined as –an institution endorsed or supported by Government of India primarily to provide development/Project finance to one or more sectors or sub-sectors of the economy. the institution differentiates itself by a thoughtful balance between commercial norms of operation, as adopted by any financial institution like commercial bank and developmental responsibilities. it emphasizes the long term financing of a project rather than collateral based financing apart from provision of long-term loans, equity capital, guarantees and underwriting functions, a development institution normally is also expected to upgrade the managerial and the other operational requirements of the assisted projects. Its association with its clients is of an on-going nature and of being a companion in the project than that of a plain lender like banks. Hence, the basic stress of a DFI is on long-term finance and support for activities to the sectors of the economy where the risks may be higher that may not be feasible for commercial banks to finance them. So role of DFIs is not just long term financing but more of development of significant sectors of our economy for hastening growth. These DFIs are also known as Development banks.

After independence the role of commercial banking was limited to working capital financing on short term basis so thrust of DFIs was on long term finance to industry and infrastructure

sector in India. India's first DFI was operationalized in 1948 and it set up state Financial corporations (SFCs) at the state level after passing of the SFCs act, 1951, succeeded by the development of industrial Finance corporation of India (IFCI).

The role of DFIs was to recognize the gaps in institutions and markets in our financial sector and act as a gap-filler which was made due to incapability of commercial banks to finance big infrastructure projects for long term and support them to attain growth and financial steadiness. Therefore, Govt. of India set up specialized DFIs in India to fulfil long term project financing requirements of industry and agriculture. The financial institutions in India were set up under the full control of both Central and State Governments. The Government used these institutions for the achievements in planning and development of the nation as a whole.

Role of DFIs in Indian Economy

Specialized development financial institutions (DFIs), such as, Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), National Housing Board (NHB) and Small Industry Development Bank of India (SIDBI), with majority ownership of the RBI were launched to meet the long-term financing needs of industry and agriculture in India for driving growth in our economy post-independence. There have been three phases in the evolution of DFIs in India. The first phase began with Independence and spreads to 1964 when the Industrial Development Bank of India was set up. The second phase stretched from 1964 to the middle of the 1990s when the role of the DFIs grew in importance, with the funding disbursed by them amounting to 10.3 per cent of Gross Capital Formation in 1990-91 and 15.2 per cent in 1993-94. In third phase after 1993-94, the prominence of development banking declined with the decline being particularly severe after 2000-01, as liberalization resulted in the exit of some firms from development banking and in a waning in the resources mobilised by other firms.

Evolution of DFIs in India

The process started instantly after Independence, with the setting up of the Industrial Finance Corporation (IFCI) in 1948 to embark on long term term-financing for industries. State Financial Corporations (SFCs) were formed under an Act that came into effect from August 1952 to endorse state-level, small and medium-sized industries with industrial finance. In January 1955, the Industrial Credit and Investment Corporation of India (ICICI), the first development finance institution in the private sector, came to be set up, with backing and funding of the World Bank. In June 1958, the Refinance Corporation for Industry was established, which was later taken over by the Industrial Development Bank of India (IDBI). Other DFIs that were launched included the Agriculture Refinance Corporation (1963), Rural Electrification Corporation Ltd. and HUDCO. Two other major steps in institution building were the setting up of IDBI as an apex term-lending institution and the Unit Trust of India (UTI) as an investment institution, both starting operations in July 1964 as subsidiaries of the Reserve Bank of India. There were new initiatives at the level of the states as well in the 1960s. State governments setup State Industrial Development Corporations (SIDCs) to inspire industrial development in their territories.

Specialized financial institutions set up after 1974 included NABARD (1981), EXIM Bank (1982), Shipping Credit and Investment Company of India (1986), Power Finance Corporation, Indian Railway Finance Corporation (1986), Indian Renewable Energy Development Agency (1987), Technology Development and Information Company of India, a venture fund later known as IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Ltd. (1988),

National Housing Bank (1988), the Tourism Finance Corporation of India, set up by IFCI (1989), Small Industries Development Bank of India (SIDBI), with functions relating to the micro, medium and small industries sector taken out of IDBI (1989).

Declining role of DFIs post-liberalization

In the second phase extending from the start of liberalization to the transformation of the ICICI and IDBI into commercial banks (2002-2004), the share of DFIs fell from two-thirds to just 30 per cent. Indian Govt. soon understood that development banking was not in itself suitable to deal with all its needs. This is because the financial system must not only back to growth by directing investment to crucial investment projects, but it must render development broad-based by delivering credit to sectors that may otherwise be ignored by the financial sector. Credit to support agricultural operations that are seasonal in delivery of produce and subject to much volatility is vital. But providing credit in small volumes to isolated and often remotely located borrowers surges transaction costs substantially. DFIs failed in providing cheaper loans to small scale sector and rural farm sector.

As DFIs were not having low cost deposits in form of current and saving accounts like commercial banks in India, they were not able to provide low cost finance to priority sector for long term. Although access to state funding prior to the reforms in 1991 meant that the development financial institutions were in a position to raise resources at interest costs that were much lower than if they had relied on market sources. This also allowed them to lend at rates that were rational from the point of view of industry and the infrastructural sectors. That made them the first choice for finance for Indian business, which did considerably benefit from the financial support provided by the government, in the years before the 1990s. But Govt. after 1991 reforms reduced public funding in these DFIs responsible for their decline in India. Therefore, there are a variety of ways in which the gap created by the transformation of development finance was filled. There was a shift towards bank credit and external commercial borrowing. There was improved reliance on internal resources and there was a growing role for external commercial borrowing & private equity in corporate financing.

Universal banking replacing DFIs in India

Now there is very thin line between role of DFIs and Commercial banks due to overlapping of their functions. After merger of two important DFIs ICICI and IDBI with its banking units in 2004 most of DFIs functions are being performed by commercial banks and these commercial banks are actively involved in project financing like DFIs. Therefore, Commercial banks are called universal banks which provide all kind of financial services under one roof.

But the DFIs were central to the industrialization and the development effort till the onset of liberalization cannot be denied. Their resources were crucial and the choice of areas to which they were willing to finance, which was linked to the pattern of development prescribed by the Five Year Plans, ensured that the allocation of investment was moved in directions warranted by larger development goals.

The role of development financial institutions in the new millennium

Are national development financial institutions (DFIs) still relevant? What are the critical factors that make these institutions succeed? What are concrete examples of sound, well-administered and innovative DFIs? Why do they still remain in business in countries with large

and sophisticated financial systems? How can we assess their economic and social impact? Have our views on DFIs evolved in the past decades?

All these interesting questions were discussed during the Global Symposium on Development Financial Institutions, an event jointly organized by Bank Negara Malaysia and the World Bank Group on September 19 and 20 in Kuala Lumpur, Malaysia. With the theme –Balancing Sustainability and Social Mandate: Development Financial Institutions in a New World the Global Symposium brought together 500 participants from Malaysia and around the world to discuss the challenges and opportunities faced by DFIs.

These are the three main takeaways from the Global Symposium:

Development financial institutions remain relevant.

Historically, DFIs have been created by governments around the world to promote economic growth and support social development. They typically provide credit and a wide range of capacity-building programs to households, SMEs, and even larger private corporations whose financial needs are not sufficiently served by private banks or local capital markets. In doing so, they seek to promote strategic sectors of the economy, such as agriculture, international trade, housing, tourism, infrastructure, and green industries, among other sectors.

Although many of the institutions were created several decades ago, data shows that many governments around the world still see them as a relevant instrument to pursue economic goals. It is estimated that around 20% of all development financial institutions currently in operation around the world were created in the past 17 years. A further 33% were set up during the 80s and 90s – the decades in which mass privatizations took place in various parts of the world.

Views towards national development financial institutions have evolved over the years.

For decades, the World Bank Group has worked with development financial institutions in many countries by providing lines of credit, guarantees, and technical assistance programs. Our approach towards these institutions have changed from full support for their establishment during the 60s and 70s to a more cautious approach during the 80s and 90s which saw more closure or privatization of state-owned financial institutions. Since the global financial crisis of 2008, we are seeing a more balanced appreciation of their role and mandate.

During the 2008 Global Financial Crisis, development financial institutions played an important countercyclical role in many jurisdictions, by scaling up their lending operations when private financial institutions experienced temporary difficulties in granting credit. Moreover, in the aftermath of the global financial crisis the loan portfolio of more than two thirds of DFIs has continued to expand at double digit growth rates, thus contributing to global economic recovery efforts.

Financial sustainability and good governance are critical elements for the success of DFIs.

It is a risky activity to finance projects in strategic sectors of the economy where there is insufficient financing from the private sector. To be effective, DFIs need to have business models that ensure long-term financial sustainability. They also need to have sound risk-management tools and high corporate governance standards that insulate them from undue political interference.

In the past, we have seen multiple examples of poorly performing development financial

institutions that have become a heavy fiscal burden. Their poor performance has led to credit market distortions that displace and crowd out private financial institutions. When they're weak, they also become vulnerable to political interests, resulting in high non-performing loans and wasting of taxpayers' money.

During the Global Symposium it was clear that we all need to learn lessons from the past. Financial sustainability and good governance of development financial institutions are critical elements that cannot be compromised. To achieve that, the institutions need to have well-defined mandates, be subject to high standards on corporate governance and transparency, and be regulated and supervised with standards applicable to other financial institutions. Moreover, owners of development financial institutions need to have the ability to properly monitor their business activities, assess their social and economic impact, and compare their interventions versus other public policy alternatives.

The timing of this global symposium could not be better. We need to think of innovative instruments to attract and channel new resources to finance our developmental aspirations, as outlined in the 2030 Sustainable Development Goals now more than ever. Reliable and well-administered development financial institutions with a well-defined mandate and sound governance framework will continue to be an important vehicle to accelerate economic and social development. They can create new channels to crowd-in the private sector. Moreover, they can play a catalytical role by generating new knowledge, convening stakeholders, and providing technical assistance to build capacity in the private and public sectors.

Recent Developments in Project Finance

2016 was a challenging year in the project finance market. Sluggish growth, low commodity prices, and the ongoing impact on commercial banks of the Basel reforms all worked to create a reluctant global market where global project finance volumes fell by over ten per cent compared to 2015. Lending fell by a comparable fifteen per cent.

Nation-specific tensions exacerbated these global trends. In the West, political uncertainty following the UK's referendum decision to leave the European Union, and the outcome of the US presidential elections, stifled investment in energy and infrastructure projects; whereas in Africa, there were more restructurings than normal, and the drop in crude oil prices caused a number of companies to divest their assets and substantially reduce exploration activities – a particularly stark change compared to the previously booming African oil & gas sector, epitomised by Vitol's US\$4.7 billion Offshore Cape Three Project in Ghana.

In fact, oil & gas projects were the biggest losers in 2016: by the end of January 2016, energy groups had announced the postponement or cancellation of the closing of approximately US\$400 billion of investments in oil and gas projects since the price of oil began its precipitous decline. From June 2016, the amount of unspent capital, set aside for capital investment, doubled from \$200 billion to \$380 billion and an estimated 2.9 million barrels of oil a day are now not expected to come on stream until early in the 2020s.

2017 was, and 2018 looks set to be somewhat different however. Investor confidence strengthened, commentators are more optimistic, and new opportunities abound – particularly in Asia-Pacific, where project finance volumes increased by 55.9 per cent in 2017 compared to 2016, and demand for infrastructure projects is robust. In fact, the Asian Development Bank (ADB) has estimated that the region should invest \$1.7 trillion a year in infrastructure until

2030 to maintain its current growth rate, eliminate poverty and tackle climate change. Additionally, the price of crude oil is forecast to stabilise and perhaps rise over 2018 as global economic growth returns. With this optimism in mind, this article considers three key trends that are emerging in 2018.

The rise of renewable energy

Perhaps the most notable trend is the global renaissance in renewable energy projects (primarily solar or wind, but also biomass and geothermal). In 2017, power generation from renewable sources rose by nine per cent, four times its 2000 levels. In 2016 (despite the overall negative conditions for project financings) and 2017, over half of new energy capacity added year on year was made up of renewable sources. In the third quarter of 2017, US\$66.9 billion was invested in renewable projects worldwide, up forty per cent on the corresponding period in 2016. Solar generation itself rose by thirty per cent, outstripping net growth in coal generated power (previously the greatest source of energy in the world). In Japan, solar projects in particular contributed to the total of fifty new renewable deals in the Japanese power sector, valued at US\$8 billion altogether.

National policies have been key drivers of the increased renewable activity. In Mexico, since the Energy Reform initiated by Enrique Peña Nieto's government, the country has sought and secured a regular succession of renewables deals through their auction system, such as the 377MW solar PV project in the Aguascalientes region, recently won by French renewable energy developer Neoen (November 2017).

The MENA region in particular, however, has buoyed the renewable energy sector through its immense investment in solar and wind power projects. Prompted by the Pan-Arab Renewable Energy Strategy (motivated by the region's particular vulnerability to climate change, its natural climatic advantages and a governmental desire to divert domestic oil consumption to the export market), Middle Eastern governments have pledged themselves to ambitious targets to achieve a sustainable energy future, and thereby stimulated much activity. Dubai, for example, aims to generate twenty-five per cent of its energy from clean sources by 2030, and seventy-five per cent by 2050. And in January 2017, the UAE promised a US\$163 billion investment in clean energy in order that half of the country's power demand is met by renewable sources by 2050. In Egypt, the government aims to have an installed renewable capacity share of twenty per cent by 2022.

Renewable energy technology has also become cheaper: solar panels are now sixty-two per cent cheaper than they were in 2009, and a recent consortium of JinkoSolar and Marubeni submitted an Abu Dhabi tender at the record low price of 2.42 US cents per kWh for the Sweihan Solar Plant. Such conditions have stimulated a wave of renewable projects that look set to continue well into 2018 and beyond. Saudi Arabia, for example, plans to add approximately 4 GW of renewable projects in 2018 alone, and estimates that eight projects will begin construction over the next year. Further notable project financings in the sector include the Gabal El Zeit Wind Project in Suez, Egypt (which closed in December 2017) and was the first major power sector financing in Egypt since the Arab Spring, and the first renewable energy Independent Power Producer project of its size and kind. The Scatec Solar Project, Egypt (October 2017), was also notable in its financing of some of the first utility scale solar plants in Egypt.

The project bond market

A second key emerging trend is the re-development of the project finance bond market, and the re-introduction of project bonds into mainstream financings in numbers comparable now to pre-financial crisis and the millennium (when project bonds were more commonly used in financings). Usually, the popularity of project bonds rises and falls according to the cost of other sources of financing. Over 2017, project bond and institutional investor activity in the sector increased by forty-six per cent to US\$63.7 billion, whereas loan volumes remained static year-on-year. In light of investor reluctance and perceived investor vulnerability in 2016, such a development has been regarded positively: the bonds enabled project financings to continue without a capital funding shortfall, in otherwise challenging conditions.

Bonds have been used with increased engagement in Asia: the ADB has launched a programme to support project bonds in forty-eight Asian nations. Their programme successfully supported the green project bond debt in the Philippines' US\$252 million Tiwi-MakBan geothermal power plant. Commentators have interpreted the programme as successfully setting a precedent for future green bond issuances in the region. In Europe, too, the European Investment Bank has created a 'Europe 2020 Project Bond Initiative', which aims at increasing the use of project bonds in European infrastructure financings in transport, energy and information and communication technology. The €504 million bond issuance for the Port of Calais in France is just one example of the projects the initiative has supported. In Abu Dhabi, the Fujairah F1 Water and Power Plant followed a precedent set by the Shuweihat S2 IWPP, and was refinanced with US\$400 million amortising bonds, issued by Emirates Sembcorp Water & Power Company (the SPV that operates the plant) in December 2017.

The ACWA Power Bond further highlights the increased significance of bonds in project financings. In this issuance, Saudi Arabian developer ACWA Power accessed US\$814 million in capital, secured against seven power generating assets. Project-level debt is serviced before dividends are paid to bond holders, thus making it 'truly unique'. There was much popular demand for the bond – it was nearly 250 per cent oversubscribed, encouraging ACWA to reportedly consider returning to the bond market in 2018 with another project-backed issuance.

Liquefied Natural Gas

The Liquefied Natural Gas (LNG) market has also seen considerable recent change. Over the year, the price of LNG declined (especially in the Asian spot market), which forced prices on long-term LNG sale and purchase agreements to fall. The effect of this, particularly when taken with the global stagnation in energy demand during 2016, was to cancel or suspend LNG to power projects in the US, Canada and Australia.

Nevertheless, in 2017, the market grew in strength – in part due to the changes that the sector has undergone. For example, about 30 per cent of LNG contracts are now short term, at less than two years, enabling prices to be lower and commitments to shrink, which suits project sponsors. In fact, global demand for LNG is predicted to rise by two per cent a year to 2030, and from then, to increase at four to five per cent per year. In Saudi Arabia, it has been announced that the nation plans to increase LNG's share of the power mix to seventy per cent (from fifty per cent) by the end of the 2020s.

In practice, these statistics translate into an estimated twenty or more gas to power projects coming on stream globally from now to 2023. The decline in gas prices that has accompanied the rise in demand, and changes to typical LNG contracts has successfully increased the competitiveness of LNG to power projects compared to coal or other energy sources. This has

contributed to a boom in LNG to power projects in South America, the Middle East and South America.

Of these trends, in 2018 we expect the rise of renewable energy projects in particular to continue and strengthen. India is a country of particular interest in this sector: it has been reported to boast the greatest potential solar and wind capacity in the Asia-Pacific region, and its government has set a target of reaching 175GW of renewable energy in their mix by 2022. Investor appetite for project bonds also looks set to continue: as mentioned above, it is rumoured that ACWA power will issue another project-backed bond. If the size of their first issuance set the tone, it is likely that this issuance will also be high-value and bolster the market further. As for LNG, the Asian market is certainly one to watch, with current estimates predicting that Asian LNG demand will make up seventy per cent of total global demand until 2030. And, of these three markets, it is thought that up to 2040, the LNG to power market will see the strongest growth.

UPDATE & TRENDS in INDIA

Some recent trends and hot topics related to project finance transactions in India include the following:

RBI Revised Framework:

The RBI, by its circular dated 12 February 2018 (Revised Framework), has completely revamped the regulatory framework for resolution of stressed assets. It supersedes all existing restructuring frameworks including resolution under the joint lenders' forum and strategic debt restructuring and provides for a unified framework for restructuring of stressed assets. The Revised Framework stipulates stricter and close monitoring of the borrower accounts and compulsory rating requirement in relation to the restructured accounts. Lenders are required to report to the Central Repository of Information on Large Credits about default in any account with aggregate exposure of 50 million rupees and above on weekly basis. Under the Revised Framework, as soon as there is a default in a borrower entity's account with any lender, all lenders (either singly or jointly) shall be required to formulate a resolution plan (RP) that may involve any action or plan or reorganisation including change in ownership or restructuring or sale of exposure, etc. The RP will require unanimous approval of all lenders. For accounts where the aggregate exposure of the eligible lenders in such account is in excess of 20 billion rupees, the lenders are required to mandatorily initiate and implement an RP within the prescribed timelines, failing which the account is required to be mandatorily referred for resolution under the Code. A key impact of the Revised Framework is that it mandates a time-bound mechanism of resolution of the stressed assets outside the insolvency regime, failing which the mandatory referral to resolution under the Code is prescribed.

The Revised Framework has also impacted lenders looking to provide last-mile finance to stalled or stressed projects on a priority lending basis. While earlier it was being provided under the aegis of RBI regulations prescribed in respect of stressed assets and approval of joint lenders' forum of creditors with prescribed majority, it may now be explored as an option for revival of the stressed companies under RBI Revised Framework.

High yields: We are also increasingly seeing offshore issuance of US dollar denominated notes or bonds by entities incorporated offshore, proceeds of which are being utilised to either subscribe to non-convertible debentures issued by the Indian borrower or to advance external commercial borrowings under the RBI framework.

Changes in FPI regime: The RBI has set out certain sectoral concentration limits and has clarified that limits for investments by foreign portfolio investors (FPI) shall be treated on an aggregate related party basis. Investments by an FPI must not exceed 50 per cent of any issue of corporate bonds and it must not, in any case, have an exposure of more than 20 per cent of its corporate bond portfolio to a single corporate (including exposure to entities related to the corporate).

TOT model: NHAI launched the toll-operate-transfer model to monetise existing highway networks by auctioning the rights to collect toll for a specified period against upfront payment to NHAI. The first such concession was awarded in relation to seven major highways in the states of Gujarat and Andhra Pradesh for an upfront payment of 96.8 billion rupees. The concessionaire is free to avail debt funding for the entire upfront concession fee to be paid to NHAI.

Interim finance: We are increasingly seeing non-banking finance companies providing ‘super priority interim financing’ to companies in respect of which insolvency proceedings have been initiated. These loans are typically smaller in size, and are provided to meet the costs of running the company during the period of the resolution under the Code.

MODULE V: DEBT SECURITIZATION & DERIVATIVE PRODUCTS

Concept of Debt Securitisation

In the simplest language, debt securitization is a process where companies raise money by pledging the cash-flows from their current and/ or future assets. Unlike a traditional loan, in this case, what is given as collateral to secure the debt is the very present and future receipts/ income to be generated from the project (*or from any other project*) for which the loan is being taken.

The enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) in December 2002 paved the way for securitization in India. On the upside, this allows the company to get cash up front, which can be put to use in the business or be used in order to pay off existing debt.

Types of Debt Securitization

There are 3 types of securitization methods which a company can choose from:

1. Asset Backed Securitization: In this method, companies pledge their existing assets with the lending institution to secure the loan.
2. Mortgage Backed Securitization: In this method, loans are secured by real estate, wherein the lender has the right to sell the property, if the borrower defaults.
3. Future Revenue Flow Securitization: In this, future/ prospective cash flows of the company is pledged as security to raise funds, for example – sale of power, toll revenue, rental income etc.

In a lot of industries, particularly infrastructure and power companies, it is common to securitize future earnings (cash flows), to receive loans for current and future expansion. In other words, future cash flows are assigned as collateral against the loan given by the bank or any other financial institutions.

Example

Suppose Company ABC wants to open a multiplex and is in need of funds for the same. To raise funds, Company ABC will securitize its future cash flows (*cash flows arising from sale of movie tickets and food items in the future*) in the form of securities to raise money.

This will benefit lenders as they will have a claim over the future cash flows generated from the multiplex. Company ABC will also benefit as loan obligations will be met from cash flows generated from the multiplex itself.

A typical future flow structure involves the borrowing company selling its future product (receivable) to the financial institution (bank, NBFC etc.)

Future Flow

Securitization – Gaining Importance in Infra Projects

This type of securitization provides a new way of financing for many developing countries like India. Sectors like power, infrastructure which require huge capital outlay and where the projects have long gestation periods are increasingly adopting this method of financing.

Infrastructure companies have increasingly started securitizing receivables from their existing projects to arrange funds for setting up new projects. The following table provides a list of future flow securitization opportunities in various sectors:

Sector	Future Flow to be Securitized
Power	Meter rentals
	Receivables from bulk consumers
Telecom	Phone rentals
	Lease receipt from optical fibers
	Rentals/user charges
Transport Infrastructure	Toll collection from commercial vehicles
	Airline ticket receivables
	Landing and parking fees for airports
Coal, Oil & Gas	Revenue from sale of coal, oil, and gas
	Royalty from mining and exploration
Urban Infrastructure	Property tax collection

Some key features of Future Flow Securitization

1. Low interest cost: Securitization provides a low cost financing option to companies.
2. Diversification: Securitization helps the company in diversifying its funding sources.
3. Uncertain Receivables: by its very nature, future cash flows are uncertain and depend on various factors like performance of the company, economic conditions, government policies etc.
4. Credit Risk/default risk: Since future cash flow transactions involves the transfer of receivables that do not exist at the time of granting of the loan, it is necessary for the lending companies to have a thorough understanding about the borrowing company's operational record. The lending company always faces a risk as to whether the future cash flows will in fact be generated as per expectations, or at all.

