New Financial Institutions and Instruments viz. Depositories, Factoring

Financial Institution (FI)

A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange. Financial institutions encompass a broad range of business operations within the financial services sector including banks, trust companies, insurance companies, brokerage firms, and investment dealers. Virtually everyone living in a developed economy has an ongoing or at least periodic need for the services of financial institutions.

How Financial Institutions Work?

Financial institutions serve most people in some way, as financial operations are a critical part of any economy, with individuals and companies relying on financial institutions for transactions and investing. Governments consider it imperative to oversee and regulate banks and financial institutions because they do play such an integral part of the economy. Historically, bankruptcies of financial institutions can create panic.

Types of Financial Institutions

Financial institutions offer a wide range of products and services for individual and commercial clients. The specific services offered vary widely between different types of financial institutions.

1. Commercial Banks-

A commercial bank is a type of financial institution that accepts deposits, offers checking account services, makes business, personal, and mortgage loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses. A commercial bank is where most people do their banking, as opposed to an investment bank.

Banks and similar business entities, such as thrifts or credit unions, offer the most commonly recognized and frequently used financial services: checking and savings accounts, home mortgages, and other types of loans for retail and commercial customers. Banks also act as payment agents via credit cards, wire transfers, and currency exchange.

2. Investment Banks-

Investment banks specialize in providing services designed to facilitate business operations, such as capital expenditure financing and equity offerings, including initial public offerings (IPOs). They also commonly offer brokerage services for investors, act as market makers for trading exchanges, and manage mergers, acquisitions, and other corporate restructurings.

3. Insurance Companies-

Among the most familiar non-bank financial institutions are insurance companies. Providing insurance, whether for individuals or corporations, is one of the oldest financial services. Protection of assets and protection against financial risk, secured through insurance products, is an essential service that facilitates individual and corporate investments that fuel economic growth.

4. Brokerage Firms-

Investment companies and brokerages, such as mutual fund and exchange-traded fund (ETF) provider Fidelity Investments, specialize in providing investment services that include wealth management and financial advisory services. They also provide access to investment products that may range from stocks and bonds all the way to lesser-known alternative investments, such as hedge funds and private equity investments.

Financial Instrument

Financial instruments are assets that can be traded, or they can also be seen as packages of capital that may be traded. Most types of financial instruments provide efficient flow and transfer of capital all throughout the world's investors. These assets can be cash, a contractual right to deliver or receive cash or another type of financial instrument, or evidence of one's ownership of an entity.

Understanding Financial Instruments

Financial instruments can be real or virtual documents representing a legal agreement involving any kind of monetary value. Equity-based financial instruments represent ownership of an asset. Debt-based financial instruments represent a loan made by an investor to the owner of the asset.

Types of Financial Instruments

Financial instruments may be divided into two types: cash instruments and derivative instruments.

1. Cash Instruments

- The values of cash instruments are directly influenced and determined by the markets. These can be securities that are easily transferable.
- Cash instruments may also be deposits and loans agreed upon by borrowers and lenders.

2. Derivative Instruments

- The value and characteristics of derivative instruments are based on the vehicle's underlying components, such as assets, interest rates, or indices.
- An equity options contract, for example, is a derivative because it derives its value from the underlying stock. The option gives the right, but not the obligation, to buy or sell the stock at a specified price and by a certain date. As the price of the stock rises and falls, so too does the value of the option although not necessarily by the same percentage.
- There can be over-the-counter (OTC) derivatives or exchange-traded derivatives. OTC is a market or process whereby securities–that are not listed on formal exchanges–are priced and traded.

Depositories

Depository System

It is a system whereby the transfer and settlement of scrips take place not through the traditional method of transfer deeds and physical delivery of scrips but through the modern system of effecting transfer of ownership of securities by means of book entry on the ledgers or the depository without the physical movement of scrips.

The new system, thus, eliminates paper work, facilitates automatic and transparent trading in scrips, shortens the settlement period and ultimately contributes to the liquidity of investment in securities. This system is also known as 'scripless trading system'.

i) Depository

A depository is an entity which helps an investor to buy or sell securities such as stocks and bonds in a paper-less manner. Securities in depository accounts are similar to funds in bank accounts.
A depository is a firm wherein the securities of an investor are held in electronic form and who carries out the transactions of securities by means of book entry. The depository acts as a defecto owner of the securities lodged with it for the limited purpose of transfer of ownership. It functions as a custodian of securities of its clients. The name of the depository appears in the records the issuer as the registered owner of securities.

Depositories are institutions which hold your securities(Shares, bonds, debentures, Mutual Fund Units) in electronic form which is also known as dematerialization of shares or DEMAT account. So, Depositories are mainly responsible and accountable for safe-keeping of your securities and keep a record of all your trades.

Currently there are two Depositories in India that are registered by SEBI, which are:-

- Central Depository Services Limited (CDSL)
- National Services Depository Limited(NSDL)

ii) The Participant

- A participant is an agent of the depository. He functions as a bridge between the depository and the beneficial owners. He maintains the ownership records of every beneficial owner in book entry form. Both the depository and the participant have to be registered with the Securities and Exchange Board of India.

- SEBI grants necessary approval for the same only on the satisfaction of the condition that adequate systems and safeguards are available in such companies in order to ensure against manipulation of records and transactions.

iii) The Beneficial Owner

Beneficial owner means a person whose name is recorded as such with a depository. A beneficial owner is the real owner of the securities who has lodged his securities with the depository in the form of book entry. He has all the rights and liabilities associated with the securities.

iv) The Issuer

The issuer is the company which issues the security. It maintains a register for recording the names of the registered owners of securities, the depositories. These issuers send a list of shareholders, who opt for the depository system, to the depositories.

