FINANCIAL SERVICE

(Specialization paper in Finance)

VI SEMESTER

CORE COURSE

BBA6 B15

B.B.A

(2019 Admission onwards)

UNIVERSITY OF CALICUT

School of Distance Education,

Calicut University P.O.,

Malappuram - 673 635, Kerala.

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UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

BBA 2019 Admission onwards

BBA6 B15 (Finance Elective 3)

FINANCIAL SERVICE

Prepared by:

Siddeeque Melmuri
Asst. Prof.
School of Distance Education
University of Calicut

Scruitinized by:

Abdurahiman Karuthedath
Asst. Prof.of Commerce
Malabar College of Advanced Studies, Vengara.

Syllabus

BBA6B15 (Finance Elective 3)

FINANCIAL SERVICES

Time:5 Hours per week **Credits: 4**

Internal: 20 **External 80**

Course Objective:

the students with an understanding of the various financial services and investment opportunities available in the country

Learning Outcomes:

On completion of the course students will be able to aware of various financial services available in Indian financial system

Module I : Financial Services: Meaning and importance of financial services- classification of financial services- fund based and fee based services-capital market services – stock broking and depository services – regulation of capital market services in India.

10 Hours

Module II : Fund Investments: Mutual funds-meaning and importance-organisation of mutual funds-types of schemes- fund units and valuation- merits and demerits of mutual funds- mutual fund regulations in India. Pension funds; Exchange Traded Funds (ETFs)-ETF vs

Mutual Funds- investment implications of ETF. **20 Hours**

Module III : Investment Banking and Merchant Banking: Meaning, nature and functions of merchant banking – pre and post issue management services – loan syndication- Merchant banking services in India –SEBI merchant bank regulations. **20 Hours**

Module IV : Lease Finance and Venture Capital Finance: Lease finance- meaning and definition- types of lease- merits and demerits of lease financing. Venture capital finance: meaning and importance – risk capital – angel investing, crowd funding and private equity (PE). **15 Hours**

Module V : Credit Rating and Factoring Services: Credit rating – meaning, importance and advantages – rating methodology- credit rating agencies in India. Factoring services – meaning, scope and functions – types of factoring services – forfaiting and international factoring. **15 Hours**

Reference Books:

1. Khan M Y, Financial Services, Tata McGraw-Hill Publishing Co.Ltd New Delhi.
2. Gupta, N K and Monika Chopra,FinancialMarkets,Institutions and Servoces, Ane Books India.
3. Bharathi V Pathak, Indian Financial System, Pearson Education, New Delhi.
4. YogeshMaheswari, Investment Management, PHI New Delhi
5. Avadhani, V A, Security Analysis and Portfolio Management, Himalaya Publishing House.

Module I
FINANCIAL SERVICES

The Indian financial services industry has undergone a metamorphosis since1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry.

In fact, one of the world's largest industries today is the financial services industry.

Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation.

Meaning of Financial Services

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilisation and allocation of savings.

Thus, it includes all activities involved in the transformation of savings into investment.

Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organisations that deal with the management of money. These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.

Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

Financial services can also be called financial intermediation. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. There are various institutions which render financial services. Some of the institutions are banks, investment companies, accounting firms, financial institutions, merchant banks, leasing companies, venture capital companies, factoring companies, mutual funds etc. These institutions provide variety of services to corporate enterprises. Such services are called financial services. Thus, services rendered by financial service organisations to industrial enterprises and to ultimate consumer markets are called financial services. These are the services and facilities required for the smooth operation of the financial markets. In short, services provided by financial intermediaries are called financial services.

Functions of financial services

1. Facilitating transactions (exchange of goods and services) in the economy.

2. Mobilizing savings (for which the outlets would otherwise be much more limited).

3. Allocating capital funds (notably to finance productive investment).

4. Monitoring managers (so that the funds allocated will be spent as envisaged).

5. Transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

Characteristics or Nature of Financial Services

From the following characteristics of financial services, we can understand their nature:

1. **Intangibility**: Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

2. Inseparability: Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect understanding between the financial service institutions and its customers.

3. Perishability: Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

4. Variability: In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations have to offer a wide range of products and services.

This means the financial services have to be tailor-made to the requirements of customers. The service institutions differentiate their services to develop their individual identity.

5. Dominance of human element: Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled personnel to market the quality financial products.

6. Information based: Financial service industry is an information based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

Importance of Financial Services

The successful functioning of any financial system depends upon the range of financial services offered by financial service organisations. The importance of financial services may be understood from the following points:

1. Economic growth: The financial service industry mobilises the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. Promotion of savings: The financial service industry mobilises the savings of the people by providing transformation services. It provides liability, asset and size transformation service by providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. Capital formation: Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. Creation of employment opportunities: The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. Contribution to GNP: Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

6. Provision of liquidity: The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

Types of Financial Services

Financial service institutions render a wide variety of services to meet the requirements of individual users. These services may be summarized as below:

1. Provision of funds:

(a) Venture capital

(b) Banking services

(c) Asset financing

(d) Trade financing

(e) Credit cards

(f) Factoring and forfaiting

2. Managing investible funds:

(a) Portfolio management

(b) Merchant banking

(c) Mutual and pension funds

3. Risk financing:

(a) Project preparatory services

(b) Insurance

(c) Export credit guarantee

4. Consultancy services:

(a) Project preparatory services

(b) Project report preparation

(c) Project appraisal

(d) Rehabilitation of projects

(e) Business advisory services

(f) Valuation of investments

(g) Credit rating

(h) Merger, acquisition and reengineering

5. Market operations:

(a) Stock market operations

(b) Money market operations

(c) Asset management

(d) Registrar and share transfer agencies

(e) Trusteeship

(f) Retail market operation

(g) Futures, options and derivatives

6. Research and development:

(a) Equity and market research

(b) Investor education

(c) Training of personnel

(d) Financial information services

Scope of Financial Services

The scope of financial services is very wide. This is because it covers a wide range of services. The financial services can be broadly classified into two: (a) fund based services and (b) non-fund services (or fee-based services)

Fund based Services

The fund based or asset based services include the following:

1. Underwriting
2. Dealing in secondary market activities
3. Participating in money market instruments like CPs, CDs etc.
4. Equipment leasing or lease financing
5. Hire purchase
6. Venture capital
7. Bill discounting.
8. Insurance services
9. Factoring
10. Forfaiting
11. Housing finance
12. Mutual fund

Non-fund based Services

Today, customers are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, the financial service companies or financial intermediaries provide services on the basis of non-fund activities also. Such services are also known as fee based services. These include the following:

1. Securitisation
2. Merchant banking
3. Credit rating
4. Loan syndication
5. Business opportunity related services
6. Project advisory services
7. Services to foreign companies and NRIs.
8. Portfolio management
9. Merger and acquisition
10. Capital restructuring
11. Debenture trusteeship
12. Custodian services
13. Stock broking

The most important fund based and non-fund based services (or types of services) may be briefly discussed as below:

A. Asset/Fund Based Services

1. **Equipment leasing/Lease financing:** A lease is an agreement under which a firm acquires a right to make use of a capital asset like machinery etc. on payment of an agreed fee called lease rentals. The person (or the company) which

acquires the right is known as lessee. He does not get the ownership of the asset. He acquires only the right to use the asset. The person (or the company) who gives the right is known as lessor.

2. Hire purchase and consumer credit: Hire purchase is an alternative to leasing. Hire purchase is a transaction where goods are purchased and sold on the condition that payment is made in instalments. The buyer gets only possession of goods. He does not get ownership. He gets ownership only after the payment of the last instalment. If the buyer fails to pay any instalment, the seller can repossess the goods. Each instalment includes interest also.

3. Bill discounting: Discounting of bill is an attractive fund based financial service provided by the finance companies. In the case of time bill (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer’s account. Thus, the bank purchases the bill and credits the customer’s account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In short, discounting of bill means giving loans on the basis of the security of a bill of exchange.

4. Venture capital: Venture capital simply refers to capital which is available for financing the new business ventures. It involves lending finance to the growing companies. It is the investment in a highly risky project with the objective of earning a high rate of return. In short, venture capital means long term risk capital in the form of equity finance.

5. Housing finance: Housing finance simply refers to providing finance for house building. It emerged as a fund based financial service in India with the establishment of National Housing Bank (NHB) by the RBI in 1988. It is an apex housing finance institution in the country. Till now, a number of specialised financial institutions/companies have entered in the filed of housing finance.

Some of the institutions are HDFC, LIC Housing Finance, Citi Home, Ind Bank Housing etc

6. Insurance services: Insurance is a contract between two parties. One party is the insured and the other party is the insurer. Insured is the person whose life or property is insured with the insurer. That is, the person whose risk is insured is called insured. Insurer is the insurance company to whom risk is transferred by the insured. That is, the person who insures the risk of insured is called insurer. Thus insurance is a contract between insurer and insured. It is a contract in which the insurance company undertakes to indemnify the insured on the happening of certain event for a payment of consideration. It is a contract between the insurer and insured under which the insurer undertakes to compensate the insured for the loss arising from the risk insured against.

According to Mc Gill, “Insurance is a process in which uncertainties are made certain”. In the words of Jon Megi, “Insurance is a plan wherein persons collectively share the losses of risks”.

Thus, insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join themselves against such an event. The document which contains all the terms and conditions of insurance (i.e. the written contract) is called the ‘insurance policy’. The amount for which the insurance policy is taken is called ‘sum assured’. The consideration in return for which the insurer agrees to make good the loss is known as ‘insurance premium’. This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

7. **Factoring:** Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in respect of account receivables. The factor undertakes the responsibility of collecting the account receivables. The financial institution (factor) undertakes the risk. For this type of service as well as for the interest, the factor charges a fee for the intervening period. This fee or charge is called *factorage.*

8. Forfaiting: Forfaiting is a form of financing of receivables relating to international trade. It is a non-recourse purchase by a banker or any other financial institution of receivables arising from export of goods and services. The exporter surrenders his right to the forfaiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a technique that helps the exporter sells his goods on credit and yet receives the cash well before the due date. In short, forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter. The exporter need not bother about collection of export bill. He can just concentrate on export trade.

9. Mutual fund: Mutual funds are financial intermediaries which mobilise savings from the people and invest them in a mix of corporate and government securities. The mutual fund operators actively manage this portfolio of securities and earn income through dividend, interest and capital gains. The incomes are eventually passed on to mutual fund shareholders.

Non-Fund Based/Fee Based Financial Services

1. **Merchant banking:** Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined a merchant banker

as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

2. **Credit rating**: Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the creditworthiness of a company by an independent organisation.

3. **Stock broking**: Now stock broking has emerged as a professional advisory service. Stock broker is a member of a recognized stock exchange. He buys, sells, or deals in shares/securities. It is compulsory for each stock broker to get himself/herself registered with SEBI in order to act as a broker. As a member of a stock exchange, he will have to abide by its rules, regulations and bylaws.

4. **Custodial services**: In simple words, the services provided by a custodian are known as custodial services (custodian services). Custodian is an institution or a person who is handed over securities by the security owners for safe custody. Custodian is a caretaker of a public property or securities. Custodians are intermediaries between companies and clients (i.e. security holders) and institutions (financial institutions and mutual funds). There is an arrangement and agreement between custodian and real owners of securities or properties to act as custodians of those who hand over it. The duty of a custodian is to keep the securities or documents under safe custody. The work of custodian is very risky and costly in nature. For rendering these services, he gets a remuneration called custodial charges.

Thus custodial service is the service of keeping the securities safe for and on behalf of somebody else for a remuneration called custodial charges.

5. **Loan syndication**: Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. In a loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager.

A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

6. **Securitisation (of debt):** Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of *securitization*. Securitisation is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitised.

Securitisation is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non- marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments.

Securitisation is different from factoring. Factoring involves transfer of debts without transforming debts into marketable securities. But securitisation always involves transformation of illiquid assets into liquid assets that can be sold to investors.

Capital Market Services

Capital market simply refers to a market for long term funds. It is a market for buying and selling of equity, debt and other securities. Generally, it deals with long term securities that have a maturity period of above one year. Capital market is a vehicle through which long term finance is channelized for the various needs of industry, commerce, govt. and local authorities.

According to W.H. Husband and J.C. Dockerbay, *"the capital market is used to designate activities in long term credit, which is characterised mainly by securities of investment type".*

Thus, capital market may be defined as an organized mechanism for the effective and smooth transfer of money capital or financial resources from the investors to the entrepreneurs.

Characteristics of Capital Market

1. It is a vehicle through which capital flows from the investors to borrowers.

2. It generally deals with long term securities.

3. All operations in the new issues and existing securities occur in the capital market.

4. It deals in many types of financial instruments. These include equity shares, preference shares, debentures, bonds, etc. These are known as securities. It is for this reason that capital market is known as 'Securities Market'.

5. It functions through a number of intermediaries such as banks, merchant bankers, brokers, underwriters, mutual funds etc. They serve as links between investors and borrowers.

6. The constituents (players) in the capital market include individuals and institutions. They include individual investors, investment and trust companies, banks, stock exchanges, specialized financial institutions etc.

Functions of a Capital Market

The functions of an efficient capital market are as follows:

1. Mobilise long term savings for financing long term investments.

2. Provide risk capital in the form of equity or quasi-equity to entrepreneurs.

3. Provide liquidity with a mechanism enabling the investor to sell financial assets.

4. Improve the efficiency of capital allocation through a competitive pricing mechanism.

5. Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment etc.

6. Enable quick valuation of instruments – both equity and debt.

7. Provide insurance against market risk through derivative trading and default risk through investment protection fund.

8. Provide operational efficiency through:

(a) simplified transaction procedures,

(b) lowering settlement times, and

(c) lowering transaction costs.

