Unit III

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HIRE PURCHASE

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of last installment.

FEATURES OF HIRE PURCHASE AGREEMENT

1.Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.

2. Each installment is treated as hire charges.

3. The ownership of the goods passes from the seller to the buyer on the payment of the installment.

4. In case the buyer makes any default in the payment of any installment the seller has right to reposses the goods from the buyer and forfeit the amount already received treating it as hire charge.

5. The hirer has the right to terminate the agreement any time before the property passes. The is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charge on the goods in question.

LEGAL POSITION

The Hire. Purchase Act, 1972 defines a hire purchase agreement as, ‘an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement under which:

1. Payment is to be made in instalments over a specified period.
2. The possession is delivered to the purchaser at the time of entering into a contract.
3. The property in the goods passes to the purchaser on payment of the last instalment.

4. Each instalment is treated as hire charge so that if default is made in payment of any one instalment, the seller is entitled to take away the goods.
5. The hirer/purchaser is free to return the goods without being required to pay any further instalments falling due after the return.

Hire Purchase Agreement

There is no prescribed form for a hire purchase agreement, but it has to be in writing and signed by both parties to the agreement.

A hire purchase agreement must contain the following particulars:

(i) The description of goods in a manner sufficient to identify them.

(ii) The hire purchase price of the goods.

(iii) The date of commencement of the agreement.

(iv) The number of instalments in which hire purchase price is to be paid, the amount, and due date.

HIRE PURCHASE AND CREDIT SALE

Higher purchase transaction is different from credit sale.In case of actual sale, the title in the property i.e., ownership and possession is transferred to the purchase simultaneously. in hire purchase, the ownership remains with the seller until last instalment is paid.

HIRE PURCHASE AND INSTALMENT SALE

Hire purchase transaction is different from instalment system. In case of instalment system it is not only the possession but also the ownership of goods which is transferred to the buyer immediately at the time of agreement. Further, when the buyer stops payment of dues, the seller has no right to right to reposses the goods. He has the only right to sue the buyer for the non payment by returning the goods but has the right of disposing of the goods in any manner as he likes. Any loss of goods should be borne only by the buyer as risk lies with the ownership.

HIRE PURCHASE AND LEASING

Hire purchase is also different from leasing.

1. **Ownership -** In a contract of lease, the ownership rests with the lessor throughout and the lease (hirer) has no option purchase the goods.

2. **Method of Financing** - Leasing is a method of financing business assets whereas hire purchase is a method of financing both business assets and consumer articles.

3. **Depreciation** - In leasing, depreciation and investment allowance can not be claimed by

the lessee, In hire purchase, deprecation and investment allowance can be claimed by the hirer.

4. **Tax Benefits** - The entire lease rental is tax deductible expense. Only the interest component of the hire purchase installment is tax deductible.

5. **Salvage Value -** The lessee, not being the owner of the asset, does not enjoy the salvage value of the asset. The hirer, in purchase, being the owner of the asset, enjoys salvage value of the asset.

6. **Deposit** - Lessee is not required to make any deposit whereas 20% deposit is required in here purchase.

7. **Rent-Purchase -** With lease, we rent and with hire purchase we buy the goods.

8.**Extent of Finance** - Lease financing is invariably 100 per cent financing: It requires no immediate down payment or margin money by the lessee. In hire purchase, a margin equal to 20-25 per cent of the cost of the asset is to be paid by the hirer.

9. **Maintenance** - The cost of maintenance of the hired asset is to be borne by the hirer himself. In case of finance lease only, the maintenance of leased asset is the responsibility of the lessee.

10. **Reporting** - The asset on hire purchase is shown in the balance sheet of the hirer. The leased assets are shown by way of foot note only.

BANK CREDIT FOR HIRE-PURCHASE BUSINESS

The subsidiary of commercial banks lend to the dealer or to finance intermediary who has already financed articles sold by the dealer to the hirer under a hire-purchase contract. While considering proposals from dealers or hire-purchase financing companies, the bank subsidiary has to take extra precautions, looking to the particular nature of transaction under hire-purchase contract.

