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Unit-3

HIRE PURCHASE

Hire purchase agreements are the kind of agreements whereby the owner of goods allows a person (the hirer) to hire goods from him for a specific period of time by paying instalments. Here, the hirer has the option to buy the goods at the end of the contract if all the instalments are paid respectively. Most of us get into the dilemma of whether this is a contract of sale.

Hire purchase agreement is not a contract of sale but a contract of bailment as the hirer hardly has the option to buy the goods and it is a notable fact that although the hirer has the right of using the goods, he is not the legal owner while the term of the agreement is functioning. In India, all the hire purchase finance organisations are controlled by the Hire Purchase Act, 1972. However, a Bill was initiated in the year 1989 for making certain amendments which could never come into force.

Such a transaction has two basic elements which are governed by the Indian Contract Act, 1872 and Sale of Goods Act, 193:

1. **Bailment-** This aspect of the hire purchase agreement is governed by Chapter IX of the Indian Contract Act which covers finance agreements like the purchase of consumer durables such as motor vehicles, computers, household appliances like televisions, refrigerator.
2. **Sale-** This aspect of the hire purchase agreement is a part of the Sale of Goods Act. The law commission had recommended in its eighth report of Sale of Goods Act that there should be a separate enactment regulating hire-purchase transaction. As there were no proper laws to regulate such transactions of hire purchase hence provisions were made by a separate act called the Hire Purchase Act 1972.

Features of Hire Purchase Agreement

- One should be cautious while selecting the asset and enquire about the rightful owner of that assets because it may so happen that the goods are hired and later on, it is found that the vendor is not entitled to those goods.
- Keeping a check on the cumulative instalment amount is very necessary to make sure that it should not exceed the actual value of assets.
- It is also required that the hirer should possess the copy of the hire purchase agreement.
- Hire purchase agreement is such that it can be changed as per the convenience with the consent of both the parties i.e. the hirer and the hiree just like any other agreement.
- The hirer should make sure that the agreement mentions the hire charges and other terms of payment and their consequences in the manner he understands and interprets and the terms are favourable as far as possible and agreeable.
- There should be transparency and the agreements should have clarity of terms that are mutually agreeable by the parties.
- This mode is generally used for cars and high-value electrical goods where the buyers are not able to pay for the goods directly.
- Generally, If we compare buying something with a hire purchase agreement with buying something outright, the former would cost you more.
- In a hire purchase agreement ownership is transferred to the purchaser after the full payment of the particular article.

Working of a Hire Purchase Agreement

A hire purchase agreement is somewhat similar to the concept of rent-to-own transactions which gives the purchaser a fair chance to buy the article whenever it is feasible to him while the agreement is in force. Likewise, hire purchase gives a benefit to the purchaser by providing them with fewer credits by diverting the cost of expensive articles which they otherwise could not have afforded over a time period. However, the purchaser is not eligible to be the owner of the article unless he has paid the full amount of the article, which means it is no way related to the extension of credit.

And as in Hire Purchase, the ownership is not transferred initially as the articles that they hire are protected by the vendor because the full payment is not yet done. The vendor must have the assurance that the article would be kept in good

condition until the full payment is received. So it is one of the secured ways of transaction.

Hire Purchase and Installment Sale

Unlike in the instalment sale, where the buyer becomes the owner of the property immediately as the contract is signed by both the parties but in case of a hire purchase agreement, the hire purchase is eligible to be the owner only after the payment of all the required instalments to the hire vendor.

- Installment is a contract of sale. Here the buyer has all rights to dispose of the property as he wants, but in a hire purchase agreement, the hire-purchaser and hire-vendor are related to each other as a bailee and a bailor which does not allow the hire-purchaser to dispose of a property in any manner.
- As in case of instalments, the buyer becomes the owner immediately after signing the contract. So, any loss to the goods will be compensated by the buyer himself but in case of a hire purchase agreement, the hire-purchaser is not bound to compensate for the losses to the goods (if any) if was taken care of with due diligence as the hire-purchaser is not yet the absolute owner.
- In case of default in payment of instalments the seller is only entitled to sue the buyer for the unpaid amount of installment and has no right to repossess the property. But in case of default in payment of installment by the hire-purchaser in a hire purchase agreement, the hire-vendor has a right to repossess the property.
- In case of an installment, a buyer cannot terminate the contract and is liable to pay all the instalments. But in case of a hire purchase agreement, the hire-purchaser can terminate the contract if he wishes to and can return the goods but is not entitled to pay the remaining instalments.

