RANI CHANNAMMA UNIVERSITY

B.Com – 6th Semester **Indian Financial Services**

UNIT – 4: FACTORING AND FORFAITNG

1. Introduction 2. Meaning and Definitions
3.Features 4. Process
5.Objectives and Functions 6.Types
7.Advantages and disadvantages 8.Simple Problems

1. INTRODUCTION:

Business firms are always interested in sales maximization, which helps to earn maximum profits. It can be achieved through cash as well as credit sales. As cash sales alone cannot satisfy all customers, it insists them to adopt credit sales also. But, credit sales involves some risks like blocking of working capital, bad debts, diversion of concentration, time consumption, losing some business opportunities due to shortage of short term funds, collection costs, spoiling of business relations owing to repeated follow up for collection etc.

Now a days, a new kind of agencies have emerged in financial services sector who primarily help in collection of debts of businessmen and secondly, provide advance against such debts before collection. Thus, those agencies relieve the businessmen from the risks of credit sales and help smooth running of business. Naturally, these agencies charge commission for such agency service. These agencies are known as **FACTORS** in domestic trade and **FORFAITORS** in international trade, of course there are some differences.

2. MEANING AND DEFINITIONS:

The word Factoring is derived from the Latin word 'Facere'. It means 'to make' or 'to do'. The business firms get their part of works done through the Factors. The credit sales create debtors or book debts. These are handed over to specialized agencies called 'Factors'. It is like business process outsourcing. Therefore, factoring means 'a continuous process in which the business firms (clients) transfer the book debts to Factor who pays the amounts back to client after collecting from debtors and also deducting his commission'.

Many scholars have defined the term factoring. A few of them are as given below-

M.Y. Khan -

"An agreement in which receivables arising out of sale of goods/ services are sold by a firm (Client) to the factor (a financial intermediary) as a result of which the title to the goods/ services represented by the said receivables passes on to the factor".

Dictionary of Finance-

"The buying of trade debts of a manufacturer or a trader, assuming the task of debt collection and accepting the credit risk. It is providing the manufacturer or trader with the amount of working capital. A firm that engages in factoring is called a factor".

3. FEATURES

The two definitions bring out some of the important characteristics like-

Factoring is -

1. A financial service.
2. A contract between the seller (client) and the collector (factor).
3. Purchasing the receivables or book debts of client, and collecting and returning to client.
4. Advancing amount up to 80% is paid by factor to client and balance 20% after collection.
5. Shifting the risk of collection of receivables to factor.
6. Like conversion of credit bills into ready cash.
7. A type of credit management technique.
8. A method of business process outsourcing (BPO) activity.

4. PROCESS

The following diagram narrates the steps involved in the process of Factoring-

1- A Customer places order with the seller

2 - Factor and client fix the customer limit

3 - Client delivers goods and invoice with notice to pay to the factor.

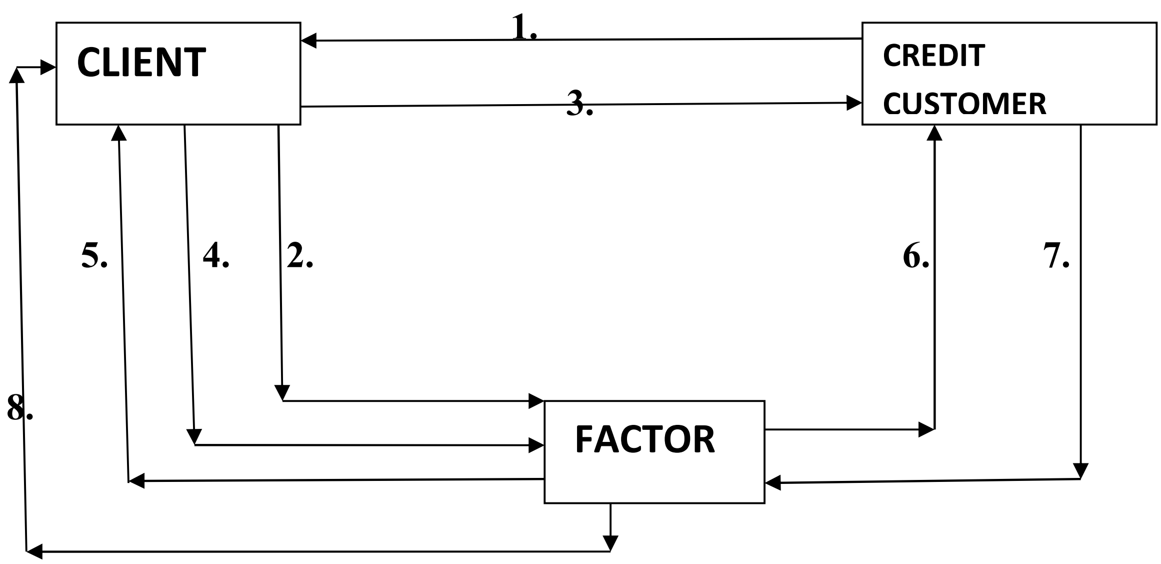
4 - Client sends invoice copy to the factor.

5 - Factor advances up to 80% of debt amount to client.

6 - Factor does follow up with the customer.

7 - Customer pays to factor on maturity.

8 - Factor pays balance amount to the client.



5. OBJECTIVES AND FUNCTIONS

Factoring is not merely an agency service, it is more than that. It stands unique because of the functions it performs. When the goods are sold on credit basis, any delay in collection results into blocking of working capital, increase in the cost of funds, waste of time due to legal procedures, increase in bad debts, increased life of receivables etc. This affects the routine activities of the organization. If the scale of operations is small, the outstanding dues are harmful as they cause end of an organization. In order to overcome these problems, factoring is essential in these days.