When offered this type of business, the bank subsidiary would make an assessment of the standing and financial position of the dealer or of the hire-purchase company , and take into consideration the principles of good lending and carry out the procedure below:

1. **Customer** - When approached for hire purchase facility the subsidiary should take care to make the assessment of the standing and financial position of the business customer.

2. **Purpose** - The type of goods being used to finance in the hire-purchase transaction is of great importance. In the event of default the bank may reconsider repossessing the goods and selling them to clear the advance. Thus, if the goods can be readily sold elsewhere (e.g. a

relatively new car) , them these agreements are better security than those for (say) cameras which will have a lower resale value.

3. **Amount** - Bank subsidiaries taking up hire-purchase business would do well to discourage small individual loans. In order to ensure proper servicing and monitoring, it is also essential to a have floor limit in the amount of individual hire-purchase transactions. While it may be about Rs. 50,000 for automobile sector, it may be about Rs. 10,000 for consumer durables.

4. **Period** - The facility will normally be extended over to three years.

5. **Repayment** - Repayment are spread evenly, or agreed, over the loan period. The repayment should be adaptable to the hirer's needs. The repayment can usually be tailor made to suit the income generated from the use of asset so that it is self-financing. Sometimes, repayment holidays can be allowed and repayment is delayed until the asset is operational or producing profit. To ensure timely recovery in the case of car two-wheeler, and consumer durable financing, it would be preferable to have institutional tie-ups with employers/employees' cooperative societies for which eligibility criteria can be laid down.

6. **Security**- Technically hire purchase advance is against hypothecation of equipment/vehicles and pledge of hundis/pronotes and lodgements of hirepurchase agreements. The bank subsidiary will ask the borrower to complete the bank's form of security to charge the security. under an equitable/hypothecation charge. If the borrower is a limited company which is not of sufficient strength to allow equitable/hypothecation facility and if suitable security is not of sufficient strength to allow equitable/ hypothecation facility and if suitable security is not available it is normal to obtain a debenture over the assets of the company under which a floating charge is obtained.If necessary the bank subsidiary will ask the hirer to furnish a guarantor of means and the bank would in such a case insist that the guarantor of means and the bank would in such a case insist that the guarantor should also accept the hundies. It is a practice with some banks to insist for insurance policy to indemnify the bank against the default of the hirer. The premiums will be charged to the hirer.In view of the cost and difficulty of the repossession of a fast depreciating asset, the customer's ability to repay is vital and no reliance is placed on security.

7. **Monitoring and Control** - The bank needs to exercise control over the on-going situation. A periodical certificate should be obtained from the finance company at the monthly intervals, stating the total amount of outstanding but excluding those hire-purchase agreements which have become in arrears and are, therefore, suspects. One or two months in arrears may be acceptable but more than that suggest that the particular hirer is in permanent

default. The bank will keep running total of these amounts, returning agreements which have become lapsed to their customers.

LEASING

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

A Lease is Defined as "'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent."

James C. Van Horne 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'

Thus in a contract of lease there are two parties involved (i) lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

Leasing as a Source of Finance

Leasing is an important source of finance for the lessee. Leasing companies finance for :

1. Modernisation of business.
2. Balancing equipment.
3. Cars, scooters and other vehicles and durables.
4. Items entitled to 100% or 50% depreciation.
5. Assets which are not being financed by banks/institutions.

STEPS INVOLVED IN LEASING TRANSACTION

The steps involved in a leasing transaction are summarised as follows:

1. First, the lessee has to decide the asset required and select the supplier. He has to decide

about the design specifications, the price, warranties, terms of delivery, servicing etc.
2. The lessee, then enters into a lease agreement with the lessor. The lease agreement contains the terms and conditions of the lease such as,

(a) The basic lease period during which the lease is irrecoverable.
(b) The timing and amount of periodical rental payments during the lease period.
(c) Details of any option to renew the lease or to purchase the asset at the end of the period.
(d) Details regarding payment of cost of maintenance and repairs, taxes, insurance and other expenses.

3. After the lease agreement is signed the lessor contacts the manufacturer and requests him to supply the asset to the lessee. The lessor makes payment to the manufacturer after the asset has been delivered and accepted by the lessee.