Examples of debt securitization against future receivables

1. Jaypee Power has securitized its future receivables from Vishnuprayag Project for Rs. 1,650 Cr. and also the Company has securitized receivables from Baspa – II HEP for Rs. 1,100 Cr.
2. Superconnectivity Ltd's access controlled 8/6 lane rack of length 27.7 kms on NH8 – Securitization of the toll receivables for Delhi-Gurgaon.
3. DLF also securitized its future rents to pay off its short-term debt obligations. Rent securitization is the securitization of future rent receivables, under which a developer pledges, its future rentals from a commercial space to a bank that disburses a loan against the rent receivables.

Scope of Securitisation and Indian Experience

The major players in the asset securitisation market in India are expected to be commercial FIs, PSUs, Corporates, Government bodies, Mutual Funds, Pension Funds, etc. Securitisation generally pre-supposes that the Originator has a bulk of its assets in the form of self-amortising financial assets, either with or without underlying security. It is also imperative that these assets should have a clearly established repayment schedule. Moreover, since capital market instruments have a minimum marketable tenure, the receivables underlying the securities should themselves have a sufficiently long tenure, so as not to frustrate the securitisation exercise.

While securitisation started off in the housing loan sector, the development of the securitisation market as a standard funding option across most industries has been the result of a constantly expanding universe of securitisable non-mortgage asset types. This chapter lays emphasis on three potential areas of securitisation in India - MBS, ABS and Infrastructure Sector.

Mortgage Backed Securities (MBS)

The securitisation of assets historically began with, and in sheer volume remains dominated by residential mortgages. The receivables are generally secured by way of mortgage over the property being financed, thereby enhancing the comfort for investors. This is because mortgaged property does not normally suffer erosion in its value like other physical assets through depreciation. Rather, it is more likely that real estate appreciates in value over time. Further,

1. the receivables are medium to long-term, thus catering to the needs of different categories of investors;
2. the receivables consist of a large number of individual homogenous loans that have been underwritten using standardised procedures. It is hence suitable for securitisation;
3. in the US where it originated, these mortgages were also secured by guarantees from the Government;
4. the receivables also satisfy investor preference for diversification of risk, as the geographical spread and diversity of receivable profile is very large.

In the Indian context, the funds requirement in the housing sector is immense, estimated at Rs. 150,000 crore during the current five-year plan. Of this, it is envisaged that about Rs 52,000 crore would be financed by the formal sector. It is unlikely that this gap can be filled out of budgetary allocation or regular bank credit. Securitisation allows this gap to be bridged by directly accessing the capital markets without intermediation. Securitisation tends to lower the cost at which the housing sector accesses funds. It also facilitates a sufficiently deep long term

debt market. It is estimated that about Rs 2,500 crore would be mobilised through the securitisation route during the current five-year plan.

Asset Backed Securities (ABS) – Existing assets

Auto loans:

Though securitisation was made popular by housing finance companies, it has found wide application in other areas of retail financing, particularly financing of cars and commercial vehicles. In India, the auto sector has been thrown open to international participation, greatly expanding the scope of the market. Auto loans (including instalment and hire purchase finance) broadly fulfil the features necessary in securitisation. The security in this case is also considered good, because of title over a utility asset. The development of a second hand market for cars in India has also meant that foreclosure is an effective tool in the hands of auto loan financiers in delinquent cases.

Originators are NBFCs and auto finance divisions of commercial banks.

(b) Investments:

Investments in long dated securities as also the periodical interest instruments on these securities can also be pooled and securitised. This is considered relevant particularly for Indian situation wherein the FIs are carrying huge portfolios in Government securities and other debt instruments, which are creating huge asset-liability mismatches for the institutions.

Government securities issued domestically in Indian Rupee can be bundled and used to back foreign currency denominated bonds issues. It would more be of the nature of derivative. The subordinated Government securities are intended to absorb depreciation in the value of the rupee thereby protecting to certain extent the senior securities that the Government securities back. The senior securities are directed at the international capital markets and are structured using offshore SPVs by countries like Mexico.

Similarly, under the STRIPs mechanism, the interest coupons on the Government dated securities are separated and traded in the secondary markets. Such interest instruments can also be bundled and securitised in the normal asset securitisation method.

(c) Others:

Financiers of consumer durable, Corporates whose deferred trade receivables are not funded by working capital finance, etc are Originators of other asset classes amenable to securitisation. Corporate loans, in a homogeneous pool of assets, are also subject to securitisation

There is virtually no known instance so far in the United States or in other countries of an ABS transaction having failed. This is despite the fact that the markets for ABS are exceptionally large. Industry experts attribute this to three main factors. ABS transactions are always planned, prepared and carried out with great care. Second reason is the intrinsic value of the paper and in particular the high level of transparency on the quality of the underlying assets. Third, ABS transactions are sponsored generally by large and well known institutions which can't afford to jeopardise their reputation with investors, the majority of which are institutional investors.

Securitisation of infrastructure receivables

Securitisation of wholesale assets refers mainly to the use of securitisation as a technique for infrastructure funding. The availability of an efficient infrastructure framework is vital to the economic growth and prosperity of any country. Traditionally, infrastructure facilities have been developed and provided by Governments and are looked upon as basic privileges of a citizen and have thus been accorded priority for Government investment. The Central Government has envisaged that more than 40% of the annual central plan outlay would be for the development of infrastructure.² In the context of India's size, population, and economic growth, the present infrastructure continues to be inadequate and will require massive incremental investment to sustain economic growth. Hence, the participation of private capital in the development of infrastructure (over and above the Government's direct involvement) is essential. The India Infrastructure Report submitted by the Rakesh Mohan Committee in 1995 estimated that a total outlay of Rs 400,000 – 450,000 crore would be required for infrastructure financing in the period of 1996-2001. Some of the broad observations outlined in the report in respect of various infrastructure segments are detailed in the table hereunder.

Table 3: Criticality of Requirements and Outlay for Infrastructure

Segment	Criticality of Requirements – Status in 1995	Outlay estimated (Rs. crore)
Urban Infrastructure	Water Supply – Covering 20% of total population Toilet facilities covering 23.55% of households Sanitation – Covering 52% of households	94,000
Power	Peak Shortage of 19% and energy shortage of 8%. Addition of upto 111,500 MW from 1996-2006	500,000
Telecom	Penetration of 1.3 telephones for every 100 people	60,000
Roads	Of the total 165,000 km of highway (State and National) – 2% are four lane highways, 34% in the form of two lane highways and 64% single lane highways	95,000
Ports	Operating at optimal capacity utilisation and marred by lower efficiencies and delays because of using second and third generation equipment	25,000

Along with the Government's earnest attempt at attracting private investment into infrastructure funding, the role of innovative funding techniques such as securitisation is vital. The suitability of securitisation for infrastructure funding stems from the fact that cash flows

are stable and concession driven, and also because ultimate credit risk (which is central to the concept of securitisation) is partly guaranteed by Government. Securitisation is particularly appropriate at the post-commissioning stage when the project begins to generate cash, with overall project risk being largely replaced by credit risk.

Some of the typical characteristics of infrastructure projects that set them apart from other financing needs are:

Multiple level project risks: Infrastructure financing involves risk participation at multiple levels and is complex to understand for individual investors. The nature of project risk in various stages is volatile, it is highest in the pre-commissioning stage and is sought to be mitigated through contractual framework, which is concession driven or provides guaranteed returns. These guarantees and concessions are typically extended by Government and quasi Government organisations and thus minimise financial risk.

Unconventional asset cover: Infrastructure projects are typified by the creation of unconventional assets. The assets of an infrastructure project could comprise roads or bridges, jetties and quays in a port infrastructure project, drills and rigs pertaining to an oil well, water treatment plants. These assets are not amenable to resale or reapplication and hence are unacceptable as security cover to conventional lenders. Furthermore, the step-in rights to lenders are non-existent since such projects are awarded on the basis of concession and are on a Build Operate and Transfer (BOT) basis with the 'ownership' of such assets resting with the State or Central Government.

Tenure and size of funds required: Infrastructure projects are typically long gestation projects involving high capital outlay and back-ended project returns. The sources of funds would hence have to be long term and provide for a sufficient moratorium.

Securitisation will benefit infrastructure financing because it:

1. permits funding agencies whose sector exposures are choked, to continue funding to those sectors.
2. permits the participation of a much larger number of investors by issue of marketable securities.
3. lowers the cost of funding infrastructure projects; long term funding (a sine quo non for most infrastructure projects) is more feasible in securitised structures than conventional lending.
4. facilitates risk participation amongst intermediaries that specialise in handling each of the component risks associated with infrastructure funding (while these may initially be borne by regular financial intermediaries and insurance companies, it is expected that specialised institutions would develop over time).
5. shifts the focus of funding agencies to evaluation of credit risk of the transaction structure rather than overall project risk. This is because the other components of project risk (as mentioned above) would be borne by specialised intermediaries, at a fee.

Relevance of securitisation in some infrastructure sectors

(a) Power

Various public sector units (PSUs) have a high financial exposure to state electricity boards

(SEBs), some of which are sub-standard loans since several SEBs have inadequate solvency for meeting obligations on the due date. Securitisation in the power sector can be divided into the following segments:

Receivables of PSUs such as National Thermal Power Corporation, Coal India Ltd., Power Finance Corporation, Rural Electrification Corporation, National Hydel Power Corporation, etc. from various SEBs can be securitised to reduce/rebalance financial exposure of these PSUs.

Securitisation of SEB revenues for resource raising.

(b) Roads

Private sector road projects are expected to earn revenues from toll collections and concessions. However these projects carry multiple level of risks which could be summarised as under:

Construction risk – In event of inordinate delays in procuring land and completing implementation.

Traffic Estimation risk – Accuracy of estimating traffic in various segments i.e. commercial vehicles, buses, passenger cars, two wheelers and achieving desired traffic estimates

Toll collection risk – Intent and willingness of users to pay requisite tolls for usage.

Considering the multiple levels of risk, securitisation could be used to splice various levels of risks and thereby facilitate financial closure at an optimal cost of capital.

In a typical road project, the Project Company could expect receivables from three broad categories of constituents. This could be classified under various "risk" categories as under:

i) Low Risk Users - Government/Quasi Government agencies which may have provided concessions or awarded the project on a BOT basis. The Government or its agency would guarantee a minimum toll/traffic or would provide concession in the form of a fixed return. The guarantee element would carry the same risk as that of the Government agency providing such assurance. Receivables from this nature could be securitised to low risk investors.

ii) Medium Risk Users - A road or a bridge to be constructed by the Project Company could be used in a large measure by industrial or corporate users, who would pay lump-sum tolls for usage of the road. The receivables from such entities could be securitised to users with a medium risk appetite.

iii) Other Users - A road would be used by passengers, one-time users and others. The toll receivables from small users would continue to be received by the Project Company.

(c) Ports

The revenues of typical port projects would be in the nature of stowage and loading revenues levied on ships, which stop at the port of call. In addition, ports tend to provide storage facilities for chemicals, cargo, petroleum products, etc. to several large companies. The port authority/operator contract such storage facilities for a long tenure. The port revenues of this nature are suitable to securitisation.

(d) Urban Infrastructure

Primarily, the opportunity in urban infrastructure is in the areas of housing loans (the same has been covered under the section pertaining to mortgage securitisation). The other areas under urban infrastructure are water supply, sewage facilities, garbage disposal, etc

Further, the above list is illustrative and not exhaustive. Wherever a reasonably certain sum of money will be received over a certain time, not very short, securitisation possibility exists. In short, the scope of securitisation is vast; ultimately being limited only by the consideration that assets proposed to be securitised must fundamentally be income bearing.

Future receivables:

Providers of utilities such as electricity and telephone services have an excellent opportunity of securitising electricity meter rentals and telephone rentals. The receivables in these cases are very widely spread, and delinquency record very favourable. A specific case can be that of VSNL. Being the sole gateway for inward traffic of international calls, the company gets a large and steady inflow of foreign exchange, that is ideal for securitisation.

Export Receivables:

Securitisation of export receivables can be considered by (i) the financing FIs or (ii) exporters themselves. The basic requirement for securitisation would be that the receivables have a reasonable span of life so that they can be segregated and covered by a market instrument. The securitisation of export receivables over a medium to long term period could thus be securitised by any of the above entities. Among the Institutional lenders, EXIM Bank may be able to undertake securitisation since they are involved in financing exporters on deferred terms. Among the exporters, those engaged in export of capital goods may be able to do securitisation if the relevant mechanism is in place.

The export receivables are offshore dollar cash flow transactions as secured financing backed by future dollar receivables that can be isolated outside of India. In these transactions, the rights to receive future dollar cash flows can be transferred to an SPV outside India. The offshore vehicle issues the securities. As a result, the cash flows are first received outside India for payment to investors. Thus, it is possible to receive a rating on the securities higher than the India sovereign ceiling.

Because the primary goal in these transactions is to isolate the India sovereign risk, offshore dollar receivable transactions should be structured using special purpose vehicles outside of India. The securities that would be issued, moreover, would be dollar denominated and directed to investors outside of India. Consequently, these transactions are not affected by the legal issues in the Indian scenario. Such transactions are reported to have been done in Mexico. Exchange Control Department, RBI may examine the issue.

Forfeiture of concessional finance on exports:

Currently the RBI regulations state that export receivables must first be used to liquidate the packing credit facility or any other form of concessional export finance, if available.

The concerned department/s of RBI may re-examine the issue keeping in view the international practice and the huge potential to securitise export receivables. RBI may consider issuing a clarification that exporters would continue to be eligible for concessional export finance in the event of a securitisation transaction being carried out as long as upfront purchase consideration is paid in foreign currency.

Credit card receivables:

Securitisation of credit card receivables is an innovation that has found wide acceptance. Although the average tenure of credit available to a credit card holder is generally very short (less than two months), it is revolving in nature. The lacuna of short tenor of the receivables is hence overcome by 'substitution', whereby collections are used for fresh purchases of receivables. Thus a securitisable asset of marketable tenure comes into being. The structure in this case is generally pay-through, since it is impossible to match the payment made by the cardholder with the payment to the investor.

Originators are credit card divisions/subsidiaries of commercial banks, including a number of foreign banks.

Airline ticket receivables:

Future sales of airline tickets can be securitised considering the predictability of the cashflows from the same.

Future oil sales:

Oil sales from confirmed oilfields can form a large pool of assets that are suitable for securitisation, especially considering that the Obligators would normally be high quality corporates.

Lease rentals:

Equipment and real estate leases exhibit characteristics that are amenable to securitisation, particularly in respect of a fixed payment schedule for the lease rentals. In the Indian context, there is ample scope for securitisation of these future flows in this asset class in view of the impressive growth of hire purchase and leasing finance companies, especially after the issue of guidelines by the RBI regulating their functioning. While portfolios of lease/hire purchase receivables are obvious choices, securitisation can also be attempted for lease rentals from individual commercial properties, provided they are sufficiently big and backed by an agreement. Structuring securitisation transactions in this asset class would have to take into consideration the payment schedule of the underlying receivables, i.e. balloon, bullet, front-ended, back-ended and so on. Incorporation of international risks is necessary in the case of import leasing and cross-border leasing.

Originators are NBFCs and leasing divisions of commercial banks.

The Indian Experience

Securitisation is a relatively new concept in India but is gaining ground quite rapidly. CRISIL rated the first securitisation program in India in 1991 when Citibank securitised a pool from its

auto loan portfolio and placed the paper with GIC Mutual Fund (a case study of one of Citibank's subsequent deals is discussed later in detail). Since then, securitisation of assets has begun to emerge as a clear option of fund raising by corporates and a few transactions of well-rated companies have taken place in the country. While some of the securitisation transactions which took place earlier involved sale of hire purchase or loan receivables of non-banking financial companies (NBFCs), arising out of auto-finance activity, many manufacturing companies and service industries are now increasingly looking towards securitising their deferred receivables and future flows also. Information on past deals is not readily available, as most of them have been bilateral one-to-one and unrated transactions. In the context of rated transactions, CRISIL has rated about 50 transactions till date, with volume aggregating to well over Rs 4,500 crore. Other rating agencies in India, viz., ICRA, DCR and CARE have also been actively involved in the process. The majority of these being in the nature of outright sales of auto loan portfolios without subsequent issue of securities and do not amount to securitisation in the real sense. There has till date been no instance of downgrading of the rating assigned to any of these transactions. As per an estimate, out of the total asset securitisation attempted between 1992 and 1998, as much as

35 % relates to hire purchase receivables of truck and auto loan segment. The car loan segment of the auto loans market has been more successful than the commercial vehicle loan segment mainly because of factors such as perceived credit risk, higher volumes and homogeneous nature of receivables. Other types of receivables for which securitisation has been attempted include property rental receivables, power receivables, telecom receivables, lease receivables etc.

However, while several ABS transactions may have assumed a form similar to that of securitisation, the absence of marketable securities available for distribution to several investors would imply that in substance all these transactions partake of the essential characteristics of a structured loan deal rather than of a securitisation transaction. So far, 'Securitisation' in India was meant to imply any of the following distinct activities:

Structured obligations against receivables (whether loans or debentures/bonds)
Outright sale of financial/trade receivables without issue of securities
Securitisation transactions involving assignment of receivables to an SPV and issue of securities backed by these receivables

In the first type, there is no legal true sale of receivables. The lenders/investors rely on a structured payment mechanism for timely servicing of their dues and not on the performance of the assets. Further, the receivables do not go off the balance sheet of the Originator and the lenders/investors continue to have full recourse to the Originator. In the second type, while the Originator would get the benefit of off-balance sheet funding, it fails to satisfy a basic requirement of securitisation i.e. issue of securities backed by these receivables. Securitisation is incomplete unless it involves an issue of (marketable) securities whereby the risks and rewards are channeled into the capital market (at least into the wholesale segment). Thus, only the third type of activity falls under the category of true securitisation as understood internationally.

The first two types are already witnessing some activity from certain lending institutions. Other players in the reckoning are multinationals like GE Capital and Citibank who have been

acquiring asset portfolios generated by local NBFCs like Ashok Leyland Finance, 20th Century Finance and other companies like TELCO.

The third type of activity, which would involve issue of tradable securities either in the form of PTCs or structured debentures, is the one that is expected to see larger volumes in the long run. This segment would comprise within it, both corporates willing to raise funds against their assets as also FIs wanting to securitise their loan portfolios. In fact, organisations like HUDCO and Rural Electrification Corporation have already evinced interest in creating a securitisation structure for their future investments in the infrastructure area.

Some of the pioneering transactions that have either been concluded or are being structured in this regard are described in the following sections.

(a) Housing Loans

Housing loan portfolios are considered to be high quality assets with diversified risk and attractive returns. They are by their nature amenable to securitisation. In India however, in spite of outstanding to the tune of Rs 12,0003 crore in the organised sector, no transaction has yet achieved successful completion. This needs to be analysed in light of the experience in the US markets, where the overwhelming majority of securitisation deals have been of housing loans or MBS.

However, of late there has been a perceptible positive orientation of Government policies towards securitisation for the housing sector. The five-year Plan documents have repeatedly emphasised the need for developing a secondary mortgage market (SMM) for bridging the resource constraint confronting the housing sector. The Ninth Five-Year Plan has strongly recommended securitisation as an important source of funds for the housing sector and has envisaged Rs. 2500 crore to come by way of securitisation.

The National Housing Policy (1992) of the Government of India also identified securitisation as an essential measure for generating resources for housing. In particular, it has emphasised the development of a SMM in the country in order to channelise funds from wide range of investors and help integrate the housing finance system with overall finance system, especially the capital market. That securitisation has come to represent a major policy plank of the Government, is further manifested in the recently announced National Habitat and Housing Policy (1998), which lays emphasis on the National Housing Bank (NHB) playing a lead role in mortgage securitisation and development of a SMM in the country. NHB has taken up the issue of securitisation with state Governments through the Ministry of Urban Development.

NHB is now proposing a pilot issue of MBS, as a prelude to the development of a SMM in the country. The pilot project involves securitising a pool of housing loans originated by four Housing Finance Companies. The pool would include unencumbered loans given to individuals for residential houses, in the states of Maharashtra, Tamil Nadu, Gujarat and Karnataka, with maximum loan to value ratio (LTV) of 80%. NHB would act as the SPV and facilitate the transaction. The issue is proposed to be launched in FY 1999 – 2000 and is expected to be a path-breaking issue for MBS transactions in the country. All the major procedural, legal, and taxation issues are in the process of being resolved in this transaction, thus paving the way for classical securitisation transactions to take off in the country.

As with the rest of the world, the potential for mortgage securitisation is enormous. In the case of mortgage securitisation there are specific issues that stymie the process. These are the long tenure of loans, low spreads, cumbersome foreclosure procedures, prepayment risks etc., all of which have led to its tardy progress. A major hurdle in India is simplified foreclosure norms. Once this happens, housing finance institutions (HFIs) will be able to tackle delinquencies effectively and will be willing to lend with less stringent credit evaluation. This is expected to enlarge volumes in the formal sector, helping a wider section of society (who would otherwise have approached the unorganised sector) to borrow at lower rates.

(b) Auto loans – Citibank Case

Citibank assigned a cherry-picked auto loan portfolio to People's Financial Services Ltd. (PFSL), an SPV floated for the purpose of securitisation by paying the required amount of stamp duty (0.1%) to ensure true sale. This is a limited company and can act only as SPV for asset securitisation. This SPV is owned and managed by a group of distinguished legal counsels. PFSL then proceeded to issue 'Pass Through Certificates' to investors. These certificates were rated by CRISIL and listed on the wholesale debt market of the National Stock Exchange (NSE), with HG Asia and Birla Marlin as the market makers. Global Trust Bank acted as the Investors' Representative. Citibank played the role of servicer. The certificates are freely transferable and each of the transfer will have a stamp cost of 0.10%.

The coupon of the security was high in spite of good quality of the underlying asset portfolio, because investors expected a premium to compensate for their unfamiliarity with the certificates. The investor base was limited mostly to MFs. FIs were hesitant because of the unsecured nature of the instrument and the absence of clarity on whether the certificates could be treated on par with other debt securities in their investment policy. Although the certificates were listed on the NSE, there was very little secondary market activity because there was absence of adequate amount of alternative security of similar risk profile.

Besides Citibank, NBFCs like Ashok Leyland Finance, 20th Century Finance etc. have securitised their auto loan portfolio, though, of course, these transactions involved assignment of receivables only and not issuance of securities. The asset portfolios were bought by one or two large institutions. TELCO has also reportedly sold over Rs 550 crore of its auto loan portfolio in multiple tranches through this route.

(c) SEB receivables – KEB case

Another important asset class for the purpose of securitisation pertains to the power sector. The Government is keen to securitise the outstanding dues of various State Electricity Boards (SEBs) and the total market of such receivables is estimated at around Rs.10, 000 crore⁴. However, securitisation of these receivables is feasible provided they are sufficiently credit enhanced, preferably with Government guarantee.

The initiative in this regard has been taken by Karnataka Electricity Board (KEB) who, in a recent transaction, are securitising around Rs 210 crore of their outstanding dues from various State owned public enterprises. The outstanding dues of KEB are being assigned to another State owned subsidiary, Karnataka Renewable Energy Development Ltd. (KREDL) which is acting as the SPV and in turn issuing securities. The securities are being credit enhanced by way of a guarantee from the Karnataka Government with a structured payment mechanism. HUDCO has agreed to be the investor and subscribe to the securities in full.

(d) Future Flows

Traditionally, existing receivables, where receivables are not contingent upon the performance of the Originator were securitised. The asset classes mentioned above viz. housing mortgage, auto loans, industrial loan receivables, etc. belong to the category of existing assets. As mentioned earlier, of late, 'future flow securitisation', is gaining momentum. Remittances from overseas workers, international telephone settlements, export receivables, future sale of oil and gas and other commodities, project cashflows and toll receivables are finding favour with investors. Some illustrations are given below:

(i) Future receivables - L&T case

The recent case of a power plant construction being financed through the capital markets is an example of future flow securitisation. Although Larsen & Toubro bagged the Build, Lease and Operate contract for a 90-MW captive power plant for Indian Petrochemical Corporation Ltd. (IPCL), it preferred to transfer it to an SPV – India Infrastructure Developers Ltd. (IIDL) which issued debentures in the private placement market. The debentures would be serviced out of the lease rentals due to IIDL from IPCL. L&T's guarantee was also available to a limited extent. The novelty of this transaction is that instead of a plain loan with say, 3:1 debt equity ratio, the project was financed in the form of a securitisation like structure through the capital market with a much higher gearing ratio.