Objectives	Functions
1. To collect the credit amount.	**1.** Collecting the credit amount.
2. To avail finance.	**2.** Availing finance as advance.
3. To monitor credit risk.	**3.** Managing credit risks.
4. To avail advisory services.	**4.** Getting advisory services.
5. To investigate the credit.	**5.** Investigating credit.
6. To manage the sales ledger.	**6.** Managing the sales ledger.

i. To Collect the Credit (Collecting the credit amount)**:**

The factor accepts the book debts and receivables for collection. They act on behalf of the client. The right to collect debts is handed over by businessmen. Factor acts as a holder for value. Therefore, collecting debts is the main objective of factors. This avoids the need for credit collection department.

ii. To Avail Finance (Availing finance as advance)**:**

Generally, the factor advances finance to the client. The factor agrees to pay 80% of the book debts and balance 20% after collection. This helps the client to continue his business activities. It solves problem of working capital. It carries interest charges.

iii. To Monitor Credit Risk (Managing credit risks)**:**

Factor guarantees the client about collection of credit sales. In case of sans recourse factoring bears the risk of bad debts also. The risk of bad debts is transferred to factor. The client is relieved from many credit risks.

iv. To Avail Advisory Service (Getting advisory services)**:**

The factors provide most valuable services regarding credit customers, their standing, business opportunities etc. These help to bring changes in products, credit policies, saves consultancy fees etc.

v. To Investigate the Credit (Investigating credit)**:**

The credit collection risk depends upon the credit worthiness of the customer. The factors assess customers' the 'real-worth' of credit customers. The 'rating of the customer' by factors will be accurate. The client is helped lot with the factors' credit information.

vi. To Manage the Sales-ledger (Managing the sales ledger)**:**

The sales ledger is managed by the factors. They undertake all the activities relating to sales ledger. This reduces the burden of much of client's tasks.

These are the value added services provided by factors.

6. TYPES OF FACTORS

There are various types of factors based on variety of services rendered by them i.e. package of services made available to clients. They are-

1. With Recourse Factoring:

The term recourse means to go back to. It means the factor goes back to client to recover the loss due to bad debts. In this case, the factor does not accept the credit risk.

2. Without (Sans) Recourse Factoring:

The factor does not go back to the client for the non-collection of dues from debtors. In other words, the factor bears risk of bad-debts. The client becomes free from loss on account of bad debts. But, client has to pay additional charges for this service.

3. Advance Factor:

In this type, factor pays advance amount to the client. It may be in between 80% to 85% of debt amount accepted for collection. And also charges interest on such an advance.

4. Maturity Factoring:

This is just opposite of advance factoring. Factor agrees to pay the amount as and when it is collected. It is collected on maturity date itself.

5. Notified (Disclosed or Bulk) Factoring:

The agreement between client and factor is made known to debtor. It is disclosed by writing the name of factor in the invoice- copy.

6. Undisclosed / Confidential, Invoice Factoring:

The name of factor is kept secret or confidential. The factor renders all services but without notice to customer. The factor is the controller of all transactions but collection is done in the name of client.

7. Domestic Factoring:

All the parties to the agreement belong to the same country. The agreement is made on the same country's regulations.

8. International Factoring:

The parties to factoring belong to different countries. The four parties viz. client (the exporter), importer (the customer), exporter's factor and importer's factor belong to different countries.

9. Agency Factoring:

In this type, all the works are shared between the factor and client. The factor provides finance and bears credit risks and the client manages sales ledger, administration and collection work. The factor simply acts as agent of client.

10. Supplier's Guarantee Factoring:

The factoring services take place between two suppliers. If more numbers of middlemen are involved in the sale, the factor acts between two suppliers and provides factoring services.

11. Limited Factoring:

The factor restricts his services to only selected customers of clients. The factor does not provide factoring services to all credit customers of the client.

12. Buyer Based Factoring:

The factor provides the list of customers and he will accept credit sales made only to such customers. The factor bears the risk of only selected credit customers. **13. Seller Based Factoring:**

The factor is very selective in offering services to the sellers. The services are not provided to all sellers.

14. Full Factoring:

The factor provides full-range of factoring services. The service lines include all functions discussed above.

7. ADVANTAGES AND DISADVANTAGES

ADVANTAGES:

Factoring has become boon to most of the industrial organizations. Its advantages follows-

1) Ready Cash: The advance factors make available the funds on entering into agreement. It is as good as cash sales. It is more helpful to new businesses.

2) Increased Volume: The client can concentrate on production and sales activities. This helps to increase sales and profitability with fewer risks of bad-debts.

3) Professional Credit Collection: Factor is a professional agency or institution. As factor is a professionally organized setup, with no worries, credit collection can be handed over to him.

5) A Part of Sales Management: The 'factor' is becoming a part of sales management. The management of sales ledger activities such as maintaining accounts, analysis of outstanding, customer relationship etc. is entrusted to the factor.

6) Advisory Services: Factoring is a value added service. It provides variety of consultancy services. Client is much benefited by these services.

7) Health Economy: Business firms get returns in time as the production, marketing, collection activities are concentrated. Economy gets best products and service. The corporate growth supports the economic progress. In total, factoring helps to grow economy in healthy way.

8) No Volume Restrictions: In most of the cases, the factors accept any amount to credit for collection. Factoring may be used as one-time measure by the organization. There is no obligation to employ factors continuously.

DISADVANTAGES:

The Factoring suffers from some of problems. They are as follows-

1) Cost of Factoring: In relation to other sources of finance, the cost of factoring services is more.