CONTENTS OF A LEASE AGREEMENT

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following:

1. Description of the lessor, the lessee, and the equipment.
2. Amount, time, and place of lease rental payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased equipment.
5. Lessee's responsibility for maintenance, repairs, registration, etc.and the lessor's right in case of default by the lessee.
6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.
7. Insurance to be taken by the lessee on behalf of the lessor.
8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.
9. Option of lease renewal for the lessee.
10. Return of equipment on expiry of the lease period.
11. Arbitration procedure in the event of dispute.

TYPES OF LEASE

The lease agreement can be classified broadly into four categories:

1.Financial Lease - A financial lease is also known as Capital lease, Long term lease, Net lease and Close lease. In a financial lease, the lessee selects the equipments , settles the price and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable

and non-cancellable contractual agreement with the leasing company. The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it. He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period. The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain a non - cancellable clause which means that the lessor transfers the title to the lessee at the end of the lease period.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available. The leasing company also charges nominal service charges to cover legal and other costs. The leasing company may also insist on collaterals or bank's guarantee in individual cases. In a large number of cases, the financial leases are used as financing cum tax planning tool. The high cost of equipments such as office equipment, diesel generators, machine tools, textile machinery, containers, locomotives etc., are leased under financial lease.

2. OPERATING LEASE - An operating lease is also known as Service lease, Short term lease or True lease. In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment. This means that the lease is for a limited period, may be a month, six months, a year or few years. The lease is terminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. The risk of obsolescence is enforced on the lessor who will also bear the cost of maintenance and other relevant expenditure. The lessor also does the services like handling warranty claims, paying taxes, scheduling and performing maintenance and keeping complete records lease is suitable for, (i) Computers, copy machines and other office equipments, vehicles, material handling equipments etc. Which are sensitive to obsolescence and (ii) Where the lessee is interested in tiding over temporary problem.

Distinction between a Financial Lease and Operating Lease :

Financial Lease

1. A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment.

2. It excludes provisions for maintenance or taxes which are paid separately by the lessee.

3. The risk of obsolescence is assumed by the lessee.

4, Contract period ranges from medium to long term.
5. Contracts are usually non-cancellable.
6. Air crafts, land and building -heavy machinery are leased.
7. The lease involves a financial commitment similar to a loan by a leasing company. It places the lessee in a position of borrow.
8. The lessor fulfills financial function.

Operating Lease

1.An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period.
2. Operating lease provides for maintenance expenses and taxes of the lessor.
3.Leasing company assumes risk of obsolescence.
4.Contract period ranges from intermediate to short term.
5.Contracts are usually cancellable either by the lessor or by the lessee.
6.Computers, office equipments, automobiles, truck etc. are leased.
7. The financial commitment is restricted to regular rental payment. The rentals find a place in the P & L A/c. of the lessee.
8.The lessor fulfills service function.

3. Leverage Lease - A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from Rs.50 lakhs to Rs.2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties, the lessee, the lessor and the lender. The lessor acquires the assets as per the terms of the lease agreement but finances only a part of the total investment, say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc. are acquired. Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment. By investing 20% or 25% of the cost of an asset, the lessor is entitled to 100% allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

4. Sale And Lease Back- Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The

firm receives the sale price in cash and gets the right to use the asset during the lease period. The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on a net net basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase the property at the termination of lease. . The sale and lease back agreement is beneficial to both lessor and lessee. The lessee gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

5. Cross Border Lease - Cross border lease is international leasing and is known as transnational leasing. It relates to a lease transaction between a lessor and lessee domiciled in different countries and includes exports leasing. In other words the lessor may be of one country and the lessee may be of another country. To illustrate, if a leasing company in USA makes a available an Air bus on lease to Air India, there would be a cross border lease.Indian leasing industry is unlikely to deal in export border leases for big ticket items such as aircraft but it is well placed to contribute to India's export earnings by offering the lease option. First Leasing Company has jnitiated discussions with Bulgar Leasing of Bulgaria to export bull dozers and shovels in significant number of an export lease to that country.