Facilities Offered By Depository System:

(a) Dematerialization.

(b) Rematerialization.

(c) Electronic settlement of trade.

(d) Nomination facility.

(e) Electronic credit of securities allotted in public, rights and bonus issue.

(f) Pledging or hypothecation of dematerialized securities.

(g) Freezing of Demat accounts.

(h) Stock lending/borrowing facilities, etc.

Advantages of the Depository System

a. Reduction in paper work.

b. Elimination of risks associated with physical scrips such as theft, forgery, multilation, loss of share certificates etc.

c. Elimination of bad delivers.

d. Increased liquidity of scrips through speedy settlement and reduction in delays in registration.

e. Low transaction costs for purchase and sale of securities compared to physical mode.

f. No stamp duty on transfer of securities.

g. Facilities the issuer companies to update the information regarding shareholders and to communicate with them in better ways.

h. Attract foreign investors and promoting foreign investment.

i. Emergence of healthy and efficient capital market.

j. Greater opportunity for the development of sophisticated custodial services etc.

Who regulates depositories and depository participants?

The Securities and Exchange Board of India is responsible for the registration, regulation and inspection of the depository. A depository participant is also answerable to the SEBI. It can be operational only after registration with SEBI post recommendation by NSDL or CDSL.

Factoring

Factoring implies a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables, from a financial institution (factor). It is a financing technique, in which there is an outright selling of trade debts by a firm to a third party, i.e. factor, at discounted prices.

The modern factoring involves a continuing arrangement under which a financing institution assumes the credit control/protection and collection functions for its client, purchases his receivables as they arise (with or without recourse to him for credit losses, i.e., customer's financial inability to pay), maintains the sales ledger, attends to other book-keeping duties relates to such accounts receivables and performs other auxiliary functions.

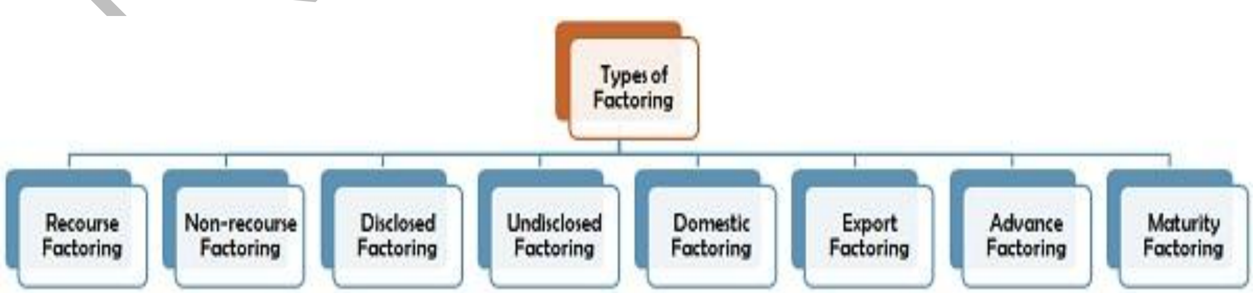
Factoring is an asset based method of financing as well as specialized service being the purchase of book debts of a company by the factor, thus realizing the capital tied up in accounts receivables and providing financial accommodation to the company.

Factoring can be both domestic and for exports. In domestic factoring, the client sells goods and services to the customer and delivers the invoices, order documents, etc. to the factor and inform the customer of the same.

In return, the factor makes a cash advance and a statement to the client. The factor then sends a copy of all the statements of accounts, remittances, receipts, etc. to the customer, on receiving them, the customer sends the payment to the factor.

In case of export factoring two 'factors' are involved. The factor in the customer's country is called "Import Factor" while the one in the client's country is called the "Export Factor". All the transactions remain similar in the case of international factoring, the only difference being that the export factor has to send the shipping documents to the import factor and the import factor has to pass on the ultimate collection to the export factor.

Types of Factoring



(i) Resource factoring-

In Recourse factoring the credit risk remains with the client though the debt is assigned to the factor, i.e., the factor can have recourse to the client in the event of non-payment by the customer.

(ii) Non- Resource factoring-

The Non-Recourse Factoring also called as 'Old-line factoring'. It is an arrangement whereby he factor has no recourse to the client when the bill remains unpaid by the customer. Thus, the risk of bad debt is absorbed by the factor.

(iii) Disclosed Financing-

The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.

(iv) Undisclosed Factoring-

The form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

(v) Domestic Factoring-

When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.

(vi) Export Factoring-

Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

(vii) Advance Factoring-

In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

(viii) Maturity Factoring-

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

Advantage of Factoring

1. It is help to improve the current ratio. Improvement in the current ratio is an indication of improved liquidity. Enables better working capital management. This will enable the unit to offer better credit terms to its customers and increase orders.

2. It is increase in the turnover of stocks. The turnover of stock into cash is speeded up and this results in larger turnover on the same investment.

3. It ensures prompt payment and reduction in debt.

4. It helps to reduce the risk. Present risk in bills financing like finance against accommodation bills can be reduced to minimum.

5. It is help to avoid collection department. The client need not undertake any responsibility of collecting the dues from the buyers of the goods.

Limitations of Factoring

1. Factoring is a high risk area, and it may result in over dependence on factoring, mismanagement, over trading of even dishonesty on behalf of the clients.

2. It is uneconomical for small companies with less turnover.

3. The factoring is not suitable to the companies manufacturing and selling highly specialized items because the factor may not have sufficient expertise to asses the credit risk.

4. The developing countries such as India are not able to be well verse in factoring. The reason is lack of professionalism, non-acceptance of change and developed expertise