2) Shortage of Funds: The factors of India are suffering from the shortage of funds. So, they are not in a position to finance all the businessmen.

3) Poor Credit Rating: The credit rating is very poor. This makes factors tasks difficult. Sometimes, they hesitate to accept credit collection of some sellers or some customers' accounts.

4) Loss of Customer Relations: The seller may lose the personal relations with customers. The factoring agency enters in between the seller and customer.

5) Lack of Credit Information: Due to the lack of information about customers, the factors fail to assess the extent of credit risks. They may not accept all accounts of all customers.

6) Stamp Duty: The factoring involves assignment of debt. This invites stamp duty. This increases the cost of factoring.

7) Not Suitable: The factoring is not suitable for firms which sell to large number of customers smaller amount of credit sales.

8) No Credit Insurance: Factoring also involves heavy loss due to non-collection from credit customers. But, the protection is not available. This is hampering growth of factoring.

9) Lack of Evaluation Techniques: There is no standard method to evaluate factoring services. Therefore, selection of factors is difficult for businessmen.

3. SIMPLE PROBLEMS

(A) For 5 marks

Problem- 1: May 2019. Following is the information of Reliance Ltd.

a) Annual Sales – Rs. 30,00,000 of which 80% is on credit.

b) Average collection period – 30 days

c) Factor's fee is 2% plus a commission – 4% on total amount of debt plus 1% del-credere commission.

d) A factor is advancing 90% of credit sales.

e) Management costs saved due to factoring is Rs. 12,000 p.a.

f) Bad debts are at 2% on credit sales.

g) Assume 360 days in a year.

Calculate the cost of factoring without Recourse.

SOLUTION:

Working Notes:

i) Annual credit sales = 80% of 30 lakhs = 24 lakhs

ii) Average credit sales = $\frac{30}{360}$ x 24,00,000 = 2,00,000

iii) Factor's fee 2% on 2,00,000 = 4,000

iv) Factor's commission 4% on 2,00,000 = 8,000

v) Del credere commission 1% on 2,00,000 = 2,000

vi) Average Mgt. cost = $\frac{30 \times 12{,}000}{360}$ = 1,000

vii) Bad debts 2% on 2,00,000 = 4,000

- **Costs of Factoring Without Recourse:**

i) Fee		4,000	
ii) Commission		8,000	
iii) Del credere commission		2,000	14,000
Less: Savings	(i) Mgt. Costs	1,000	
	(ii) Bad debts	4,000	5,000
	Net Costs		9,000

Problem-2: April/May 2014 and 2018

Calculate the factoring cost and advances to be paid by the factor to his clients if factoring without recourse from the following:

i) Annual sales Rs. 20,00,000 of which 80% is on credit.

ii) Average collection period 90 days.

iii) Factoring commission-3% on receivables.

iv) Interest on advances-18% p.a. after holding 10% reserve.

v) Management cost of receivables Rs. 24,000 p.a.

vi) Bad debts are 3% on credit sales.

SOLUTION: Working Notes

i) Average credit sales : 16,00,000 x90/360 = 4,00,000

ii) Factor's commission : 4,00,000 x3/100 = 12,000

iii) Reserve amount with Factor : 10% of 4,00,000 = 40,000

iv) Bad debts = $\frac{3 \times 4{,}00{,}000}{100}$ = 12,000

v) Management cost = $\frac{24{,}000 \times 90}{360}$ = 6,000

vi) Net advance to Client : Average sales – (Commission + Reserve)

= 4,00,000 – (12,000+40,000)

= 3,48,000

vii) Interest on advance = $\frac{3{,}48{,}000 \times 18 \times 90}{100 \times 360}$ = 15,660

a) Factoring Cost : Commission + Interest on Advance

= 12,000+ 15,660 = Rs. 27,660

b) Advance Payable by Factor: Rs. 3,48,000.

Problem-3: Jain Co. Ltd. gives the following information seeking suggestion about factor's services:

a) Annual credit sales were Rs. 48,00,000
b) Average collection period is 60 days
c) Factor's commission is 4% on credit sales
d) Bad debts are to the extent of 2% on credit sales
e) Annual management costs are Rs. 48,000
f) Factors charge additional 2% on credit sales in case of without recourse terms
g) Assume 360 days in a year.

Calculate Net Factoring Costs (A) If factoring is with recourse and (B) If factoring is without recourse

SOLUTION:

Working Notes:

i) Average credit sales = $\frac{48,00,000 \times 60}{360} = 8,00,000$

ii) Factor's commission= $\frac{4 \times 8,00,000}{100} = 32,000$

iii) Bad debts = $\frac{2 \times 8,00,000}{100} = 16,000$

iv) Average Mgt. Costs = $\frac{48,000 \times 60}{360} = 8,000$

v) Additional charges = $\frac{2 \times 8,00,000}{100} = 16,000$

(A) Factor's costs if with Recourse:

1.	Costs: Commission	32,000
2.	Less: Savings – Mgt. costs	8,000
	Net Factor's cost	24,000

(B) Factor's costs if without Recourse:

1.	Costs : Commission	32,000	
	Addl. Charges	16,000	48,000
2.	Less: Savings:		
	Mgt. costs	8,000	
	Bad debts	16,000	24,000
	Net Factor's cost		24,000

Conclusion: Factoring under both the types of factors is same. The client may appoint either of the factors.

(B) For 15 marks Problem-4: April/May 2016

M/s. Ajay Trading Co. sells its products on credit basis also. During the year 2014-15 its total credit sales amounted to Rs.64,00,000. Their average collection period is 3 months and the experience shows that 4% of the credit sales results into bad debts.