(ii) RIICO case

This was the first attempt at issue of structured debt paper backed by the cash flows arising out of future receivables of a utility. Rajasthan State Electricity Board (RSEB) proposed to raise resources to the tune of Rs.250 crore, but, on account of its weak balance sheet, was not able to access the market directly. A structure was, therefore, devised whereby a pool of receivables comprising RSEB's high value customers was selected based on their payment history. The pool was then rated and credit enhancements were built. While no SPV was set up specifically for the purpose of the transaction, an existing profit-making Government Company, viz. Rajasthan State Industrial Development and Investment Corporation Ltd. (RIICO), was selected as the borrowing entity and the future cash flows and underlying receivables were charged to RIICO. The bonds backed by cash flows were issued by RIICO to various investors by means of a privately placed issue. The investors continued to have recourse to the issuer i.e. RIICO in the event of shortfall in cash flows. The high stamp duties then prevalent, as also certain legal and market-related hurdles, delayed the introduction of full-fledged securitisation at that juncture.

Since the first issuance in 1991, the ABS have been very popular with the NBFCs in India. Over Rs.2000 crore of debt has been raised through this route⁵. The repayment history of all the issues has been extremely satisfactory. The level of cash collateral to support 'AAA' rating has come down (from a peak of 16% to an average of 8%). While the investors enjoyed a higher yield, the cost to NBFCs was lower than the traditional sources such as bank loans and public deposits. The primary market size of commercial loans and auto loans is expected to be about Rs.11, 000 crore and grows annually by 6% - 8%.

EMs have high cost of raising funds and look for alternative sources for raising funds at cheaper sources. FIs in Asia have large illiquid debt to get rid off. These countries have the potential to benefit from securitisation as soon as the situation improves in South East Asia. Some of the countries in EMs have introduced specific securitisation laws. Eastern Europe offers good scope with the growth of consumer assets; export credit for traditional markets is

growing in countries like Poland, Czech republic, Hungary, Slovakia. After the success of securitisation of credit cards and workers remittances in Turkey, other markets in the region like Israel, Lebanon, Egypt are ready for consumer type securitisation. Latin America is already on the path of active securitisation and is well ahead of the other EMs.

There is a huge potential for infrastructure finance in EMs. FIs can securitise their loans for infrastructure projects and the same can be sold to potential local or foreign investors. This presupposes a well-developed secondary debt market.

Government guaranteed loans may remain excluded from securitisation, as they are less efficient.

Privatisation is revolutionising the economic practices in the EMs. Banks are going to the markets for raising equity in the wake of reducing State funding. Their shares are being quoted in the stock markets. They are being forced to improve ROE and the efficiencies of the capital deployed. This gives them the opportunity to consider securitisation in an aggressive way.

Market penetration of FIs in the area of origination of loans will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time.

Certain potentials for securitisation especially in the mortgage sector in India and elsewhere are as under:

Increasing share of tertiary sector, urbanisation and demand for houses

Reduction of poverty and fast development of enlightened middle/upper middle classes in India and elsewhere

Disappearance of joint family system and demand for new houses

Housing initiatives

The increasing size of the middle class and the resultant continuous increase in the demand for new houses as well as loans for renovation will increase the demand for mortgage finance in the EMs in future. Mortgages retain the major share of securitisation so far.

Presently, investors include FIs, special funds raised for the purpose of investment in ABS, pension funds, insurance companies, mainly from USA or Europe. Local investors from Asia look forward for higher returns, as their cost of raising funds is high. Saving rates in Southeast Asia have been 32 percent of GDP versus 21 percent in Latin America, according to ING Baring estimates. Although the local investors' appetite from these EMs is dependent upon the deepening of the markets, the huge savings may provide potential as the process for widening and deepening of these financial markets is taken up.

Future Prospects

In brief, securitisation will grow in future for two significant reasons:

- a) securitised paper is rated more creditworthy than the FI itself
- b) strict capital requirements are imposed on the FIs

Future trends in securitisation of assets will not only be influenced by those FIs who are knowledgeable about this process, and therefore, aware of its potential but will also be affected by the level of knowledge in the financial community as a whole as well as the perception of the regulators. While the benefits that securitisation brings in its wake are well documented, it may however, be worthwhile to examine whether the domestic financial markets are sufficiently developed to accept the product and utilise it efficiently.

The debt market has deepened and widened in recent years in India after the introduction of financial sector reforms. The recent recommendation of the committee on financial sector reforms (Narasimhan Committee Phase II) stipulates that the minimum shareholding by Government / Reserve Bank of India in the equity of the nationalised banks should be brought down to 33%. The same report also emphasises financial restructuring with the objective of, inter alia, hiving off non-performing-asset portfolio from the books of the FIs through securitisation. According to an estimate, Indian banks may be able to raise funds at 200 BP above US Treasury rate for an issue of US\$ 150 mn. with a maturity of five years, giving them a gain of 200 to 400 BP. over the domestic rates after taking care of related expenses. The securitised paper can be raised in a period of 16 weeks after signing the mandate with advisors/lead manager. The costs involved are advisors' fee to the tune of 1.5% of issue size, rating agency fee US \$ 300,000, legal expenses US\$ 500,000 and road shows US\$ 100,000. The guidelines of RBI restricting the quantum of the public deposits that can be raised by an NBFC have given them further incentive to look for alternative sources of funds. The opening of the insurance sector for privatisation can create demand for the securitised paper.

The Indian financial system is sound and very well developed. A number of new financial products have arrived and been tested in the market during the brief period since the reforms began. The past few years have also witnessed a healthy trend towards computerisation of transaction and information management systems. The availability of computer technology would thus permit the capture and manipulation of large databases, which are a basic requisite in structuring, securitised products.

The debt market is poised for substantial growth with the development of the sovereign yield curve across different maturities and the active participation of primary dealers.

The Indian market has existing well-developed institutions, specialised regulators in Banking, Capital Markets, Rating Agencies and also a well-developed regime of controls and supervision.

The infrastructure sector has already started witnessing contracting of debt in a tradable form by most lending institutions. This has been concurrent with the advent of Structured Debt Obligations which has in turn familiarised Rating Agencies to 'SO' ratings.

The existence of specialised financing institutions like Housing Finance Companies, Urban / Infrastructure development Bodies like Housing and Urban Development Corporation (HUDCO), Rural Electrification Corporation (REC) etc. who not only have existing securitisable portfolios but also have the capacity to keep creating such assets with a view to securitising them. Since most such institutions are facing resource constraints, securitisation will enable them to focus on their core competency of supporting infrastructure products through the gestation stage and securitising them later, rather than funding them till maturity.

The domestic financial institutions are fast reaching their prudential limits in various sectors. Further lending by them to these sectors is thus dependent upon their being able to securitise their existing portfolios.

The investors with long term funds have traditionally favoured equity and Government securities portfolio and have stayed out of debt. Also the present illiquidity of the loan portfolios does not allow FIs to actively manage or manipulate the related sector, interest rate or maturity risks. This places a restriction on further asset expansion, as assets once taken on the books necessarily need to be carried till maturity. Securitisation will provide solution for their requirements.

The market is thus at a stage where debt is increasingly going to be offered in a tradable form, whether or not secondary market trades take place in individual cases. Securitisation, by converting debt into tradable financial instruments, provides an opportunity for more efficient reallocation of sector specific risks among a more diversified set of players. By offering an exit option, it channelises surpluses that have so far remained untapped, to capital-deficient sectors of the economy.

Asset and Mortgage Backed securities

Asset Backed Securities

Asset-backed securities, also called ABS, are pools of loans that are packaged and sold to investors as securities—a process known as –securitization.¹ The type of loans that are typically securitized includes home mortgages, credit card receivables, auto loans (including loans for recreational vehicles), home equity loans, student loans, and loans for boats.

Asset-Backed Securities: How They Work

When a consumer takes out a loan, their debt becomes an asset on the balance sheet of the lender. The lender, in turn, can sell these assets to a trust or –special purpose vehicle,¹ which packages them into an asset-backed security that can be sold in the public market. The interest and principal payments made by consumers –pass through¹ to the investors that own the asset-backed securities. Typically, individual securities are gathered into "tranches" or groups of loans with similar ranges of maturities and delinquency risks.

The ABS market first developed in the 1980s. In 1986, mortgage-backed securities were added to the investment-grade bond index that later became known as the Barclays U.S. Aggregate Bond Index.

If you own a bond mutual fund, particularly an index fund, there's a good chance that the portfolio includes exposure to ABS. There are also a number exchange-traded funds dedicated solely to asset-backed securities, among them the Vanguard Mortgage-Backed Securities ETF (VMBS), which holds mortgage-backed pass-through securities issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC) with maturities ranging from 3 to 10 years. It is a relatively safe ABS fund with an expense ratio of 0.07%.

ABS Benefits

The benefit for the issuer of an ABS is that the issuer removes these items from its balance sheet, thereby gaining both a source of new funds as well as greater flexibility to pursue new business. The benefit to the buyer—usually institutional investors—is that they can pick up additional yield relative to government bonds and augment their portfolio diversification.

ABS Risks

While some investors have success with ABS investments, some ABS have historically turned out to be bad investments. It was the meltdown of ABS holding sub-prime mortgages that initiated the Great Recession that began in late 2007.

Only financially sophisticated, wealthy investors should buy individual asset-backed securities directly. Evaluating the underlying loans requires considerable research and the process of acquiring the necessary data isn't always straightforward.

ABS carry some prepayment risk, which is the chance that investors will experience reduced cash flows caused by borrowers paying off their loans early, particularly in a low-yield environment when borrowers can refinance existing loans at lower rates.

The mixed history of ABS securities suggests that some caution needs to be exercised, even when buying AAA or AA rated ABS. In the past, the credit ratings attached to ABS by Moody's and other rating agencies have not always been reliable. It's also prudent to only buy ABS ETFs from large, highly regarded issuers, such as BlackRock, Fidelity, or Vanguard, and to invest in investment-grade products.

Mortgage backed securities

Mortgage-backed securities are investments that are secured by mortgages. They're a type of asset-backed security. A security is an investment that is traded on a secondary market. It allows investors to benefit from the mortgage business without ever having to buy or sell an actual home loan. Typical buyers of these securities include institutional, corporate or individual investors.

When you invest in an MBS, you are buying the rights to receive the value of a bundle of mortgages. That includes the monthly payments and the repayment of the principal. Since it is a security, you can buy just a part of the mortgage. You receive an equivalent portion of the payments. An MBS is a derivative because it derives its value from the underlying asset.

How a Mortgage-Backed Security Works

First, a bank or mortgage company makes a home loan. The bank then sells that loan to an investment bank. It uses the money received from the investment bank to make new loans.

The investment bank adds the loan to a bundle of mortgages with similar interest rates. It puts the bundle in a special company designed for that purpose. It's called a Special Purpose Vehicle or Special Investment Vehicle. That keeps the mortgage-backed securities separate from the bank's other services. The SPV markets the mortgage-backed securities. The mortgages stay in the SPV.

Government agencies are also involved in most mortgage-backed securities. These are Fannie Mae, Freddie Mac, and Ginnie Mae. Fannie Mae and Freddie Mac both buy and sell MBS. The federal government guarantees the payments. Those who bought an MBS knew they wouldn't lose their investment. Ginnie Mae also guarantees that investors would receive their payments.

The Different Types

The simplest MBS is the pass-through participation certificate. It pays the holders their fair share of both principal and interest payments made on the mortgage bundle.

In the early 2000s, the MBS market grew very competitive. Banks created more complicated investment products to attract customers. For example, they developed collateralized debt obligations for loans other than mortgages. But they also applied this derivative strategy to MBS.

The investment banks sliced the mortgage bundles into similar risk categories, known as tranches. The least risky tranche contained the first one to three years of payments. Borrowers were most likely to pay the first three years. For adjustable-rate mortgages, these years also have the lowest interest rates.

Some investors preferred the riskier tranche because they have higher interest rates. Those tranches contained the fourth through seventh years of payments. As long as interest rates remained low, then risks remained predictable. If the borrower prepaid the mortgage because he or she refinanced, then investors received their initial investment back.

Risk grew when interest rates rose. Borrowers of adjustable-rate mortgages were caught off guard when their payments rose. They couldn't refinance because interest rates were higher. That meant they were more likely to default. The investors lost everything (Ryan Gosling explaining it in the movie "The Big Short").

Changed the Housing Industry

The invention of mortgage-backed securities completely revolutionized the housing, banking and mortgage businesses. At first, mortgage-backed securities allowed more people to buy homes. During the real estate boom, many banks and mortgage companies made loans with no money down. That allowed people to get into mortgages they couldn't afford. The lenders didn't care. They knew they could sell the loans, and not pay the consequences when and if the borrowers defaulted.

That created an asset bubble. It burst in 2006 with the subprime mortgage crisis. Since so many investors, pension funds and financial institutions owned mortgage-backed securities; everyone took losses. That's what created the 2008 financial crisis.

How They Went Wrong

President Lyndon Johnson created mortgage-backed securities when he authorized the 1968 Charter Act. It also created Fannie Mae. He wanted to give banks the ability to sell off mortgages. That would free up funds to lend to more homeowners.

LBJ didn't expect the Charter Act to remove good lending practices. Banks soon realized that they would no longer have to take the loss if the borrower didn't pay off the loan. The banks got paid for making the loan but didn't get hurt if the loan went bad. They weren't as careful about the credit-worthiness of borrowers.

Mortgage-backed securities also allowed non-bank financial institutions to enter the mortgage business. Before MBS, only banks had large enough deposits to make long-term loans. They had the deep pockets to wait until these loans were repaid 15 or 30 years later. The invention of MBS meant that lenders got their cash back right away from investors on the secondary market. Mortgage lenders sprang up everywhere. They also weren't too careful about the solvency of their customers. It created more competition for traditional banks. They had to lower their standards to compete.

Worst of all, MBS were not regulated. The federal government regulated banks to make sure their depositors were protected. But those rules didn't apply to MBS and mortgage brokers. Bank depositors were safe, but MBS investors were not protected at all.

Differences between Asset Backed and Mortgage backed securities

Asset-backed securities (ABS) and mortgage-backed securities (MBS) are two of the most important types of asset classes within the fixed-income sector. MBS are created from the pooling of mortgages that are sold to interested investors, whereas ABS is created from the pooling of non-mortgage assets. These securities are usually backed by credit card receivables, home equity loans, student loans, and auto loans. The ABS market was developed in the 1980s and has become increasingly important to the U.S. debt market. Despite their apparent similarities, the two types of assets possess key differences.

The Structures of ABS and MBS

The structure of these types of securities are based on three parties: the seller, the issuer, and the investor. Sellers are the companies that generate loans for sale to issuers and act as the servicer, collecting principal and interest payments from borrowers. ABS and MBS benefit sellers because they can be removed from the balance sheet, allowing sellers to acquire additional funding.

Issuers buy loans from sellers and pool them together to release ABS or MBS to investors, and can be a third-party company or special-purpose vehicle (SPV). Investors of ABS and MBS are typically institutional investors that use ABS and MBS in an attempt to obtain higher yields than government bonds and provide diversification.

Examples of Asset-Backed Securities

There are many types of ABS, each with different characteristics, cash flows and valuations. Here are some of the most common ABS types:

Home Equity ABS:

Home equity loans are very similar to mortgages, which in turn makes home equity ABS similar to MBS. The major difference between home equity loans and mortgages is that the borrowers of a home equity loan typically do not have good credit ratings, which is why they were unable to receive a mortgage. Therefore, investors need to review borrowers' credit ratings when analyzing home equity loan-backed ABS.

Auto Loan ABS:

Auto loans are types of amortizing assets, and so the cash flows of an auto loan ABS include monthly interest, principal payment, and prepayment. Prepayment risk for an auto loan ABS is much lower when compared to a home equity loan ABS or MBS. Prepayment only happens when the borrower has extra funds to pay the loan. Refinancing is rare when the interest rate falls because cars depreciate faster than the loan balance, resulting in the collateral value of the car being less than the outstanding balance. The balances of these loans are normally small and borrowers won't be able to save significant amounts from refinancing at a lower interest rate, giving little incentive to refinance.

Credit Card Receivable ABS:

Credit card receivables are a type of non-amortizing asset ABS. They don't have scheduled payment amounts, while new loans and changes can be added to the composition of the pool.

The cash flows of credit card receivables include interest, principal payments, and annual fees. There is usually a lock-up period for credit card receivables where no principal will be paid. If the principal is paid within the lock-up period, new loans will be added to the ABS with the principal payment that makes the pool of credit card receivables staying unchanged. After the lock-up period, the principal payment is passed on to ABS investors.

Examples of Mortgage-Backed Securities

Most mortgage-backed securities are issued by Ginnie Mae (the Government National Mortgage Association), Fannie Mae (the Federal National Mortgage Association) or Freddie Mac (the Federal Home Loan Mortgage Corporation), which are all U.S. government-sponsored enterprises.

MBS from Ginnie Mae are backed by the full faith and credit of the U.S. government, which guarantees that investors receive full and timely payments of principal and interest. In contrast, Fannie Mae and Freddie Mac MBS are not backed by the full faith and credit of the U.S. government, but both have special authority to borrow from the U.S. Treasury if necessary.

Mortgage-backed securities can be purchased at most full-service brokerage firms and some discount brokers. The minimum investment is typically \$25,000; however, there are some MBS variations (collateralized mortgage obligations, or CMOs) that can be purchased for less than \$5,000. Investors that don't want to invest directly in a mortgage-backed security, but want exposure to the mortgage market may consider exchange-traded funds (ETFs) that invest in mortgage-backed securities such as the SPDR Barclays Mortgage Backed Bond ETF (MBG), the iShares MBS ETF (MBB), and the Vanguard Mortgage-Backed Securities Index ETF (VMBS). ETFs trade similar to stocks on regulated exchanges and can be sold short and purchased on margin. Like stocks, ETF prices fluctuate throughout each trading session in response to market events and investor activities.

How to Determine Value

It is important to measure the spread and pricing of bond securities and know the type of spread that should be used for different types of ABS and MBS. If the securities do not have embedded options such as call, put or certain prepayment options, the zero-volatility spread (Z-spread) can be used as a measurement. The Z-spread is the constant spread that makes the price of a security equal to the present value of its cash flow when added to each Treasury spot rate.

For example, we can use the Z-spread to measure credit card ABS and auto loan ABS. Credit card ABS does not have any options, making the Z-spread an appropriate measurement. Although auto loan ABS do have prepayment options, they're not typically exercised, making it possible to use the Z-spread for measurement.

If the security has embedded options, then the option-adjusted spread (OAS) should be used. The OAS is the spread adjusted for the embedded options. To derive the OAS, the binomial model can be used if cash flows depend on current interest rates but not on the path that led to the current interest rate.

Another way to derive the OAS is through the Monte Carlo model, which needs to be used when the cash flow of the security is the interest rate path dependent. MBS and Home Equity ABS are types of interest rate path-dependent securities where OAS from the Monte Carlo model would be used for valuations. However, this model can be quite complex and needs to be checked for accuracy throughout its usage.

Associated Risks

Both ABS and MBS have prepayment risks, though these are especially pronounced for MBS. Prepayment risk means borrowers are paying more than their required monthly payments, thereby reducing the interest of the loan. Prepayment risk can be determined by current and issued mortgage rate difference, housing turnover and mortgage rates. For instance, if a mortgage rate begins at 9%, drops to 4%, rises to 10% and then falls to 5%, homeowners would likely refinance their mortgages the first time the rates dropped. Therefore, to deal with prepayment risk, ABS and MBS have tranching structures to help distribute prepayment risk. Investors can choose a tranche based on their own preferences and risk tolerance.

One additional type of risk involved in ABS is credit risk. ABS has a senior-subordinate structure to deal with credit risk called credit tranching. The subordinate or junior tranches will absorb all of the losses up to their value before senior tranches begin to experience losses. Subordinate tranches typically have higher yields than senior tranches due to the higher risk incurred.

The Bottom Line

Asset-backed and mortgage-backed securities can be quite complicated in terms of their structures, characteristics, and valuations. Investors have access to these securities through indexes such as the U.S. ABS index. For those who want to invest in ABS or MBS directly, it's imperative to conduct a thorough amount of research and weigh your risk tolerance prior to making any investments.

Collateralized Debt obligations and Credit Default Swaps

CDOs

CDOs, or collateralized debt obligations, are financial tools that banks use to repackage individual loans into a product sold to investors on the secondary market. These packages consist of auto loans, credit card debt, mortgages or corporate debt. They are called collateralized because the promised repayments of the loans are the collateral that gives the CDOs their value.

CDOs are a particular kind of derivative. As its name implies, a derivative is any financial product that derives its value from another underlying asset. Derivatives like put options, call options, and futures contracts have long been used in the stock and commodities markets.

CDOs are called asset-backed commercial paper if the package consists of corporate debt. Banks call them mortgage-backed securities if the loans are mortgages. If the mortgages are made to those with a less than prime credit history, they are called subprime mortgages.

Banks sold CDOs to investors for three reasons:

1. The funds they received gave them more cash to make new loans.
2. It moved the loan's risk of default from the bank to the investors.
3. CDOs gave banks new and more profitable products to sell. That boosted share prices and managers' bonuses.

Advantages

At first, CDOs were a welcome financial innovation. They provided more liquidity in the economy. CDOs allowed banks and corporations to sell off their debt. That freed up

more capital to invest or loan. The spread of CDOs is one reason why the U.S. economy was robust until 2007.

The invention of CDOs also helped create new jobs. Unlike a mortgage on a house, a CDO is not a product that you can touch or see to find out its value. Instead, a computer model creates it. Thousands of college and higher-level graduates went to work in Wall Street banks as "quant jocks." Their job was to

write computer programs that would model the value of the bundle of loans that made up a CDO. Thousands of salespeople were also hired to find investors for these new products.

As competition for new and improved CDOs grew, these quant jocks made more complicated computer models. They broke the loans down into "tranches," which are simply bundles of loan components with similar interest rates.

Here's how that works. Adjustable-rate mortgages offered "teaser" low-interest rates for the first three to five years. Higher rates kicked in after that. Borrowers took the loans, knowing they could only afford to pay the low rates. They expected to sell the house before the higher rates were triggered.

The quant jocks designed CDO tranches to take advantage of these different rates. One tranche held only the low-interest portion of mortgages. Another tranche offered just the part with the higher rates. That way, conservative investors could take the low-risk, low-interest tranche, while aggressive investors could take the higher-risk, higher-interest tranche. All went well as long as housing prices and the economy continued to grow.

Disadvantages

Unfortunately, the extra liquidity created an asset bubble in housing, credit cards, and auto debt. Housing prices skyrocketed beyond their actual value. People bought homes so they could sell them. The easy availability of debt meant people used their credit cards too much. That drove credit card debt to almost \$1 trillion in 2008.

The banks that sold the CDOs didn't worry about people defaulting on their debt. They had sold the loans to other investors, who now owned them. That made them less disciplined in adhering to strict lending standards. Banks made loans to borrowers who weren't credit-worthy. That ensured disaster.

What made things even worse was that CDOs became too complicated. The buyers didn't know the value of what they were buying. They relied on their trust of the bank selling the CDO. They didn't do enough research to be sure the package was worth the price. The research wouldn't have done much good because even the banks didn't know. The computer models based the CDOs' value on the assumption that housing prices would continue to go up. If they fell, the computers couldn't price the product.

How CDOs Caused the Financial Crisis

This opaqueness and the complexity of CDOs created a market panic in 2007. Banks realized they couldn't price the product or the assets they were still holding. Overnight, the market for CDOs disappeared. Banks refused to lend each other money because they didn't want more CDOs on their balance sheet in return. It was like a financial game of musical chairs when the music stopped. This panic caused the 2007 banking crisis.

The first CDOs to go south were the mortgage-backed securities. When housing prices started to drop in 2006, the mortgages of homes bought in 2005 were soon upside-down. That created the subprime mortgage crisis. The Federal Reserve assured investors it was confined to housing. In fact, some welcomed it and said that housing had been in a bubble and needed to cool down.

What they didn't realize was how derivatives multiplied the effect of any bubble and any subsequent downturn. Not only banks were left holding the bag, but they were also holding the pension funds, mutual funds, and corporations. It was until the Fed and the Treasury started buying these CDOs that a semblance of functioning returned to the financial markets.