INSTALMENT BUYING, HIRE PURCHASE AND LEASING

In instalment buying, the property passes on the buyer immediately as soon as the first instalment is made. the balance amount is payable in instalments. Under the contract of instalment the buyer has no right to return the goods. In case of default, the seller has the right to file a suit in the court of law to recover his dues.

Hire purchase is an agreement under which the owner delivers the goods to the buyer who agrees to make periodical payment as hire charges. The possession of goods vests with the hirer but the ownership remains with the seller. On full payment of hire charges, the buyer gets the option of purchasing the goods. On default, the seller can reclaim the goods, subject to certain provisions of Hire Purchase Act.

Hire purchase resembles leasing in certain ways. In both the cases the right to use the equipment is transferred to the hirer/lessee.

In leasing, the entire lease rentals represents a hire charge and it is treated as expense and hence tax deductible. Under hire purchase, a part of instalment represents capital payment and hence it is not an expense. A part of the instalment is interest on the loan which is considered as revenue expenditure and hence it is tax deductible. In leasing, rental charges

are debited to profit and loss account and the leased asset is not shown in the balance sheet of the leasee. As against this, the hire purchaser capitalises the asset brought under hire purchaser capitalises the asset brought under hire purchase contract. The liability for future hire purchase instalments not yet due is shown separately in the balance sheet.

Advantages of Lease

The following are the advantages of leasing :

1. **Permit Alternative Use of Funds** : A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.
2. **Faster and Cheaper Credit**: Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going through formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.
3. **Flexibility** : Leasing arrangements may be tailored to the lessee's needs more easily that ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to be low.
4. **Facilitates Additional Borrowings** : Leasing may increase long term ability to acquire funds. The lessee can utilise more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arises .
5. **Protection against obsolescence** : A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.
6. **No Restrictive Covenants** : The restrictive covenants such as debt equity ratio, declaration of dividend etc., which are usually imposed under debenture or loan agreement are absolutely absent in a lease agreement.
7. **Hundred Percent Financing**: Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So hundred percent financing is assured to the lessee.
8. **Boon to Small Firm** : The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial

institutions.

Disadvantages of Leasing

1. Lease is not suitable mode of project finance. This is because rentals are repayable soon after entering into lease agreement while in new projects cash generations may start only after a long gestation period.
2. Certain tax benefits/incentives such as subsidy may not be available on leased equipment.
3. The value of real assets such as land and building may increase during lease period. In such a case the lessee loses the advantage of a potential capital gain.
4. The cost of financing is generally higher than that of debt financing.
5. A manufacturer who wants to discontinue a particular line of business will not in a position to terminate the contract except by paying heavy penalties. If it is a owned asset the manufacturer can sell the equipment at his will.6. If the lessee is not able to pay rentals regularly, the lessor would suffer a loss particularly when the asset is a sophisticated one and lone liquid.
7. In case of lease agreement, it is lessor who has purchased the asset from the supplier and not the lessee. Hence, the lessee by himself ta not entitled to any protection in case the supplier commits breach of warranties in respect of the leased assets.
8. In the absence of exclusive laws dealing with the lease transaction, several problems crop up between lessor and lessee resulting in unnecessary complications and avoidable tension.

SECURITISATION

Securitisation of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions like banks by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares. Thus, it is nothing but a process of removing long term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long term assets, creates securities against them, gets them rated and sells them to investors. It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into

assets and assets into securities and so on. Securitisation helps to recycle funds at a reasonable cost and with less credit risk. It helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments. Again from another angle also, securitisation is a boon to financial institutions. From the risk management point of view, the lending financial institutions have to absorb the entire credit risk by holding the credit outstandings in their own portfolio. Securitisation offers a good scope for risk diversification. It is worthwhile to note that the entire transaction relating to securitisation is carried out on the asset side of the Balance Sheet. That is one asset (illiquid) is converted into another asset (cash).

Definition

Securitisation helps to liquify assets mainly of medium and long term loans and receivables of financial institutions.

The concept of securitisation can be defined as follows: "A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities".