They enter into a contract with Sharad Factors who charge 2% commission on the net advance made to M/s. Ajay Trading Co. The advance is to the extent of 90% of the credit sales and carries 15% interest per year.

The estimated cost of collecting credit amount per year is about Rs.1,60,000. M/s. Ajay Trading Co. wants to make the cost- benefit analysis of factoring.

SOLUTION: Working Notes:

- Average credit sales : 64,00,000 x 3/12 = 16,00,000
- Factor's commission : 16,00,000 x 2/100 = 32,000
- Reserve amount with Factor : 10% of 16,00,000 = 1,60,000

- Net advance to Client : Average sales – (Commission + Reserve)
  = 16,00,000 – (32,000+1,60,000)
  = 14,08,000
- Interest on advance = $\frac{14,08,000 \times 15 \times 3}{100 \times 12}$ = 52,800
- Bad debts = $\frac{4 \times 16,00,000}{100}$ = 64,000
- Management cost = $\frac{1,60,000 \times 3}{100}$ = 40,000

(A) Cost with Factoring (Recourse) :

Costs: Commission	= 32,000	
Interest	= 52,800	84,800
Less: Savings: Credit Mgt. Cost		40,000
Net factoring cost		**44,800**

(Since it is recourse factoring, bad debts are borne by the client himself.)

(B) Cost without Factoring:

Credit mgt. cost	= 40,000	
Interest	= 52,800	
Bad debts	= 64,000	1,56,800
Less: Savings		
Commission		32,000
Net cost without Factor		1,**24,800**

(C) DECISION: It is clear that the cost of managing debtors without Factor's services is more (i.e. Rs. 1,24,800) while the cost with the services of factor is lesser (Rs. 44,800). Therefore, it is better to take the services of Factor for collection of debtors. If Factor is without Recourse, the risk of bad debts stands shifted to Factor but they may charge additional commission for the same.

FORFEITING OR FORFAITING

Forfaiting as a financial service is used as an exporter's financial tool. An immediate finance after exporting the goods is provided to the exporter. This service is provided by an agency called Forfeiter. (Forfaiter and forfeitor are one and same).

A) MEANING AND DEFINITION:

The French word 'forfait' is the origin term which means 'surrender of rights' or 'to give something'. The exporter has to give up his rights over receivables to an agency. The agency collects the payment from receivables. Such an agency is called 'Forfaiter'. But, after receiving the rights over receivables, it pays immediate cash to exporter.

The term forfeiting has been defined as follows by experts and authorities.

Dictionary of FINANCE:

"Forfaiting is a form of debt discounting for exporters in which a forfeiter accepts at a discount and without recourse a promissory note, bills of exchange, letter of credit etc. received from a foreign buyer by an exporter. Maturities are normally from one to three years. Thus, the exporter receives payments without risk at the cost of the discount."

It is the non-recourse purchase by a bank or any other financial institution, of the receivables of exporter arising from export transaction.

FEATURES

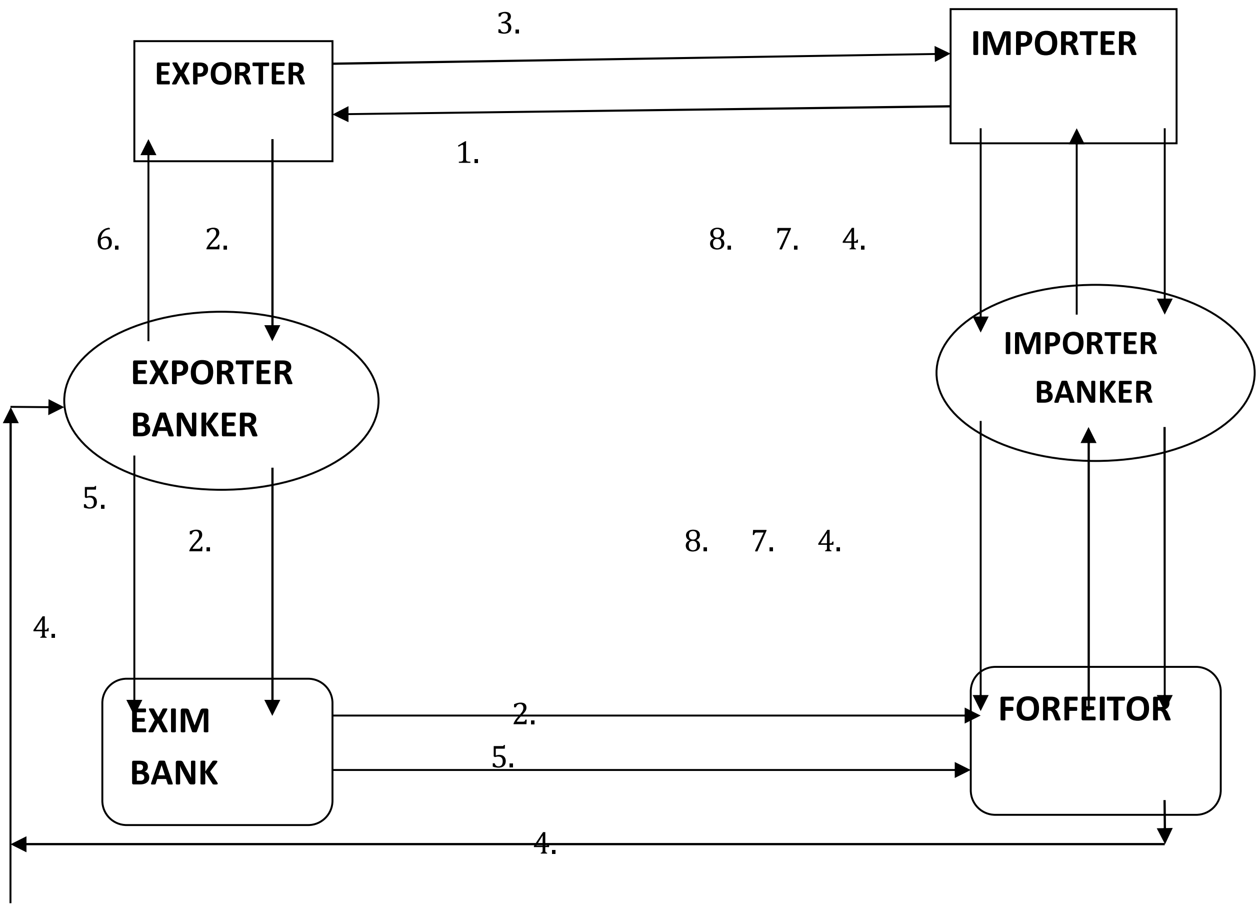
From, the above definitions, the features of forfeiting can be listed as follows-