Collateralized debt obligations (CDOs) are a type of structured credit product in the world of asset-backed securities. The purpose of these products is to create tiered cash flows from mortgages and other debt obligations that ultimately make the entire cost of lending cheaper for the aggregate economy. This happens when the original money lenders give out loans based on less stringent loan requirements. The idea is that if they can break up the pool of debt repayments into streams of investments with different cash flows, there will be a larger group of investors who will be willing to buy in.

For example, by splitting a pool of bonds or any variation of different loans and credit-based assets that mature in 10 years into multiple classes of securities that mature in one, three, five and 10 years, more investors with different investment horizons will be interested in investing. In this article, we'll go over CDOs and how they function in the financial markets.

For simplicity, this article will focus mostly on mortgages, but CDOs do not solely involve mortgage cash flows. The underlying cash flows in these structures can be comprised of credit receivables, corporate bonds, lines of credit, and almost any debt and instruments. For example, CDOs are similar to the term "subprime", which generally pertains to mortgages, although there are many equivalents in auto loans, credit lines and credit card receivables that are higher risk.

How do CDOs work?

Initially, all the cash flows from a CDO's collection of assets are pooled together. This pool of payments is separated into rated tranches. Each tranche also has a perceived (or stated) debt rating to it. The highest end of the credit spectrum is usually the 'AAA' rated senior tranche. The middle tranches are generally referred to as mezzanine tranches and generally carry 'AA' to 'BB' ratings and the lowest junk or unrated tranches are called the equity tranches. Each specific rating determines how much principal and interest each tranche receives.

The 'AAA'-rated senior tranche is generally the first to absorb cash flows and the last to absorb mortgage defaults or missed payments. As such, it has the most predictable cash flow and is usually deemed to carry the lowest risk. On the other hand, the lowest rated tranches usually only receive principal and interest payments after all other tranches are paid. Furthermore they are also first in line to absorb defaults and late payments. Depending on how spread out the entire CDO structure is and depending on what the loan composition is, the equity tranche can generally become the "toxic waste" portion of the issue.

Note: This is the most basic model of how CDOs are structured. CDOs can literally be structured in almost any manner, so CDO investors can't presume a steady cookie-cutter

breakdown. Most CDOs will involve mortgages, although there are many other cash flows from corporate debt or auto receivables that can be included in a CDO structure.

Who Buys CDOs?

Generally speaking, it is rare for John Q. Public to directly own a CDO. Insurance companies, banks, pension funds, investment managers, investment banks and hedge funds are the typical buyers. These institutions look to outperform Treasury yields, and will take what they hope is appropriate risk to outperform Treasury returns. Added risk yields higher returns when the payment environment is normal and when the economy is normal or strong. When things slow or when defaults rise, the flip side is obvious and greater losses occur.

Asset Composition Complications

To make matters a bit more complicated, CDOs can be made up of a collection of prime loans, near prime loans (called Alt.-A loans), risky subprime loans or some combination of the above. These are terms that usually pertain to the mortgage structures. This is because mortgage structures and derivatives related to mortgages have been the most common form of underlying cash flow and assets behind CDOs. (To learn more about the subprime market and its meltdown, see our *Subprime Mortgage Meltdown* feature.)

If a buyer of a CDO thinks the underlying credit risk is investment grade and the firm is willing to settle for only a slightly higher yield than a Treasury, the issuer would be under more scrutiny if it turns out that the underlying credit is much riskier than the yield would dictate. This surfaced as one of the hidden risks in more complicated CDO structures. The most simple explanation behind this, regardless of a CDO's structure in mortgage, credit card, auto loans, or even corporate debt, would surround the fact that loans have been made and credit has been extended to borrowers that weren't as prime as the lenders thought.

Other Complications

Other than asset composition, other factors can cause CDOs to be more complicated. For starters, some structures use leverage and credit derivatives that can trick even the senior tranche out of being deemed safe. These structures can become synthetic CDOs that are backed merely by derivatives and credit default swaps made between lenders and in the derivative markets. Many CDOs get structured such that the underlying collateral is cash flows from other CDOs, and these become leveraged structures. This increases the level of risk because the analysis of the underlying collateral (the loans) may not yield anything other than basic information found in the prospectus. Care must be taken regarding how these CDOs are structured, because if enough debt defaults or debts are prepaid too quickly, the payment structure on the prospective cash flows will not hold and the some tranche holders will not receive their designated cash flows. Adding leverage to the equation will magnify any and all effects if an incorrect assumption is made.

The simplest CDO is a 'single structure CDO'. These pose less risk because they are usually based solely on one group of underlying loans. It makes the analysis straightforward because it is easy to determine what the cash flows and defaults look like.

Are CDOs Justified, or Funny Money?

As mentioned before, the existence of these debt obligations is to make the aggregate loaning process cheaper to the economy. The other reason is that there is a willing market of investors who are willing to buy tranches or cash flows in what they believe will yield a higher return to

their fixed income and credit portfolios than Treasury bills and notes with the same implied maturity schedule.

Unfortunately, there can be a huge discrepancy between perceived risks and actual risks in investing. Many buyers of this product are complacent after purchasing the structures enough times to believe they will always hold up and everything will perform as expected. But when the credit blow-ups happen, there is very little recourse. If credit losses choke off borrowing and you are one of the top 10 largest buyers of the more toxic structures out there, then you face a large dilemma when you have to get out or pare down.

In extreme cases, some buyers face the "NO BID" scenario, in which there is no buyer and calculating a value is impossible. This creates major problems for regulated and reporting financial institutions. This aspect pertains to any CDO regardless of whether the underlying cash flows come from mortgages, corporate debt, or any form of consumer loan structure.

Will CDOs Ever Disappear?

Regardless of what occurs in the economy, CDOs are likely to exist in some form or fashion, because the alternative can be problematic. If loans cannot be carved up into tranches the end result will be tighter credit markets with higher borrowing rates.

This boils down to the notion that firms are able to sell different cash flow streams to different types of investors. So, if a cash flow stream cannot be customized to numerous types of investors, then the pool of end product buyers will naturally be far smaller. In effect, this will shrink the traditional group of buyers down to insurance companies and pension funds that have much longer-term outlooks than banks and other financial institutions that can only invest with a three- to five-year horizon.

The Bottom Line

As long as there is a pool of borrowers and lenders out there, you will find financial institutions that are willing to take risk on parts of the cash flows. Each new decade is likely to bring out new structured products, with new challenges for investors and the markets.

CDS

Definition of Credit Default Swap –

CDS are a financial instrument for swapping the risk of debt default. Credit default swaps may be used for emerging market bonds, mortgage-backed securities, corporate bonds and local government bond

- The buyer of a credit default swap pays a premium for effectively insuring against a debt default. He receives a lump sum payment if the debt instrument defaults.
- The seller of a credit default swap receives monthly payments from the buyer. If the debt instrument defaults they have to pay the agreed amount to the buyer of the credit default swap.

Example-1 of Credit Default Swap

- An investment trust owns £1 million corporate bond issued by a private housing firm.
- If there is a risk the private housing firm may default on repayments, the investment trust may buy a CDS from a hedge fund. The CDS is worth £1 million.

- The investment trust will pay interest on this credit default swap of say 3%. This could involve payments of £30,000 a year for the duration of the contract.
- If the private housing firm doesn't default. The hedge fund gains the interest from the investment bank and pays nothing out. It is simple profit.
- If the private housing firm does default, then the hedge fund has to pay compensation to the investment bank of £1 million – the value of the credit default swap.
- Therefore the hedge fund takes on a larger risk and could end up paying £1million

The higher the perceived risk of the bond, the higher the interest rate the hedge fund will require.

Example-2 of Credit Default Swap

- Example, suppose that Lloyds TSB has lent money to riskymortgage.co.uk in the form of a £1,000 bond.
- Lloyds TSB may then purchase a credit default swap from another company e.g. a Hedge Fund.
- If the firm (Riskymortgage.co.uk) default on the loan, then the hedge fund will pay Lloyds TSB the value of the loan.
- Thus Lloyds TSB has insurance against loan default. The hedge fund has the opportunity to make a profit, so long as the firm does not default on the loan.
- The riskier the loan, the higher will be the premium required on buying a credit default swap.

Why Would People Buy Credit Default Swaps?

Hedge against risk.

Suppose an investment fund owned mortgage bonds from riskymortgage.co.uk. It might be worried about losing all its investment. Therefore, to hedge against the risk of default, they could purchase a credit default swap from Lloyds TSB. If riskymortgage.co.uk defaulted, they will lose their investment, but receive a pay-off from Lloyds to compensate. If they don't default, they have paid a premium to Lloyds but have had security.

Speculation e.g. risk is underpriced.

Suppose a hedge fund felt risky mortgage was very likely to default because of a rise in home repossessions. They would buy a credit default swap. If the debt defaulted, then they would make a profit from Lloyds TSB. Note you don't have to actually own debt to take a credit default swap.

The riskier a bond is the higher premium will be required from a buyer of a credit default swap. It is argued that credit default swaps provide an important role in indicating the riskiness/creditworthiness of a firm.

Arbitrage

If a company's financial position improves, the credit rating should also improve and therefore, the CDS spread should fall to reflect improved rating. This makes CDS more attractive to sell CDS protection. If the company position deteriorated, CDS protection would be more attractive to buy. Arbitrage could occur when dealers exploit any slowness of the market to respond to signals.

Credit Default Swaps in Markets

- The first credit default swap was introduced in 1995 by JP Morgan. By 2007, their total value has increased to an estimated \$45 trillion to \$62 trillion. Although since only 0.2% of investment companies default, the cash flow is much lower than this actual amount.
- The size of the credit default market dwarfs that of the stock market and the bond market they represent. Therefore, this shows that credit default swaps are being used for speculation and not insuring against actual bonds.
- Credit Default Swaps are unregulated and because they get traded so frequently there is an uncertainty of who owns them and whether the holders can actually pay in the event of a negative credit event.

Credit Default Swaps and Credit Crisis

Some have suggested credit default swaps have exacerbated the financial crisis of 2008. E.g. When Lehman Brother went bankrupt, it meant a lot of credit default guarantees would go unrewarded. E.g. Washington Mutual bought corporate bonds in 2005 and hedged their exposure by buying CDS protection from Lehman brothers. With Lehman brothers going bankrupt this CDS protection was nullified.

Others say that credit default is only an instrument reflecting changes in risk and are not the cause of the underlying liquidity problems

A credit default swap is a financial derivative that guarantees against bond risk. Swaps work like insurance policies. They allow purchasers to buy protection against an unlikely but devastating event. Like an insurance policy, the buyer makes periodic payments to the seller. The payment is quarterly rather than monthly.

Most of these swaps protect against default of high-risk municipal bonds, sovereign debt, and corporate debt. Investors also use them to protect against the credit risk of mortgage-backed securities, junk bonds, and collateralized debt obligations.

Example

Here's an example to illustrate how swaps work. A company issues a bond. Several companies purchase the bond, thereby lending the company money. They want to make sure they don't get burned if the borrower defaults. They buy a credit default swap from a third party. It agrees to pay the outstanding amount of the bond if the lender defaults. Most often, the third party is an insurance company, bank, or hedge fund. The swap seller collects premiums for providing the swap.

Pros

Swaps protect lenders against credit risk. That enables bond buyers to fund riskier ventures than they might otherwise. Investments in risky ventures spur innovation and creativity, which boost economic growth. This is how Silicon Valley became America's innovative advantage.

Companies that sell swaps protect themselves with diversification. If a company or even an entire industry defaults, they have the fees from other successful swaps to make up the difference. If done this way, swaps provide a steady stream of payments with little downside risk.

Cons

Swaps were unregulated until 2009. That meant there was no government agency to make sure the seller of the swap had the money to pay the holder if the bond defaulted. In fact, most

financial institutions that sold swaps were undercapitalized. They only held a small percentage of what they needed to pay the insurance. The system worked until the debtors defaulted.

Unfortunately, the swaps gave a false sense of security to bond purchasers. They bought riskier and riskier debt. They thought the CDS protected them from any losses.

Pros

- Protect lenders against risk.
- Provide a stream of payments.

Cons

- Unregulated until 2009.
- Gave a false sense of security.

How Swaps Caused the 2008 Financial Crisis

By mid-2007, there was more than \$45 trillion invested in swaps. That was more than the money invested in the U.S. stocks, mortgages, and U.S. Treasuries combined. The U.S. stock market held \$22 trillion. Mortgages were worth \$7.1 trillion, and U.S. Treasuries were worth \$4.4 trillion. In fact, it was almost as much as the \$65 trillion produced by the entire world.

Credit default swaps on Lehman Brothers debt helped cause the 2008 financial crisis.

Lehman Brothers owed \$600 billion in debt. Of that, \$400 billion was "covered" by credit default swaps.

That debt was only worth 8.62 cents on the dollar. The companies that sold the swaps were American International Group, Pacific Investment Management Company, and the Citadel hedge fund.

They didn't expect all the debt to come due at once. When Lehman declared bankruptcy, AIG didn't have enough cash on hand to cover swap contracts. The Federal Reserve had to bail it out.

Even worse, banks used swaps to insure complicated financial products. They traded swaps in unregulated markets. The buyers had no relationships to the underlying assets. They didn't understand their risks. When they defaulted, swap sellers like Municipal Bond Insurance Association, Ambac Financial Group Inc., and Swiss Reinsurance Co. were hit hard.

Overnight, the CDS market fell apart. No one bought them because they realized the insurance wasn't able to cover large or widespread defaults. They accumulated capital and made fewer loans. That cut off funding for small businesses and mortgages. These were both large factors that kept unemployment at record levels.

Dodd-Frank

In 2009, the Dodd-Frank Wall Street Reform Act regulated credit default swaps in three ways. First, the Volcker Rule prohibited banks from using customer deposits to invest in derivatives, including swaps.

Second, it required the Commodity Futures Trading Commission to regulate swaps. It specifically required a clearinghouse be set up to trade and price them.

Third, it phased out the riskiest CDS.

Many banks shifted their swaps overseas to avoid U.S. regulation. Although all G-20 countries agreed to regulate them, many were behind the United States in finalizing the rules. But that changed in October 2011. The European Economic Area regulated swaps with the MiFID II.

The JP Morgan Chase Swap Loss

On May 10, 2012, JP Morgan Chase CEO Jamie Dimon announced the bank lost \$2 billion betting on the strength of credit default swaps. By 2014, the trade had cost \$6 billion.

The bank's London desk executed a series of complicated trades that would profit if corporate bond indexes rose. One, the Markit CDX NA IG Series 9 maturing in 2017, was a portfolio of credit default swaps. That index tracked the credit quality of 121 high-quality bond issuers, including Kraft Foods and Walmart. When the trade started losing money, many other traders began taking the opposite position. They hoped to profit from JPMorgan's loss, thus compounding it.

The loss was ironic. JP Morgan Chase first introduced credit default swaps in 1994. It wanted to insure itself from the risk of default on the loans it held on its books.

The Greek Debt Crisis and CDS

Swaps' false sense of security contributed to the Greek debt crisis. Investors bought Greek sovereign debt, even though the country's debt-to-gross domestic product ratio was higher than the European Union's 3 percent limit. The investors also bought CDS to protect them from the potential of default.

In 2012, these investors found out just how little the swaps protected them. Greece required the bondholders to take a 75 percent loss on their holdings. The CDS did not protect them from this loss. That should have destroyed the CDS market. It set a precedent that borrowers, like Greece, could intentionally circumvent the CDS payout. The International Swaps and Derivatives Association ruled that the CDS must be paid, regardless.

Forwards

A forward contract is a private agreement between two parties giving the buyer an obligation to purchase an asset (and the seller an obligation to sell an asset) at a set price at a future point in time.

How a Forward Contract Works

There are two kinds of forward-contract participants: hedgers and speculators.

Hedgers do not usually seek a profit but rather seek to stabilize the revenues or costs of their business operations. Their gains or losses are usually offset to some degree by a corresponding loss or gain in the market for the underlying asset.

Speculators are usually not interested in taking possession of the underlying assets. They essentially place bets on which way prices will go. Forward contracts tend to attract more hedgers than speculators.

Why Forward Contracts Matter

A forward contract is beneficial for several key sectors of a national economy because it is simply an agreement to buy an asset on a specific date for a specified price. It is the simplest

form of derivatives, which is a contract with a value that depends on the spot price of the underlying asset. The assets often traded in forward contracts include commodities like grain, precious metals, electricity, oil, beef, orange juice, and natural gas, but foreign currencies and financial instruments are also part of today's forward markets.

Forward Contract Example

If you plan to grow 500 bushels of wheat next year, you could sell your wheat for whatever the price is when you harvest it, or you could lock in a price now by selling a forward contract that obligates you to sell 500 bushels of wheat to, say, Kellogg after the harvest for a fixed price. By locking in the price now, you eliminate the risk of falling wheat prices. On the other hand, if prices rise later, you will get only what your contract entitles you to.

If you are Kellogg, you might want to purchase a forward contract to lock in prices and control your costs. However, you might end up overpaying or (hopefully) underpaying for the wheat depending on the market price when you take delivery of the wheat.

Valuing Forward Contracts

The value of a forward contract usually changes when the value of the underlying asset changes. So if the contract requires the buyer to pay \$1,000 for 500 bushels of wheat but the market price drops to \$600 for 500 bushels of wheat, the contract is worth \$400 to the seller (because he or she would get \$400 more than the market price for his or her wheat). Forward contracts are a zero-sum game; that is, if one side makes a million dollars, the other side loses a million dollars.

Forward contracts may be "cash settled," meaning that they settle with a single payment for the value of the forward contract. For example, if the price of 500 bushels of wheat is \$1,000 in the spot market (the current market price) when the forward contract expires, but the forward contract requires the buyer to pay only \$800, then the seller can just settle the contract by paying the buyer \$200 instead of actually delivering 500 bushels of wheat and collecting a below-market price. The buyer might appreciate this; after all, the only other way he would see his \$200 profit is if he purchased the wheat for \$800 and then turned around and sold it at the market price (\$1,000). (On a side note, when the spot price is higher than the forward-contract price, this is called backwardation; the opposite condition is called contango.)

It is important to note that forward contracts also present a risk of price manipulation, because a small transaction completed at an above- or below-market price could affect the value of a much larger forward contract.

Forward Contracts vs. Futures Contracts

Futures and forwards both allow people to buy or sell an asset at a specific time at a given price, but forward contracts are not standardized or traded on an exchange. They are private agreements with terms that may vary from contract to contract.

In addition, settlement occurs at the end of a forward contract. Futures contracts settle every day, meaning that both parties must have the money to ride the fluctuations in price over the life of the contract.

The parties to a forward contract also tend to bear more credit risk than the parties to futures contracts because there is no clearinghouse involved that guarantees performance. Thus, there

is always a chance that a party to a forward contract will default, and the harmed party's only recourse may be to sue. As a result, forward contract prices often include premiums for the added credit risk.

Forward Markets Commission and its role

Rules are part of everyday human life and we find them in schools, at work place, and in general society. Rules are like guidelines, and help people to understand what is acceptable and what is not. Without rules, the world would probably be chaotic.

Similarly, our financial system is also regulated by independent regulators in the field of banking, insurance, capital market, commodities market and pension funds.

The Reserve Bank of India regulates the banking system, while Securities and Exchange Board of India (SEBI) regulates the securities market. The Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector.

However, many of us are not aware about who regulates the commodity market in India? Just as SEBI regulates the stock market, Forward Markets Commission (FMC) regulates the commodity market.

Let's try to know more about FMC and its role.

FMC: Commodity regulator

Headquartered in Mumbai, FMC is a regulatory authority for commodity futures market in India. FMC is the chief regulator of forward and futures markets in India. FMC comes under the Ministry of Consumer Affairs, Food and Public Distribution because futures traded in India are traditionally in food commodities.

FMC is a legal body set up under Forward Contracts (Regulation) Act 1952. The Act provides that the Commission should consist of minimum two and maximum four members appointed by the Central Government. The chairman of the FMC is nominated by the central government.

At present five national exchanges, viz. Multi Commodity Exchange, National Commodity and Derivatives Exchange, National Multi Commodity Exchange, Indian Commodity Exchange Ltd and ACE Derivatives and Commodity Exchange, regulate forward trading in 113 commodities. Besides, there are 16 commodity specific exchanges recognised for regulating trade in various commodities approved by FMC under the Forward Contracts (Regulation) Act, 1952.

Commodities traded on these exchanges comprise:

- Edible oilseeds: Groundnut, mustard seed, cotton seed, sunflower, rice bran oil, soy oil, etc.
- Food grains: Wheat, gram, dals, bajra, maize etc.
- Metals: Gold, silver, copper, zinc etc.
- Spices: Turmeric, pepper, jeera etc.
- Fibres: Cotton, jute, etc.
- Others: Gur, rubber, natural gas, crude oil etc.

Functions of FMC

- To advise the central government in respect of the recognition or the withdrawal of recognition from any association.
- To advise the central government in respect of issues arising out of the administration of the Forward Contracts (Regulation) Act 1952.
- To keep forward markets under observation and to take such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it under the Act.
- To collect and whenever the Commission thinks it necessary, to publish information regarding the trading conditions in respect of goods to which any of the provisions of the Act is made applicable, including information regarding supply, demand and prices, and to submit to the central government, periodical reports on the working of forward markets relating to such goods.
- To make recommendations to improve the organisation and working of forward markets;
- To undertake the inspection of accounts and other documents of any recognised association, registered association or any member of such association whenever it considers it necessary.

FMC has powers of deemed civil court for

- Summoning and enforcing the attendance of any person and examining him on oath.
- Requiring the discovery and production of any document.
- Receiving evidence on affidavits.
- Requisitioning any public record from any office.

Futures

Futures contracts give the buyer an obligation to purchase an asset (and the seller an obligation to sell an asset) at a set price at a future point in time.

Evolution of Futures Market in India

Organised futures market evolved in India by the setting up of "Bombay Cotton Trade Association Ltd." in 1875. In 1893, following widespread discontent amongst leading cotton mill owners and merchants over the functioning of the Bombay Cotton Trade Association, a separate association by the name Bombay Cotton Exchange Ltd was constituted.

Futures trading in oilseeds was organised in India for the first time with the setting up of Gujarati Vyapari Mandali in 1900, which carried on futures trading in groundnut, castor seed and cotton. Before the Second World War broke out in 1939 several futures markets in oilseeds were functioning in Gujarat and Punjab.

Futures trading in Raw Jute and Jute Goods began in Calcutta with the establishment of the Calcutta Hessian Exchange Ltd., in 1919. Later East Indian Jute Association Ltd., was set up in 1927 for organizing futures trading in Raw Jute. These two associations amalgamated in 1945 to form the present East India Jute & Hessian Ltd., to conduct organised trading in both Raw Jute and Jute goods.

In case of wheat, futures markets were in existence at several centres at Punjab and U.P. The most notable amongst them was the Chamber of Commerce at Hapur, which was established in 1913. Other markets were located at Amritsar, Moga, Ludhiana, Jalandhar, Fazilka, Dhuri,

Barnala and Bhatinda in Punjab and Muzaffarnagar, Chandausi, Meerut, Saharanpur, Hathras, Gaziabad, Sikenderabad and Barielly in U.P.

Futures market in Bullion began at Mumbai in 1920 and later similar markets came up at Rajkot, Jaipur, Jamnagar, Kanpur, Delhi and Calcutta. In due course several other exchanges were also created in the country to trade in such diverse commodities as pepper, turmeric, potato, sugar and gur(jaggory).

After independence, the Constitution of India brought the subject of "Stock Exchanges and futures markets" in the Union list. As a result, the responsibility for regulation of commodity futures markets devolved on Govt. of India. A Bill on forward contracts was referred to an expert committee headed by Prof. A.D.Shroff and Select Committees of two successive Parliaments and finally in December 1952 Forward Contracts (Regulation) Act, 1952, was enacted.

The Act provided for 3-tier regulatory system;

- (a) An association recognized by the Government of India on the recommendation of Forward Markets Commission,
- (b) The Forward Markets Commission (it was set up in September 1953) and
- (c) The Central Government.