9. Develop integration among:

(a) debt and financial sectors,

(b) equity and debt instruments,

(c) long term and short term funds.

10. Direct the flow of funds into efficient channels through investment and disinvestment and reinvestment.

Major Players or Participants (or Intermediaries) in the Capital Market

There are many players (intermediaries) in the primary market (or capital market). Important players are as follows:

1. **Merchant bankers:** In attracting public money to capital issues, merchant bankers play a vital role. They act as issue managers, lead managers or comanagers (functions in detail is given in following pages)

2. **Registrars to the issue**: Registrars are intermediaries who undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue.

3. **Bankers:** Some commercial banks act as collecting agents and some act as co-ordinating bankers. Some bankers act as merchant bankers and some are brokers. They play an important role in transfer, transmission and safe custody of funds.

4. Brokers: They act as intermediaries in purchase and sale of securities in the primary and secondary markets. They have a network of sub brokers spread throughout the length and breadth of the country.

5. **Underwriters**: Generally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public, if the issue is not

fully subscribed by the public. Underwriters may be financial institutions, banks, mutual funds, brokers etc.

Special Features of the Indian Capital Market

Indian capital market has the following special features:

1. Greater reliance on debt instruments as against equity and in particular, borrowing from financial institutions.

2. Issue of debentures specifically, convertible debentures with automatic or compulsory conversion into equity without the normal option given to investors.

3. Floatation of Mega issues for the purpose of take over, amalgamation etc. and avoidance of borrowing from financial institutions for the fear of their discipline and conversion clause by the bigger companies, and this has now become optional.

4. Avoidance of underwriting by some companies to reduce the costs and avoid scrutiny by the FIs. It has become optional now.

5. Fast growth of mutual funds and subsidiaries of banks for financial services leading to larger mobilisation of savings from the capital market.

Procedure for Dealing at Stock Exchange (Trading Mechanism or Method of Trading on a Stock Exchange)

Outsiders are not allowed to buy or sell securities at a stock exchange. They have to approach brokers. Dealings can be done only through brokers. They are the members of the stock exchange. The following procedure is followed for dealing at exchanges:

1. **Selection of a broker:** An individual cannot buy or sell securities directly at stock exchange. He can do so only through a broker. So he has to select a broker through whom the purchase or sale is to be made. The intending investor or seller may appoint his bank for this purpose. The bank may help to choose the broker.

2. **Placing an order**: After selecting the broker, the next step is to place an order for purchase or sale of securities. The broker also guides the client about the type of securities to be purchased and the proper time for it. If a client is to sell the securities, then the broker shall tell him about the favourable time for sale.

3. **Making the contract:** The trading floor of the stock exchange is divided into different parts known as trading posts. Different posts deal in different types of securities. The authorised clerk of the broker goes to the concerned post and expresses his intention to buy and sell the securities. A deal is struck when the other party also agrees. The bargain is noted by both the parties in their note books. As soon as order is executed a confirmation memo is prepared and is given to the client.

4. **Contract Note:** After issue of confirmation memo, a contract note is signed between the broker and the client. This contract note will state the transaction fees (commission of broker), number of shares bought or sold, price at which they are bought or sold, etc.

5. **Settlement:** Settlement involves making payment to sellers of shares and delivery of share certificate to the buyer of shares after receiving the price. The settlement procedure depends upon the nature of the transactions. All the

transactions on the stock exchange may be classified into two- ready delivery contracts and forward delivery contracts.

a. Ready delivery contract: A ready delivery contract involves the actual payment of the amount by the buyer in cash and the delivery of securities by the seller. A ready delivery contract is to be settled on the same day or within the time period fixed by the stock exchange authorities.

b. Forward delivery contracts: These contracts are entered into without any intention of taking and giving delivery of the securities. The traders in forward delivery securities are interested in profits out of price variations in the future. Such transactions are settled on the settlement days fixed by the stock exchange authorities. Such contracts can be postponed to the next settlement day, if both the parties agree between themselves. Such postponement is called 'Carry over' or 'badla'. Thus 'carry over' or 'badla' means the postponement of transaction from one settlement period to the next settlement period.

Rolling Settlement

Rolling settlement has been introduced in the place of account period settlement. Rolling settlement system was introduced by SEBI in January 1998.

Under this system of settlement, the trades executed on a certain day are settled based on the net obligations for that day. At present, the trades relating to the rolling settlement are settled on T + 2day basis where T stands for the trade day.

It implies that the trades executed on the first day (say on Monday) have to be settled on the 3rd day (on Wednesday), i.e., after a gap of 2 days. This cycle would be rolling and hence there would be number of set of transactions for delivery every day. As each day's transaction are settled in full, rolling settlement helps in increasing the liquidity in the market. With effect from January 2, 2002, all scrips have been brought under compulsory rolling mode.

Depository Services

A depository is an organization which holds securities in electronic book entries at the request of the shareholder through the medium of a depository participant. A depository keeps the scrips on behalf of the investors. It undertakes the custodian role. A depository participant is an agent of the depository through which it interfaces with the investor. A depository can be compared to a bank. Investors can avail the services offered by a depository. To utilize the services offered by a depository, the investor is required to open an account called 'demat account with the depository. The demat account is opened through a depository participant. Thus it is very similar to the opening of an account with any of the branches of a bank in order to utilize the services of that bank. The objective is to allow for the faster, convenient and easy mode of affecting the transfer of securities. Thus, financial services relating to holding, maintaining and dealing securities in electronic form by a financial intermediary known as depository are called depository services.

Constituents of Depository System

There are four players in the depository system. They are : (1) Depository Participant, (2) Investor (Beneficial owner), (3) Issuer, and (4) Depository.

Depository Participant: DP is an agent of the depository. If an investor wants to avail the services offered by the depository, the investor has to open an account with a DP. It function as a bridge between the depository and the owners.

A DP may be a financial institution, bank, custodian, a clearing corporation, a stock broker or a “NBFC.

Investor (Beneficial Owner): He is the real owner of the securities who has lodged his securities with the depository in the form of a book entry.

Issuer: This is the company which issues the security.

Depository: It is a firm which holds the securities of an investor in electronic form in the same way a bank holds money. It carries out the transaction of securities by means of book entry, without any physical movement of securities.

National Securities Depository Ltd. (NSDL)

NSDL was registered by SEBI on June 7, 1996 as India’s first depository to facilitate trading and settlement of securities in the dematerialized form. It was promoted by IDBI, UTI and NSE (National Stock Exchange). The objective is to provide electronic depository facilities for securities traded in the equity and debt markets in the country. NSDL has been set up to cater to the demanding needs of the Indian capital markets.

Functions / Services of NSDL

The following are the functions or services of NSDL :

1. Maintenance of individual investors’ beneficial holdings in an electronic form.

2. Trade settlement

3. Automatic delivery of securities to the clearing corporation

4. Dematerialisation and rematerialisation of securities.

5. Allotment in the electronic form in case of IPOs.

6. Distribution of dividend

7. Facility for freezing / locking of investor accounts

8. Facility for pledge and hypothecation of securities.

9. Internet based services such as SPEED-c and IDeAS

Central Depository Services (India) Ltd. (CDSL)

The CDSL is the second depository set up by the Bombay Stock Exchange and co-sponsored by the SBI, Bank of India, Union bank of India, and Centurian Bank. The CDSL commenced operations on March 22, 1996. The CDSL was set up with the objectives of providing convenient, dependable and secure depository services at affordable cost to all market participants. All leading stock exchanges such as Bombay Stock Exchange, National Stock Exchange, and Kolkata Stock Exchange etc. have established connectivity with CDSL.

Securities Exchange Board of India (SEBI)

Securities and Exchange Board of India (SEBI) is the nodal agency to regulate the capital market and other related issues in India. It was established in 1988 as an administrative body and was given statutory recognition in January 1992 under the SEBI Act 1992 which came into force on January 30, 1992. Before that, the Capital Issues (Control) Act, 1947 was repealed. SEBI has been constituted on the lines of Securities and Exchange Commission of USA. SEBI is consisting of the Chairman and 8 Members (one member representing the Reserve Bank of India, two members from the officials of Central Government and five other public representatives to be appointed by the Central Government from different fields). Securities and Exchange Board of India has been playing an active role in the Indian Capital Market to achieve the objectives enshrined in the Securities and Exchange Board of India Act, 1992.

The major objective of the SEBI may be summarised as follows:

- To provide a degree of protection to the investors and safeguard their rights and to ensure that there is a steady flow of funds in the market.
- To promote fair dealings by the issuer of securities and ensure a market where they can raise funds at a relatively low cost.
- To regulate and develop a code of conduct for the financial intermediaries and to make them competitive and professional.
- To provide for the matters connecting with or incidental to the above.

Section 11 of the SEBI Act deals with the powers and functions of the SEBI as follows:

- It shall be the duty of Board to protect the interests of the investors in securities and to promote the development of and to regulate the securities market by measures as deemed fit.
- To achieve the above, the Board may undertake the following measures :

1. Regulating the business in stock exchanges;

2. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, portfolio managers;

3. Registering and regulating the working of the depositories, participants, credit rating agencies;

4. Registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds;

5. Prohibiting fraudulent and unfair trade practices relating to securities markets;

6. Promoting investors education and training of intermediaries of securities markets;

7. Prohibiting insider trading in securities;

8. Regulating substantial acquisition of shares and take-over of companies; and

9. Calling for information from undertaking, inspection, concluding inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self-regulatory organisations in the securities market.

Role of SEBI in Primary Market

The primary market is under the control of Securities and Exchange Board of India. Securities and Exchange Board of India has an important role to keep the primary market healthy and efficient. It has been taking several measures for the development of primary market in India. In the meantime it is attempting to protect the interest of investors. It is issuing guidelines in respect of new issues of securities in the primary market. The role being played by the Securities and Exchange Board of India in the primary market can be understood from the following points:

1. The prime objective of establishing Securities and Exchange Board of India was to protect the interests of investors in securities, promoting the development of, and regulating the securities markets.

2. The Securities and Exchange Board of India Act came into force on 30th January, 1992. With its establishment, all public issues are governed by the rules and regulations issued by Securities and Exchange Board of India.

3. Securities and Exchange Board of India was formed to promote fair dealing in issue of securities and to ensure that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and investors.

4. The promoters should be able to raise funds at a relatively low cost. At the same time, investors must be protected from the unethical practices. Their rights must be safeguarded so that there is a ready flow of savings into the market.

There must be proper regulation and code of conduct and fair practice by intermediaries to make them competitive and professional. These are taken care of by Securities and Exchange Board of India. instrumental in bringing greater transparency in capital issues. Under the umbrella of Securities and Exchange Board of India, companies issuing shares are free to fix the premium provided that adequate disclosure is made in the offer documents. Securities and Exchange Board of India has become a vigilant watchdog with the focus towards investor protection.

6. The Securities and Exchange Board of India introduced the concept of anchor

investor on June 18, 2009 to enhance issuer's ability to sell the issue, generate more confidence in the minds of retail investors and better price discovery in the issue process. Anchor investors are qualified institutional buyers that buy a large chunk of shares a day before an IPO opens. They help arriving at an appropriate benchmark price for share sales and generate confidence in retail investors. A retail investor is one who can bid in a book-built issue or applies for securities for a value of not more than Rs. 1,00,000.

Role of SEBI in Secondary Market

Since its birth, Securities and Exchange Board of India has been playing an active role to make the secondary market healthy and efficient. It will issue guidelines for the proper functioning of the secondary market. It has the power to call periodical returns from stock exchanges. It has the power to prescribe maintenance of certain documents by the stock exchanges. It may call upon the exchange or any member to furnish explanation or information relating to the affairs of the stock exchange or any members.

Recent Developments in the Secondary Market (Steps taken by SEBI and Govt to reform the Secondary Market).

In recent years several steps have been taken to reform the secondary market with a view to improve the efficiency and effectiveness of secondary market. Some of the developments in this direction are as follows:

1. Regulation of intermediaries: Strict control is being exercised on the intermediaries in the capital market with a view to improve their functioning. The intermediaries such as merchant bankers, underwriters, brokers, sub-brokers etc. must be registered with the Securities and Exchange Board of

India. To improve their financial adequacy, capital adequacy norms have been fixed.

2. Insistence on quality securities: Securities and Exchange Board of India has announced recently revised norms for companies accessing the capital market so that only quality securities are listed and traded in stock exchanges. Further, participation of financial institutions in the capital is essential for entry into the capital market.

3. Prohibition of insider trading: Now Securities and Exchange Board of India (Insider Trading) Amendment Regulations, 2002 have been formed giving more powers to Securities and Exchange Board of India to curb insider trading. An insider is prevented from dealing in securities of any listed company on the basis of any unpublished price sensitive information.

4. Transparency of accounting practices: To ensure correct pricing and wider participation, greater efforts are being taken to achieve transparency in trading and accounting practices. Brokers are asked to show their prices, brokerage, service tax etc. separately in the contract notes and their accounts.

5. Strict supervision of stock market operations: The Ministry of Finance and Securities and Exchange Board of India supervise the operations in stock exchanges very strictly. The Securities and Exchange Board of India monitors the operations of stock exchanges very closely in order to ensure that the dealings are conducted in the best interest of the overall financial environment in the country in general and the investors in particular. Strict rules have been framed with regard to recognition of stock exchanges, membership, management, maintenance of accounts etc. Again, stock

exchanges are inspected by the officers of the Securities and Exchange Board of India from time to time.