1. A contract between the exporter and forfeiter.
2. Exporter surrenders rights over receivables of importer to forfeiter.
3. Forfeiter assumes the credit risk and provides 100% cash immediately (less discount)
4. Forfeiter collects the bills, value from the importer as and when due.
5. It is always done without recourse to exporter.
6. It covers medium to long term maturities.

B) FORFAITING V/s FACTORING:

Basis	FACTORING	FORFEITING
1. Meaning	It is service towards collection either with or without assuming all risks.	It is non-recourse purchase of export bills by a forfeiter in export trade.
2. Area	Relates mostly to domestic trade.	Relates only to international trade.
3. Scope	Variety of services is given in addition to collection of debts.	Main activity is advance financing and assuming risks.
4.No. of parties	Involves three parties.	Involves six parties viz. Ex. Imp. Both bankers, EXIM, Forfeiter.
5. Advance	About 80% to 85%	Pays 100% in advance after deducting charges.
6. Recourse	It may be either with or without Recourse	It is always without Recourse.
7. Refinance	No facility of refinance.	Forfeiter can rediscount export bills
8. Term	It is short term finance measure	It is short term to medium term
9. Activities	It is simple to arrange factoring	It involves lot of procedure relating to foreign trade.

(C) PROCESS OF FORFAITING:



1) Commercial contract between the foreign buyers and the Indian exporter.
2) Exporter gets commitment to forfeit bill of exchange from forfeiter through his banker and EXIM Bank.
3) Delivery of goods by the Indian Exporter to the foreign buyer.
4) Importer's Banker collects debt instrument from importer and gives it to Exporter's Bank.
5) Exporter's Bank endorses debt instruments without recourse in favour of the forfeiter through EXIM Bank.
6) Exporter's bank pays amount of discounted bill to exporter.
7) Forfeiter submits bill for payment on maturity to importer's bank and banker submits/presents for payment.
8) Importer's banker collects & pays it to forfeiter.

(D) ADVANTAGES OF FORFAITING:

The forfeiting as a financial service brings the following benefits to the concerned parties, especially to exporter or client.

1) An advance finance of 100% export value to exporter.
2) The risk of debt collection is borne by the forfeiter.
3) The Balance- Sheet of exporter becomes light.
4) The current ratio and liquidity position improve.
5) Exporter can concentrate on export business as his time is saved.
6) The cost of debt collection is saved.

7) The exchange rate risk is shifted as the payment is received in advance.
8) It provides medium and long term financial facilities.
9) It creates employment opportunities.
10) The documentation procedure is simple.
11) The advance amount can be applied to some other productive activities.

DISADVANTAGES OR DIFFICULTIES:

1) More number of legal procedure and formalities are involved.
2) Lack of reliable data about the importer's credit worthiness.
3) High discount rates.
4) Credit risk is shifted but political risk is heavy.
5) Fixed forfeiting rates are not available.

UNIT – 4: MODERN SERVICES

1. **DEMATERIALIZATION**
   a. Meaning
   b. Features
   c. Process
   d. Objectives
   e. Functions
   f. Merits and Demerits
2. **Re-materialization**
   a. Meaning
   b. Process

1. DEMATERIALIZATION

a) Meaning and Definition:

The economic liberalization policy has brought number of changes in financial market. At the same time there were investor complaints. The complaints were about the irregularities in physical handling of securities. Therefore, in order to overcome the defects and difficulties of physical trading system, an alternative modern method was introduced called "dematerialization". In this, there is no material for the securities issued by the companies.

The term dematerialization means, moving away from material form of securities. It is a situation in which physical certificates of the investor are taken by the company and destroyed. In demat, no physical materials exist.

Desai Vasant-

" Dematerialization is a process by which the physical certificates of an investor are taken back by the company/registrar and actually destroyed and an equivalent number of securities are credited in the electronic holdings of that investor".