"Securitisation is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

Structured Securities Vs Conventional Securities

Securitisation is basically a structured financial transaction. It envisages the issue of securities against illiquid assets and such securities are really structured securities. It is so because, they are backed by the value of the underlying financial asset and the credit support of a third party also. At this stage, one should not confuse such structured securities with conventional securities like bonds, debentures etc. They differ from each other in the following respects.

(1) **Source of repayment**: In the case of conventional securities, the primary source of repayment is the earning power and cash flow of the issuing company. But, under securitisation, the issuing company is completely free from this botheration since the burden of repayment is shifted to a pool of assets or to a third party.

(2) **Structure**: Under securitisation, the securities may be structured in such a way so as to achieve a desired level of risk and a desired level of rating depending upon the type and amount of assets pooled. Such a choice is not available in the case of conventional securities.

(3) **Nature**: In fact, these structured securities are basically derivatives of the traditional debt instruments. Ofcourse, the credit standing of these securities is well supported by a pool of assets or by a guarantee or by both.

Securitisation Vs Factoring At this stage, one should not confuse the term 'securitisation' with that of 'factoring'. Since both deal with the assets viz., book debts and receivables, it is very essential that the differences between them must be clearly understood. The main differences are:

(i)Factoring is mainly associated with the assets (book debts and receivables) of manufacturing and trading companies whereas securitisation is mainly associated with the assets of financial companies.

(ii) Factoring mainly deals with trade debts and trade receivables of clients. On the other hand, securitisation deals with loans and receivables arising out of loans like Hire purchase finance receivables, receivables from Government departments etc.

(iii) In the case of factoring, the trade debts and receivables in questions are short term in nature whereas they are medium term or long term in nature in the case of securitisation.

(iv) The question of issuing securities against book debts does not arise at all in the case of factoring whereas it forms the very basis of securitisation.

(v) The factor himself takes up the 'collection work' whereas it can be done either by the originator or by a separate servicing agency under securitisation.

(vi) Under factoring, the entire credit risk is passed on to the factor. But under securitisation, a part of the credit risk can be absorbed by the originator by transferring the assets at a discount.

MODUS OPERANDI

For the operational mechanics of securitisation, the following parties are required:

(i) The originator

(ii) A Special Purpose Vehicle (SPV) or a trust

(iii) A merchant or investment banker

(iv) A credit rating agency

(v) A servicing agent-Receiving and Paying agent (RPA)

(vi) The original borrowers or obligors

(vii) The prospective investors ie., the buyers of securities

The various stages involved in the working of securitisation are as follows:

(1) Identification stage/process

(2) Transfer stage/process

(3) Issue stage/process

(4) Redemption stage/process

(5) Credit Rating stage/process

1.Identification Process - The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called 'identification process'.

2. 'Transfer Process - After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale ie., full transfer of assets in question for valuable consideration or by passing them for a collateralised loan. Generally, it is done on an outright sale basis. This process of passing through the selected pool of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

3. Issue Process - After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different names like 'Pay through Certificates', 'Pass through Certificates'. Interest only Certificates, Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronise with the maturities of the securitised loans or receivables.

4. Redemption Process - The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator or a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer. Thus, under

securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either 'with recourse' to the originator or 'without recourse'. The usual practice is to make it 'without recourse'. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment of interest and principal to the investors.

5. Credit Rating Process - Since the pass through certificates have to be publicly issued, they require credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least by one credit rating agency on the eve of the securitisation. The issues could also be guaranteed by external guarantor institutions like merchant bankers which would enhance the credit worthiness of the certificates and would be readily acceptable to investors. This rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interest by the SPV.

Role of Merchant Bankers - Merchant or investment bankers can play a big role in asset securitisation. They generally act as Special Purpose Vehicle. There are many issues involved in securitisation namely the timing of the issue of pass through certificates, pricing of these certificates for marketing and above all underwriting of these issues. In private placement, they act as agents for the issuer connecting the sellers and buyers. They can also involve in structuring the issue to see that the issue meets all legal, regulatory, accounting, tax and other requirements. In all these aspects, merchant bankers have a definite role to play. The mere fact that an issue has been underwirtten by a popular merchant banker will add credit to that issue and it would become more attractive from the investor's point of view. Thus, securitisation enlarges the activities of the merchant bankers too.