6. Discouragement of manipulations: The Securities and Exchange Board of India is taking all steps to prevent price manipulations in all stock exchanges. It has given instructions to all stock exchanges to keep special margins in addition to normal ones on the scrips which are subject to wide price fluctuations. The

Securities and Exchange Board of India itself insists upon a special margin of 25% or more (in addition to the regular margin) on purchases of scrips which are subject to sharp rise in prices. All stock exchanges have been directed to suspend trading in scrip in case any one of the stock exchanges suspends trading in that scrip for more than a day due to price manipulation or fluctuation.

7. Prevention of price rigging: Greater powers have been given to Securities and Exchange Board of India under Securities and Exchange Board of India (Prohibition of fraudulent and unfair trade practices relating to security markets) Regulations, 1995 to curb price rigging.

8. Protection of investors' interests: Stock exchanges are given instructions to take timely action for the redressal of grievances of investors. For this purpose, the Securities and Exchange Board of India issues "Investors Guidance Service' to guide and educate the investors about grievances and remedies available. It also gives information about various investment avenues, their merits, tax benefits available etc. Disciplinary Action Committees have been set up in each stock exchange to take up complaints against companies, brokers etc. The Securities and Exchange Board of India itself takes up complaints against companies, brokers etc. Further,

each stock exchange is under a legal obligation to create an investor protection fund.

9. Free pricing of securities: Now any company is free to enter the capital market to raise the necessary capital at any price that it wants. Recently, the Securities and Exchange Board of India has permitted companies to issue shares below the face value of Rs. 10 and liberalised the norms for initial public offerings.

10. Freeing of interest rates: Interest rates on debentures and on PSU bonds were freed in August 1991 with a view to raising funds from the capital market at attractive rates depending on the credit rating.

11. Setting up of credit rating agencies: Credit rating agencies have been set up for awarding credit rating to the money market instruments, debt instruments, deposits and equity shares also. Now all debt instruments must be compulsorily credit rated by a credit rating agency so that the investing public may not be deceived by financially unsound companies.

12. Introduction of electronic trading: The OTCEI has started its trading operations through the electronic media. Similarly, BSE switched over to electronic trading system in 1995, called BOLT. Again, NSE went over to screen based trading with a national network.

13. Establishment of OTC / OTCEI / NSE: To overcome delay, price rigging, manipulation etc., OTC/ OTCEI and NSE have been established. OTC markets are fully automated exchanges where trading would be carried out through network of telephone/ computers/ tellers spread throughout the country.

14. Introduction of depository system: To avoid bad delivery, forgery, theft, delay in settlement and to speed up the transfer of securities, the depository system has been approved by the Parliament on July 23, 1996.

15. Buy back of shares: Now companies have been permitted to buy back their own shares.

16. Disinvestment of shares of PSUs: To bring down the Govt. holding and to push up the privatisation process, the disinvestment programme has been implemented. A Disinvestment Commission has been established for this purpose.

17. Stock watch system: The Securities and Exchange Board of India introduced a new stock watch system to trace out the source of undesirable trading if any in the market. The stock watch system simply works as a mathematical model which keeps a constant watch on the market movements.

18. Trading in derivatives: L.C. Gupta Committee which had gone into the question of introduction of derivative trading, has recommended introducing trading in index futures to start with and then trading in options. Recently, future funds also have been permitted to trade in derivatives.

19. Stock lending mechanism: To make the capital market active by putting idle stocks to work, stock lending scheme has been introduced by the Securities and Exchange Board of India.

20. International listing: The big event in the history of Indian capital market is the listing company’s share on an American stock exchange.

21. Rolling settlement: In July 2001, Securities and Exchange Board of India made rolling settlement on a T + 5 cycles

compulsory in 414 stocks and the rest of the stocks should follow it from January 2002. But now T + 2 rolling settlement have been introduced for all securities.

22. Margin trading: Another development in the secondary market is the introduction of margin trade.

Module II
FUND INVESTMENTS

Mutual funds represent one of the most important institutional forces in the market. They are institutional investors. They play a major role in today's financial market. The first mutual fund was established in Boston in 1924 (USA).

Meaning of Mutual Funds

Small investors generally do not have adequate time, knowledge, experience and resources for directly entering the capital market. Hence they depend on an intermediary. This financial intermediary is called mutual fund.

Mutual funds are corporations that accept money from savers and then use these funds to buy stocks, long term funds or short term debt instruments issued by firms or governments. These are financial intermediaries that collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. They invest the funds collected from investors in a wide variety of securities i.e. through diversification. In this way it reduces risk.

Mutual fund works on the principle of "small drops of water make a big ocean". It is a form of collective investment. To get the surplus funds from investors, it adopts a simple technique. Each fund is divided into a small share called 'units' of equal value. Each investor is allocated units in promotion to the size of his investment.

Mutual fund is a trust that pools the savings of investors. The money collected is then invested in financial market instruments such as shares, debentures and other securities.

The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. Thus mutual fund invests in a variety of securities (called diversification). This reduces risk. Diversification reduces the risk because all stock and/ or debt instruments may not move in the same direction.

According to the Mutual Fund Fact Book (published by the Investment Company Institute of USA), “a mutual fund is a financial service organization that receives money from shareholders, invests it, earns return on it, attempts to make it grow and agrees to pay the shareholder cash demand for the current value of his investment”.

SEBI (mutual funds) Regulations, 1993 defines a mutual fund as ‘a fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations.

Features of Mutual Funds

Mutual fund possesses the following features:

1. Mutual fund mobilizes funds from small as well as large investors by selling units.

2. Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.

3. Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.

4. Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.

5. Mutual fund provides switching facilities to investors who can switch from one scheme to another.

6. Various schemes offered by mutual funds provide tax benefits to the investors.

7. In India mutual funds are regulated by agencies like SEBI.

8. The cost of purchase and sale of mutual fund units is low.

9. Mutual funds contribute to the economic development of a country.

Types of Mutual Funds (Classification of Mutual Funds)

Mutual funds (or mutual fund schemes) can be classified into many types. The following chartshows the classification of mutual funds:

Mutual Funds

<u>On the basis of Operation</u>

Open ended

Close ended

<u>On the basis of Return</u>

Income fund

Growth fund

Conservative fund

<u>On the basis of Investment</u>

Equity fund

Bond fund

Balanced fund

Money market mutual fund

Taxation fund

Leveraged fund

Index bond fund

These may be briefly described as follows:

A. On the basis of Operation

1. Close ended funds: Under this type of fund, the size of the fund and its duration are fixed in advance. Once the subscription reaches the predetermined level, the entry of investors will be closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to their holding.

Features of Close ended Funds

(a) The period and the target amount of the fund is fixed beforehand.

(b) Once the period is over and/ or the target is reached, the subscription will be closed (i.e. investors cannot purchase any more units).

(c) The main objective is capital appreciation.

(d) At the time of redemption, the entire investment is liquidated and the proceeds are liquidated and the proceeds are distributed among the unit holders.

(e) Units are listed and traded in stock exchanges.

(f) Generally the prices of units are quoted at a discount of upto 40% below their net asset value.

2. Open-ended funds: This is the just reverse of close-ended funds. Under this scheme the size of the fund and / or the period of the fund is not fixed in advance. The investors are free to buy and sell any number of units at any point of time.

Features of Open-ended Funds

(a) The investors are free to buy and sell units. There is no time limit.

(b) These are not trade in stock exchanges.

(c) Units can be sold at any time.

(d) The main motive income generation (dividend etc.)

(e) The prices are linked to the net asset value because units are not listed on the stock exchange.

Difference between Open-ended and Close-ended Schemes

1. The close-ended schemes are open to the public for a limited period, but the open-ended schemes are always open to be subscribed all the time.

2. Close-ended schemes will have a definite period of life. But he open-ended schemes are transacted in the company.

3. Close-ended schemes are transacted at stock exchanges, where as open-ended schemes are transacted (bought and sold) in the company.

4. Close-ended schemes are terminated at the end of the specified period. Open-ended schemes can be terminated only if the total number of units outstanding after repurchase fall below 50% of the original number of units.

B. On the basis of return/ income

1. Income fund: This scheme aims at generating regular and periodical income to the members.

Such funds are offered in two forms. The first scheme earns a target constant income at relatively low risk. The second scheme offers the maximum possible income.

Features of Income Funds

(a) The investors get a regular income at periodic intervals.

(b) The main objective is to declare dividend and not capital appreciation.

(c) The pattern of investment is oriented towards high and fixed income yielding securities like bonds, debentures etc.

(d) It is best suited to the old and retired people.

(e) It focuses on short run gains only.

2. Growth fund: Growth fund offers the advantage of capital appreciation. It means growth fund concentrates mainly on long run gains. It does not offers regular income. In short, growth funds aim at capital appreciation in the long run. Hence they have been described as “Nest Eggs” investments or long haul investments.

Features of Growth Funds

(a) It meets the investors’ need for capital appreciation.

(b) Funds are invested in equities with high growth potentials in order to get capital appreciation.

(c) It tries to get capital appreciation by taking much risk.

(d) It may declare dividend. But the main objective is capital appreciation.

(e) This is best suited to salaried and business people.

3. Conservative fund: This aims at providing a reasonable rate of return, protecting the value of the investment and getting capital appreciation. Hence the investment is made in growth oriented securities that are capable of appreciating in the long run.

C. On the basis of Investment

1. Equity fund: it mainly consists of equity based investments. It carried a high degree of risk. Such funds do well in periods of favourable capital market trends.

2. Bond fund: It mainly consists of fixed income securities like bonds, debentures etc. It concentrates mostly on income rather than capital gains. It carries lower risk. It offers secure and steady income. But there is no chance of capital appreciation.

3. Balanced fund: It has a mix of debt and equity in the portfolio of investments. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

4. Fund of fund scheme: In this case funds of one mutual fund are invested in the units of other mutual funds.

5. Taxation fund: This is basically a growth oriented fund. It offers tax rebates to the investors. It is suitable to salaried people.

6. Leverage fund: In this case the funds are invested from the amounts mobilized from small investors as well as money borrowed from capital market. Thus it gives the benefit of leverage to the mutual fund investors. The main aim is to increase the size of the value of portfolio. This occurs when the gains from the borrowed funds are more than the cost of the borrowed funds.

The gains are distributed to unit holders.

7. Index bonds: These are linked to a specific index of share prices. This means that the funds mobilized under such schemes are invested principally in the securities of companies whose securities are included in the index concerned and in the same proportion. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

8. Money market mutual funds: These funds are basically open ended mutual funds. They have all the features of open ended mutual funds. But the investment is made is highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills etc. These are money market instruments.

9. Off shore mutual funds: The sources of investments for these funds are from abroad.

10. Guilt funds: This is a type of mutual fund in which the funds are invested in guilt edged securities like government securities. It means funds are not invested in corporate securities like shares, bonds etc.

Objectives of Mutual Funds

1. To mobilise savings of people.

2. To offer a convenient way for the small investors to enter the capital and the money market.

3. To tap domestic savings and channelize them for profitable investment.

4. To enable the investors to share the prosperity of the capital market.

5. To act as agents for growth and stability of the capital market.

6. To attract investments from the risk aversers.

7. To facilitate the orderly development of the capital market.

Advantages (Importance) of Mutual Funds

Mutual funds are growing all over the world. They are growing because of their importance to investors and their contributions in the economy of a country. The following are the advantages of mutual funds:

1. Mobilise small savings: Mutual funds mobilize small savings from the investors by offering various schemes. These schemes meet the varied requirements of the people. The savings of the people are channelized for the development of the economy. In the absence of mutual funds, these savings would have remained idle.

2. Diversified investment: Small investors cannot afford to purchase the shares of the highly established companies because of high market price. The mutual funds provide this opportunity to small investors. Even a very small investor can afford to invest in mutual funds. The investors can enjoy the wide portfolio of the investments held by the fund. It diversified its risks by investing in a variety of securities (equity shares, bonds etc.) The small and medium investors cannot do this.

3. Provide better returns: Mutual funds can pool funds from a large number of investors. In this way huge funds can be mobilized. Because of the huge funds, the mutual funds are in a position to buy securities at cheaper rates and sell securities at higher prices. This is not possible for individual investors.

In short, mutual funds are able to give good and regular returns to their investors.

4. Better liquidity: At any time the units can be sold and converted into cash. Whenever investors require cash, they can avail loans facilities from the sponsoring banks against the unit certificates.

5. Low transaction costs: The cost of purchase and sale of mutual fund units is relatively less. The brokerage fee or trading commission etc. are lower. This is due to the large volume of money being handled by mutual funds in the capital market.

6. Reduce risk: There is only a minimum risk attached to the principal amount and return for the investments made in mutual funds. This is due to expert supervision, diversification and liquidity of units.

7. Professional management: Mutual funds are managed by professionals. They are well trained. They have adequate experience in the field of investment. Thus investors get quality services from the mutual funds. An individual investor would never get such a service from the securities market.

8. Offer tax benefits: Mutual funds offer tax benefits to investors. For instance, under section 80 L of the Income Tax Act, a sum of Rs. 10,000 received as dividend from a mutual fund (in case of

UTI, it is Rs. 13,000) is deductible from the gross total income.

9. Support capital market: The savings of the people are directed towards investments in capital markets through mutual funds. They also provide a valuable liquidity to the capital market.

In this way, the mutual funds make the capital market active and stable.

10. Promote industrial development: The economic development of any nation depends upon its industrial advancement and agricultural development. Industrial units raise funds from capital markets through the issue of shares and debentures. Mutual funds supply large funds to capital markets. Besides, they create demand for capital market instruments (share, debentures etc.). Thus mutual funds provide finance to industries and thereby contributing towards the economic development of a country.

11. Keep the money market active: An individual investor cannot have any access to money market instruments. Mutual funds invest money on the money market instruments. In this way, they keep the money market active.