Forward Contracts (Regulation) Rules were notified by the Central Government in July 1954

The Act divides the commodities into 3 categories with reference to extent of regulation, viz:

- (a) The commodities in which futures trading can be organised under the auspices of recognized association.
- (b) The Commodities in which futures trading is prohibited.
- (c) Those commodities, which have neither been regulated for being traded under the recognized association nor prohibited, are referred as Free Commodities and the association organised in such free commodities is required to obtain the Certificate of Registration from the Forward Markets Commission.

In the seventies, most of the registered associations became inactive, as futures as well as forward trading in the commodities for which they were registered came to be either suspended or prohibited altogether.

The Khusro Committee (June 1980) had recommended reintroduction of futures trading in most of the major commodities, including cotton, kapas, raw jute and jute goods and suggested that steps may be taken for introducing futures trading in commodities, like potatoes, onions, etc. at appropriate time. The government, accordingly initiated futures trading in Potato during the latter half of 1980 in quite a few markets in Punjab and Uttar Pradesh.

After the introduction of economic reforms since June 1991 and the consequent gradual trade and industry liberalization in both the domestic and external sectors, the Govt. of India appointed in June 1993 one more committee on Forward Markets under Chairmanship of Prof. K.N. Kabra.

The Committee submitted its report in September 1994. The majority report of the Committee recommended that futures trading be introduced in:

- 1) Basmati Rice
- 2) Cotton and Kapas
- 3) Raw Jute and Jute Goods
- 4) Groundnut, rapeseed/mustard seed, cottonseed, sesame seed, sunflower seed, safflower seed, copra and soybean, and oils and oilcakes of all of them.
- 5) Rice bran oil
- 6) Castor oil and its oilcake
- 7) Linseed
- 8) Silver
- 9) Onions.

The committee also recommended that some of the existing commodity exchanges particularly the ones in pepper and castor seed may be upgraded to the level of international futures markets.

The liberalised policy being followed by the Government of India and the gradual withdrawal of the procurement and distribution channel necessitated setting in place a market mechanism to perform the economic functions of price discovery and risk management.

The National Agriculture Policy announced in July 2000 and the announcements of Finance Minister in the Budget Speech for 2002-2003 were indicative of the Governments resolve to put in place a mechanism of futures trade/market.

As a follow up the Government issued notifications on 1.4.2003 permitting futures trading in the commodities, with the issue of these notifications futures trading is not prohibited in any commodity. Options trading in commodity are, however, presently prohibited.

How do Futures Contracts work?

The assets often traded in futures contracts include commodities, stocks, and bonds. Grain, precious metals, electricity, oil, beef, orange juice, and natural gas are traditional examples of commodities, but foreign currencies, emissions credits, bandwidth, and certain financial instruments are also part of today's commodity markets.

There are two kinds of futures traders: hedgers and speculators. Hedgers do not usually seek a profit by trading commodities futures but rather seek to stabilize the revenues or costs of their business operations. Their gains or losses are usually offset to some degree by a corresponding loss or gain in the market for the underlying physical commodity.

For example, if you plan to grow 500 bushels of wheat next year, you could either grow the wheat and then sell it for whatever the price is when you harvest it, or you could lock in a price now by selling a futures contract that obligates you to sell 500 bushels of wheat after the harvest for a fixed price. By locking in the price now, you eliminate the risk of falling wheat prices. On the other hand, if the season is terrible and the supply of wheat falls, prices will probably rise later -- but you will get only what your contract entitled you to. If you are a bread manufacturer, you might want to purchase a wheat futures contract to lock in prices and control

your costs. However, you might end up overpaying or (hopefully) underpaying for the wheat depending on where prices actually are when you take delivery of the wheat.

Speculators are usually not interested in taking possession of the underlying assets. They essentially place bets on the future prices of certain commodities. Thus, if you disagree with the consensus that wheat prices are going to fall, you might buy a futures contract. If your prediction is right and wheat prices increase, you could make money by selling the futures contract (which is now worth a lot more) before it expires (this prevents you from having to take delivery of the wheat as well). Speculators are often blamed for big price swings, but they also provide a lot of liquidity to the futures market.

Futures contracts are standardized, meaning that they specify the underlying commodity's quality, quantity and delivery so that the prices mean the same thing to everyone in the market. For example, each kind of crude oil (light sweet crude, for example) must meet the same quality specifications so that light sweet crude from one producer is no different from another and the buyer of light sweet crude futures knows exactly what he's getting.

The ability to trade futures contracts relies on clearing members, which manage the payments between buyer and seller. They are usually large banks and financial services companies. Clearing members guarantee each trade and thus require traders to make good-faith deposits (called margins) in order to ensure that the trader has sufficient funds to handle potential losses and will not default on the trade. The risk borne by clearing members lends further support to the strict quality, quantity and delivery specifications of futures contracts.

Why do Futures Contracts matter?

Futures trading is a zero-sum game; that is, if somebody makes a million dollars, somebody else loses a million dollars. The downside is unlimited. Because futures contracts can be purchased on margin, meaning that the investor can buy a contract with a partial loan from his broker, traders have an incredible amount of leverage with which to trade thousands or millions of dollars worth of contracts with very little of his own money. Further, futures contracts require daily settlement, meaning that if the futures contract bought on margin is out of the money on a given day, the contract holder must settle the shortfall that day. The unpredictable price swings for the underlying commodities and the ability to use margins makes trading futures a risky proposition that takes a tremendous amount of skill, knowledge and risk tolerance.

Options

Options are derivative instruments, meaning that their prices are derived from the price of their underlying security, which could be almost anything: stocks, bonds, currencies, indexes, commodities, etc. Many options are created in a standardized form and traded on an options exchange like the Chicago Board Options Exchange (CBOE), although it is possible for the two parties to an options contract to agree to create options with completely customized terms.

There are two types of options: call options and put options. A buyer of a call option has the right to buy the underlying asset for a certain price. The buyer of a put option has the right to sell the underlying asset for a certain price.

Here are many different types of options that can be traded and these can be categorized in a number of ways. In a very broad sense, there are two main types: calls and puts. Calls give the

buyer the right to buy the underlying asset, while puts give the buyer the right to sell the underlying asset. Along with this clear distinction, options are also usually classified based on whether they are American style or European style. This has nothing to do with geographical location, but rather when the contracts can be exercised.

Options can be further categorized based on the method in which they are traded, their expiration cycle, and the underlying security they relate to. There are also other specific types and a number of exotic options that exist. On this page we have published a comprehensive list of the most common categories along with the different types that fall into these categories. We have also provided further information on each type.

- Calls
- Puts
- American Style
- European Style
- Exchange Traded Options
- Over The Counter Options
- Option Type by Expiration
- Option Type by Underlying Security
- Employee Stock Options
- Cash Settled Options
- Exotic Options

Calls

Call options are contracts that give the owner the right to buy the underlying asset in the future at an agreed price. You would buy a call if you believed that the underlying asset was likely to increase in price over a given period of time. Calls have an expiration date and, depending on the terms of the contract, the underlying asset can be bought any time prior to the expiration date or on the expiration date.

Explanation of Call Options

Of the two main types of options, calls and puts, it's calls that are more popular. A call is a contract that gives the owner of the option the right to purchase the underlying security at a fixed price at some point either before the contract expires, or at the expiration date.

The owner of a call pays a price to purchase the contract, but isn't obligated to proceed with buying the underlying security. If the owner does decide to go ahead and buy the security, this is known as exercising an option. The seller of the contract has to sell the underlying security if the buyer decides to exercise their option.

You would buy a call if you believe that the price of the underlying security was likely to rise. You can also choose to sell calls if you felt the price would fall. Many trading strategies involve the use of calls and there are many benefits of trading this type of option.

Characteristics

A call option is a financial contract between two parties: the holder and the writer. The holder of the call is the owner of the contract; this means they have purchased the right to buy the underlying security. The seller of the call is called the writer, and they sell the contract for a

price which is paid by the holder. The contract would contain terms for the strike price, the underlying security, and the expiration date.

The underlying security is the asset on which the contract is based. For example, if you bought a call based on shares in Company X, then you would be buying the right to purchase shares in that company. The strike price stipulates the price at which you have the option of purchasing the underlying security. The expiration date is, quite simply, the date on which the contract expires.

With an American style option, the holder can choose to buy the underlying asset at any time before the expiration date. This is more flexible than a European style option where the holder cannot buy the underlying security until the expiration date; they must make a decision at that point whether to do so or whether to let the contract expire.

Should the holder of a call go ahead and initiate the purchase of the underlying security, this is known as exercising their option. The holder can also, at any time, choose to try and sell their contracts.

There are three distinct states that the holder of a call contracts can experience – in the money, at the money, or out of the money. In the money is when the underlying security is at a higher price than the strike price, at the money is when the security is equal to the strike price and out of the money is when the security is worth less than the strike price. The obvious time for the holder of a call to exercise their option, or sell it, is when it is in the money, but there are a number of factors that may influence their decision.

Price

The price of calls is mostly determined by how the strike price compares to the current price of the underlying asset. For example, if you were buying a call and the contract gave you the option of buying company stock at a strike price that was lower than the current trading price of that stock (i.e. it was in the money) then you would essentially be buying theoretical profit that was already in the contract. This profit is known as intrinsic value and is one of two components that make up the price of call options; the other one is extrinsic value.

The extrinsic value is the part of the price that you pay to the seller or writer of the contract for the right to own the contract. This basically serves as compensation to the writer of the contract for the risk that they are exposing themselves to. The price of a call that is at the money or out of the money (i.e. with no built in profit) would be made up entirely of extrinsic value. The following simplified example illustrates how the pricing works.

Shares in Company X are trading at \$100 and the following call contracts are available for sale at the specified ask price.

- \$103 Strike Price - \$2.00 Ask Price
- \$100 Strike Price - \$4.00 Ask Price
- \$98 Strike Price - \$6.00 Ask Price

The first contract is out of the money because the strike price is higher than the current trading price. The \$2.00 price is made up entirely of extrinsic value, as there is no existing profit. You would need the stock to rise above \$103 before you could exercise your option and make a profit.

The second contract is at the money options— as the strike price is equal to the current trading price. The \$4.00 price is also made up entirely of extrinsic value due to there being no existing profit. The extrinsic value is higher than the above example, as the stock does not need to rise in price as much before you could exercise and make a profit.

The third contract is in the money options shows that the strike price is above the current trading price. The \$6.00 price is made of \$2.00 intrinsic value to represent the \$2.00 profit that is already in the contract. The remaining \$4.00 is the extrinsic value.

Benefits of Trading Calls

Trading calls is a great way to take advantage of the price movements of various assets without having to actually own those assets. They are good leverage tools that can potentially provide big profits relative to the amount risked. With calls it's possible to benefit from the rising prices of the relevant underlying security without the same level of risk exposure of owning that security.

For example, if you buy a call based on the stock of a particular company and that stock falls dramatically in price then you don't necessarily suffer that entire loss of value. Your losses would be limited to the amount you had paid for the options contract. If the stock does go up in price then you can either exercise your option to buy the stock or sell the contract to realize your profit.

Calls are also a useful instrument for hedging against price changes in investments that you already own.

The examples below highlight how calls can be used as an alternative to actually investing in stocks. These examples are somewhat simplified but they at least give you an idea of some of the advantages. For the sake of these examples we are ignoring commissions and fees incurred for buying and selling stocks and options contracts.

Example 1

Stock in Company X is trading at \$100 and you have \$10,000 capital to invest. You believe that the stock is going to rise in price so you choose to invest your \$10,000 capital in 100 shares of this company. The stock does indeed rise to \$105 and you choose to sell your 100 shares for a profit of \$500.

Example 2

Rather than buying shares in Company X, you decide to buy calls. Calls with a strike price of \$100 are trading at \$4.00, and you invest just \$4,000 of your capital in options contracts. This would give you the right to purchase 1,000 shares in the company at the strike price of \$100. With the stock rising to \$105, you could exercise your option to buy 1,000 shares at \$100 and sell immediately at \$105 for a gross profit of \$5,000.

After taking the original investment of \$4,000 into account, you have made a total of \$1,000. By buying calls instead of stocks, you made double the profit and only risked a portion of your capital.

It's worth pointing out, however, that there are some disadvantages to owning calls too. There is always the risk of an options contract expiring with no value if the stock trades below the

strike price until the expiration date. Also, if you are investing in stock options rather than stocks themselves then you don't receive a dividend if one is paid out to stockholders.

Buying & Selling Calls

To trade calls you will need to engage the services of a suitable broker who can execute your transactions for you on the exchanges. The simplest and easiest way to buy and sell them is by opening an account with an online stockbroker.

Puts

Put options are essentially the opposite of calls. The owner of a put has the right to sell the underlying asset in the future at a pre-determined price. Therefore, you would buy a put if you were expecting the underlying asset to fall in value. As with calls, there is an expiration date in the contract.

Put options are one of the two main types of options contracts: the other type being calls. A put is a contract that gives the owner of that contract the right to sell the relevant underlying asset at a predetermined price by a predetermined date. The person buying the put contract pays a price to do so and that gives them the right, but not the obligation, to go ahead and sell the underlying security. Doing so is referred to as exercising an option. If the buyer of the options contract does exercise their option, then the other party to the contract must purchase the underlying security at the agreed terms.

Therefore you would buy a call if you felt the underlying security was likely to rise in price, but you would buy a put if you believed the price was going to fall. Puts are very flexible and an excellent instrument for leverage as well as a useful hedging tool.

Characteristics

There are two parties involved in a put options contract, known as the holder and the writer. The writer of the contract sells it for a price and is taking on the obligation to purchase the underlying asset at the agreed price. Whoever buys the contract is known as the holder, and that means they have the right to sell the underlying asset at the agreed price if they choose to exercise their option. The stated price that the asset can be sold at is known as the strike price. The contract will also have an expiration date.

Puts can be based on a range of underlying securities. Stock in publically listed companies is common, but you can also buy them based on indices, commodities, currencies, or a combination of different financial instruments. For example, if you bought a put based on stock in a specific company, you would be buying the right to sell shares in that company at the strike price.

You don't have to physically own the relevant underlying security at the time of buying a put. If you do not own the security this is known as a naked put. In practice, puts are rarely exercised and a monetary exchange based on the value is more likely.

Puts can be very broadly split into two distinctive categories: American style and European style. Under the terms of an American style put, the owner of the contract can choose to exercise their option at any point up to and including the expiration date. With a European style put, the owner must decide whether or not to exercise their option on the expiration date.

American style contracts are therefore significantly more flexible than European style contracts. As such they are far more common, although they tend to be more expensive because the holder must pay for that increased flexibility.

The holder of a put can also choose to try and sell the contract if they prefer. If the price of the underlying security has dropped below the strike price, it may be more profitable for the holder to sell it to another investor rather than exercising their option. This is often the case if it is a naked put and the holder doesn't actually own the underlying security.

When the price of the underlying security is below the strike price, the contract is said to be in the money. If the price is equal to the strike price the contract is at the money and if the price is above the strike price it is out of the money. These terms are applicable only when it comes to selling puts; in the money options attract higher prices for obvious reasons.

Price

What the price of the underlying security is relative to the strike price of the contract largely determines the price of a put. If you were buying a put that granted you the right to sell a security at a strike price that was above the current trading price of that security – an in the money option – then it would already have some built in profit. The amount of built in profit in the contract is known as the intrinsic value, which is one component that constitutes the market price of an option. The other component is extrinsic value.

Extrinsic value is the part of the cost that relates to the potential benefit you may get from owning the contract. The writer of contracts is exposing themselves to a risk when selling those contracts and extrinsic value essentially represents their return for taking that risk.

The market price of an option will contain both intrinsic and extrinsic value when it's in the money. Those which are out of the money or at the money have no intrinsic value and their prices are made up entirely of extrinsic value. To highlight exactly how the pricing works we have provided some simple examples.

A number of puts based on Company X stock are for sale when the shares in the company are trading at \$50. The following contracts are on the market at the specified ask prices.

- \$48.50 Strike Price - \$1.00 Ask Price
- \$50 Strike Price - \$2.00 Ask Price
- \$51 Strike Price - \$3.00 Ask Price

The put with a strike price of \$48.50 is out of the money as the stock is currently trading higher than the strike price. There is no existing profit, so the \$1.00 price is purely extrinsic value. In order to be able to exercise this option for a return, you would need the price of Company X stock to fall below \$48.50.

The put with the \$50 strike price is at the money as the stock is trading at a price exactly equal to the strike price. Once again the price, \$2.00, is just extrinsic value as there is no profit built into the contract. The extrinsic value is higher than the above example so you would only need the stock price to fall below \$50 to exercise your option for a return.

The put with the \$51 strike price has some built in profit as the shares are currently trading lower than the strike price. This means it's in the money, with \$1.00 of intrinsic value. The \$2.00 balance of the asking price represents the extrinsic value of this contract.

Benefits of Trading Puts

Puts are very useful for investors and traders as they can be used in a variety of ways. They are a straightforward way to speculate on any given security falling in value and can potentially provide a decent return without the higher exposure of simply short selling that security.

With puts it's possible to make money from falling prices without needing to trade on margin and you can also limit your exposure to risk too. They can also be used to hedge against any potential price fall of a security that you already own but choose to hold on to.

If you believed that stock in a particular company was going down too low and was short sold; you would obviously profit if it did so, but you could have potentially large losses if the stock went up significantly. However, if you had bought puts based on that stock instead, your losses would be limited to the amount you had paid for them.

You would still make a profit if the stock did fall because you could either exercise your option to sell the stock at the agreed strike price or you could sell your puts for a higher price than you paid.

You can also use puts as a leverage tool to increase the potential returns on the capital you have to invest. In our section on Strategies for Trading Options we provide details of many strategies, a number of which use puts.

Please see the below examples which illustrate how buying puts can work compared to short selling a security. Although these examples are very simplified, they should give you an idea of why they can be an attractive investment. Please note, in these examples we have ignored the commissions and fees from brokers that you would incur when buying and selling stock or options contracts.

Example 1

You believe that stock in Company X, currently trading at \$50, is going to fall and as decide to such short sell 200 shares. If the stock goes down by \$10 to \$40 you could close your position for a profit of \$10 per share, which at 200 shares gives you a profit of \$2,000. However, if the stock went up by \$10 to \$60 and you were forced to close your position to avoid any further losses, you would not gain the \$2000.

Example 2

Instead of short selling stock in Company X, you decide to buy 2 lots of puts instead, with an at the money strike price of \$50 and an ask price of \$2.00. A lot typically represents 100 shares, so 2 lots would represent 200 shares and your total investment would be \$400. With the stock going down by \$10 to \$40, you could exercise your options for a gross profit of \$2,000. You must of course deduct your original \$400 investment for net profit of \$1,600. Although you haven't made quite as much as if you had short sold the stock. It's still a decent profit.

If the stock had risen, though, to \$60, you are at a real advantage having bought puts. If the stock remains at \$60 by the expiration date of your contracts, you have lost only the \$400 you originally invested in them – as opposed to the \$2,000 you would have lost by short selling the

stock. Also, if the stocks rise to \$60 before the contracts expire you can still hang on to them and see if the stock falls again. You cannot lose any more if they rise even further, but if they should drop below the \$50 before expiration you can still make a profit.

There are a couple of downsides of buying puts as you can see. There is always the risk that your contracts expire worthless and you may not necessarily make the same level of profit as you could by short selling. The additional flexibility they offer though, together with the limited risk, makes them a very attractive trading tool.

Buying & Selling Puts

The easiest way to trade puts is to sign up at an online broker and open a trading account. You will be able to instruct your broker to execute your transactions on the exchanges just by accessing your online account. Online brokers are also typically the cheapest way to buy and sell options contracts.

American Style

The term –American style| in relation to options has nothing to do with where contracts are bought or sold, but rather to the terms of the contracts. Options contracts come with an expiration date, at which point the owner has the right to buy the underlying security (if a call) or sell it (if a put). With American style options, the owner of the contract also has the right to exercise at any time prior to the expiration date. This additional flexibility is an obvious advantage to the owner of an American style contract.

Options contracts can all be put into one of two distinct categories – American style and European style. These categories having nothing to do with part of the world the contracts are bought and sold in, but relate to the actual terms of the contract.

An options contract that is American style allows the holder of that contract to exercise their option to buy or sell the underlying security at any time prior to the expiration date. Most options traded on the exchanges are American style, and they tend to be far more popular.

Options can be categorized in a variety of ways and some of these are relatively straightforward. For example a call is one that gives the holder the right to buy a specified asset, while a put grants the holder the right to sell a specified asset. Options can be categorized by what underlying security is used, or how they are sold. There are also a few of them that are classed as exotics, such as barrier options or look back options, and are customized and more complex.

All of these types are financial contracts consisting of two parties – the writer and the holder. The writer of a contract is providing the holder with the right to buy or sell a specific underlying security at a specific strike price. The holder pays the necessary asking price in order to buy the contract and get the right to buy or sell the relevant security. These contracts all contain a fixed expiration date at which point the contract terminates if the holder has not exercised their option.

Every single options contract can be classified as either American style or European style. The difference between these two styles may not seem significant, but it's actually a very important difference. The key characteristic of American style options is that the terms of these contracts allow the holder to exercise at any time during the contract.

The majority of the more commonly traded options or those that are traded on the exchanges by brokers and easily accessible to members of the public fall into the American style category. For the purposes of most trading strategies, the flexibility that they offer is essential. This additional flexibility does come at a price though, as American style contracts do tend to be more expensively priced than European style contracts.

American Style Options Pricing

When options are listed for sale on the exchanges, they are listed with an ask price that is the price you must pay to purchase them. The price is made up of two components: intrinsic value and extrinsic value. Contracts are not specifically broken down into these components when listed on the exchanges, but you do need to understand what these two terms mean and the differences between the two.

Intrinsic value is the term used for any profit that is essentially already built into the contract. Let's look at a hypothetical example of a call contract for sale.

A call gives the holder the right to buy a specific security at a fixed strike price, so let's say the security is stock in Company X and the strike price is \$50. If shares in Company X are trading at \$55, then a call with a strike price would effectively contain \$5 worth of profit, as you could exercise your option to buy the stock at \$50 and sell it immediately for \$55.

This is known as an "in the money" contract. The \$5 profit that already existed in the contract is the intrinsic value. If the strike price was equal to the current trading price (an at the money contract) or above the current trading price (an out of the money contract) then there is no built in profit and therefore no intrinsic value.

Extrinsic value is the part of the price over and above any intrinsic value and basically represents the actual cost of owning the contract. The intrinsic value is a true, inherent value as the profit is actually there to be realized. The extrinsic value is the additional cost for any benefit that you might get from owning the contract. For example, the extrinsic value of the call in the example above would be based on the possibility and likelihood of shares in the company increasing in price during the term of the contract.

The extrinsic value of American style options tends to be higher than European style options, because of the flexibility of being able to exercise at any time, to be able to take advantage of price fluctuations in the underlying security. As the expiration date of a contract gets nearer, the extrinsic value declines due to the decreasing amount of time left to benefit from any such fluctuations.

Advantages of American Style Options

The real advantage of American style contracts over European style contracts is the flexibility that they offer. When you own American style contracts you have the right to exercise at any point up until the expiration date of the contract. This in itself gives you a number of benefits that can help you maximize your returns from trading.

If you own calls where the underlying security is company stock, and that company stock is quite volatile and jumping down in price, then you can choose to exercise at a precise time when you feel the company stock is at its peak. This enables you to use your own judgment and cash in on your investment at the time that you feel is right, rather than waiting until the

expiration date and hoping that you can make a profit at that point. In practice, you would probably choose to sell your contracts rather than exercise, but the principle remains the same.

Another benefit as a result of this flexibility relates to dividends. If you own stock in a dividend paying company then you will receive a regular pay-out, typically annually, based on company profits and the number of shares you own. Owning calls in such company stock would give you the right to purchase company shares, but you wouldn't be entitled to any dividends.

However, you could choose to exercise to buy those shares at dividend time – meaning you would be entitled to dividends. It would only make sense to do this if the expected dividends were higher than any extrinsic value in the contracts you were exercising, but this is another example of how the flexibility of American style options can be used to your advantage.

Buying & Selling American Style Options

Most American style options are exchange traded contracts that are bought and sold on the exchanges. In order trade them yourself you will need the services of a broker to execute transactions on your behalf. The easiest way to buy and sell these contracts is to sign up for an account with an online broker.

European Style

The owners of European style options contracts are not afforded the same flexibility as with American style contracts. If you own a European style contract then you have the right to buy or sell the underlying asset on which the contract is based only on the expiration date and not before.