Parties to a Hire Purchase Agreement

In the hire purchase agreement, the contract is basically between two parties viz. the hire-purchaser and the hire-vendor and sometimes there is an involvement of a third party that is the financer.

Lease

Definition, Features, Advantages, Disadvantages, Types

A lease is a contract under which one party, the lessor (owner of the asset), gives another party (the lessee) the exclusive right to use the asset usually for a specified time in return for the payment of rent.

Leasing is the process by which a firm can obtain the use of certain fixed assets for which it must make a series of contractual, periodic, tax-deductible payments. A lease is a contract that enables a lessee to secure the use of the tangible property for a specified period by making payments to the owner.

Major Features of Lease

The major features or elements of the leasing are the following:

1. **The Contract:** There are essentially two parties to a contract of lease financing, namely the owner and the user.
2. **Assets:** The assets, property to be leased are the subject matter lease financing contract.
3. **Lease Period:** The basic lease period during which the lease is non-cancelable.
4. **Rental Payments:** The lessee pays to the lessor for the lease transaction is the lease rental.
5. **Maintain:** Provision for the payment of the costs of maintenance and repair, taxes, insurance, and other expenses appertaining to the asset leased.
6. **Term of Lease:** The term of the lease is the period for which the agreement of lease remains in operation.
7. **Ownership:** During the lease period, ownership of the assets is being kept with the lessor, and its use is allowed to the lessee.
8. **Terminating:** At the end of the period, the contract may be terminated.
9. **Renew or Purchase:** An option to renew the lease or to purchase the assets at the end of the basic period.
10. **Default:** The lessee may be liable for all future payments at once, receiving title to the asset in exchange.

Advantages of Lease Financing

The advantages from the viewpoint of the lessee

1. **Saving of Capital:** Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way, the saving in capital or financial resources can be used for other productive purposes, e.g., purchase of inventories.
2. **Flexibility and Convenience:** The lease agreement can be tailor-made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.
3. **Planning Cash Flows:** Leasing enables the lessee to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.
4. **Improvement in Liquidity:** Leasing enables the lessee to improve its liquidity position by adopting the sale and leaseback technique.
5. **Shifting of Risk of Obsolescence:** The lessee can shift the risk upon lessor by acquiring the use of assets rather than buying the asset.
6. **Maintenance and Specialized Services:** In case of special kind of lease arrangement, the lessee can avail specialized services of the lessor for maintenance of asset leased. Although lesser charges higher rentals for providing such services, leases see overall administrative, and service costs are reduced because of specialized services of the lessor.
7. **Off-the-Balance-Sheet-Financing:** Leasing provides “off-balance-sheet” financing for the lessee in that the lease is recorded neither as an asset nor as a liability.

The advantages from the viewpoint of the lessor

There are several extolled advantages of acquiring capital assets on lease:

1. **Higher profits:** The Lessor can get higher profits by leasing the asset.
2. **Tax Benefits:** The Lessor being the owner of an asset, can claim various tax benefits such as depreciation.
3. **Quick Returns:** By leasing the asset, the lessor can get quick returns than investing in other projects of the long gestation period.

Disadvantages of Lease Financing

The disadvantages from the viewpoint lessee

1. **Higher Cost:** The lease rental includes a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at a higher cost.
2. **Risk:** Risk of being deprived of the use of assets in case the leasing company winds up.
3. **No Alteration in Asset:** Lessee cannot make changes in assets as per his requirement.
4. **Penalties on Termination of Lease:** The lessee has to pay penalties in case he has to terminate the lease before the expiry lease period.