Valuation of Mutual Funds

Net Asset Value

NAV or Net Asset Value is the market value of the securities held by the scheme. Since market value of securities changes every day, NAV of a scheme also changes daily. The NAV per unit of all mutual fund schemes is updated on AMFI's website and the Mutual Funds' website by 9 p.m. that very day.

NAV= Market or Fair Value of Scheme's investments + Current Assets - Current Liabilities and Provision NAV / Number of Units outstanding under Scheme on the Valuation Date

All the Asset Management Companies value the investments of their Schemes as mandated by the principles of 'fair valuation' or such other principles/regulations as be prescribed by SEBI from time to time. This is done to ensure fair treatment to all investors including existing investors as well as investors seeking to purchase or redeem units of mutual funds in all schemes at all points of time.

This policy and procedures are reviewed at least once in a financial year by an internal auditor. The periodic report from the internal auditor verifying accuracy and authenticity of valuation of investments in accordance with this policy is presented before the Board of AMC and Trustee.

Whenever there is an investment in new type of securities / assets other than mentioned in existing policy, it shall be made only after establishment of the valuation methodologies for such securities / assets by the Valuation Committee with the approval of the Board of the AMC and Trustee.

Underlying Valuation Methodology

The valuation of investments shall be based on the principles of fair valuation i.e. valuation should reflect the realizable value of the securities/assets.

Investment in any new type of security shall be made only after establishment of the valuation methodology for such type of security with the approval of the AMC Board.

The valuation norms of each of the asset class is as follows:

1. Valuation of Traded Securities - equity / equity related security (such as convertible debentures, equity warrants, etc.)/preference shares

On a valuation day, these securities will be valued at the last quoted closing price on the National Stock Exchange of India Limited (NSE). In case a security is not traded on the NSE, it will be valued at the last quoted closing price on the Bombay

Stock Exchange Limited (BSE). If a security is not traded on any stock exchange on a valuation day, the last quoted closing price on NSE or BSE (in the order of priority) on the earliest previous day would be considered. Such day should not be more than thirty days prior to the valuation day.

If the security cannot be priced as per the above-mentioned criteria, then the valuation will be determined by the Valuation Committee based on the principles of fair valuation. During this process, the Valuation Committee will also consider if the price of the security is available on any recognized stock exchange other than the NSE and BSE and if the same is reliable/ can be considered for fair valuation.

Valuation of Exchange Traded Fund (ETF)

ETFs are - valued at closing market prices available on the stock exchange i.e. NSE. If the closing price is not available on NSE then the closing prices available on BSE is considered. If price at both NSE and BSE are not available, the latest NAV of the fund is considered

Valuation of Debt & Money Market Instruments

Asset Management Companies usually appoint independent external valuation agencies approved by AMFI, such as ICRA and CRISIL Ltd, an, to conduct the daily valuation of all debt and money market instruments by following all the procedures as laid below and provide the daily MTM prices for valuation with necessary justification. Securities are then valued at the average of the prices provided by these 2 valuation agencies.

Valuation of money market and debt securities with residual maturity of < 60 days:

All money market and debt securities, including floating rate securities, with residual maturity of up to 60 days shall be valued at the weighted average price at which they are traded on the valuation day. When such securities are not traded on a valuation day, they shall be valued on amortization basis.

Valuation of money market and debt securities with residual maturity of > 60 days

All money market and debt securities, including floating rate securities, with residual maturity of more than 60 days shall be valued at weighted average price at which they are traded on the valuation day.

Mutual Funds in India

In India the first mutual fund was UTI. It was set up in 1964 under an Act of parliament. During the year 1987-1992, seven new mutual funds were established in the public sector. In 1993, the government changed its policy to allow the entry of private corporates and foreign institutional investors into the mutual fund segment. Now the commercial banks like the SBI, Canara Bank,

Indian bank, Bank of India, Punjab National Bank etc. have entered into the field. LIC and GIC have also entered into the market. By the end of March 2000, there was 36 mutual funds, 9 in the public sector and 27 in the private sector. However UTI dominated the mutual fund sector. In India mutual funds are being regulated by agencies like SEBI. Mutual funds play an important role in promoting saving and investment within the country. There are around 196 mutual fund schemes, and the amount of assets under their management was Rs. 47,000 crores in 1993, Rs. 80,590 crores in 2003 and it went up to Rs. 2, 17,707crores by 31.3.2006. Thus mutual funds are growing in India. However, their growth rate is very slow.

PROBLEMS OF MUTUAL FUNDS IN INDIA

The following are some of the main problems that are being faced by Indian mutual funds.

1. Liquidity crisis.
2. Lac of innovation.
3. Inadequate research.
4. Conventional pattern of investment.
5. No provision for performance guarantee.
6. Inadequate disclosures.
7. Delays in service.
8. No rural sector investment base.
9. Poor risk management.

SEBI GUIDELINES ON MUTUAL FUNDS

Mutual funds in India are now governed under the Securities and Exchange Board of India(mutual fund) Regulations,1996. SEBI has provided a four tier system for managing the affairs of mutual funds. The four constituents in the organisation of a mutual funds are:

1. **The sponsoring company, called Sponsor:** SEBI(mutual funds) Regulations define Sponsor as any person who acting alone or in combination with another body corporate, establishes a mutual fund. SBI Mutual fund is sponsored by

State Bank of India, LICMF is sponsored by Life Insurance Corporation (LIC) of India. Sponsors have to comply with the following regulations laid down by SEBI.

a. Application and fee: a sponsor has to file an application for registration of a mutual fund in the prescribed form along with an application with fee of Rs.100000. the sponsors must furnish all information and give clarifications as may be required by the board.

b. Eligibility criteria: the sponsor may be granted a certificate of registration provided following conditions are satisfied.

i. The sponsor has a sound track reecord and general reputation of fairness and integrity in all his business transactions for not less than 5 years.

ii. The sponsor has contributed atleast 40% of the worth of AMC.

iii. A trustee has been appointed by the sponsers who will act as trustee for the mutual fund.

iv. An AMC is appointed to manage and operate the scheme of such funds.

v. A custodian is appointed to keep custody of the securities and carry out the custodian activities.

c. Grant of certificate of registration.

d. Annual fee.

2. **The trustees:** SEBI(mutual fund) Amendment regulations. 1999 defines trustee as "a person who holds the property of the mutual fund in trust for benefit of the unit-holders and includes a trustee company and the directors of the trustee company." SEBI (mutual fund) regulatons, 1996 from 16to 18 contain guidelines with regard to operation of trustees

3. Asset management company (AMC):

SEBI regulations require that mutual funds be managed by a seperate body corporate. The sponsor or the trustee shall appoint an AMC. The application for the approval of AMC has to be made in Form D. The appointment of AMC can be terminated by majority of the trustees or by 75% of the unit-holders of the scheme. Any change in the appointment of

AMC requires the prior approval of the Board and the unit-holders.

4. **Custodian:** custodian is defined under SEBI (mutual funds) Regulations.1996 as " a person who has been granted a certificate of registration to carry on the business of custodian of securities under the securities and Exchange Board of India (custodian of securities) Regulations, 1996. Custodian provides custodial services and ensures safe-keeping of securities. He performs the following functions.

i. Maintains accounts of securities of a client.

ii. Collects the benefits or rights accuring to the client in respect of secutities.

iii. Maintains and reconciles the records of securities.

iv. Helps in transfer of the securities in the name of trust.

v. Prevents any manipulation of records and documents.

The following are the SEBI regulations with regard to custodian.

Appointment of custodian (SEBI Regulation 26)

i. The mutual fund shall appoint a custodian to carry out the custodian services for the schemes of the fund and sent intimation of the same to the board within fifteen days of the appointment of the custodian.

ii. No custodian in which the sponsor or its associates holds 50% or more of the voting rights of the share capital of the custodian or where 50 % or more of the directors of the custodian represent the interest of the sponsor or its associates, shall act as custodian for a mutual fund constitutes by the same sponsor or any of its associate or subsidiary company.

PENSION FUND

Pension funds, which are also known as retirement funds, is a kind of savings scheme where you (as an employee) invest a small portion of your income/salary into a designated savings plan. The main objective of this plan is to get a steady flow of income after you complete your active years of service.

In India, the pension funds are divided into two stages. The first stage is the accumulation stage wherein you pay or invest in the pension plan throughout your active work years until the retirement age. Once you attain the retirement age, the second stage begins, which is the vesting stage. In this stage, you start getting annuities until death.

BENEFITS OF INVESTING IN PENSION FUNDS

One of the most significant pension benefits is that lets you save for long-term. Whether you choose a scheme that requires you to invest a lump sum amount or smaller amounts, you get guaranteed savings. The pension funds create an annuity that you can use to invest further and get steady income post retirement.
Many pension funds offer a lump sum payback to the investor when they attain the retirement age or in case of their death, whichever event occurs earlier. This implies that the pension fund also gives you the benefit of an insurance cover.
Another benefit of investing in a **pension fund** is that it negates the effect of inflation and provides inflation-adjusted returns.

TYPES OF PENSION FUNDS IN INDIA

In India, the pension plans are broadly classified into three types, which are: The funds that are sponsored by an insurance company. In the fund, the investor’s money is invested in

debts alone and is best suited for conservative and low-risk investors.
Unit Linked Plans invest the funds in both debt funds and equities. It is one of the most popular pension funds and lets the investors create a balanced portfolio. Lastly, the National Pension Scheme, which is the government-sponsored fund. Under this scheme, the funds are either invested in government securities or debt securities.

1. NPS

The government of India introduced the National Pension Scheme (NPS) as a financial cushion for retired persons. Some of its features are as follows:

- You have to invest in this scheme until 60 years of age.
- The least sum you must invest is Rs. 1000. There is no upper limit.
- Your money will be invested in debt and equity funds based on your preference.
- The returns depend on the performance of the funds you choose.
- When you retire, you can withdraw 60% of the savings.
- You must use the remaining 40% to buy an annuity – a retirement plan offering periodic income.

2. Public Provident Fund (PPF)

PPF is a long-term investment scheme with a 15 years' tenure. Thus, the impact of compounding is enormous, especially towards the end of the term.

Every year you can invest a maximum of Rs. 1.5 lakhs in your PPF account. You can pay upfront or through twelve instalments staggered over the financial year. Your PPF investments are eligible for tax deductions under Section 80C of the Income Tax Act (ITA). The interest you earn is also tax-free.

The government sets the interest rate on PPF every financial quarter, based on the profits from government securities. The funds are not market-linked.

3. Employee Provident Fund (EPF)

EPF is a government savings platform for salaried employees. Both your employer and you have to make equal contributions towards your EPF account. Your share is removed from your salary every month. The Employees' Provident Fund Organisation (EPFO) sets the interest rate on the investment. On retirement, you receive the total funds contributed by you and your employer along with the accrued interests.

4. Annuity plans with life cover

Such plans provide a life cover along with a regular source of income. If an unfortunate event occurs while the plan is active, your family member receives a lump-sum payout, however there are other options too that do not offer this financial coverage. Annuity plans are of two types:

A. Deferred Annuity

It is a contract with an insurance provider helping you build a retirement corpus. You can make a single lump-sum payment or pay regular premiums over a fixed time-frame – the policy term. Thus, this scheme helps you invest as per your resources.

When the policy period ends, your pension starts. If your retirement date is far in the future, this plan is suitable for you.

B. Immediate annuity

It is a contract between an individual and insurance company, where in the individual pays a lump sum amount and receives guaranteed income for lifetime, starting almost immediately.

Exchange Traded Fund (ETF)

An exchange traded fund (ETF) is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same way a regular stock can. An ETF can be structured to track anything from the price of an individual commodity to a large and diverse collection of securities. ETFs can even be structured to track specific investment strategies.

A well-known example is the SPDR S&P 500 ETF (SPY), which tracks the S&P 500 Index. ETFs can contain many types of investments, including stocks, commodities, bonds, or a mixture of investment types. An exchange traded fund is a marketable security, meaning it has an associated price that allows it to be easily bought and sold.

An ETF is called an *exchange traded* fund because it's traded on an exchange just like stocks are. The price of an ETF’s shares will change throughout the trading day as the shares are bought and sold on the market. This is unlike mutual funds, which are not traded on an exchange, and trade only once per day after the markets close. Additionally, ETFs tend to be more cost-effective and more liquid when compared to mutual funds.

Types of ETFs

There are various types of ETFs available to investors that can be used for income generation, speculation, price increases, and to hedge or partly offset risk in an investor's portfolio.

Here is a brief description of some of the ETFs available on the market today.

Bond ETFs

Bond ETFs are used to provide regular income to investors. Their income distribution depends on the performance of underlying bonds. They might include government bonds, corporate bonds, and state and local bonds—called municipal bonds. Unlike their underlying instruments, bond ETFs do not have a maturity date. They generally trade at a premium or discount from the actual bond price.

Stock ETFs

Stock ETFs comprise a basket of stocks to track a single industry or sector. For example, a stock ETF might track automotive or foreign stocks. The aim is to provide diversified exposure to a single industry, one that includes high performers and new entrants with potential for growth. Unlike stock mutual funds, stock ETFs have lower fees and do not involve actual ownership of securities.

Industry ETFs

Industry or sector ETFs are funds that focus on a specific sector or industry. For example, an energy sector ETF will include companies operating in that sector. The idea behind industry ETFs is to gain exposure to the upside of that industry by tracking the performance of companies operating in that sector. One example is the technology sector, which has witnessed an influx of funds in recent years. At the same time, the downside of volatile stock performance is also curtailed in an ETF because they do not involve direct ownership of securities. Industry ETFs are also used to rotate in and out of sectors during economic cycles.