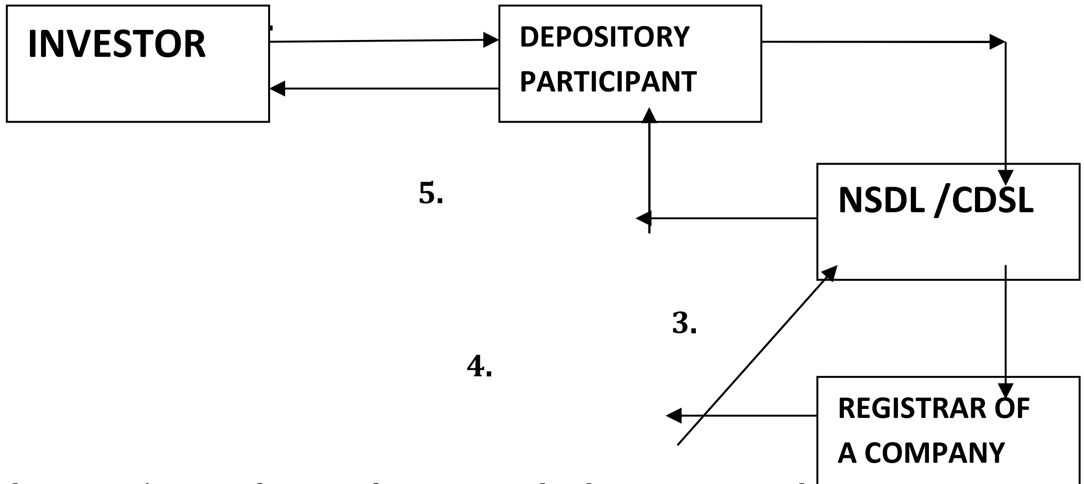
b) Features

1. No Physical certificates.
2. Shares/securities allotted in electronic form,
3. An account is to be opened with a depository.
4. The dematerialized shares become fungible losing their individual folio numbers, serial numbers, etc.
5. The shares and debentures are tradable only in dematerialized form/ mode.
6. The initial public offer allotment is made through dematerialization mode.

Steps involved are as follows ---

1. The investor has to request to his depository participant to convert his shares into demat mode with DRF (Demat Request Form). For this, the application and original shares certificates are to be handed over with all details.
2. The Depository Participant forwards the application to NSDL/CDSL, after verification of application. (NSDL-National Securities Depository Limited and CDSL- Central Depository Services Limited)

c) Process



3. The NSDL/CDSL after verification sends the same records for the confirmation of Company Registrar.

4. The Company Registrar verifies with the records in company. He keeps the original certificates and makes necessary records in the books of company. And confirmation slip is handed over to NSDL/CDSL.

5. The NSDL/CDSL records the dematerialized shares in its accounts. It updates all the records and returns the same to Depository Participant.

6. The 'Depository Participant prepares a computerized 'Statement of Account Holding' and returns to customer.

d) Objectives

There are several reasons to convert the physical shares into electronic mode. The following are the objectives of dematerializations-

1) To Reduce Irregularities: The process of dematerialization aims at reducing the irregularities. The irregularities, delays, fakeness, losses etc. will not repeat.

2) To Speed-up Trading: As the dematerialized shares are credited directly to demand account, the trading can be performed at any speed. Within minutes, investor can buy and sell the securities.

3) To Reduce Cost: No stamp duty on sale and purchase of security. Hence, the reduction in sales increases the volume of transaction.

4) To Facilitate on Screen Trading: The investor can buy and sell on line by referring on-screen prices of shares. This activity needs dematerialized form of shares.

5) To Meet the Legal Requirement: The demat has become an obligation on the part of investor. From 1999, no security is traded in the stock exchanges, in physical mode.

7) To avoid the risk of settlement of securities.

8) To create a system for the central handling of all securities.

9) To promote country's competitiveness by meeting the global standard

e) Functions The dematerialization is actually performed by depositories. The following activities are performed by the depository-

1. Acceptance of Applications: The applications for dematerialization are submitted by investor to depository participant of their locality. The depository participants submit the same with note to the NSDL/CDSL. The depository opens an account in its records subject to the confirmation of Registrar of Company.

2. **Confirmation of Account:** The NSDL/CDSL submits the share certificates to the Registrar of Company. The Registrar after confirmation sends the report to NSDL. He destroys the original share-certificates.

3. **Accounting the Trading:** The investor may buy and sell the securities through online trading. At the closure of the trading hours, the NSDL/CDSL has to finalise the account balance.

4. **Accounting the Charge on Security:** The investor is permitted to create charge on his security. This requires the pledging of securities. This is accounted by depository. Till the pledge contract is over, the securities are maintained under safe custody.

5. **Arranging Re-materialization:** The investor may need securities in physical form. He may submit the application for withdrawal of securities.

6. **Corporate Services:** The depository renders the corporate services. The dividend, bonus, right offers of the company are to be taken to the account of client.

7. **Accounting Information:** The details of accounts are submitted to depository participant. The depository participant provides the summary to the client.

f) Merits:

The following are the advantages to various parties.

(I) Investors: The investor is the primary beneficiary of dematerialization. The advantages are,

1. **Trading in Any Smaller Lots:** The dematerialization system permits the trading of securities without any limits i.e. an investor can sell and buy as small as 1 unit and any maximum number.
2. **Free Transfer:** The trading results into transfer of shares. There is no stamp-duty on such transfer.
3. **Removal of Physical Movement Drawbacks:** The complaints such as postal delay, loss in transit, wrong posting, thefts of cheques, storing, mis- understanding of documents, etc. will not be there in dematerialization.
4. **Financial Facility:** The dematerialization provides easy finance. The demat stocks can be pledged and hypothecated.
5. **Safety Measures:** There is a facility of 'Locking' the accounts. The secret code is provided by the Depository Participant to each investor.
6. **Time Saving:** He need not go to post, courier services, and banks to apply for trading activities. This saves time and cost of operation.
7. **Easy Receipts:** The procedure of receiving sale value is simple.