The disadvantages from the viewpoint lessor

1. **High Risk of Obsolescence:** The Lessor has to bear the risk of obsolescence as there are rapid technological changes.
2. **Price Level Changes:** In the case of inflation, the prices of an asset rise, but the lease rentals remain fixed.
3. **Long term Investment:** Leasing requires the long-term investment in the purchase of an asset, and takes a long time to cover the cost of that asset

Types of the Lease

Leasing takes different types which are given below;

- Based on Nature.

1. Operating lease.
2. Financial lease.

- Based on the Method of Lease.

1. Direct lease.
2. Sale & Leaseback.
3. Leverage lease.

Based on Nature:

1.Operating Lease: An operating lease is a cancelable contractual agreement whereby the lessee agrees to make periodic payments to the lessor, often for 5 or fewer years, to obtain an asset set's services. According to the International Accounting Standards (IAS-17), an operating lease is one that is not a finance lease.

2.Financial Lease: A financial (or capital) lease is a longer-term lease than an operating lease that is non-cancelable and obligates the lessee to make payments for the use of an asset over a predetermined. period of time. According to the International Accounting Standard (IAS-17), in a financial lease, the lessor transfer to the lessee substantially all the risks and rewards identical to the ownerships of the asset whether or not the title is eventually transferred.

Based on the Method of Leasing

1.Direct Lease: Under direct leasing, a firm acquires the right to use an asset from the manufacture directly. The ownership of the asset leased out remains with the manufacture itself.

2.Sale & Leaseback: Under the sale & leaseback arrangement, the firm sells an asset that it owns and then leases to the same asset back from the buyer. This way, the lessee gets the assets for use, and at the same time, it gets cash.

3.Leveraged Lease: Leveraged lease is the same as the direct lease, except that a third party, the lender, is involved in addition to the lessee & lessor. The lender partly finances the purchase of the asset to be leased; the lessor turns to be a borrower.

Difference between the Operating and Financial Lease

Topics	Operating Lease	Financial Lease
Definition	Operating lease is short term lease used to finance assets & is not fully amortized over the life of the asset.	A financial lease is the lease used in connection with long term assets & amortizes the entire cost of the asset over the life of the lease.
Duration	Short term leasing	Long term leasing
Cost	The lessor pays the maintenance cost.	Lessee pays the maintenance cost.
Cancel & Changeable	Cancelable lease & It is a changeable lease contract.	Non-cancelable lease & It is not a changeable lease contract.
Risk	lessor bears the risk of the asset.	The lessee bears the risk of the asset.
Purchase	At the end of the asset is hot purchasable.	At the end of the contract, the asset is purchasable.
Renew	It is a renewable contract.	It is not a renewable contract.
Also called	Service lease, short term lease, cancelable lease.	A capital lease, long term lease, non-cancelable lease.

So, from the above discussion, we can say that lease is a contract under which one party the lessor (owner) of an asset agrees agreed to grant the use of that asset to another, the lessee in exchange for periodic rental payments. The rent is a tax-deductible expense.

Meaning of Securitisation:
RBI in its circular on Securitization of Standard Assets, describes Securitization.
"as a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment".
ADVERTISEMENTS:
Securitisation can be defined as:
"Acquisition of financial assets by any securitization company or reconstruction company from any originator, whether by raising funds by such securitization company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise."
In such cases the cash flow from the underlying pool of assets is used to service the securities issued by the SPV.
Let us try to understand it from a layman's view. In the normal course assets like loans and securities held by banks/financial institutions are expected to yield a quantifiable stream of future income (e.g. EMIs etc.). However, since this income is yet to be realised, it cannot be brought onto their books immediately. Through the process of Securitization Banks try to encash these future flows of as- yet-unrealised income.:
We can also sum up that securitisation means the conversion of existing or future cash in-flows into tradable security which then is sold in the market. The cash inflow from financial assets such as mortgage loans, automobile loans, trade receivables credit card receivables, fare collections become the security against which borrowings are raised.
Securitization thus follows a two-stage process. In the first stage there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle (SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.
Process of Securitisation:
We have seen above that Securitisation is a process by which the future cash inflows of an entity (originator) are converted and sold as debt instruments.