Commodity ETFs

As their name indicates, commodity ETFs invest in commodities, including crude oil or gold. Commodity ETFs provide several benefits. First, they diversify a portfolio, making it easier to hedge downturns. For example, commodity ETFs can provide a cushion during a slump in the stock market. Second, holding shares in a commodity ETF is cheaper than physical possession of the commodity. This is because the former does not involve insurance and storage costs.

Currency ETFs

Currency ETFs are pooled investment vehicles that track the performance of currency pairs, consisting of domestic and foreign currencies. Currency ETFs serve multiple purposes. They can be used to speculate on the prices of currencies based on political and economic developments for a country. They are also used to diversify a portfolio or as a hedge against volatility in forex markets by importers and exporters. Some of them are also used to hedge against the threat of inflation.

Inverse ETFs

Inverse ETFs attempt to earn gains from stock declines by shorting stocks. Shorting is selling a stock, expecting a decline in value, and repurchasing it at a lower price. An inverse ETF uses derivatives to short a stock. Essentially, they are bets that the market will decline. When the market declines, an inverse ETF increases by a proportionate amount. Investors should be aware that many inverse ETFs are exchange traded notes (ETNs) and not true ETFs. An ETN is a bond but trades like a stock and is backed by an issuer like a bank. Be sure to check with your broker to determine if an ETN is a good fit for your portfolio.

In the U.S., most ETFs are set up as open-ended funds and are subject to the Investment Company Act of 1940 except where subsequent rules have modified their regulatory requirements. Open-end funds do not limit the number of investors involved in the product.

How to Begin Investing in ETFs

With a multiplicity of platforms available to traders, investing in ETFs has become fairly easy. Follow the steps outlined below to begin investing in ETFs.

1. **Find an investing platform:** ETFs are available on most online investing platforms, retirement account provider sites, and investing apps like Robinhood. Most of these platforms offer commission-free trading, meaning you don't have to pay fees to the platform providers to buy or sell ETFs. However, a commission-free purchase or sale does not mean that the ETF provider will also provide access to their product without associated costs. Some areas in which platform services can distinguish their services from others are convenience, services, and product variety. For example, smartphone investing apps enable ETF share purchase at the click of a button. This may not be the case for all brokerages, which may ask investors for paperwork or a more complicated situation. Some well-known brokerages, however, offer extensive educational content that helps new investors become familiar with and research ETFs.

2. **Research ETFs:** The second and most important step in ETF investing involves researching them. There is

a wide variety of ETFs available in the markets today. One thing to remember during the research process is that ETFs are unlike individual securities like stocks or bonds. You will need to consider the whole picture—in terms of sector or industry—when you commit to an ETF. Here are some questions you might want to consider during the research process:

3. What is your time frame for investing?
4. Are you investing for income or growth?
5. Are there particular sectors or financial instruments that excite you?
6. **Consider a trading strategy:** If you are a beginning investor in ETFs, dollar-cost averaging or spreading out your investment costs over a period of time is a good trading strategy. This is because it smooths out returns over a period of time and ensures a disciplined (as opposed to a haphazard or volatile) approach to investing. It also helps beginning investors learn more about the nuances of ETF investing. When they become more comfortable with trading, investors can move out to more sophisticated strategies like swing trading and sector rotation.

7.

Exchange Traded Funds	**Mutual Funds**
ETFs are a type of index funds that track a basket of securities.	Mutual funds are pooled investments into bonds, securities, and other instruments that provide returns.
ETF prices can trade at a premium or at a loss to the net asset value of the fund.	Mutual fund prices trade at the net asset value of the overall fund.
ETFs are traded in the markets during regular hours just like stocks are.	Mutual funds can be redeemed only at the end of a trading day.
Some ETFs can be purchased commission-free and are cheaper than mutual funds because they do not charge marketing fees.	Some mutual funds do not charge load fees, but most are more expensive than ETFs because they charge administration and marketing fees.
ETFs do not involve actual ownership of securities.	Mutual funds own the securities in their basket.

ETFs diversify risk by tracking different companies in a sector or industry in a single fund.	Mutual funds diversify risk by creating a portfolio that spans multiple asset classes and security instruments.
ETF trading occurs in-kind, meaning they cannot be redeemed for cash.	Mutual fund shares can be redeemed for money at the fund's net asset value for that day.
Because ETF share exchanges are treated as in-kind distributions, ETFs are the most tax-efficient amongst all three types of financial instruments.	Mutual funds offer tax benefits when they return capital or include certain types of tax-exempt bonds in their portfolio.

Module III

INVESTMENT BANKING AND MERCHANT BANKING

The word 'merchant banking' was originated among the Dutch and Scottish traders. Later on it was developed and professionalised in the UK and the USA. Now this has become popular throughout the world.

Meaning and Definition of Merchant Banking

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services.

The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking. We can define merchant banking as a process of transferring

capital from those who own it to those who use it. According to Random House Dictionary, "merchant bank is an organization that underwriters securities for corporations, advices such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks". According to SEBI (Merchant Bankers) Rules 1992, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering corporate advisory services inrelation to such issue management". In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

Thus merchant banking involves a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, preparation of feasibility reports etc. It is not necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialise in one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

In short, merchant banking involves servicing any financial need of the client.

Difference between Merchant Bank and Commercial Bank

Merchant banks are different from commercial banks. The following are the important differences between merchant banks and commercial banks:

1. Commercial banks basically deal in debt and debt related finance. Their activities are clustered around credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant bankers is equity and equity related finance. They deal with mainly funds raised through money market and capital market.

2. Commercial banks' lending decisions are based on detailed credit analysis of loan proposals and the value of security offered. They generally avoid risks. They are asset oriented.

But merchant bankers are management oriented. They are willing to accept risks of business.

3. Commercial banks are merely financiers. They do not undertake project counselling, corporate counselling, managing public issues, underwriting public issues, advising on portfolio management etc. The main activity of merchant bankers is to render financial services for their clients. They undertake project counselling, corporate counselling in areas of capital restructuring, mergers, takeovers etc., discounting and rediscounting of short-term paper in money markets, managing and underwriting public issues in new issue market and acting as brokers and advisors on portfolio management.

Functions (Services) of Merchant Bankers (Scope of Merchant Banking)

Merchant banks have been playing an important role in procuring the funds for capital market for the corporate sector for financing their operations. They perform some valuable functions. The functions of merchant banks in India are as follows:

1. Corporate counseling: One of the important functions of a merchant banker is corporate counseling. Corporate counseling refers to a set of activities undertaken to ensure efficient functioning of a corporate enterprise through effective financial management. A merchant banker guides the client on aspects of organizational goals, vocational factors, organization size, choice of product, demand forecasting, cost analysis, allocation of resources, investment decisions, capital and expenditure management, marketing strategy, pricing methods etc. The following activities are included in corporate counseling:

(a) Providing guidance in areas of diversification based on the Government's economic and licensing policies.

(b) Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.

(c) Rejuvenating old-line companies and ailing sick units by appraising their technology and process, assessing their requirements and restructuring their capital base.

(d) Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.

(e) Arranging for the approval of the financial institutions/banks for schemes of rehabilitation involving financial relief, etc.

(f) Monitoring of rehabilitation schemes.

(g) Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

2. Project counseling: Project counseling relates to project finance. This involves the study of the project, offering advisory services on the viability and procedural steps for its implementation.

Project counseling involves the following activities:

(a) Undertaking the general review of the project ideas/project profile.

(b) Providing advice on procedural aspects of project implementation.

(c) Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.

(d) Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consents for implementation of the project.

(e) Assisting in obtaining approvals/licenses/permissions/grants, etc from government agencies in the form of letter of intent, industrial license, DGTD registration, and government approval for foreign collaboration.

(f) Identification of potential investment avenues.

(g) Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.

(h) Undertaking financial study of the project and preparation of viability reports to advise on the framework of institutional guidelines and laws governing corporate finance.

(i) Providing assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas, covering the technical, financial and economic aspects of the project from the point of view of their acceptance by financial institutions and banks.

(j) Advising and assisting clients in preparing applications for financial assistance to various national financial institutions, state level institutions, banks, etc.

3. Pre-investment studies: Another function of a merchant banker is to guide the entrepreneurs in conducting pre-investment studies. It involves detailed feasibility study to evaluate investment avenues to enable to decide whether to invest or not. The important activities involved in preinvestment studies are as follows:

(a) Carrying out an in-depth investigation of environment and regulatory factors, location of raw material supplies, demand projections and financial requirements in order to assess the financial and economic viability of a given project.

(b) Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to promote corporate profitability and growth in the long run.

(c) Offering a package of services, including advice on the extent of participation, government regulatory factors and an environmental scan of certain industries in India.

4. Loan syndication: A merchant banker may help to get term loans from banks and financial institutions for projects. Such loans may be obtained from a single financial institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from commercial banks. The following activities are undertaken by merchant bankers under loan syndication:

(a) Estimating the total cost of the project to be undertaken.

(b) Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.

(c) Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.

(d) Selecting institutions and banks for participation in financing.

(e) Follow-up of term loan application with the financial institutions and banks, and obtaining the approval for their respective share of participation.

(f) Arranging bridge finance.

(g) Assisting in completion of formalities for drawing of term finance sanctioned by institutions by expediting legal documentation formalities, drawing up agreements etc. as prescribed by the participating financial institutions and banks.

(h) Assessing working capital requirements.

5. Issue management: Issue management involves marketing or corporate securities by offering them to the public. The corporate securities include equity shares, preference shares, bonds, debentures etc. Merchant bankers act as financial intermediaries. They transfer capital from those who own it to those who need it. The security issue function may be broadly classified into two – pre-issue management and post-issue management. The pre-issue management involves the following functions:

(a) Public issue through prospectus.

(b) Marketing and underwriting.

(c) Pricing of issues.

These may be briefly discussed as follows:

(a) Public issue through prospectus: To being out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. First the prospectus should be drafter. The copies of consent of experts, legal advisor, attorney, solicitor, bankers, and bankers to the issue, brokers and underwriters are to be obtained from the company making the issue. These copies are to be filed along with the prospectus to the Registrar Companies. After the prospectus is ready, it has to be sent to the SEBI for clearance. It is only after clearance by SEBI, the prospectus can be filed with the Registrar. The brokers to the issue, principal agent and bankers to issue are appointed by merchant bankers.

(b) Marketing and underwriting: After sending prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaigns and fixing date of board meeting to approve and pass the necessary resolutions. The role of merchant banker in publicity campaigns to help selecting the media, determining the size and publications in which the advertisement should appear. The merchant bank shall decide the number of copies to be printed, check accuracy of statements made and ensure that the size of the application form and prospectus are as per stock exchange regulations. The merchant banker has to ensure that he material is delivered to the stock exchange at least 21 days before the issue opens and to the brokers to the issue, and underwriters in time.

(c) Pricing of issues: Pricing of issues is done by companies themselves in consultation with the merchant bankers. An existing listed company and a new company set up by an existing company with 5 year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with 2 ½ years track record of constant profitability can freely price the issue. The premium can be determined after taking into consideration net asset value, profit earning capacity and market price. The price and premium has to be stated in the prospectus.

Post-issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedures, mailing of allotment letters, share certificates and refund orders. Merchant bankers help the company by co-ordinating the above activities.

6. Underwriting of public issue: In underwriting of public issue the activities performed by merchant bankers are as follows:

(a) Selection of institutional and broker underwriters for syndicating/ underwriting arrangements.

(b) Obtaining the approval of institutional underwriters and stock exchanges for publication of the prospectus.

(c) Co-ordination with the underwriters, brokers and bankers to the issue, and the Stock Exchanges.

7. Portfolio management: Merchant bankers provide portfolio management service to their clients. Today every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. Merchant bankers help the investors in this regard. They study the monetary and fiscal policies of the government. They study the financial statements of companies in which the investments have to be made by investors. They also keep a close watch on the price movements in the stock market.

The merchant bankers render the following services in connection with portfolio management:

(a) Undertaking investment in securities.

(b) Collection of return on investment and re-investment of the same in profitable avenues, investment advisory services to the investors and other related services.

(c) Providing advice on selection of investments.

(d) Carrying out a critical evaluation of investment portfolio.

(e) Securing approval from RBI for the purchase/sale of securities (for NRI clients).

(f) Collecting and remitting interest and dividend on investment.

(g) Providing tax counseling and filing tax returns through tax consultants.

8. Merger and acquisition: A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over refers to the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises

merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

9. Foreign currency financing: The finance provided to fund foreign trade transactions is called 'Foreign Currency

Finance'. The provision of foreign currency finance takes the form of exportimport trade finance, euro currency loans, Indian joint ventures abroad and foreign collaborations.

The main areas that are covered in this type of merchant activity are as follows:

(a) Providing assistance for carrying out the study of turnkey and construction contract projects.

(b) Arranging for the syndication of various types of guarantees, letters of credit, pre-shipment credit, deferred post-shipment credit, bridge loans, and other credit facilities.

(c) Providing assistance in opening and operating bank accounts abroad.

(d) Arranging foreign currency loans under buyer's credit scheme for importing goods.

(e) Arranging deferred payment guarantees under suppliers credit scheme for importing capital goods.

(f) Providing assistance in obtaining export credit facilities from the EXIM bank for export of capital goods, and arranging for the necessary government approvals and clearance.

(g) Undertaking negotiations for deferred payment, export finance, buyers credits, documentary credits, and other foreign exchange services like packing credit, etc.

10. Working capital finance: The finance required for meeting the day-to-day expenses of an enterprise is known as 'Working Capital Finance'. Merchant bankers undertake the following activities as part of providing this type of finance:

(a) Assessment of working capital requirements.

(b) Preparing the necessary application to negotiations for the sanction of appropriate credit facilities.