II) Corporate Sector:

1. **Reduction in Records:** The process of dematerialization reduces the documentation and paper work. The allotment of shares, transfer of shares, dividend, bonus, payment etc. are done without paper work.
2. **Investor Friendly:** The Company will have better relations with investors.
3. **Company Gains Goodwill:** The reputation of company increases. It is matter of credit if all investors are demat holders. It is an added value to the image of company.

III) Economy:

1. Better functioning of stock exchange.
2. The value and volume of trade in Stock Exchange increases.
3. It attracts the small investors towards capital market as they can buy even one share at one time.

4. It creates new employment opportunities.
5. The revenue to the stock-exchanges and Government increases.
6. The improved competitiveness in the international market

Demerits:

1. Technical Failure: The dematerialization totally depends upon the centralized demat records with NSDL and CSDL. If technical problem arises at centralized depository system, then whole system is adversely affected.

2. Wrong Postings: The re-adjustment of accounts involves great difficulties in case of wrong postings.

3. Heavy Charges: The Depository Participant charges high amount and percentage as transaction cost. The custodial charges are heavy.

2. REMATERIALISATION:

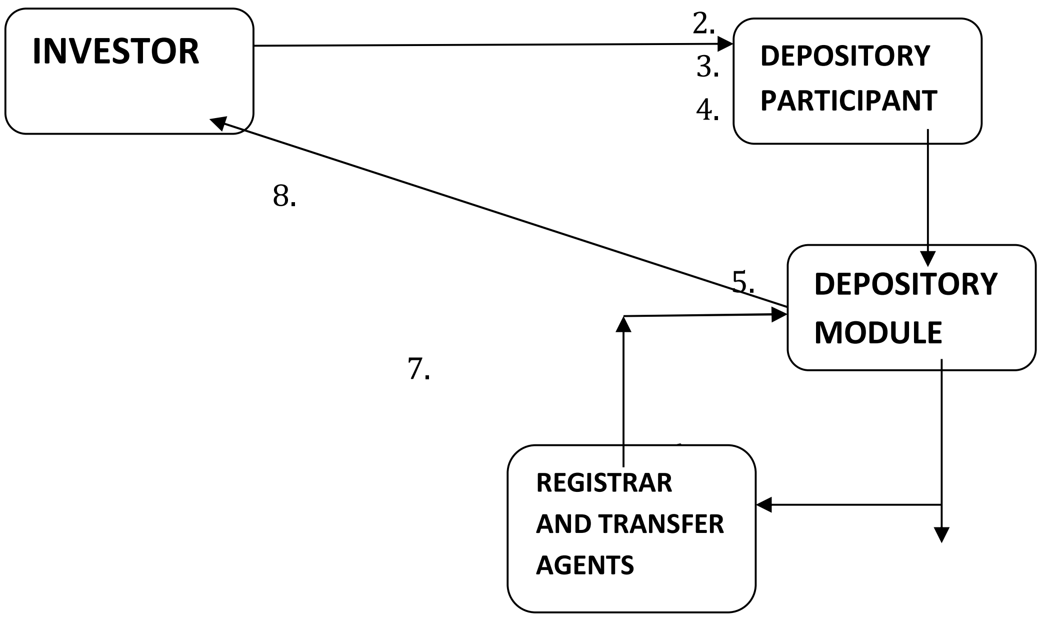
Rematerialisation is just opposite of dematerialization. Here, the shares held in electronic form are converted into physical form. In some cases, the investor may wish to hold the shares in physical form. For this, the process is just opposite to dematerialization.

Features:

1. A client can rematerialize his dematerialized holdings at any point of time.
2. The dematerialization process is completed within 30 days.
3. The securities sent for rematerialisation cannot be traded.

The Process:

1. Investor requests DP for Remat
2. DP verifies request form & acknowledges
3. DP also verifies signature on form with specimen
4. DP enters the request in DPM (Depository Participant Module-software provided by DP) and generates RRN (Remat Requisition No.)
5. Depository sends DPM to DM (electronic process)
6. DM forwards to R&T agent



7. R&T agent arranges for printing of securities and forwards to DM
8. DM will deliver securities to investor.

CREDIT RATING

a) **Introduction**
b) **Meaning and Definitions**
c) **Features**
d) **Objectives**
e) **Institutions**
f) **Benefits**
g) **Process**
h) **Symbols**

a) INTRODUCTION:

Every company goes to primary markets in order to raise capital through public issue of shares. They also raise debt from public in the form of debentures, bonds, long term loans, fixed deposits etc. But, it becomes quite difficult for such companies to convince and prove their standing and asking investors to contribute their savings as capital in unknown organizations. The investors are provided with ample of published information, details, statements etc. The investors are unable to evaluate about the companies on their own either they do not have requisite knowledge or no time to make analysis. Here, the necessity of an independent organization arises which should rate the company in question and make an assessment to speak about the worth of investment and risks involved in it. This is done by the **Credit Rating Institutions.**

b) MEANING AND DEFINITIONS

Standard & Poors (S&P)

"CR helps investors by providing an easily recognizable simple tool that couples a possibly unknown issuer with an informative and meaningful symbol of credit quality"

Rating agency Moody's opine -

"a rating is an opinion on the future ability and legal obligation of the issuer to make timely payment for principal and interest on a specific fixed income security. The rating measures the probability term rating incorporate an assessment of the expected monetary loss should a default occur."

Vasant Desai

"CR is a symbolic indicator of the current opinion of relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated"

V.A. Avadhani

"CR is essentially giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of debt instrument to meet the debt servicing obligation in time and in full"

Therefore, Credit Rating is "a guidance to investors and creditors in determining the risk involved in the debt instruments or credit obligation institutions."

c) FEATURES:

The above definitions bring forth the following features-

1. Rating is compulsory for issue of any debt instrument.
2. It may be extended from debt instruments to equity or other securities.
3. It guides investors in their decisions of portfolio investments.
4. It is valid at a point of time, because it is on current information of company.
5. It may be revised and changed by the rating agency.