All options contracts use one of two distinctive styles; European style and American style. European style contracts must be exercised on fixed expiration dates, while American style contracts can be exercised at any point. These two terms are applied entirely based on those characteristics, and are not related to geographical reasons.

The cost of owning European style options is generally lower than American style options because they are generally less common.

Options contracts come in a wide range of different forms and can be categorized in a number of ways. They can be categorized based on the underlying security they represent or based on how and where they were sold. Then the two main types, calls and puts, come into play. Calls give the holder the right buy a specific security while puts give the holder the right to sell a specific security. There are also more complex types known as exotics. These could include binary options and barrier options.

All of these types can be put into one of the two style categories: American or European. A European style contract, like any other options contract, has two parties involved. The holder of the contract who is the party buying the contract or the right to buy or sell the underlying security. The writer is the one who is providing that right and is obligated to comply should the holder exercise.

The underlying security is specified in the contract, along with the strike price; this is the point at which the contract can be bought or sold if the holder decides to exercise. The contract also contains an expiration date, and it is on this date that the holder must decide whether or not to

exercise. This is where European style contracts differ from American style contracts, which can be exercised at any time prior to the expiration date.

Although European style contracts don't offer the same flexibility for exercising as American style contracts, they can still be sold at any time up until the day before expiration so there are still possibilities for locking in profit prior to them expiring. There are a number of trading strategies that European style contracts can be used for. It's also worth noting that the reduced flexibility of European style contracts tends to make them cheaper than American style contracts.

Pricing

To understand how the price of options is determined, you should be familiar with the terms intrinsic value and extrinsic value. When you see an options contract listed for sale on the exchanges its asking price will essentially be a total of these two components. Only the total price will be listed, but you really need to understand how that price is broken down, and the differences between the two components.

Intrinsic value is the actual inherent value of the contract. If there is profit that is effectively built into a contract when it's offered for sale, then that is the intrinsic value and it's included in the total price of the contract. For example, a call gives the holder the right to buy the relevant underlying security at an agreed fixed price; this is known as the strike price. If the strike price is lower than the price of the security at the time when the contract is bought, then the holder gains some immediate intrinsic value.

A call where the strike price is lower than the price of the security is said to be an in the money contract. If the strike price is equal to the security price, it's said to be at the money. If the strike price is above the price of the security, it's said to be out of the money. For puts, where the holder has a right to sell the relevant security, the terms are actually reversed. An in the money put is when the strike price is higher than the current security price and an out of the money put is when the strike price is lower than the current security price.

It's very useful to understand the distinction between these terms if you are trading options. Only in the money contracts have any intrinsic value. The prices of at the money and out of the money options are made up entirely of extrinsic value.

Extrinsic value is essentially the cost of owning the contract in addition to any intrinsic value that already exists. While the intrinsic value represents a tangible amount of value, extrinsic value is intangible and based on what might or might not happen to the price of the underlying security during the term of the contract.

The extrinsic value of a contract is a representation of the risk being taken by the writer who provided the option. Because there is no flexibility in when European style options can be exercised, the risk to the writer is less than when the holder can exercise at any time. As such, the extrinsic value of European style options is typically less than American style options.

Advantages of European Style Options

The advantages of European style options are really quite simple. When buying a European style contract you will usually save money on the price of the contract, as the extrinsic value component is generally less due to you only being able to exercise at the expiration date. If you

are confident that the contract will contain sufficient intrinsic value by that time, then the reduced extrinsic value will effectively increase your profits.

Writers of European style contracts have the advantages of a fixed timeline and less risk being involved because they are not exposed to the possibility of the contracts being exercised before their specific expiration date.

Buying & Selling European Style Options

As European style options tend to be traded over the counter (OTC) rather than on the exchanges, they aren't necessarily as accessible as American style options. However, there are a number of online stock brokers that let you trade OTC products. Using an online broker is probably the easiest and most cost effective way to trade options.

Exchange Traded Options

Also known as listed options, this is the most common form of options. The term -Exchange Traded is used to describe any options contract that is listed on a public trading exchange. They can be bought and sold by anyone by using the services of a suitable broker.

Over The Counter Options

-Over The Counter (OTC) options are only traded in the OTC markets, making them less accessible to the general public. They tend to be customized contracts with more complicated terms than most Exchange Traded contracts.

Option Type by Underlying Security

When people use the term options they are generally referring to stock options, where the underlying asset is shares in a publically listed company. While these are certainly very common, there are also a number of other types where the underlying security is something else. We have listed the most common of these below with a brief description.

Stock Options: The underlying asset for these contracts is shares in a specific publically listed company.

Index Options: These are very similar to stock options, but rather than the underlying security being stocks in a specific company it is an index – such as the S&P 500.

Forex/Currency Options: Contracts of this type grant the owner the right to buy or sell a specific currency at an agreed exchange rate.

Futures Options: The underlying security for this type is a specified futures contract. A futures option essentially gives the owner the right to enter into that specified futures contract.

Commodity Options: The underlying asset for a contract of this type can be either a physical commodity or a commodity futures contract.

Basket Options: A basket contract is based on the underlying asset of a group of securities which could be made up stocks, currencies, commodities or other financial instruments.

Option Type by Expiration

Contracts can be classified by their expiration cycle, which relates to the point to which the owner must exercise their right to buy or sell the relevant asset under the terms of the contract. Some contracts are only available with one specific type of expiration cycle, while with some contracts you are able to choose. For most options traders, this information is far from essential, but it can help to recognize the terms. Below are some details on the different contract types based on their expiration cycle.

Regular Options:

These are based on the standardized expiration cycles that options contracts are listed under. When purchasing a contract of this type, you will have the choice of at least four different expiration months to choose from. The reasons for these expiration cycles existing in the way they do is due to restrictions put in place when options were first introduced about when they could be traded. Expiration cycles can get somewhat complicated, but all you really need to understand is that you will be able to choose your preferred expiration date from a selection of at least four different months.

Weekly Options:

Also known as weeklies, these were introduced in 2005. They are currently only available on a limited number of underlying securities, including some of the major indices, but their popularity is increasing. The basic principle of weeklies is the same as regular options, but they just have a much shorter expiration period.

Quarterly Options:

Also referred to as quarterlies, these are listed on the exchanges with expirations for the nearest four quarters plus the final quarter of the following year. Unlike regular contracts which expire on the third Friday of the expiration month, quarterlies expire on the last day of the expiration month.

Long-Term Expiration Anticipation Securities:

These longer term contracts are generally known as LEAPS and are available on a fairly wide range of underlying securities. LEAPS always expire in January but can be bought with expiration dates for the following three years.

Employee Stock Options

These are a form of stock option where employees are granted contracts based on the stock of the company they work for. They are generally used as a form of remuneration, bonus, or incentive to join a company.

Employee stock options aren't the same as other types of options that are typically bought and sold on the exchanges by traders. They are, however, increasingly being used by both private and public companies, so it is a useful topic to understand if you ever are offered them by your employer.

These options are basically a form of remuneration for employees, and can be given by the employer for a number of reasons

Employee Stock Options & How They Work

Employee stock options are basically a form of call options because they give you the right to buy stock in the company that you work for at a strike price, at some point in the future. If you

are given them by your employer, they will have a fixed price at which you can purchase company shares. If the company shares go up in value, then you can buy them at the pre-agreed price and effectively make an instant profit.

These work as good incentives to the employers, as the employers only get any reward out of them if company stock goes up in price. This firstly provides a good motivation to the employer to help make the company a success, and also mean the company only incurs a cost if the company is doing well.

Employee stock options can be given out in a variety of ways and for a number of different reasons. For example, a company trying to recruit someone they really wanted working for them could offer them as an incentive to join the company. They could also be offered to existing employees as part of their salary, or as a bonus for hitting specific performance targets.

There are certain terms relating to employee stock options that you might like to understand. The holder is the person that owns them. So you are the holder of any options that you are given. The strike price is the price at which the holder is entitled to buy the stock at once the contract allows. The contract will also include an expiration date; the date by which the employee must exercise their option to buy the stock if they wish to.

Most contracts of this type include a vesting period; during this period the holder is not able to exercise their right to purchase stock. Once the contract allows the holder to exercise, they become known as vested options. The contract will usually also include a waiting period, which stipulates a period during which shares bought through exercising cannot be sold on the open market.

Most employers issue employee stock options with a vested period as a means of keeping the employees at the company. They automatically expire if the holder decides to leave the company, so they serve their purpose in that respect. Often, companies will issue contracts with a vesting schedule that allows the employee to buy stock every so often over a long period. For example, a company may issue stock options for 3000 shares where the employee can buy 500 shares every six months over a 3 year period.

The waiting period in employee stock options can vary greatly depending on a number of factors. Waiting periods give the employers some control over when shares in their company are going to be sold on the stock markets. They can range from just a few days to several months.

Advantages & Disadvantages of Employee Stock Options

The biggest advantage of employee stock options is that they will typically be more valuable than an alternative that might be offered in cash. For employees working in companies that have the potential to experience rapid growth, they can end being worth much more money than they could have expected to earn through traditional remuneration. Start-up companies in the certain industries are particularly likely to offer them, and many employees in such companies have made millions of dollars when the company ends up becoming a real success.

There are of course some disadvantages too. The benefits of them are not always immediately realizable – if there is a long vesting period for example, or a lengthy waiting period. This might not be a problem for an employee making a good regular salary, but if stock options

make up a big proportion of an employee's remuneration it could be an issue. Employee stock options also have the potential to be worthless. For example, if the employee should leave the company then they would expire. Alternatively the company share price could drop well below the strike price meaning there was no value in them.

However, the benefits probably outweigh the disadvantages, particularly because there are often tax advantages involved too. These advantages can depend on exactly how the options are issued and the local tax legislation. If you are offered the choice between employee stock options and a more standard form of monetary compensation, then you need to look at all the factors involved and determine what is best for you and your own personal set of circumstances.

Cash Settled Options

Cash settled contracts do not involve the physical transfer of the underlying asset when they are exercised or settled. Instead, whichever party to the contract has made a profit is paid in cash by the other party. These types of contracts are typically used when the underlying asset is difficult or expensive to transfer to the other party.

Cash settled options have a specific feature related to the way they are settled. Usually when the holder of an options contract exercises that contract, they either buy or sell the relevant underlying asset. However, when a cash settled option is exercised the writer of the contract pays any profit due to the holder in cash rather than any asset transfer taking place.

Because of this cash settled options are usually used when based on underlying assets that would prove difficult or costly to transfer.

Options contracts use one of two forms of settlement; physical settlement and cash settlement. Physical settlement is the most commonly used type of settlement; the majority of contracts involve the transfer of the underlying security in the event of the holder exercising. For example, if the holder of a call based on a specific stock exercises then they would buy the relevant stock from the writer of that call at the agreed strike price. Conversely, the holder of a put would sell the relevant stock to the writer.

Cash settlement is different because no assets, other than cash, are exchanged. If an underlying asset cannot easily be transferred, then cash settlement makes more sense. Index options could include cash settlement as an index and not a physical asset. When you buy index options you are essentially betting on the movement of the underlying index. If you correctly forecast which way the index will move and you own the relevant type of contract, then you will receive a payment from the contract writer when you exercise. Commodity options often use cash settlement options such as transferring physical commodities which can often be impractical and expensive.

Most cash settled options are European style, meaning that the holder must choose whether or not to exercise at the expiration of the contract. There is usually no point in exercising a cash settled option early anyway because there is no actual asset to be bought or sold. If the holder wanted to gain any profit prior to the expiration date, then it would make more sense to simply sell the contract.

When a contract represents a profit to the holder at the time of expiry, they will usually be automatically exercised and the writer will be liable to settle the necessary amount with the holder at that point.

In terms of trading strategies, there is little difference between physical settlement and cash settlement.

The biggest issue is that cash settled options tend to be European style contracts that don't allow the same flexibility for exercising as American style contracts do. This creates some limitations, but any strategy that does not rely on being able to exercise early can be used to trade cash settled options.

Pricing

The price of cash settled options contracts is made up of two components; this is the same for the price of options in general. These two components are intrinsic value and extrinsic value. The intrinsic value represents any profit that already exists – i.e. if it was a call and the price of the underlying security is higher than the strike price of the security. When a contract has intrinsic value, it's said to be in the money.

Contracts can also be at the money, when the strike price and the current security price are the same, but they therefore contain no intrinsic value. The same is true for out of the money contracts, where the underlying security is currently worth less than the strike price.

Because at the money and out of the money contracts have no intrinsic value, their prices are made up entirely of extrinsic value. Extrinsic value is different from intrinsic value as it doesn't represent anything tangible per se. It's the part of the cost that reflects the potential for making money on the contract, and effectively serves as compensation to the writer of the contract for the risks involved on their part.

Advantages & Disadvantages

The single biggest advantage of cash settlement is that it represents a way of trading options based on assets and securities that wouldn't work with physical settlement. Cash settled options have enabled traders to buy and sell contracts on things such as indices and certain commodities that are either impossible or impractical to physically transfer.

The only real disadvantage of cash settlement is that it tends to be available only on European style options that are not as flexible as American style options when it comes to being able to choose when to exercise. If you wanted to use a contract to actually physically buy or sell specific securities then cash settlement options would not be suitable of course – but that is not what their purpose is.

Buying & Selling Cash Settled Options

Trading cash settled options is just as easy as trading any other kind of options contract. The simplest and usually the cheapest way to buy and sell them is to use an online stock broker. Online stock brokers can execute transactions on your behalf for the purchase and sale of contracts. They typically charge very competitive fees and commissions.

Exotic Options

Exotic option is a term that is used to apply to a contract that has been customized with more complex provisions. They are also classified as Non-Standardized options. There are a plethora

of different exotic contracts, many of which are only available from OTC markets. Some exotic contracts, however, are becoming more popular with mainstream investors and getting listed on the public exchanges. Below are some of the more common types.

Barrier Options: These contracts provide a pay-out to the holder if the underlying security does (or does not, depending on the terms of the contract) reach a pre-determined price.

Barrier options are a type of exotic options contract. They are fairly similar to standard types of contract but with an important additional feature – the barrier. The barrier is a fixed price at which the contract is either activated or terminated, depending on the exact terms of the contract.

They come in a variety of different types. They can be either European style or American style, although they are typically European style. They can also be either calls or puts. They can be based on a number of different underlying securities and they are particularly common for trading forex.

To simplify the subject of barrier options as much as possible, we have provided details below of some of the common types with examples of how they work. You will also find information on the advantages of trading using barrier options, and how you can buy and sell these contracts. The following topics are covered:

- Knock In and Knock Out
- Up and In
- Down and In
- Up and Out
- Down and Out
- Double Barrier Options
- Advantages of Barrier Options
- Buying and Selling Barrier Options

Knock In and Knock Out

In the first instance, barrier options contracts can be either knock in or knock out. The fundamental difference between these two is that knock ins require the underlying security to reach a certain price for the option to be activated while knock outs are terminated if the underlying security reaches a specified price.

A knock in contract starts out inactive and only becomes active when the underlying security reaches a predetermined price that is specified in the contract. This price is known as the knock in price. A knock out contract starts out active, but is automatically cancelled if the underlying security reaches a predetermined price known as the knock out price. Once a knock out contract is cancelled, it's worthless cannot be reactivated even if the underlying security reverts in price.

There are two main types of knock in contracts and two main types of knock out contracts. Knock ins can be either up-and-in or down-and-in, and knock outs can be either up-and-out or down-and-out. Further details on each these, with examples, can be found below.

Up and In

An up and in barrier options contract starts out dormant, and contains a knock in price that is above the current price of the underlying security. It only becomes active if the underlying security moves above the knock in price. If the expiration date is reached without the underlying security reaching the knock in price then the contract expires without any value. Although some contracts pay the holder a rebate it is usually only a small percentage of the original price.

Example of an up and in

- Call Option
- European Style
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike Price of \$55
- Knock In Price of \$60
- No rebate

If you bought the above contracts and the price of Company X stock never reached the knock in price of \$60 before the expiration date then your contracts would expire without value, even if the stock was trading above the strike price of \$55. If the stock price was \$60, or higher, at the expiration date then your options would become active. You could then exercise and buy the stock at \$55 and make a profit.

Alternatively you could sell the contracts at some point prior to the expiration date if you were able to make a profit in that way.

Down and In

A down and in barrier options contract also starts out dormant. The knock in price is set at a price that is below the current trading pricing of the underlying security, and the contract is activated only if the security falls below that knock in price. As with an up and in, if the security does not reach the knock in price by the expiration date then the contract expires worthless.

Example of a down and in

- Put Option
- European Style
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike Price of \$45
- Knock In Price of \$40
- No rebate

If you owned the above contracts and the price of Company X stock either went up, stayed static, or didn't fall as low as the knock in price by the date of expiration, then those contracts would expire. If the stock fell to \$40, or lower, then on the expiration date you would be able to exercise to realize a profit.

Such contracts are often based on cash settlement, which means you wouldn't actually have to buy the underlying security and then sell it for a profit. However you would only receive your

profits in cash. You may also be able to sell your contracts for profit at some point before the expiration date if their value had increased.

Up and Out

An up and out barrier option is a type of knock out contract, which means it starts out active. The contract automatically expires, though, if the price of the underlying asset moves above the specified knock out price before the expiration date. If the knock out price is reached then the contract is terminated permanently and basically ceases to exist.

Example of an up and out

- Call Option
- European Style
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike Price of \$55
- Knock Out Price of \$60
- No rebate

If you owned contracts with the above characteristics, then you would be hoping for the underlying stock to move above the strike price, but stay below the knock out price. If the price of the stock was at \$59 on the expiration date then you would be able to exercise and make a profit. However, if the stock went above \$60 at any time, then the contract would automatically expire with a value of zero.

Down and Out

A down and out barrier options contract is also a type of knock out, meaning that the contract starts out active. With a down and out, the knock out price is set at a price below the current price of the underlying security. Should the price of the security falls below the knock out price at any time during the term of the contract, then the contract would also expire.

Example of a down and out

- Put Option
- European Style
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike Price of \$45
- Knock Out Price of \$40
- No rebate

If you bought contracts with the above terms, then you would be anticipating the underlying stock to fall in value, but only by a moderate amount. If the stock price was lower than the strike price of \$45 but higher than the knock out price of \$40, at the time of expiration then you would be able to exercise to make a profit. If they were cash settled options, then you would receive a pay-out under those circumstances. However, if the price of the stock fell below the knock out price of \$40 at any time, then the contracts would cease to exist.

Double Barrier Options

Double barrier options are another form of knock out contract, also known as double knock-outs. These are effectively a combination of the up and out contract and the down and out

contract. They have two knock out prices: one that is above the price of the underlying security at the time of the contract being written and one that is below that price. Therefore, a double barrier can be knocked out if the price of the security moves significantly in either direction. This increases the risk of the holder of the contract seeing their investment expire worthless.

Advantages of Barrier Options

Barrier options carry a higher risk to the holder than the more standard types of contracts. With a knock in contract, the holder needs the price of the underlying security to move a certain amount if they are to exercise for a profit. This means that if the underlying security only moves a little in price there may be no profits to be taken.

With a knock out contract, the holder carries the risk of their investment basically ceasing to exist if the underlying security moves significantly and reaches the knock out price. Double barrier options carry even more risk, as price movements in either direction can result in the contracts expiring.

There is, however, one fairly significant advantage that barrier options offer traders, regardless of what trading strategies they are using. Because of the increased risk that the holder has to take, barrier options are generally cheaper than contracts that do not include a barrier price. This allows for greater profitability should you correctly predict price movements in the relevant underlying security.

As a basic rule, if you were expecting significant price movements in the underlying security then you would invest in knock in contracts. If you were expecting small price movements then you would invest in knock out contracts.

Buying & Selling Barrier Options

Barrier options contracts are traded only in the over the counter markets rather than the more accessible exchanges. The OTC markets are not as easy to access as not all brokers will allow you to buy and sell contracts that are not traded on the public exchanges.

Binary Options: When a contract of this type expires in profit for the owner, they are awarded a fixed amount of money.

Binary options contracts are known by a number of different names such as all-or-nothing, digital, or even fixed return options. They are defined by one specific feature; they pay out a fixed return to the holder if they are making a profit by the time of expiration, regardless of how much profit they have gained. They are called binary options simply because there are two possible outcomes – the holder either gets the fixed pay out or loses their initial investment.

They have been around for quite some time, and they were originally considered an exotic contract type. Because of this, they were only available over the counter. They are still available over the counter, but following a rule change by the Options Clearing Corporation which led to standardized features of a range of binary options, the Securities and Exchange Commission approved their listing on the exchanges. Since 2008 some exchanges have listed binary options on a number of stock and indices and a variety of exchange traded funds.

There are a few different types of binary options, as they can be classified in a number of different ways.

Binary Calls & Binary Puts

The two main types of options contracts in general are calls, which you would buy if you expected the underlying security to rise in price, and puts which you would buy if you expected the underlying security to fall in price. These same categories can be used to classify binary options and the same principles apply; you would buy binary calls on an underlying security you thought would increase in price and binary puts on an underlying security you thought would fall in price.

Therefore, if you owned binary calls and the price of the relevant underlying security was above the specified strike price at the time of expiration – i.e. the contract was in the money – then you would receive a fixed pay-out. The pay-out would be based on either a fixed absolute amount per contract owned (for example \$1), or a fixed percentage of the original investment (for example 75%).

If the price of the underlying security was below the specified strike price at the time of expiration, i.e. the contract was out of the money, then you would lose the money you had invested in those contracts. Some binary options can actually allow for a certain percentage of the price of the contracts to be returned to the holder when they complete the contract. The contracts are usually written with a strike price equal to the price of the underlying security, which is known as being at the money.

If you were to buy binary puts, then the situation is reversed. The contract would be in the money at the time of expiration if the price of the underlying security was below the strike price then you would receive a pay-out in those circumstances. You would lose your investment, or gain any percentage returned to you under the terms of the contract. Only if the contract was out of the money at the time of expiration this would occur. A binary put would be out of the money if the price of the underlying security was above the specified strike price.

Exercise Style

Binary options will be one of two styles based on how they can be exercised; there are American style contracts and European style binary contracts. American style contracts allow the holder to exercise at any time during the term of the contract, while European style contracts are not as flexible, and holders of those contracts can only exercise at the point of expiration. Given the nature of binary options they are usually European style, and are automatically exercised at expiration if they are in the money.

Settlement

Binary options can be further classified based on how they are settled. Any contract is settled in one of two ways:

- A physical settlement or
- A cash settlement.

The majority of binary options are cash settled, meaning that any profit is paid for in cash. Contracts that are settled in this way are known as cash-or-nothing options. There are also asset-or-nothing contracts, which can be settled with the underlying asset, but these are much less common.

Strategy for Trading Binary Options

There are a number of trading strategies that use binary options. In particular, they can be useful for hedging existing positions that are profitable. For example, if you owned stocks that you already made some money on but were concerned that they might drop off in price a little, then you could buy binary puts based on those stocks. If the price of your stocks did indeed fall in price by a small amount, you may offset some or all of that drop by the return from your puts.

Binary puts would not offer you full protection against a significant fall in price, but this does represent a relatively cost effective way to protect against small to moderate falls. If you were concerned about a significant fall in the price of stocks you owned then you may be better off selling those stocks or using a standard put.

Buying & Selling Binary Options

Some binary options are available on the easily accessible exchange markets, while others are only available over the counter. If you are buying exchange traded contracts then you can use pretty much any broker. For the easiest and cheapest way to trade these binary options you should consider brokers that typically have low commissions and fees and still offer an efficient service. If you are buying over the counter, then you might be better off choosing a broker suitable for over the counter transactions.

Chooser Options: These were named "Chooser," options because they allow the owner of the contract to choose whether it's a call or a put when a specific date is reached.

Compound Options: These are options where the underlying security is another options contract.

Look Back Options: This type of contract has no strike price, but instead allows the owner to exercise at the best price the underlying security reached during the term of the contract.

Lookback options are exotic contracts that offer the holder the advantage of being able to exercise at an optimal point. Essentially, at expiration the holder can look back (hence the name) at how the price of the underlying asset has performed and maximize their profits by taking advantage of the biggest price differential between the strike price and the price of the underlying asset.