11. Acceptance credit and bill discounting: Merchant banks accept and discount bills of exchange on behalf of clients. Merchant bankers give loans to business enterprises on the security of bill of exchange. For this purpose, merchant bankers collect credit information relating to the clients and undertake rating their creditworthiness.

12. Venture financing: Another function of a merchant banker is to provide venture finance to projects. It refers to provision of equity finance for funding high-risk and high-reward projects.

13. Lease financing: Leasing is another function of merchant bankers. It refers to providing financial facilities to companies that undertake leasing. Leasing involves letting out assets on lease for a particular period for use by the lessee. The following services are provided by merchant bankers in connection with lease finance:

(a) Providing advice on the viability of leasing as an alternative source for financing capital investment projects.

(b) Providing advice on the choice of a favourable rental structure.

(c) Providing assistance in establishing lines of lease for acquiring capital equipment, including preparation of proposals, documentations, etc.

14. Relief to sick industries: Merchant bankers render valuable services as a part of providing relief to sick industries.

15. Project appraisal: Project appraisal refers to evaluation of projects from various angles such as technology, input, location, production, marketing etc. It involves financial appraisal, marketing appraisal, technical appraisal, economic appraisal etc. Merchant bankers render valuable services in the above areas.

The functions of merchant banker can be summarized as follows:

(a) Issue management.

(b) Underwriting of issues.

(c) Project appraisal.

(d) Handling stock exchange business on behalf of clients.

(e) Dealing in foreign exchange.

(f) Floatation of commercial paper.

(g) Acting as trustees.

(h) Share registration.

(i) Helping in financial engineering activities of the firm.

(j) Undertaking cost audit.

(k) Providing venture capital.

(l) Arranging bridge finance.

(m) Advising business customers (i.e. mergers and takeovers).

(n) Undertaking management of NRI investments.

(o) Large scale term lending to corporate borrowers.

(p) Providing corporate counseling and advisory services.

(q) Managing investments on behalf of clients.

(r) Acting as a stock broker.

Objectives of Merchant Banking

The objectives of merchant banking are as follows:

1. To help for capital formation.

2. To create a secondary market in order to boost the industrial activities in the country.

3. To assist and promote economic endeavour.

4. To prepare project reports, conduct market research and pre-investment surveys.

5. To provide financial assistance to venture capital.

6. To build a data bank as human resources.

7. To provide housing finance.

8. To provide seed capital to new enterprises.

9. To involve in issue management.

10. To act as underwriters.

11. To identify new projects and render services for getting clearance from government.

12. To provide financial clearance.

13. To help in mobilizing funds from public.

14. To divert the savings of the country towards productive channel.

15. To conduct investors conferences.

16. To obtain consent of stock exchange for listing.

17. To obtain the daily report of application money collected at various branches of banks.

18. To appoint bankers, brokers, underwrites etc.

19. To supervise the process on behalf of NRIs for their ventures.

20. To provide service on fund based activities.

21. To assist in arrangement of loan syndication.

22. To act as an acceptance house.

23. To assist in and arrange mergers and acquisitions.

Role of Merchant Bankers in Managing Public Issue

In issue management, the main role of merchant bankers is to help the company issuing securities in raising funds for the purpose of financing new projects, expansion/ modernization/ diversification of existing units and augmenting long term resources for working capital requirements.

The most important aspect of merchant banking business is to function as lead managers to the issue management. The role of the merchant banker as an issue manager can be studied from the following points:

1. Easy fund raising: An issue manager acts as an indispensable pilot facilitating a public/ rights issue. This is made possible with the help of special skills possessed by him to execute the management of issues.

2. Financial consultant: An issue manager essentially acts as a financial architect, by providing advice relating to capital structuring, capital gearing and financial planning for the company.

3. Underwriting: An issue manager allows for underwriting the issues of securities made by corporate enterprises. This ensures due subscription of the issue.

4. Due diligence: The issue manager has to comply with SEBI guidelines. The merchant banker will carry out activities with due diligence and furnish a Due Diligence Certificate to SEBI.

The detailed diligence guidelines that are prescribed by the Association of Merchant Bankers of India (AMBI) have to be strictly observed. SEBI has also prescribed a code of conduct for merchant bankers.

5. Co-ordination: The issue manger is required to co-ordinate with a large number of institutions and agencies while managing an issue in order to make it successful.

6. Liaison with SEBI: The issue manager, as a part of merchant banking activities, should register with SEBI. While managing issues, constant interaction with the SEBI is required by way of filing of offer documents, etc. In addition, they should file a number of reports relating to the issues being managed.

Merchant Banking in India

Prior to the enactment of Indian Companies Act, 1956, managing agents acted as merchant bankers. They acted as issue houses for securities, evaluated project reports, provided venture capital for new firms etc. Few share broking firms also functioned as merchant bankers.

With the rapid growth in the number and size of the issues made in the primary market, the need for specialized merchant banking service was felt. Grindlays Bank (foreign bank) opened its merchant banking division in 1967, followed by Citibank in 1970. SBI started its merchant banking division in 1972 and it followed up by setting up a fully owned subsidiary in 1980, namely SBI

Capital Markets Ltd. The other nationalized banks and financial institutions, like IDBI, IFCI, ICICI, Securities and Finance Company Ltd., Canara Bank (Can Bank Financial Services Ltd.),

Bank of India (BOI Finance Ltd.) and private sector financial companies, like JM Financial and Investment Consultancy Services Ltd., DSP Financial Consultancy Ltd. have also set up their merchant banking divisions.

With over 1,100 merchant bankers operating in the country, the primary market activity is picking up. Merchant banking services have assumed greater importance in the present capital market scenario. With the investor becoming more cautious and discerning, the role of merchant banker has gained more prominence.

In India, apart from the overall control by the RBI, merchant bankers' operations are closely supervised by the SEBI for their proper functioning and investor protection.

Setting up and management of merchant banks in India

In India a common organizational set up of merchant bankers to operate is in the form of divisions of Indian and Foreign banks and financial institutions, subsidiary companies established by bankers like SBI, Canara Bank, Punjab National Bank, Bank of India, etc. some firms are also organized by financial and technical consultants and professionals. Securities and exchanges Board of India (SEBI) has divided the merchant bankers into four categories based on their capital adequacy. Each category is authorized to perform certain functions. From the point of Organizational set up India's merchant banking organizations can be categorized into 4 groups on the basis of their linkage with parent activity. They are:

a) Institutional Base:-

Merchant banks function as an independent wing or as subsidiary of various Private/ Central Governments/ State Governments Financial institutions. Most of the financial institutions in India are in public sector and therefore such set up plays a role on the lines of governmental priorities and policies.

b) Banker Base:-

These merchant bankers function as division/ subsidiary of banking organization. The parent banks are either nationalized commercial banks or the foreign banks operating in India. These organizations have brought professionalism in merchant banking sector and they help their parent organization to make a presence in capital market.

c) Broker Base:-

In the recent past there has been an inflow of Qualified and professionally skilled brokers in various Stock Exchanges of India. These brokers undertake merchant banking related operating also like providing investment and portfolio management services.

d) Private Base:-

These merchant banking firms are originated in private sectors. These organizations are the outcome of opportunities and scope in merchant banking business and they are providing skill oriented specialized services to their clients. Some foreign merchant bankers are also entering either independently or through some collaboration with their Indian counterparts. Private Sectors merchant banking firms have come up either as sole proprietorship, partnership, private limited or public limited companies. Many of these firms were in existence for quite some time before they added a new activity in the form of merchant banking services by opening new division on the lines of commercial banks and All India Financial Institution (AIFI).

Categories of Merchant Banks

Merchant bankers are classified into four categories according to the SEBI (Merchant Banking) Regulations 1992. These are as follows:

(a) Category – I: To carry on any activity relating to issue management and act as adviser, consultant manager, underwriter and portfolio manager for capital issues.

(b) Category – II: To act as adviser, consultant, co-manager, underwriter and portfolio manager for capital issues.

(c) Category – III: To act as underwriter, adviser, and consultant to an issue.

(d) Category – IV: To act only as adviser or consultant to an issue.

Weakness of merchant banks / Problems of merchant banks

1. SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management. It restricts the scope of merchant bank activities.

2. SEBI guidelines stipulate a minimum net worth of Rs.1 crore for authorisation of merchant bankers. Small but professional merchant bankers are facing difficulty for adhering such net worth norms.

3. Non cooperation of the issuing companies in timely allotment of securities and refund application money is another problem of merchant bankers.

4. Unhealthy competition among large number of merchant banks compels them to reduce their profit margin, commission etc.

5. There is no exact regulatory framework for regulating and controlling the working of merchant banks in India.

6. Fraudulent and fake issue of share capital by the companies are also posing problems for merchant banks who act as lead manager or issue manager of such issues.

Regulations by SEBI on Merchant Banking

Reforms for the merchant bankers

SEBI has made the following reforms for the merchant banker

1. Multiple categories of merchant banker will be abolished and there will be only one equity merchant banker.

2. The merchant banker is allowed to perform underwriting activity. For performing portfolio manager, the merchant banker has to seek separate registration from SEBI.

3. A merchant banker cannot undertake the function of a non banking financial company, such as accepting deposits, financing others' business, etc.

4. A merchant banker has to confine himself only to capital market activities.

Recognition by SEBI on merchant bankers

SEBI will grant recognition a merchant banker after taking into account the following aspects

1. Considering how much the merchant are professionally competent.

2. Whether they have adequate capital

3. Track record, experience and general reputation of merchant bankers.

4. Quality of staff employed by merchant bankers, their adequacy and available infrastructure are taken into account. After considering the above aspects, SEBI will grant permission for the merchant banker to start functioning.

Conditions by SEBI for merchant bankers

SEBI has laid the following conditions on the merchant bankers, for conducting their operations. They are

1. SEBI will give authorization for a merchant banker to operate for 3 years only. Without SEBI's authorization, merchant bankers cannot operate.

2. The minimum net worth of merchant banker should be Rs. 1 crore.

3. Merchant banker has to pay authorization fee, annual fee and renewal fee.

4. All issue of shares must be managed by one authorized merchant banker. It should be the lead manager.

5. The responsibility of the lead manager will be clearly indicated by SEBI.

6. Lead managers are responsible for allotment of securities, refunds, etc.

7. Merchant banker will submit to SEBI all returns and send reports regarding the issue of shares.

8. A code of conduct for merchant bankers will be given by SEBI, which has to be followed by them.

9. Any violation by the merchant banker will lead to the revocation of authorization by SEBI

Module IV
LEASE FINANCE AND VENTURE CAPITAL FINANCE

Meaning of leasing

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.

2. The document in which this contract is written.

3. A great way companies can conserve capital.

4. An easy way vendors can increase sales.

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

Importance of Lease Financing

Lease financing is based on the observation made by Donald B. Grant:

"Why own a cow when the milk is so cheap? All you really need is milk and not the cow."

Leasing industry plays an important role in the economic development of a country by providing money incentives to lessee. The lessee does not have to pay the cost of asset at the time of signing the contract of leases. Leasing contracts are more flexible so lessees can structure the leasing contracts according to their needs for finance. The lessee can also pass on the risk of obsolescence to the lessor by acquiring those appliances, which have high technological obsolescence. Today, most of us are familiar with leases of houses, apartments, offices, etc.

The advantages of leasing include:

a. Leasing helps to possess and use a new piece of machinery or equipment without huge investment.

b. Leasing enables businesses to preserve precious cash reserves.

c. The smaller, regular payments required by a lease agreement enable businesses with limited capital to manage their cash flow more effectively and adapt quickly to changing economic conditions.

d. Leasing also allows businesses to upgrade assets more frequently ensuring they have the latest equipment without having to make further capital outlays.

e. It offers the flexibility of the repayment period being matched to the useful life of the equipment.

f. It gives businesses certainty because asset finance agreements cannot be cancelled by the lenders and repayments are generally fixed.

g. However, they can also be structured to include additional benefits such as servicing of equipment or variable monthly payments depending on a business's needs.

h. It is easy to access because it is secured – largely or entirely – on the asset being financed, rather than on other personal or business assets.

i. The rental, which sometimes exceeds the purchase price of the asset, can be paid from revenue generated by its use, directly impacting the lessee's liquidity.

j. 'ease instalments are exclusively material costs.

k. Using the purchase option, the lessee can acquire the leased asset at a lower price, as they pay the residual or non-depreciated value of the asset.

l. For the national economy, this way of financing allows access to state-of-the-art technology otherwise unavailable, due to high prices, and often impossible to acquire by loan arrangements.

Limitation of leasing

a. It is not a suitable mode of project financing because rental is payable soon after entering into lease agreement while new project generate cash only after long gestation period.

b. Certain tax benefits/ incentives/subsidies etc. may not be available to leased equipments.

c. The value of real assets (land and building) may increase during lease period. In this case lessee may lose potential capital gain.

d. The cost of financing is generally higher than that of debt financing.

e. A manufacturer(lessee) who want to discontinue business need to pay huge penalty to lessor for pre-closing lease agreement

f. There is no exclusive law for regulating leasing transaction.

g. In undeveloped legal systems, lease arrangements can result in inequality between the parties due to the lessor's economic do'inance, which may lead to the lessee signing an unfavourable contract.

TYPES OF LEASE

(a) Financial lease

(b) Operating lease.

(c) Sale and lease back

(d) Leveraged leasing and

(e) Direct leasing.

1) Financial lease

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease‘. In India, f’nancial leases are very popular with high-cost and high technology equipment.

2) Operational lease

An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

3) Sale and lease back

It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals.

However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement.

4) Leveraged leasing

Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

5) Direct leasing

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 manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

Other types of leasing:

1) First Amendment Lease: The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual po’ition will be covered if the purchase option is exercised.