These debt instruments are popularly known as "Pay Through or Pass Through Certificates", with a fixed rate of return to the holders of beneficial interest. Under this process, the originator of a typical securitisation actually transfers a portfolio of financial assets to a "Special Purpose Vehicle" (SPV). (An SPV is an entity specially created for doing the securitisation deal. It invites investment from investors, uses the invested funds to acquire to receivables of the originator An SPV may be a trust, corporation, or any other legal entity.)
As a consideration for the transfer of such a portfolio, the originator gets cash up-front on the basis of a mutually agreed valuation of the receivables.
The transfer value of the receivables is arrived in such a way so as to give the lenders a reasonable rate of return. In 'pass-through' and 'pay-through' securitisations, receivables are transferred to the SPV at the inception of the securitisation, and no further transfers are made. All cash collections are paid to the holders of beneficial interests in the SPV (basically the lenders).

Securitisation deal usually passes through the following stages:

1. First of all the originator determines which assets they want to securitise.
2. At second stage originator has to find out a SPV or new SPV is formed.
3. The SPV collects the funds from investors and in return issues securities to them.
4. The SPV acquires the receivables under an agreement at their discounted value.
5. The Servicer for the transaction is appointed, who is usually the originator.
6. The debtors are/are not notified depending on the legal requirements.
7. The Servicer collects the receivables, usually in an escrow mechanism, and pays off the collection to the SPV.
8. The SPV either passes the collection to the investors, or reinvests the same to pay off to investors at stated intervals.
9. In case of default, the servicer takes action against the debtors as the SPV's agent.
10. When only a small number of outstanding receivables are left to be collected, the originator may clean up the transaction by buying back the outstanding receivables.
11. At the end of the transaction, the originator's profit, if retained and subject to any losses to the extent agreed by the originator, in the transaction is paid off.

Advantages of the Securitisation:

1. Securitization helps in raise funds for the standard assets, though the rating of the originator may not be high;

2. Securitised assets (receivables) go off the balance sheet of the originator which at times can be of great help to the originator. For example, a bank may need to reduce its exposure to credit so as to meet the capital adequacy norms.:
3. Securitization also helps in generating liquidity which may; be critical at times for the bank/company.
4. Small investors are able to profit from such deals as under this scheme even they can invest small amounts through SPV and acquire beneficial interest in the securitized assets.

Disadvantages of the Securitization:

1. Securitization is an off-balance sheet item. The originator may thus be able to hide the true picture of its financial health by securitization of its good assets and keeping only substandard assets in its portfolio.
2. Another disadvantage of securitization is its opaqueness. For example, a company may have taken huge liabilities but that may not be reflected in the balance sheet or conventional financial statements of the company. This is especially true where the securitisation is with recourse i.e. if the receivables which have been-securitised to the SPV, but later become NPA.

In such a case, the SPV will have the right to recover the dues from the originator. Thus, in such cases, it may be realized later on that the originator actually had a large amount of contingent liabilities but these were not reflected in the balance sheet.

Securitization in Indian Market:

Securitisation in India started around 1991. However, the first few transactions that took place during the period from 1991-2000 were in the nature of secured lending. However, it was from 2002 that this segment saw some renewed activity with auto loans on the forefront. Indian market was still afraid to take chances and the issues were predominantly of ‘AAA’ rated notes.

There are only few players in the Indian market, which is dominated by few private sector banks and some aggressive Mutual Funds only. Public sector banks remain mostly out of picture due to various reasons including the legal issues. These impediments have failed to develop the secondary market.

In spite of number of constraints, the securitization market in India grew significantly during the period from 2002 to 2004. In April 2005 RBI issued the draft guidelines. This resulted in slowdown in the market as banks were readjusting their strategies in the light of draft guidelines.