For options traders this is obviously a major benefit, as lookback options can be used to solve one of the biggest problems they face: market timing. This is basically choosing when to enter a position and when to exit it, with the aim obviously being to time entry and exit to make the largest possible returns.

Because of the way lookback options work, the issue of market timing becomes less important as profits are effectively guaranteed to be maximized. Also, the chances of a contract of this type expiring worthless are much lower than other types of options. For these reasons lookbacks are generally more expensive, so the advantages do come at a cost.

Lookbacks can be either calls or puts, so it's possible to speculate on either the price of the underlying security going up in value or going down. They are also known as hindsight

options, as they actually give the holder the benefit of hindsight when determining when to exercise.

To fully understand how they work, you need to be aware of the two different types of lookback options – fixed strike and floating strike. Although the concept of these two types is very similar, and both offer the potential for maximizing returns. There is a fundamental difference between the two and the way they work.

Fixed Strike

Fixed strike lookback options, as the name suggests, have a fixed strike price like most other options contracts. The advantage is in the fact that, at the time of expiration, the holder of fixed strike contracts can choose to exercise them at the point during the term of the contract where the underlying asset was at the most favorable point.

These are cash settled options, meaning the holder is paid a cash settlement equal to the profits they could have made through exercising and buying or selling the underlying asset. To make things clearer, we have provided a couple of examples below.

Example 1 of a Fixed Strike Contract

- Call Option
- European Style
- Cash Settled
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike price of \$50
- Company X stock rises to \$60 during term of contract
- Company X stock falls back to \$50 by expiration date

If you owned a standard call with the above characteristics, then your contract would expire worthless as there was no profit to be made at the point of expiration. The strike price is equal to the underlying security (stock in Company X), making it an at the money contract and there would be no financial gain in exercising.

However, with a fixed strike lookback contract, you would be able to effectively exercise at the optimal point when the stock was trading at \$10 above the strike price. In practice, the contract would be automatically settled at expiration, assuming the contract had been in the money at some point. It's a cash settled contract, so you would receive \$10 per contract owned based on theoretically being able to buy the stock at the strike price of \$50 and sell it at the point it was trading at \$60.

Example 2 of a Fixed Strike Contract

- Put Option
- European Style
- Cash Settled
- Based on stock in Company X
- Company X stock currently trading at \$50
- Strike price of \$50
- Company X stock falls to \$40 during term of contract

- Company X stock rallies to \$45 by expiration date

If you owned standard put contracts based on the characteristics above, then you would receive a \$5 cash settlement at the point of expiration for each contract owned. This is based on the fact that the stock is \$5 below the strike price, and the put gives you the right to sell at the strike price. However, with a fixed strike lookback contract, it would settle at \$10 per contract owned, based on the optimum point when the stock was trading at \$40, \$10 lower than the strike price.

Floating Strike

The floating strike lookback option is different to the fixed strike in the way that the name suggests; the strike price is not fixed at the time that the contract is written. Instead, the strike price is automatically set at the lowest price of the underlying security during the life of the contract if the call or at the highest price of the underlying security if a put. Again, we have provided a couple of examples to illustrate how these work.

Example 1 of a Floating Strike Contract

- Call Option
- European Style
- Cash Settled
- Based on stock in Company X
- Company X stock currently trading at \$70
- Strike price determined at expiration date
- Company X stock falls to \$60 during term of contract
- Company X stock rallies up to \$80 by expiration date

If you owned floating strike lookback options contracts as specified above, then you would receive a cash settlement of \$20 per contract owned at the time of expiration. The floating strike price is set at the lowest price the underlying stock reached during the term, \$60, and compared to the price of the stock at expiration date, \$80.

This difference of \$20 represents the profit to be made and, as the contracts are cash settled, that is the amount of the pay-out. Floating strike lookback options can also be physically settled, meaning you would be able to buy the stock at \$60 rather than receiving a cash settlement. You could then choose to sell the stock immediately and take your profit, or hold on to the stock if you felt it would continue to increase in price.

Example 2 of a Floating Strike Contract

- Put Option
- European Style
- Cash Settled
- Based on stock in Company X
- Company X stock currently trading at \$70
- Strike price determined at expiration date
- Company X stock rises to \$90 during term of contract
- Company X stock drops back to \$80 by expiration date

If you owned the contracts detailed above, then you would receive a cash settlement of a \$10 per contract owned. Even though it is a put, meaning you have expected the underlying stock

to fall, you have still made money despite the stock being priced higher than when you bought the contracts. This is because the strike price is set at the highest price the stock reached during the term of the contract - \$90 in this case. As the stock has dropped back down to \$80 by the time of expiration, the option settles at the difference between these two figures - \$10.

Buying & Selling Lookback Options

Lookback options are not exchange traded products that are easily accessible on the various exchanges around the world, but are actually bought and sold over the counter (OTC). It's still possible to buy them using a broker, but you would need to use one that specifically deals with OTC products.

Comparing Options to Other Financial Instruments

When it comes to trading and investment in general, there are many different financial instruments that can be used for potential profits. A financial instrument is essentially any tradable asset; whether it is cash, evidence of ownership in an entity, other commodities or even the contractual right to receive or deliver another financial instrument.

Stocks are probably the best known financial instrument, but there are also bonds, futures, and of course options contracts. There is money to be made from investing in, or trading any financial instrument if you know what you are doing.

If you are interested in options trading, then you obviously need to know what options contracts are and how they work. However, it also pays to have an understanding of other financial instruments and how they work by way of comparison. Even if your investment plan involves only trading options, it can still help to know a bit more about other financial instruments.

You may well decide to stick to only trading options, but you also may decide that you want to invest in other financial instruments too.

Differences Between Stocks & Options

If you were to ask how most people want to get involved in investing, then the most common answer would probably be buying stocks in publically listed companies. This is largely because buying stocks is one of the simplest ways to invest money, and anyone can do it with just a little bit of knowledge.

There is certainly money to be made from buying or trading stocks and there a number of people that do exactly that. However, when you compare trading stocks to trading options, there are some clear advantages that options offer.

Differences Between Bonds & Options

Bonds are another very straightforward way to invest, and they are particularly appealing to risk adverse investors who prefer conservative, safe investments. Bonds, like options, are a form of financial contract between two parties, but bonds and options are really quite different from each other.

Differences Between Forex & Options

Forex trading, trading in foreign currencies, has grown in popularity quite significantly in recent years, and successful forex traders can make serious amounts of money through this

technique. It does, however, require a lot of time and effort and it can be a stressful and intense way to invest. Foreign currencies are actually one of the many financial instruments that can be the underlying security in options contracts, so it's possible to trade options and speculate on currencies at the same time.

However, as financial instruments foreign currencies and options contracts are not really similar at all.

Differences Between Futures & Options

Futures and options are two financial instruments that are commonly used by investors and traders, often for similar reasons. Indeed, there are many similarities between the two types of contracts and they are frequently confused with each other. There is, however, one particularly fundamental difference between the two.

Differences Between Warrants & Options

Lots of financial instruments are completely different from each other, while many are really quite similar. Warrants and options are two financial instruments that are alike in many respects which often leads to investors and traders assuming they are about the same thing. While they do share many characteristics, there are a couple of significant differences between the two which are important to recognize.

Swaps & Other Derivative Products

A swap is a derivative contract between two parties that involves the exchange of pre-agreed cash flows of two financial instruments. The cash flows are usually determined using the notional principal amount (a predetermined nominal value). Each stream of the cash flows is called a -leg.

Introduced in the late 1980s, swaps are a relatively new type of derivative. Even though relatively new, their simplicity, coupled with their extensive applications, makes them one of the most frequently traded financial contracts.

Corporate finance professionals may use swap contracts to hedge risk and minimize the uncertainty of certain operations. For example, sometimes projects can be exposed to exchange rate risk and the Company's CFO may use a currency swap contract as a hedging instrument.

Unlike futures and options, swaps are not traded on exchanges but over-the-counter. In addition, counterparties in swaps are usually companies and financial organizations and not individuals, because there is always a high risk of counterparty default in swap contracts.

Some financial institutions usually participate as the market makers of swap markets. The institutions, which are also known as swap banks, facilitate the transactions by matching counterparties.

Types of Swaps

Modern financial markets employ a wide selection of such derivatives, suitable for different purposes. The most popular types include:

1. Interest rate Swap
2. Currency Swap

3. Commodity Swap
4. Credit Default Swap

Interest rate swap

Counterparties agree to exchange one stream of future interest payments for another, based on a predetermined notional principal amount. Generally, interest rate swaps involve the exchange of a fixed interest rate for a floating interest rate.

Currency swap

Counterparties exchange the principal amount and interest payments denominated in different currencies. These contracts swaps are often used to hedge another investment position against currency exchange rate fluctuations.

Commodity swap

These derivatives are designed to exchange floating cash flows that are based on a commodity's spot price for fixed cash flows determined by a pre-agreed price of a commodity. Despite its name, commodity swaps do not involve the exchange of the actual commodity.

Credit default swap

A CDS provides insurance from the default of a debt instrument. The buyer of a swap transfers to the seller the premium payments. In case the asset defaults, the seller will reimburse the buyer the face value of the defaulted asset, while the asset will be transferred from the buyer to the seller. Credit default swaps became somewhat notorious due to their impact on the 2008 Global Financial Crisis.

Applications of Swaps

Nowadays, swaps are an essential part of modern finance. They can be used in the following ways:

1. Risk Hedging
2. Access to new markets

Risk hedging

One of the primary functions of swaps is the hedging of risks. For example, interest rate swaps can hedge against interest rate fluctuations, and currency swaps are used to hedge against currency exchange rate fluctuations.

Access to new markets

Companies can use swaps as a tool for accessing previously unavailable markets. For example, a US company can opt to enter into a currency swap with a British company to access the more attractive dollar-to-pound exchange rate, because the UK-based firm can borrow domestically at a lower rate.

Types of Swap Contracts

1. Interest Rate Swaps

Interest rate swaps allow their holders to swap financial flows associated with two separate debt instruments. Interest rate swaps are most commonly used by businesses that either generate revenues linked to a variable interest rate debt instrument and incur costs linked to a

fixed interest rate debt instrument or generate revenues linked to a fixed interest rate debt instrument and incur costs linked to a variable interest rate debt instrument.

Consider a private mortgage provider that provides first-time home-buyers with financing. The private mortgage provider gives variable rate mortgage loans at a 0.25% premium over the existing interest rate, i.e., if the central bank sets an interest rate of 2%, then the private mortgage provider can give a loan at 2.25%. Clearly, the private mortgage provider's revenue is linked to the interest rate set by the central bank.

In order to start operations and provide loans, the private mortgage provider borrows \$2 billion from a large investment bank at a fixed interest rate of 2.1% for 15 years. The mortgage provider must pay the investment bank \$42 million a year for the next 15 years and also make a lump sum payment of \$2 billion at the end of the loan period. Thus, the mortgage provider's costs are fixed. However, its revenues depend on the interest payments it receives from its customers, which, in turn, is linked to the interest rate set by the central bank.

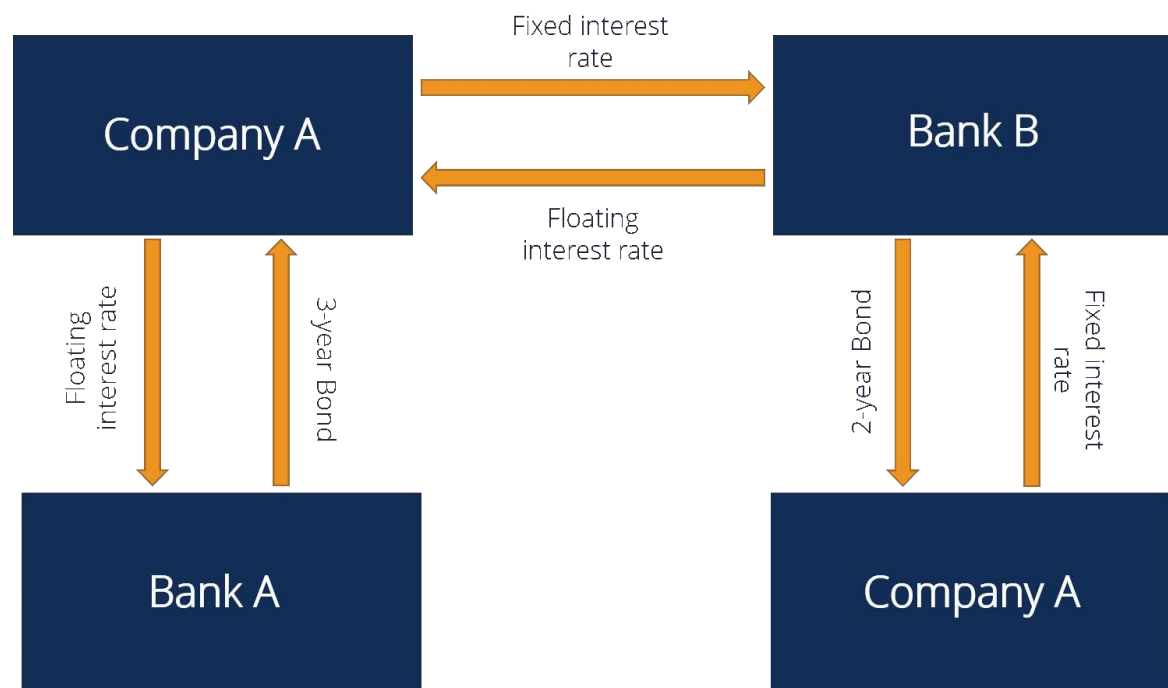
Thus, the mortgage provider's revenues are variable. If the central bank lowers the interest rate to below 1.85%, then the mortgage provider would not be able to meet its loan obligations. It can use interest rate swaps to swap his fixed interest rate payments for variable interest rate payments.

Suppose the mortgage provider buys an interest rate swap at a 0.23% premium. It implies that the party on the other side of the transaction has agreed to pay the investment bank \$42 million a year for the next 15 years, whereas the mortgage provider has agreed to pay the swap seller the bank rate +0.23% on \$2 billion for the next 15 years. The transaction can only take place if the mortgage provider and the swap seller have opposing views on whether the central bank will raise or lower the interest rate over the next 15 years.

Interest rate swaps have become an integral part of the fixed income market. These derivative contracts, which typically exchange – or swap – fixed-rate interest payments for floating-rate interest payments, are an essential tool for investors who use them in an effort to hedge, speculate, and manage risk.

What is an interest rate swap?

An interest rate swap is an agreement between two parties to exchange one stream of interest payments for another, over a set period of time. Swaps are derivative contracts and trade over-the-counter. The interest rate swap mechanism is depicted by the figure below.



The most commonly traded and most liquid interest rate swaps are known as –vanilla swaps, which exchange fixed-rate payments for floating-rate payments based on LIBOR (London Inter-Bank Offered Rate), which is the interest rate high-credit quality banks charge one another for short-term financing.

LIBOR is the benchmark for floating short-term interest rates and is set daily. Although there are other types of interest rate swaps, such as those that trade one floating rate for another, vanilla swaps comprise the vast majority of the market.

Investment and commercial banks with strong credit ratings are swap market makers, offering both fixed and floating-rate cash flows to their clients. The counterparties in a typical swap transaction are a corporation, a bank or an investor on one side (the bank client) and an investment or commercial bank on the other side.

After a bank executes a swap, it usually offsets the swap through an inter-dealer broker and retains a fee for setting up the original swap. If a swap transaction is large, the inter-dealer broker may arrange to sell it to a number of counterparties, and the risk of the swap becomes more widely dispersed.

This is how banks that provide swaps routinely shed the risk, or interest rate exposure, associated with them.

Initially, interest rate swaps helped corporations manage their floating-rate debt liabilities by allowing them to pay fixed rates, and receive floating-rate payments. In this way, corporations could lock into paying the prevailing fixed rate and receive payments that matched their floating-rate debt. (Some corporations did the opposite – paid floating and received fixed – to match their assets or liabilities.)

However, because swaps reflect the market's expectations for interest rates in the future, swaps also became an attractive tool for other fixed income market participants, including speculators, investors and banks.

What is the swap rate?

The –swap rate is the fixed interest rate that the receiver demands in exchange for the uncertainty of having to pay the short-term LIBOR (floating) rate over time. At any given time, the market's forecast of what LIBOR will be in the future is reflected in the forward LIBOR curve.

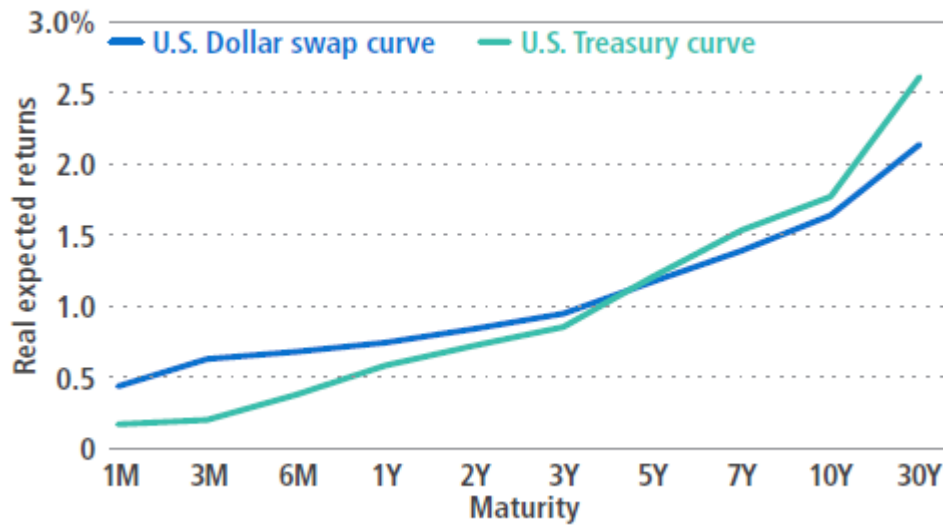
At the time of the swap agreement, the total value of the swap's fixed rate flows will be equal to the value of expected floating rate payments implied by the forward LIBOR curve. As forward expectations for LIBOR change, so will the fixed rate that investors demand to enter into new swaps. Swaps are typically quoted in this fixed rate, or alternatively in the –swap spread,¹ which is the difference between the swap rate and the equivalent local government bond yield for the same maturity.

A similar principle applies when looking at money itself and considering interest as the price for money. If the real return (adjusted for inflation) on a financial asset differs between two countries, investors will flock to the country with the higher returns. Interest rates have to change to stop this movement. The theory behind this relationship is called the interest rate parity theory. (When looking at interest rates, it is important to distinguish between real rates and nominal rates, with the difference reflecting the rate of inflation. The higher the expected inflation in a country, the more compensation investors will demand when investing in a particular currency.)

What is the swap curve?

The plot of swap rates across all available maturities is known as the swap curve, as shown in the chart below. Because swap rates incorporate a snapshot of the forward expectations for LIBOR, as well as the market's perception of other factors such as liquidity, supply and demand dynamics, and the credit quality of the banks, the swap curve is an extremely important interest rate benchmark.

U.S. SWAP AND TREASURY CURVES



Source: Bloomberg as of 31 March 2016

Although the swap curve is typically similar in shape to the equivalent sovereign yield curve, swaps can trade higher or lower than sovereign yields with corresponding maturities. The difference between the two is the –swap spread, which is shown in the chart below. Historically the spread tended to be positive across maturities, reflecting the higher credit risk of banks versus sovereigns. However, other factors, including liquidity, and supply and demand dynamics, mean that in the U.S. today the swap spread is negative at longer maturities.

Because the swap curve reflects both LIBOR expectations and bank credit, it is a powerful indicator of conditions in the fixed income markets. In certain cases, the swap curve has supplanted the Treasury curve as the primary benchmark for pricing and trading corporate bonds, loans and mortgages.

How does a swap contract work?

At the time a swap contract is put into place, it is typically considered –at the money, meaning that the total value of fixed interest rate cash flows over the life of the swap is exactly equal to the expected value of floating interest rate cash flows. In the example below, an investor has elected to receive fixed in a swap contract. If the forward LIBOR curve, or floating-rate curve, is correct, the 2.5% he receives will initially be better than the current floating 1% LIBOR rate, but after some time, his fixed 2.5% will be lower than the floating rate. At the inception of the swap, the –net present value, or sum of expected profits and losses, should add up to zero.

However, the forward LIBOR curve changes constantly. Over time, as interest rates implied by the curve change and as credit spreads fluctuate, the balance between the green zone and the blue zone will shift. If interest rates fall or stay lower than expected, the –receiver of fixed will profit (green area will expand relative to blue). If rates rise and hold higher than expected, the –receiver will lose (blue expands relative to green).

If a swap becomes unprofitable or if a counterparty wishes to shed the interest rate risk of the swap, that counterparty can set up a countervailing swap – essentially a mirror image of the original swap – with a different counterparty to —cancel out the impact of the original swap.

How to invest in interest rates swaps?

Interest rate swaps became an essential tool for many types of investors, as well as corporate treasurers, risk managers and banks, because they have so many potential uses. These include:

1. Portfolio Management
2. Speculation
3. Corporate Finance
4. Risk Management
5. Rate-locks on bond issuance

Portfolio management

Interest rate swaps allow portfolio managers to adjust interest rate exposure and offset the risks posed by interest rate volatility. By increasing or decreasing interest rate exposure in various parts of the yield curve using swaps, managers can either ramp-up or neutralize their exposure to changes in the shape of the curve, and can also express views on credit spreads. Swaps can also act as substitutes for other, less liquid fixed income instruments. Moreover, long-dated interest rate swaps can increase the duration of a portfolio, making them an effective tool in Liability Driven Investing, where managers aim to match the duration of assets with that of long-term liabilities.

Speculation

Because swaps require little capital up front, they give fixed income traders a way to speculate on movements in interest rates while potentially avoiding the cost of long and short positions in Treasuries. For example, to speculate that five-year rates will fall using cash in the Treasury market, a trader must invest cash or borrowed capital to buy a five-year Treasury note. Instead, the trader could receive fixed in a five-year swap transaction, which offers a similar speculative bet on falling rates, but does not require significant capital up front.

Corporate finance

Firms with floating rate liabilities, such as loans linked to LIBOR, can enter into swaps where they pay fixed and receive floating, as noted earlier. Companies might also set up swaps to pay floating and receive fixed as a hedge against falling interest rates, or if floating rates more closely match their assets or income stream.

Risk management.

Banks and other financial institutions are involved in a huge number of transactions involving loans, derivatives contracts and other investments. The bulk of fixed and floating interest rate exposures typically cancel each other out, but any remaining interest rate risk can be offset with interest rate swaps.

Rate-locks on bond issuance.

When corporations decide to issue fixed-rate bonds, they usually lock in the current interest rate by entering into swap contracts. That gives them time to go out and find investors for the bonds. Once they actually sell the bonds, they exit the swap contracts. If rates have gone up since the decision to sell bonds, the swap contracts will be worth more, offsetting the increased financing cost.

What are the risks?

Like most non-government fixed income investments, interest-rate swaps involve two primary risks: interest rate risk and credit risk, which is known in the swaps market as counterparty risk.

Because actual interest rate movements do not always match expectations, swaps entail interest-rate risk. Put simply, a receiver (the counterparty receiving a fixed-rate payment stream) profits if interest rates fall and loses if interest rates rise. Conversely, the payer (the counterparty paying fixed) profits if rates rise and loses if rates fall.

Swaps are also subject to the counterparty's credit risk: the chance that the other party in the contract will default on its responsibility. This risk has been partially mitigated since the financial crisis, with a large portion of swap contacts now clearing through central counterparties (CCPs). However, the risk is still higher than that of investing in a –risk-free U.S. Treasury bond.

Interest Rate Swaps in India

The Indian fixed income markets have charted impressive growth in the last few years. The current markets are vastly different from the 'administered interest rate regime' used until the early-nineties. Until 1999 market participants had to reduce duration or switch to cash if they wanted to hedge interest rate exposures or had a view that interest rates were set to rise because short-selling was not allowed. Now an investor can use interest rate derivatives to hedge against a rise in interest rates or even to profit from such moves.

The Indian interest rate derivatives market is almost 2 decades old and growing fast. The Reserve Bank of India announced the introduction of over-the-counter rupee derivatives in the form of forward rate agreements and interest rate swaps in July 1999. These have helped manage and control interest rate risks and also deepen the money markets.