2) Full Payout Lease: A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus

an acceptable rate of return, without any reliance upon the leased equipment's future resi’ual value.

3) Guideline Lease: A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

4) Net Lease: A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.

5) Open-end Lease: A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

6) Sales-type Lease: A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

7) Synthetic Lease: A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

8) Tax Lease: A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition’of this tax incentive.

9) True Lease: A type of transaction that qualifies as a lease under the Internal Revenue Code.

It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

Differences between financial lease and operating lease

1. While financial lease is a long term arrangement between the lessee (user of the asset) and the owner of the asset, whereas operating lease is a relatively short term arrangement between the lessee and the owner of asset.

2. Under financial lease all expenses such as taxes, insurance are paid by the lessee while under operating lease all expenses are paid by the owner of the asset.

3. The lease term under financial lease covers the entire economic life of the asset which is not the case under operating lease.

4. Under financial lease the lessee cannot terminate or end the lease unless otherwise provided in the contract which is not the case with operating lease where lessee can end the lease anytime before expiration date of lease.

5. While the rent which is paid by the lessee under financial lease is enough to fully amortize the asset, which is not the case under operating lease.

Regulatory frame work for Leasing in India

As there is no separate statue for leasing in India, the provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well section 148 of the Indian Contract Act defines bailment as:

“The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the ‘bailor’ and the person to whom they are delivered is called the ‘bailee’.

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

1. The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.

2. The lessor has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

VENTURE CAPITAL

There are some businesses that involve higher risks. In the case of newly started business, the risk is more. The new businesses may be promoted by qualified entrepreneurs. They lack necessary experience and funds to give shape to their ideas. Such high risk, high return ventures are unable to raise funds from regular channels like banks and capital markets. Generally people would not like to invest in new high risk companies. Some people invest money in such new high risk companies. Even though the risk is high, there is a potential of getting a return of ten times more in less than five years. The investors making such investments are called venture capitalists.

The money investd in new, high risk and high return firms is called venture capital. Venture capitalists not only provide money but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. They get good return on their investment. The percentage of the profits the venture capitalists get is called the *carry*

Meaning of Venture Capital

The term venture capital comprises of two words, namely, ‘venture’ and ‘capital’. The term ‘venture’ literally means a ‘course’ or ‘proceeding’, the outcome of which is uncertain (i.e., involving risk). The term capital refers to the resources to start the enterprise. Thus venture capital refers to capital investment in a new and risky business enterprise. Money is invested in such enterprises because these have high growth potential.

A young hi-tech company that is in the early stage of financing and is not yet ready to make a public issue may seek venture capital. Such a high risk capital is provided by venture capital funds

in the form of long term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Venture capital is the money and resources made available to start up firms and small business with exceptional growth potential (e.g., IT, infrastructure, real estate etc.). It is fundamentally a long term risk capital in the form of equity finance for the small new ventures which involve risk.

But at the same time, it a the strong potential for the growth. It thrives on the concept of high riskhigh return. It is a means of equity financing for rapidly growing private companies.

Venture capital can be visualized as ‘your ideas and our money’ concept of developing business. It is ‘patient’ capital that seeks a return through long term capital gain rather than immediate and regular interest payments as in the case of debt financing.

When venture capitalists invest in a business, they typically require a seat on the company's board of directors. But professional venture capitalists act as mentors and provide support and advice on a number of issues relating to management, sales, technology etc. They assist the company to develop its full potential. They help the enterprise in the early stage until it reaches the stage of profitability. When the business starts making considerable profits and the market value of the shares go up to considerable extent, venture capitalists sell their equity holdings at a high value and thereby make capital gains.

In short, venture capital means the financial investment in a highly risk project with the objective of earning a high rate of return.

Characteristics of Venture Capital

The important characteristics of venture capital finance are outlined as bellow:

1. It is basically equity finance.

2. It is a long term investment in growth-oriented small or medium firms.

3. Investment is made only in high risk projects with the objective of earning a high rate of return.

4. In addition to providing capital, venture capital funds take an active interest in the management of the assisted firm. It is rightly said that, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".

5. The venture capital funds have a continuous involvement in business after making the investment.

6. Once the venture has reached the full potential, the venture capitalist sells his holdings at a high premium. Thus his main objective of investment is not to earn profit but capital gain.

Types of Venture Capitalists

Generally, there are three types of venture capital funds. They are as follows:

1. Venture capital funds set up by angel investors (angels): They are individuals who invest their personal capital in start up companies. They are about 50 years old. They have high income and wealth. They are well educated. They have succeeded as entrepreneurs. They are interested in the start up process.

2. Venture capital subsidiaries of Corporations: These are established by major corporations, commercial banks, holding companies and other financial institutions.

3. Private capital firms/funds: The primary source of venture capital is a venture capital firm.

It takes high risks by investing in an early stage company with high growth potential.

Methods or Modes of Venture Financing (Funding Pattern)/Dimensions of Venture Capital

Venture capital is typically available in four forms in India: equity, conditional loan, income note and conventional loan.

Equity: All VCFs in India provide equity but generally their contribution does not exceed 49 per cent of the total equity capital. Thus, the effective control and majority ownership of the firm remain with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional loan: It is repayable in the form of a royalty after the venture is able to generate sales.

No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 and 15 per cent; actual rate depends on the other factors of the venture, such as gestation period, cost-flow patterns and riskiness.

Income note: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

Conventional loan: Under this form of assistance, the enterprise is assisted by way of loans. On the loans, a lower fixed rate of interest is charged, till the unit becomes commercially operational.

When the company starts earning profits, normal or higher rate of interest will be charged on the loan. The loan has to be repaid as per the terms of loan agreement.

Other financing methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures introduced by TCFC.

Stages of Venture Capital Financing

Venture capital takes different forms at different stages of a project. The various stages in the venture capital financing are as follows:

1. **Early stage financing:** This stage has three levels of financing. These three levels are:

(a) Seed financing: This is the finance provided at the project development stage. A small amount of capital is provided to the entrepreneurs for concept testing or translating an idea into business.

(b) Start up finance/first stage financing: This is the stage of initiating commercial production and marketing. At this stage, the venture capitalist provides capital to manufacture a product.

(c) Second stage financing: This is the stage where product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture capital firms provide larger funds at this stage.

2. Later stage financing: This stage of financing is required for expansion of an enterprise that is already profitable but is in need of further financial support. This stage has the following levels:

(a) Third stage/development financing: This refers to the financing of an enterprise which has overcome the highly risky stage and has recorded profits but cannot go for public issue. Hence it requires financial support. Funds are required for further expansion.

(b) Turnarounds: This refers to finance to enable a company to resolve its financial difficulties.

Venture capital is provided to a company at a time of severe financial problem for the purpose of turning the company around.

(c) Fourth stage financing/bridge financing: This stage is the last stage of the venture capital financing process. The main goal of this stage is to achieve an exit vehicle for the investors

and for the venture to go public. At this stage the venture achieves a certain amount of market share.

(d) Buy-outs: This refers to the purchase of a company or the controlling interest of a company's share. Buy-out financing involves investments that might assist management or an outside party to acquire control of a company. This results in the creation of a separate business by separating it from their existing owners.

Advantages of Venture Capital

Venture capital has a number of advantages over other forms of finance. Some of them are:

1. It is long term equity finance. Hence, it provides a solid capital base for future growth.

2. The venture capitalist is a business partner. He shares the risks and returns.

3. The venture capitalist is able to provide strategic operational and financial advice to the company.

4. The venture capitalist has a network of contacts that can add value to the company. He can help the company in recruiting key personnel, providing contracts in international markets etc.

5. Venture capital fund helps in the industrialization of the country.
6. It helps in the technological development of the country.
7. It generates employment.
8. It helps in developing entrepreneurial skills.
9. It promotes entrepreneurship and entrepreneurism in the country.

Venture Capital in India

In India, the venture capital plays a vital role in the development and growth of innovative entrepreneurships. Venture capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and state financial corporations. These institutions promoted entities in the private sector with debt as an instrument of funding.

For a long time, funds raised from public were used as a source of venture capital. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from the public.

In India, the need for venture capital was recognised in the 7 th five-year plan and long term fiscal policy of the Government of India. In 1973, a committee on development of small and medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) – promoted by ICICI and UTI.

The first private VC fund was sponsored by Credit Capital Finance Corporation (CEF) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation, namely, Credit Capital Venture Fund. At the same time, Gujarat Venture Finance Ltd. and AFIDC Venture Capital Ltd. were started by state-level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high networth individuals.

Risk Capital

Risk capital refers to funds allocated to speculative activity and used for high-risk, high-reward investments. Any money or assets that are exposed to a possible loss in value is considered risk capital, but the term is often reserved for those funds earmarked for highly speculative investments. Diversification is key for successful investment of risk capital, as the prospects of each investment tend to be uncertain by nature, although the returns can be far above average when an investment succeeds. Moreover, an investor needs to ensure that only a portion of total capital is considered risk capital.

In the context of venture capital, risk capital may also refer to funds invested in a promising, but still unproven, startup

Angel Investment

Angel investments are made by wealthy individuals (such as accredited investors) that invest their personal money into a company in exchange for equity in that company. This is the basic principle of angel investing.

Angel investors help startups during the seed stages, so there is a higher risk in angel investments since they are connected to unproven business models. Also, if the company does not have a product or even if they have customers, they might not have significant revenue.

But angel investors are more forgiving about the metrics that venture capitalists use to measure a potential investment. In fact, many business professionals believe that angels expanded the reach of the venture capital model.

Since angel investors can work independently or in large groups, it is not unusual for a typical investment to range anywhere from $25,000 to $100,000. In addition, there are cases when angel investors contributed even more than that.

Advantages of angel funding:

- **Great for companies that need quick capital fast.** Getting the right funds at the right time can make a huge difference when it comes to business success.
- **Funds are not loans.** There is no legal obligation to repay what is borrowed as one would have to do with business loans. Angel investors do not expect money in return, they are banking on the company increasing in value as it grows.
- **Angel investors do not only provide money.** These individuals are often well-established business professionals with years of experience under their belts. They can also help companies by sharing their thoughts and even guidance.

Disadvantages of angel funding:

- **Higher risks.** Since there is no obligation to repay the investment, investors face higher risks.
- **Pressure can be quite difficult to handle.** Investors want to see their investment pay off in a tangible way.

Crowd funding

Raising funds or capital from individuals or organizations that invest in (or donate to) projects in return for a potential profit or a reward is called crowdfunding.

We have witnessed significant growth in the popularity of crowdfunding thanks to platforms such as Indiegogo or Kickstarter. This rise has indicated great advancements for non-profits and other organizations. Thanks to this concept, many startups have secured the needed funds to launch their ideas and show the world what they have to offer.

However, keep in mind that in most jurisdictions, restrictions apply to who can fund a new business and how much they can contribute. These limitations are similar to the ones dealing with hedge fund investing.

These measures are supposed to protect unsophisticated or non-wealthy investors from putting too much of their savings at risk. After all, there are a number of businesses that fail and their investors face a high risk of losing their principal.

The majority of crowdfunding projects are based on rewards. To be precise, investors may get to participate in the launch of a new product or receive a gift for their investment. For example, the developer of a new video game may send a free copy of the game to each of the investors as a small gift.

Additionally, it is worth mentioning that equity-based crowdfunding is slowly becoming more and more popular, since it allows early-stage businesses to raise money without giving up control to venture capital investors. Still, this type of crowdfunding also allows investors to earn an equity position in the venture.

Take a look at the advantages of crowdfunding:

- **Keeping equity.** Investors are not shareholders of the company. This is the main benefit and the main reason why many entrepreneurs choose crowdfunding as a method to raise enough funds for their businesses.

- **Low financial risk.** This kind of funding enables entrepreneurs to test the waters and see if their idea has merit without having to take a lot of financial risks.
- **Tapping into an existing community.** Crowdfunding allows you to leverage an engaged community that is already looking to support ideas such as yours.

On the other hand, there are various shortcomings of crowdfunding:

- **Sustainability problem.** This method is not sustainable in the long-run nor it is an accurate representation of how successful the business venture will be in the market.
- **It may take some time (and money).** Successful crowdfunding campaigns require a lot of effort and even the founders have to invest some amount of money to build prototypes, marketing videos, and so on.
- **Idea theft.** Many entrepreneurs forget to protect their ideas and sometimes they get stolen. It often happens that established companies try to mimic what an entrepreneur is building.

Module V
CREDIT RATING AND FACTORING SERVICES

CREDIT RATING

Credit rating is a numerical representation of the creditworthiness of an individual or a business. The credit rating is a key aspect that makes or breaks a loan application. The credit rating/score acts as an indicator stating if the borrower has defaulted on loan payments before and if he is worth trusting with the new loan.

A credit score is a 3-digit number that represents the creditworthiness of the borrower. Credit rating is the analysis of the possible credit risks associated with granting a financial instrument to an individual or a company. Based on the credit score, a lender determines whether the borrower can repay the loan amount or not.

The rating is provided based on the creditworthiness and the credentials of an individual or a company. The creditworthiness of an individual or a company is decided based on the lending and borrowing transactions done in the past. Credit rating is determined after weighing the statements of liabilities and assets, and their ability to meet the debt obligations.

Objectives of Credit Rating

Credit rating aims to:

Provide superior information to the investors at a low cost;

Provide a sound basis for proper risk-return structure;

Subject borrowers to a healthy discipline, and

Assist in the framing of public policy guidelines on institutional investment.