6. Rating assigned to an instrument is applicable to that only. It is not general purpose evaluation.
7. An investor has his own freedom either to consider the rating or not.
8. Rating is done on the basis of business analysis, financial analysis, management evaluation and fundamental analysis.
9. Rating is done on request by a desired company. A company has to get rating from at least one agency or more.
10. Rating not only acts as a marketing tool for an instrument but also it enhances a company's reputation.

d) OBJECTIVES:

1. To boost confidence of investors for making their decision about where, how much and why to invest?
2. To serve as an intermediary between the financial system and investors by vanishing the dilemma about risk of investment.
3. To save the precious time of investors by supplying detailed info.
4. To reduce the unnecessary cost of issue of instruments.
5. To help to companies for maintaining a good recognition in corporate sector, and by which investors can take a corrective decisions about lending or investments by referring ratings.
6. To control unethical trade practices, ensure stability and soundness in capital market.
7. Other factors like: Globalised capital market, increased volume of private players, entry of foreign investors and companies rosy picture information rating is required.

e) INSTITUTIONS:

I) World Level:

- In year 1909 John Moody founder of Moody's Services, rated the Bonds issued by US Rail Road Organization. It was the first rating of bonds by an expert agency.
- The second credit rating agency in the world was Standard and Poor (S & P) which was introduced in 1916.
- The third institution to join these two was Fitch Investors Services.
  The above three agencies have received the recognisation from Securities and Exchange Commission (SEC), USA.
- These institutions are very strong and functioning independently and impartially.
- In U.S.A. Moody's ratings have greater value among investors and equated to bombs used by super power to destroy.

II) In India:

The credit rating services appeared for the first in India in 1988 with establishment of CRISIL.
Following are the prominent credit rating institutions in India:

1. CRISIL (1988)- Credit Rating Information Services of India Ltd.
2. IICRA/ ICRA (1991)- Investment Information and Credit Rating Agency
3. CARE (1993)- Credit Analysis and Research Ltd.
4. FRIPL (1996)- Fitch Ratings India Pvt. Ltd.
5. Brickwork Ratings Ltd.

f) BENEFITS:

(I) To Investors:

1. Accurate information- from experts
2. Boosts confidence – being impartial, unbiased
3. Knows risks in investment
4. High returns- good investment
5. Minimizes misguidance
6. Self port-folio management

(II) To company:

1. Increased confidence to enter capital market
2. Good rating helps successful establishment
3. Raising funds with less cost
4. Attraction to investors
5. Invitation to foreign investors- JVs, collaboration etc.
6. Imposes discipline and fair play
7. Obligation to maintain fair records
8. Issuing securities at high premium

(III) To Government (Society)

1. Proper channelization of savings to capital market
2. Easy motivation for capital formation
3. Increased industrial growth
4. Helps restructuring of financial system
5. Reduced burden of control over companies
6. Protection of investors at the cost of company- costs paid by company

(IV) To Rating Agency

1. Honest and impartial rating enhances its reputation
2. Efficient work increases revenues
3. No need of more agencies if quality services are provided.

f) PROCESS

11. SURVEILLANCE
10. ACCEPTANCE
9. COMMUNICATION OF RATING & REASONS
8. FIXING RATING
7. RATE DECISION MEETING
6. PREVIEW MEETING
5. TABULATION, ANALYSIS AND PREPARING
4. MEETING, VISITS & FIELD SURVEYS
3. RECEIVING INFO. & DOING RESEARCH
2. C0NSTITUTION & GIVING WORK TO TEAM
1. MANDATE

Main three stages:

I) 1 and 2 are beginning steps.

II) 3, 4 and 5 are fact finding and analysis steps.

III) 6, 7, 8, 9, 10 and 11 are rating finalization steps.

Methodology for Credit Rating:

g) SYMBOLS

A general rating basis of merit as follows:

i. High Investment Grade
ii. Investment Grade
iii. Speculative Grade
iv. Poor Grade

I. CRISIL

a) Debentures	b) Fixed Deposits	c)Short term Instruments
AAA- Highest Safety	FAAA- Highest Safety	P-1 Very strong as to timely
AA- High Safety	FAA- High Safety	P-2 Strong as to
A- Adequate Safety	FB-Inadequate Safety	P-3 Adequate as to..
BBB-Moderate Safety	FC- High Risk	P-4 Minimal as to..
BB- Inadequate Safety		P-5 Default

II) ICRA

a) Commercial Papers	**b)** Debentures- FCD/PCD/NCD	**c)** CD/ FD
A1- Highest Safety	LAAA- Highest	MAA- Highest
A2- High Safety	LAA- High	MAA- High
A3- Adequate Safety	LA-Adequate	MA- Adequate
A4- Risk Prone	LBBB- Moderate	MB- Inadequate
	LBB-Inadequate	MC- Risk Prone
	LB- Risk Prone	

III) CARE

a) Commercial Papers	b) NCD/PCD	c) Fixed Deposit
PR1- Superior	CARE AAA- Best	CARE AAA (FD)
PR2- Strong	CARE AA- High	CARE AA (FD)
PR3- Adequate	CAREA Adequate	CARE A (FD)
PR4- Risk Prone	CARE BBB- Mode	CARE BBB (FD)
	CARE BB- Inadequate	CARE BB (FD)
	CARE C- High Risk	CARE C (FD)

* * * * *

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