Only banks, primary dealers and financial institutions are allowed to trade FRAs and swaps to hedge interest rate risk for their own balance sheet management and for market-making purposes. Corporates are allowed to use these products to hedge their interest rate risk. Swaps having explicit or implicit option features such as caps, floors and collars are not permitted.

RBI started by allowing market participants to use debt market rates as benchmarks, but this was later extended to include implied foreign currency rates.

The product palette has also been changing. Initially, the swaps were indexed to overnight interest rates and the overnight indexed swaps (OIS) were the most active. Later, the reserve bank permitted foreign currency benchmarks, such as forward premium, and the market grew deeper.

The OIS and the implied rupee rates derived from foreign exchange forwards are the most actively used benchmarks. Other benchmarks over which swaps have been dealt are commercial paper rates, benchmark gilts and also constant maturity Treasury swaps.

The MIBOR swap curve has now extended to 10 years while the OIS curve extends into seven years. However, up to five-year tenors are the most liquid. New structures also permit having cash flows in rupees with the floating rate leg linked to dollar LIBOR rates, for example rupee quantos.

Trading Scenario

In India interest rate swaps are commonly traded on 2 benchmarks viz MIBOR and MIFOR. Scheduled commercial banks (excluding Regional Rural Banks), primary dealers (PDs) and all-India financial institutions (FIs) are free to undertake IRS as a product for their own balance sheet management or for market making. CCIL has, with effect from 28th March, 2014 commenced CCP clearing for IRS trades referenced to the MIBOR and MIOIS benchmark.

On 3rd August, 2015 CCIL launched an anonymous electronic trading platform for Interest Rate Swaps (IRS) referenced to Overnight MIBOR benchmark known as ASTROID (Anonymous System for Trading in Rupee OTC Interest Rate Derivatives). The system is available for trading from 9.00 am to 5.00 pm from Monday to Friday. The minimum lot size is Rs 5 Crs with a tick size of 0.0025%.

OIS volumes in India have been traditionally low, with a limited number of domestic banks, bond and fund houses using the platform for occasional hedges or trades. Operational complexities are reportedly blamed for the pronounced absence of offshore investors, and low trading volumes.

In India, OIS trading volumes averaged Rs 25,938 crore in November 2018, compared with Rs 22,724 crore in March 2018, showing an increase of 14 per cent, data from the Clearing Corporation of India showed. Globally, OIS trades run into billions of dollars.

Concentration

Though most debt market participants are permitted access to the rupee derivatives market, only a handful of players contribute significantly to the activity. Foreign banks are the most dominant players followed by a few new private sector banks. A few corporate houses are also very active in these markets. Public sector banks have a marginal presence followed by mutual funds. Insurance companies have not participated in the rupee derivatives market as yet.

Public sector banks have a large presence in the interest rate markets but their share in the rupee derivatives market is much lower. Their slow entry into this segment could likely be on account of the time taken to develop adequate skills and systems. The entry of public sector banks could benefit the market in a big way as they would be able to set larger counterparty limits on account of their size.

End Users

Bank participants have used the rupee derivative markets for trading as well as hedging their trading or investment portfolios. Also, since short-selling of gilt securities is not permitted in India, banks can use rupee derivatives to effectively short interest rates. Corporates, on the other hand, have also benefited by the introduction of rupee derivatives.

Traditionally there has only been liquidity in the Indian corporate bond market during a boom. Corporates can now tap the bond markets when demand is strong and use swaps to convert their liability to a floating rate to benefit from a further fall in interest rates if they are bullish. If they are bearish on rates they can swap their floating rate loans to fixed or extend the maturity of their loans using swaps. These are just a few simple uses of swaps but the exact applications are varied and serve a number of objectives.

2. Currency Swaps (FX Swaps)

Currency swaps allow their holders to swap financial flows associated with two different currencies.

Also known as cross-currency swaps, currency swapping are a vital financial instrument for any multinational corporation or institutional investor planning to invest in an international business venture.

While you may find them to be very similar to other financial derivatives like interest rate swaps and equity swaps, there are some fundamental qualities that make currency swapping different and comparatively more complex in nature.

Example of a cross-currency swap

Cross-currency swaps initially started as a means to get around exchange controls and rigid governmental limitations on currency transactions. However, things changed, and today currency swaps are used as a tool to hedge against foreign exchange fluctuations. By using currency swaps, entities can reduce their interest rate exposure and obtained cheaper debt, resulting in low financial risk.

Example-1

Consider the example described above: An American business that borrowed money from a US-based bank (in USD) but wants to do business in the UK. The business' revenue and costs are in different currencies.

The business needs to make interest payments in USD, whereas it generates revenues in GBP. However, it is exposed to risk arising from the fluctuation of the USD/GBP exchange rate. The business can use a USD/GBP currency swap to hedge against such a risk. If the business sells £50 million worth of goods in the UK and the exchange rate falls from £1=\$1.23 to £1=\$1.22, then the business's revenue falls from \$61.50 million to \$61 million.

In order to protect against such a risk (the USD depreciating against the GBP), the business can use a USD/GBP swap. The seller of the swap agrees to give the business \$61.5 million for £50 million regardless of what the actual exchange rate is. The transaction can only take place if the business and the swap seller have opposing views on whether the USD/GBP exchange rate will appreciate or depreciate.

Example-2

Suppose a US-based company named 'A' wants to expand its business in India. Similarly, an India-based company called 'B' wishes to enter the US market. One significant financial challenge that both companies will face is the unwillingness of domestic banks to extend loans to international corporations. In such a situation, both parties are likely to be offered loans with a high-interest rate.

The US bank will perhaps be willing to lend a loan to company B at 12%. On the other hand, Indian banks will be offering a loan to company A at an interest rate of 11%. Another alternative for these companies is to take loans from international banks, which also will come at high interest rates. In this case, both companies have a competitive advantage on their domestic turfs, where they can get a loan at lesser interest rates.

If the amount of loan that both companies require are similar, then they can decide on an agreement that will benefit them both. Company A can borrow money from a US bank, while company B can borrow money from an Indian bank. Both the companies will then swap their loans and pay each other's interest.

If there is a difference in interest rates between both the companies, they can figure out an alternative that will represent their credit obligation.

Currency swaps calculation

How do we calculate the currency swaps? Here's an example of it.

ABC is a German subsidiary of an American firm ABC. The company ABC generates income in Euros and need to send a part of that income to its parent company at the end of every year. Instead of entering in multiple forward contracts to manage currency risk, ABC signs a swap agreement with XYZ, an American subsidiary of a German company XYZ. The company ABC will then be able to send the dollar cash flows it receives from XYZ to its parent company ABC and vice versa.

Let's assume that ABC wants to swap €1,000,000 over five years period and agrees to make annual interest payments at a fixed rate of 6.00%. In return, ABC agrees to receive an equivalent dollar amount over the five periods at a fixed rate of 4.5%. The rate of exchange at the time of the agreement is \$1.40/€.

Since currency swaps are structured as debts, therefore the annual interest payment for ABC is

$$€1,000,000 \times 0.06 = €60,000$$

The final payment will be interest payment + the principal amount

$$= €60,000 + €1,000,000 = €1,060,000$$

Since the exchange rate is \$1.40/€, the equivalent dollar principal

$$= €1,000,000 \times \$1.40/€ = \$1,400,000$$

Hence, the annual interest will be

$$= \$1,400,000 \times 0.045 = \$63,000$$

The final receipt of ABC will be Interest payment + principal payment

$$= \$63,000 + \$1,400,000 = \$1,463,000$$

For simplicity, we have left out the financial intermediary. In reality, a bank acting as a swap dealer would be involved.

Features of currency swaps

Currency swaps, in simple terms, are a legal contract between two parties who agree to exchange principal amount and interest in one currency for principal amount and interest in another currency. This exchange of cash flow takes place at a fixed date and a predetermined exchange rate (either floating rate or fixed rate) throughout the contract. For accounting purpose, any currency swap is just like a foreign exchange transaction. So it does not have to be put on a company's balance sheet by law.

Many global banks operate as the middlemen in such currency swap deals. But the facilitators can also be companies that want to hedge against their global exposure, especially when it comes to foreign exchange risk.

The exchange of liabilities in currency swaps happen in three stages.

1. Initial Exchange of principal amount
2. On-going exchange of interest payment
3. Re-exchange of principal on maturity

Initial exchange of principal amount

At the beginning of a currency swap, the counterparties exchange a principal amount of money at an agreed rate of exchange. The rate is usually based on the spot exchange rate. Alternatively, counterparties can use a forward rate. However, such forward rates need to be set before the swap initiation date.

The initial exchange can be either on a physical or notional basis. Its main purpose is to establish a quantum of the principal amounts to calculate both the continuing payment of interest and the re-exchangeable principal amounts at the end of the swap.

On-going exchange of interest payment

Once the initial principal amounts establish, the counterparties then proceed to exchange interest payments. Such payments are based on the respective fixed or floating interest rates agreed upon at the beginning of the transaction.

This initiates a series of forwarding foreign exchange contracts that take place throughout the term of the swap contract.

Re-exchange of principal on maturity

When the contract matures, both the parties re-exchange the principal amounts that were decided at the outset. This three-step process is the standard practice for currency swaps in the market.

With this straight forward approach, it is easy to effectively turn a debt raised in one currency into a fully-hedged liability in another currency.

During currency swaps, the principal amount is exchanged in one of the many ways:

1. At the beginning of a currency swap contract.
2. By the end of a currency swap contract.
3. At a combination of both start and end.
4. Neither of all.

Types of currency swaps

There are basically two types of currency swaps, namely,

1. Fixed/Fixed Currency Swaps
2. Fixed/Floating Currency Swaps

Fixed/Fixed Currency Swaps

In fixed-for-fixed currency swaps, the counterparties taking loans agree to exchange currencies and pay each other a fixed interest rate on the decided principal amount. In such transactions, swapping the actual principal is not mandatory.

Instead, an alternative currency can be exchanged at the spot rate for the desired currency. However, principal amounts are always re-exchanged at the maturity of a currency swap contract. Fixed-for-fixed currency swaps are instrumental in situations where interest rates in other countries are cheaper than their own.

We will consider how a fixed for fixed currency swap works by looking at an example.

An American company may be able to borrow in the United States at a rate of 6%, but requires a loan in rand for an investment in South Africa, where the relevant borrowing rate is 9%. At the same time, a South African company wishes to finance a project in the United States, where its direct borrowing rate is 11%, compared to a borrowing rate of 8% in South Africa.

Each party can benefit from the other's interest rate through a fixed-for-fixed currency swap. In this case, the American company can borrow U.S. dollars for 6%, and then it can lend the funds to the South African company at 6%. The South African company can borrow South African rand at 8%, then lend the funds to the U.S. company for the same amount.

Fixed/Floating Currency Swaps

An alternative to fixed-for-fixed currency swaps, fixed-for-floating currency swaps are contractual agreements in which fixed rate obligations in one currency are exchanged for floating rate obligations in another currency. Here, the principal amount of the underlying loans remains unchanged.

For example, when a company in the US gets in a fixed/floating currency swap agreement with another company in the UK, it agrees to swap US dollars at fixed interest rates against pound sterling with LIBOR + floating interest rates.

Numerical example

Let's consider a case, where a company exchanges fixed rate borrowing for variable rate borrowing.

Barrow Co, a company based in the USA, wants to borrow €500m over five years to finance an investment in the Eurozone.

Today's spot exchange rate between the Euro and US \$ is $\text{€}1.1200 = \$1$.

Barrow Co's bank can arrange a currency swap with Greening Co. The swap would be for the principal amount of €500m, with a swap of principal immediately and in five years' time, with both these exchanges being at today's spot rate.

Barrow Co's bank would charge an annual fee of 0.4% in € for arranging the swap.

The benefit of the swap will be split equally between the two parties.

The relevant borrowing rates for each party are as follows:

	Barrow Co	Greening Co
USA	3.6%	4.5%
Eurozone	EURIBOR + 1.5%	EURIBOR + 0.8%

We will see what the gain on the swap for each party will be.

	Barrow Co	Greening Co	Benefit
USA	3.6%	4.5%	0.9%
Eurozone	EURIBOR + 1.5%	EURIBOR + 0.8%	0.7%
Gain on swap	0.8%	0.8%	1.6%
Bank fee	(0.2%)	(0.2%)	(0.4%)
Final gain	0.6%	0.6%	1.2%

Using this gain to work out the overall result for each company, we can provide an illustration of how the swap could work as follows:

	Barrow Co	Greening Co
Barrow Co borrows	3.6%	

	Barrow Co	Greening Co
Greening Co borrows		EURIBOR + 0.8%
Swap		
Greening Co receives		(EURIBOR)
Barrow Co pays	EURIBOR	
Barrow Co receives	(2.9%)	
Greening Co pays		2.9%
Net result	EURIBOR + 0.7%	3.7%
Bank fee	0.2%	0.2%
Overall result	EURIBOR + 0.9%	3.9%

The overall result show each party paying 0.6% less than they would have paid in they had borrowed directly in the foreign markets.

Barrow Co's original principal amount of €500m would be exchanged at the inception of the swap for \$446,428,517. The principal would be swapped back five years later, at the end of the agreement, at the original spot rate.

Benefits of currency swaps

In the world of finance, engaging in currency swaps means acquiring additional financial flexibility. It helps enterprises that are investing in growing markets reduce their exposure to currency fluctuations. Currency swaps allow re-domination of loans from one currency to another, making it possible for foreign companies to invest at lower risk in domestic markets.

Currency swaps prove to be extremely advantageous in situations where both parties stand to gain in the market. Usually, the domestic company is able to locally obtain finance at better

terms as compared to foreign companies. For big corporations, currency swaps present an opportunity of raising funds in one currency while saving money in another.

The best thing about cross-currency deals is that the risk is very minimal. In addition to that, swaps make transactions fairly easy for companies, as they are very liquid. This gives both parties the freedom to settle the agreement at any time during the contract period. Counterparties can also do an early termination of a swap deal through negotiation.

Lastly, currency swaps allow differences in the interest rates of two currencies through periodic payments, instead of the lump sum showed by forwarding points used in the forex market. This lets swaps to be customized as per the requirements of counterparties and at very attractive rates.

Summary

- 1). A currency swap is an agreement in which two parties exchange the principal amount of a loan and the interest in one currency for the principal and interest in another currency.
- 2). At the inception of the swap, the equivalent principal amounts are exchanged at the spot rate.
During the length of the swap each party pays the interest on the swapped principal loan amount.
- 3). At the end of the swap the principal amounts are swapped back at either the prevailing spot rate, or at a pre-agreed rate such as the rate of the original exchange of principals. Using the original rate would remove transaction risk on the swap.
- 4). Currency swaps are used to obtain foreign currency loans at a better interest rate than a company could obtain by borrowing directly in a foreign market or as a method of hedging transaction risk on foreign currency loans which it has already taken out.

An alternative way of currency swaps

Another way for companies to make currency swaps is by issuing bonds at the underlying rates. These bonds will then be delivered to a swap bank which will swap them to each other. Suppose both companies have each other's assets. Here, interest from the first company (i.e., company A) will be delivered to company B with the help of the swap bank. Similarly, interest from company B will be passed through to company A from the same swap bank. On the maturity date, each company will pay the principal amount to the swap bank and receive the original principal in return.

In both cases, the companies will be able to obtain foreign currency at their desired, cheaper rates, while efficiently circumventing foreign exchange risk.

Currency swaps in India

In a recent venture in 2018, India signed a currency swap agreement with Japan. It was made at the exchange rates prevailing during the time of the currency swap. Currently, India has an arrangement with nearly 25 countries to trade in their respective local currencies. This helps avoid dealing in third currency like EURO, USD, and JPY, resulting in reduced risk of volatility of exchange risk with a pre-decided exchange rate.

3. Commodity Swaps

A commodity swap is a type of derivative contract that allows two parties to exchange (or swap) cash flows which are dependent on the price of an underlying asset. In this case, the underlying asset is a commodity.

Commodity swaps are very important in many commodity-based industries such as oil and livestock. They are used to hedge against swings in the market price of the product in question. These swaps allow commodity producers and end-users to lock in at a set price for the underlying commodity.

Commodity Swap Users

Commodity producers need to manage their exposure to fluctuations in the prices for their products. They're primarily concerned with fixing prices on contracts to sell their commodities. A gold producer will want to hedge losses related to a fall in the price of gold for his current inventory, while a cattle farmer will seek to hedge his exposure to changes in the price of livestock.

End-users need to hedge the prices at which they can purchase these commodities. A university might want to lock in the price at which it purchases electricity to supply its air conditioning units for the upcoming summer months; an airline will need to lock in the price of the jet fuel it needs to purchase in order to satisfy the peak in seasonal demand for travel.

Speculators are funds or individual investors who can either buy or sell commodities by participating in the global commodities market. While many may argue that their involvement is fundamentally destabilizing, it's the liquidity they provide in normal markets that facilitates the business of the producer and of the end-user.

Why Would Speculators Look at the Commodities Markets?

Traditionally, speculators looked at the commodities market as a way to hedge against inflation and offset increased prices stemming from higher input costs.

Or, speculators can also find tremendous opportunity in commodity markets. Some analysts argue that commodity markets are more technically-driven or more likely to show a persistent trend compared to other markets like bonds or foreign exchange.

The futures markets have been the traditional vehicles for participating in the commodities markets. In fact, derivatives markets started in the commodities field.

How do Commodity Swaps Work?

Commodity swaps are not traded on centralized exchanges. They are customized, over-the-counter deals between two parties. Many of these over-the-counter deals are created through financial service companies. Most often, these companies don't actually swap the underlying commodity and will only use the price of the commodity to determine the cash flows that will be exchanged.

There are two types of commodity swaps that are generally used:

1. Fixed-floating commodity swaps
2. Commodity-for-interest swaps.

Fixed-Floating Commodity Swaps

Fixed-floating swaps are very similar to interest rate swaps. The difference is that commodity swaps are based on the underlying commodity price rather than a floating interest rate. In this type of swap contract, there are two legs,

- the floating-leg which is tied to the market price of the commodity, and
- the fixed-leg which is the agreed-upon price specified in the contract.

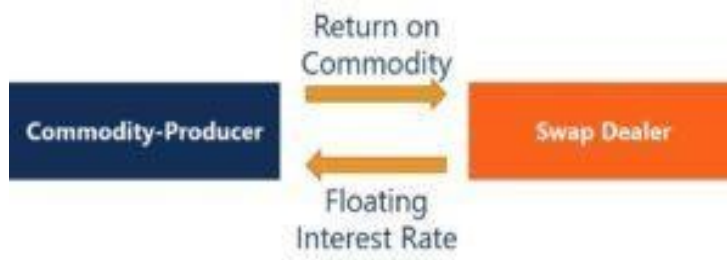
The party looking to hedge their position will enter into the swap contract with a swap dealer to pay a fixed price for a certain quantity of the underlying commodity on a periodic basis. The swap dealer will, in turn, agree to pay the party the market price of the commodity. These cash flows will net out each period, and the party who must pay more will pay the difference. On the other side, the swap dealer will also find a party looking to pay the floating price of the commodity. The swap dealer will enter into a contract with this party to accept the floating market price and pay the fixed price, which will again net out. Swap dealers such as financial service companies will play the role of a market-maker and profit from the bid-ask spread of these transactions.

Here we can see that an end-user of a commodity and a swap dealer, have entered into a commodity swap. Often, end-users of a commodity, such as fuel-intensive industries will look to pay a fixed price. In this example, the end-user will pay a fixed price and receive the market price of the commodity.

Commodity-For-Interest Swaps

A commodity-for-interest swap is very similar to an equity swap, however, the underlying asset is a commodity. One leg will pay a return based on the commodity price while the other leg is tied to a floating interest rate such as LIBOR, or an agreed-upon fixed rate.

This swap involves a notional principal or face value, specified duration, and pre-specified payment periods. Like the fixed-floating swap, these periodic payments will net out against each other and the party who must pay more based on the commodity return, interest rate, and face value will pay the difference.



Here we see an example of a commodity-for-interest swap. The commodity-producer will pay a rate based on the return of the commodity and receive a floating rate such as LIBOR. This can help the commodity-producer reduce the downside risk of a poor return based on the commodity.

What are Commodity Swaps Used For?

Commodity swaps are important tools used for a few purposes. The most common reason for using this swap is to accommodate the risk a party is willing to take. For a party looking to hedge their position against the volatility of a commodity price, they will enter into a swap to pay or receive a fixed price. On the commodity-producer side, this will guarantee a stable selling price for them. On the end-user side, this will guarantee a stable buying price for them.

For example, airline companies have significant fuel costs. They are highly exposed to swings in the price of oil. A commodity swap is one way for them to reduce this exposure.

Alternatively, a party may be looking for more exposure to the underlying commodity. For example, an investor who can borrow at LIBOR may enter into a commodity-for-interest swap looking to profit from high returns based on the commodity price.

Since commodity swaps are financial instruments, these contracts will be cash-settled and an investor will not have to be involved with any physical delivery of the commodity.

Valuing a Commodity Swap

In pricing a commodity swap, it's helpful to think of the swap as a strip of forward contracts, each priced at inception with zero market value (in a present value sense). Thinking of a swap as a strip of at-the-money forwards is also a useful and intuitive way of interpreting interest rate swaps or equity swaps.

A commodity swap is characterized by some idiosyncratic peculiarities that we should take into account. These include:

1. The cost of hedging
2. The institutional structure of the particular commodity market in question
3. The liquidity of the underlying commodity market
4. Seasonality and its effects on the underlying commodity market
5. The variability of the futures bid/offer spread
6. Brokerage fees
7. Credit risk, capital costs and administrative costs

Some of these factors must be extended to the pricing and hedging of interest rate swaps, currency swaps and equity swaps as well. The idiosyncratic nature of the commodity markets refers more to the often-limited number of participants in these markets (naturally begging questions of liquidity and market information), the unique factors driving these markets, the inter-relations with cognate markets and the individual participants in these markets.

Correlation and Basis

Many times when using commodity derivatives to hedge an exposure to a financial price, there is not one exact contract that can be used to hedge the exposure. If you are trying to hedge the value of a particular type of a refined chemical derived from crude oil, you may not find a listed contract for that individual product. But if you're lucky, you'll find an over-the-counter price.

How do the OTC Traders Hedge this Risk

OTC traders hedge the risk involved in commodity markets by looking at the correlation for clues as to how to price the OTC product they're offering. They make assumptions about the stability of the correlation and its volatility, using that to shade the price they ultimately put forward.

Correlation is an unhedgeable risk for the OTC market maker and there is very little that he can do if the correlation breaks down.

For example, if the price for your individual chemical suddenly starts dropping faster than the correlation of the chemical's price with crude oil suggests it should, the OTC dealer has to start dumping more crude oil in order to compensate.

The OTC market maker's best hope is to see enough two-way business involving end-users and producers so that his exposure is naturally hedged by people seeking to benefit from price movement in either direction.

While a commodity swap and commodity derivatives can be risky business, they're a useful and important risk-hedging tool employed by most leading energy, chemical and agricultural corporations.

Commodity Swap – Worked Example

Let us now work through an example question involving a commodity swap. An airline has entered into a contract to pay a fixed rate of \$5.00/gallon on a proportion of its fuel needs. If at the payment period, the price of fuel is \$5.20/gallon, how much has the airline saved given the contract is for 200,000 gallons of fuel?

Here we see that the airline company wants to pay a fixed rate of \$5.00 per gallon of fuel. At this point in time, the difference would be: $\$5.20/\text{gallon} - \$5.00/\text{gallon} = \$0.20/\text{gallon}$.

In total, the other party would pay the airline company $200,000 \text{ gallons} \times \$0.20/\text{gallon} = \$40,000$

This \$40,000 would offset the increase in the price of fuel paid by the airline. If the airline had to pay \$5.20/gallon for 200,000 gallons of fuel, this would cost them \$1,040,000, however due to the swap contract the net amount is: $\$1,040,000 - \$40,000 = \$1,000,000$.

If the price had been \$5.00/gallon, the airline company would have paid: $\$5.00/\text{gallon} \times 200,000 \text{ gallons} = \$1,000,000$.

We can see that due to the swap contract, the airline company is able to ensure a price of \$5.00 per gallon for the specified 200,000 gallons of fuel.