In February 2006, the Reserve Bank of India (RBI) has issued final guidelines for the Securitisation of Standard Assets. These guidelines have consolidated a

number of prevailing market practices with some stringent requirements on capital and profit recognition.

These guidelines are likely to further slowdown the issuance of these assets as market will take its own time to re-adjust to the revised guidelines which are considered as stringent. However, in the long run the market is likely to grow as now legal framework is available and RBI has given its node for this segment of activity.

Indian securitisation market is still young and banks have only limited exposure in this segment. However, slowly it is maturing rapidly through innovation, increasing sophistication and new issuances.

Pass through Certificates

A Pass-through Certificate is an instrument which signifies transfer of interest in the receivable in favour of the holder of the Pass-through Certificate.

In this case, the investors in a pass-through transaction acquire the receivables, subject to all their fluctuations, prepayment etc. The material risks and rewards in the asset portfolio, such as the risk of interest rate variations, risk of prepayments, etc. are transferred to the investors.

The main features of Pass Through Certificate can be summed as follows:

(a) Investors get a proportional interest in pool of receivables.

(b) Collections made later on are divided proportionally.

(c) All investors receive proportional payments.

(d) Cash collected by the SPV is not reinvested.

Pay Through Certificates

Under "Pay Through Certificates", the SPV instead of transferring ndivided interest on the receivables, actually issues debt securities (for example bonds, repayable on fixed dates). These debt securities in turn are backed by the mortgages transferred by the originator to the SPV.

Here the SPV can make temporary reinvestment of cash flows to the extent required for bridging the gap between the date of payments on the mortgages along with the income out of reinvestment to retire the bonds. Such bonds were called mortgage – backed bonds.

Some Important Concept

Broadly, the participants in the process of securitization can be divided into two categories; one is Primary Participant and the other is Secondary Participant.

Primary Participants

Primary Participants are the main parties in this process. The primary participants in the process of securitization are as follows:

(a) Originator: It is the initiator of deal or can be termed as securitizer. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets. The originator transfers both legal as well as beneficial interest to the Special Purpose Vehicle (discussed later).

(b)Special Purpose Vehicle: Also, called SPV is created for the purpose of executing the deal. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only and normally could be in the form of a company, a firm, a society or a trust.

The main objective of creating SPV is to remove the asset from the Balance Sheet of Originator. Since SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization. Further, it also issues the securities (called Asset Based Securities or Mortgage Based Securities) to the investors.

(c) The Investors: Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc. Since they acquire a participating in the total pool of assets/receivable, they receive their money back in the form of interest and principal as per the terms agree.

Secondary Participants

Besides the primary participant’s other parties involved in the securitization process are as follows:

(a)Obligors: Actually they are the main source of the whole securitization process. They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator. The amount due from the obligor is transferred to SPV and hence they form the basis of the securitization process and their credit standing is of paramount importance in the whole process.

(b) Rating Agency: Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available. Rating agency assesses the following:

(i)Strength of the Cash Flow.

(ii) The mechanism to ensure timely payment of interest and principal repayment.

(iii) The credit quality of securities.

(iv) Liquidity support.

(v) Strength of legal framework. Although rating agency is secondary to the process of securitization it plays a vital role.

(c)Receiving and Paying agent (RPA): Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV. It also follows up with defaulting borrower and if required initiate appropriate legal action against them. Generally, an originator or its affiliates acts as servicer.
(d)Agent or Trustee: Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of the agreement. Normally, it takes care of the interest of investors who acquire the securities.
(e) Credit Enhancer: Since investors in securitized instruments are directly exposed to the performance of the underlying and sometime may have limited or no recourse to the originator, they seek additional comfort in the form of credit enhancement. In other words, they require a credit rating of issued securities which also empowers marketability of the securities.
Originator itself or a third party say a bank may provide this additional context called Credit Enhancer. While originator provides his comfort in the form of over-collateralization or cash collateral, the third party provides it in the form of a letter of credit or surety bonds.
(f) Structurer: It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal. It ensures that deal meets all legal, regulatory, accounting and tax laws requirements.