Role of Other Parties - The other parties in the game of securitisation are the original borrowers and the prospective investors. The original borrowers referto those who have availed of the loan facilities from the lending institution i.e., the originator. They are also called obligors. Infact the success of the securitisation process depends upon these original borrowers. If they fail to meet their commitments on the due dates, the securitisation process will be at danger. Infact the receipts of cash flows from the original borrowers are passed through to the investors. The prospective investors are nothing but the public at large who are willing to purchase the pass through certificates.

Securitisable assets

The following assets aro generally securitlsed by financial institutions

(i)Term loans to financially reputed companies

(ii) Receivables from Government Departments and Companies

(iii) Credit card receivables

(iv) Hire purchase loans like vehicle loans .

(v) Lease Finance

(vi) Mortgage Loans ete,

BENEFITS OF SECURITISATION

Debt securitisation provides many benefits to all the parties, such as,the originator, investors and the regulatory authorities. Some of the important benefits are the following:

(i) **Additional Source of Fund**

The originator (i.e., the lending institution) is much benefitted because securitisation provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result, there is an immediate improvement in the cash flow of the originator. Thus, it acts as a source of liquidity.

(ii) **Greater Profitability**

Securitisation helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which, in turn, leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability. Moreover, economies of scale can be achieved since securitisation offers scope for the fuller utilisation of the existing capabilities by providing liquid cash immediately. It results in additional business turnover. Again, the originator can also act as the Receiving and Paying agent. If so, it gets additional income in the form of servicing fee.

(iii) Enhancement of Capital Adequacy Ratio

Securitisation enables financial institutions to enhance their capital adequacy ratio by reducing their assets volume. The process of securitisation necessitates the selection of a pool of assets by the financial institutions to be sold or transferred to another institution called SPV. Once the assets are transferred, they are removed from the balance sheet of the originator. It results in the reduction of assets volume, thereby increasing the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets. Thus, the removal of assets from the Balance Sheet under a true sale improves the capital adequacy norms.

(iv) **Spreading of Credit Risk**

Securitisation facilities the spreading of credit risk to different parties involved in the process of securitisation. In the absence of securitisation, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Now, the originator is able to diversify the risk factors among the various parties involved in securitisation. Thus, securitisation helps to achieve diversification of credit risks which are greater in the case of medium term and long term loans. Thus, it is used as tool for risk management.

(v) **Lower Cost of Funding**

In view of enhancement of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market at debt ratings higher than its overall corporate rating. It means that companies with low credit rating can issue asset backed securities at lower interest cost due to high credit rating on such securities. This helps to secure funds at lower cost. Moreover, the criteria for choosing the pool of assets ensures an efficient cost of funds. In the present context of scarcity of funds and higher interest rates, securitisation provides a good scope for cheap funding.

(vi) **Provision of Multiple Instruments**

From the investor's point of view, securitisation provides multiple new investment instruments so as to meet the varying requirements of the investing public. It also offers varieties of instruments for other financial intermediaries like mutual funds, insurance companies, pension funds etc. giving them many choices.

(vii) **Higher Rate of Return**

When compared to traditional debt securities like bonds and debentures, securitised securities offer better rate of return along with better liquidity. These instruments are rated by good credit rating agencies and hence more attractive. Being structured assets based securities, they offer more protection and yield a good return. The bankruptcy/winding up of the originator does not affect the investors since the payment is guaranteed by the SPV.

(viii) **Prevention of Idle Capital**

In the absence of securitisation, capital would remain idle in the form of illiquid assets like mortgages, term loans etc., in many of the lending institutions. Now, securitisation helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

(ix) **Better than Traditional Instruments**

Certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as a collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not entail any servicing needs and hence does not require much costs. These instruments, being structured asset backed securities, afford a greater protection to investors. Again, there is much transparency from the investor's point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

(x) **Other Benefits**

Securitisation, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not needed. In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrowers. There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.