Significance of Credit Rating

Credit rating is always project/instrument specific. Credit rating for different financial instruments issued by the same company at the same time can be different. In the same way credit rating for similar instruments issued by the same company at different times can also be different. Credit rating is useful for investors, banks and other financial institutions and investments advisers as it helps them taking business decisions. Credit rating by an authorized competent authority gives a bird's eye view of financial strength of an organisation and its instruments. It is of considerable help to an investor in deciding whether his investment is likely to be safe.

As financial markets have grown increasingly complex and global and borrowers base has become increasingly diversified, investors and regulators have increased their reliance on the opinions of credit rating agencies. Credit ratings attempt to provide a consistent and reasonable rank ordering of relative credit risks, with specific reference to the instrument being rated.

Credit rating can be applied in the following areas/instruments:

- Equity shares
- Rating for banking sector
- Individual credit rating

- Rating for insurance sector
- New instruments, floating rate notes, index based bonds, long-term deep discount bonds, etc.
- Rating of intermediaries in financial services
- Securitization
- Rating of companies raising funds overseas

Methodology of Credit Rating

The process of credit rating begins with the prospective issuer approaching the rating agency for evaluation. The experts in analyzing banks should be given a free hand and they will collect data and informant and will investigate the business strength and weaknesses in detail. The entire process of rating stands on the for of confidentiality and hence even the most confidential business strategies, marketing plans, future outlook etc., are revealed to the steam of analysis.

The rating is based on the investigation analysis, study and interpretation of various factors. The world of investment is exposed to the continuous onslaught of political, economic, social and other forces which does not permit any one to understand sufficiently certainty. Hence a logical approach to systematic evaluation is compulsory and within the framework of certain common features the agencies employ different methodologies. The **key factors** generally considered are listed below:

1. Business Analysis or Company Analysis

This includes an analysis of industry risk, market position of the company, operating efficiency of the company and legal position of the company.

Industry risk: Nature and basis of competition, key success factors; demand supply position; structure of industry; government policies, etc.

Market position of the company within the Industry: Market share; competitive advantages, selling and distribution arrangements; product and customer diversity etc.

Operating efficiency of the company: Locational advantages; labor relationships; cost structure and manufacturing as compared to those of competition.

Legal Position: Terms of prospectus; trustees and then responsibilities; system for timely payment and for protection against forgery/fraud, etc.

2. Economic Analysis

In order to evaluate an instrument an analyst must spend a considerable time in investigating the various economic activities and also analyze the characteristics peculiar to the industry, whose issue the analyst is concerned with. It will be an error to ignore these factors as the individual companies are always exposed to changing environment and the economic activates affect corporate profits, attitudes and expectation of investors and the price of the instrument. hence the relevance of the economic variables such as growth rate, national income and expenditure cannot be ignored. The analysis, while doing the economic forecasting use surveys, various economic indicators and indices

3. Financial Analysis

This includes an analysis of accounting, quality, earnings, protection adequacy of cash flows and financial flexibility.

Accounting Quality: Overstatement/under statement of profits; auditors qualification; methods of income recognition's inventory valuation and depreciation policies, off balance sheet liabilities etc.

Earnings Protection: Sources of future earnings growth; profitability ratios; earnings in relation to fixed income changes.

Adequacy of cash flows: In relation to dept and fixed and working capital needs; variability of future cash flows; capital spending flexibility working capital management etc.

Financial Flexibility: Alternative financing plans in ties of stress; ability to raise funds asset redeployment.

4. Management Evaluation

Track record of the management planning and control system, depth of managerial talent, succession plans. Evaluation of capacity to overcome adverse situations Goals, philosophy and strategies.

5. Geographical Analysis

Location advantages and disadvantages

Backward area benefit to the company/division/unit etc.

6. Fundamental Analysis

Fundamental analysis is essential for the assessment of finance companies. This includes an analysis of liquidity management, profitability and financial position and interest and tax sensitivity of the company.

Liquidity Management: Capital structure; term matching of assets and liabilities policy and liquid assets in relation to financing commitments and maturing deposits.

Asset Quality: Quality of the company's credit-risk management; system for monitoring credit; sector risk; exposure to individual borrower; management of problem credits etc.

Profitability and financial position: Historic profits, spread on fund deployment revenue on non-fund based services accretion to reserves etc.

Interest and Tax sensitivity: Exposure to interest rate changes, hedge against interest rate and tax low changes, etc.

Credit Rating Agency (CRA)

A credit rating agency (CRA) evaluates and assesses an individual's or a company's creditworthiness. That is, these agencies consider a debtor's income and credit lines to analyse the debtor's ability to repay the debt or if there is any credit risk associated.

Securities and Exchange Board of India (SEBI) reserves the right to authorise and regulate credit rating agencies according to SEBI Regulations, 1999 of the SEBI Act, 1992.

Working of Credit Rating Agencies

Credit rating agencies analyse an organisation, individual, or entity and assign ratings to it. These agencies have the authority to rate companies, state governments, non-profit organisations, countries, securities, local government bodies, and special purpose entities.

Many factors are considered while settling with a rating such as financial statements, type of debt, lending and borrowing history, repayment capability, past credit repayment behaviour, and more. Each of these factors contributes to a specified share in computing the end result, credit score.

The credit rating agency does not provide any decision to financial institutions on whether an entity should get a credit facility or not; rather it provides the report and additional inputs making it easier for the lender to analyse and an informed decision.

Credit Rating Agencies in India

There are several credit rating agencies in India, such as CRISIL Ltd, India Ratings and Research Pvt Ltd, ICRA Limited, CARE, Brickwork Ratings India Pvt Ltd, SMERA Ratings Limited, and Infometrics Valuation and Rating Pvt Ltd.

According to SEBI, the following credit rating agencies are registered and authorised to compute and share credit score/report with the financial institutions and applicants.

Credit Rating Information Services of India Limited

Credit Rating Information Services of India Limited (CRISIL), one of the oldest credit rating agencies, was set up in 1987. The agency stepped on to infrastructure rating in 2016. CRISIL has been operational in countries such as the USA, UK, Poland, Hong Kong, China, and Argentina in addition to India.

India Ratings and Research Pvt Ltd. (Ind-Ra)

India Ratings and Research, a wholly-owned subsidiary of Fitch Group, provides accurate and timely credit opinions on the country's credit market. The firm covers corporate issuers, financial institutions, managed funds, urban local bodies, project finance companies, and structured finance companies. The headquarters is in Mumbai and the other branch offices are in Ahmedabad, Delhi, Chennai, Bengaluru, Hyderabad, Pune, and Kolkata.

ICRA Limited

The Investment Information and Credit Rating Agency (ICRA), a joint venture of Moody's and Indian Financial and Banking Service Organisation was established in 1991. The organisation is known for assigning corporate governance rating, performance rating, mutual funds ranking, and more

CARE Limited

Credit Analysis and Research Limited (CARE) is a credit rating agency that is operational since April 1993. The agency provides a credit rating that helps corporates to raise funds for their investment requirements. Investors can make decisions based on credit risk and risk-return expectations. In addition to the head office in Mumbai, the firm has regional offices in New Delhi, Pune, Kolkata, Chandigarh, Jaipur, Ahmedabad, Bengaluru, Chennai, Coimbatore, and Hyderabad.

Brickwork Ratings India Pvt Ltd

In addition to registering with SEBI, Brickwork Ratings (BWR) is accredited by RBI and empanelled by NSIC, NCD, MSME ratings and grading services. It has received accreditation from NABARD for MFI and NGO grading. Brickwork is also authorised to grade companies seeking credit facilities from IREDA, Renewable Energy Service Providing Companies (RESCOs) and System Integrators (SIs). Canara Bank was the leading promoter and strategic planner for Brickwork.

SMERA Ratings Limited

SMERA analyses and establishes the credibility of existing micro, small, and medium enterprises (MSMEs). MSMEs can improve, grow, and avail cheaper/faster loans.

Infometrics Valuation and Ratings Pvt Limited

This SEBI-registered, RBI-accredited credit rating agency was founded by finance professionals, former bankers, and administrative services personnel. It evaluates entities such as banks, non-banking financial companies, large corporates, and small and medium scale units (SMUs).

Benefits of Credit rating:

Credit rating offers various benefits from the point of view of investors, companies, regulating authorities and public. Credit score of a company matters a lot when it comes to boost confidence in investors. Good credit rating reflects how much a company is financially strong and secure.

Benefits of credit ratings from the point of view of investors:

1. The investors can choose their investments on the basis **of** good credit ratings.

2. As the credit rating is done by professionals, the investors can rely on the credit rating.

3. It gives scope for the investors to forecast about the future of their investments.

4.A comparative study between different credit instruments enables the investors to choose their investments.

5. Even unknown securities could be purchased based on credit rating. It also enables the investors to go for a diversified investment.

6. As there is periodical review of the companies by credit rating agencies, the investors have the opportunity of swapping their weaker investment with a stronger investment, based on the credit rating.

6. The investors can minimize their existing loss by choosing effective future investment. Thus, credit ratings acts as hedge for the investors.

7. Liquidity, safety and profitability are duly considered through credit rating mechanism by investors.

Benefits of good credit ratings from the point of view of companies:

1. Companies will be able to raise funds from the market as their debt instruments are backed by good credit rating.

2. Credit rating acts as a motivation for companies to either improve their position or maintain their existing position, if they are in a higher level of credit rating.

3. When companies of equal standing are issuing their credit instruments, better placed companies are identified with a positive signal on the credit rating such as A+.

4. In the market, companies with a higher rating will be in a position to provide better liquidity for their credit instruments.

5. When companies are raising funds in the overseas market, credit rating enables them to mobilize more funds.

6. Good Credit rating will provide better security from the lenders' point of view. This will enable the companies to sell their credit instruments easily.

Benefits of credit ratings from the point of view of Regulating authorities:

1. The regulatory authorities can discipline financial institutions by insisting on good credit rating before going for public issue.

2. By imposing various conditions in credit rating, the financial soundness of the companies is maintained.

3. Any down-grading of credit rating will send clear signals to the regulating authorities to closely monitor the functioning of the company concerned.

4. The general economic condition in the company could also be analyzed by the regulating authorities from the credit rating of various companies.

5. Good Credit rating also provides authority, responsibility and accountability to the regulating authorities.

Benefits of credit ratings from the point of view of public:

1. Any unknown company or infant company cannot try to cheat the public by offering an unusually higher rate of interest, as without credit rating, the reliability of the company will be in question.

2. Proper credit rating also channelizes the savings of the public to productive purposes and prevents unwanted conspicuous consumption, such as investing in gold.

3. Public can also discriminate their investments and go in for better credit instruments on the basis of good credit rating.

4. Off-shore savings can be attracted through credit rating. Individuals settled abroad can choose investment in domestic companies based on credit rating.

5. Legal action could be taken when credit rating companies fail to fulfill their obligations. This will instill confidence in the minds of the investors.

FACTORING

When a firm sells goods on credit, cash is not received immediately. This means there is a time gap between sale of goods/services and receipt of cash out of such sale. The outstanding amounts get blocked for a period. This period depends upon the credit period allowed to buyers.

The outstanding amounts are called 'Debtors' or 'Accounts Receivables'. If the debts are not collected in time, the firm will be handicapped due to lack of sufficient working capital. The other side is that if the debts were collected speedily the amount could be used productively. Further, it is very difficult to collect debts. Moreover, there is the problem of defaults (i.e. bad debts) . In short, debtors or accounts receivables involve risks. So, business enterprises are always looking for selling the debtors for cash, even at a discount. This is possible through a financial service. Such a financial service is known as factoring.

Factoring is one of the oldest forms of commercial finance. Some scholars trace its origin to the Roman Empire. Some others trace its origin even further back to Hammurabi, 4000 years ago.

Meaning and Definition of Factoring

Like securitisation factoring also is a financial innovation. Factoring provides resources to finance receivables. It also facilitates the collection of receivables. The word factor is derived from the Latin word *facere*. It means to make or do or to get things done. Factoring simply refers to

selling the receivables by a firm to another party. The buyer of the receivables is called the factor.

Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e. credit control, sales accounting etc.

Thus factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.).

The balance is the profit of the factor for the factoring services.

Factoring can take the form of either a factoring agreement or an assignment (pledging) agreement. The factoring agreement involves outright sale of the firm's receivables to a finance company (factor) without recourse. According to this agreement the factor undertakes the receivables, the credit, the collection task, and the risk of bad debt. The firm selling its receivables (client) receives the value of the receivables minus a commission charge as compensation for the risks the factor assumes. Thereafter, customers make direct payments to the factor. In some cases receivables are sold to factor at a discount. In this case factor does not get commission. The discount is its commission. From this its expenses and losses (collection, bad debt etc.) are met. The balance represents the profit of the factor.

In an assignment (pledging) agreement, the ownership of the receivables is not transferred; the receivables are given to a finance company (factor) with recourse. The factor advances some portion of the receivables value, generally in the range of 50 – 80%. The firm (client) is responsible for service charges and interest on the advance (due to the factor) and losses due to bad debts.

According to this arrangement, customers make direct payment to the client. It should be noted that both factoring and securitisation provide financing source for receivables. In factoring, the financing source is the factor. But in securitisation, the public (investors) who buys the securities is the factoring source.

Objectives of Factoring

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.

2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.

3. To adopt better credit control policy.

4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.

5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

Types of Factoring

There are different types of factoring. These may be briefly discussed as follows:

1. Recourse Factoring: In this type of factoring, the factor only manages the receivables without taking any risk like bad debt etc. Full risk is borne by the firm (client) itself.

2. Non-Recourse Factoring: Here the firm gets total credit protection because complete risk of total receivables is borne by the factor. The client gets 100% cash against the invoices (arising out of credit sales by the client) even if bad debts occur. For the factoring service, the client pays a commission to the factor. This is also called *full factoring*.

3. Maturity Factoring: In this type of factoring, the factor does not pay any cash in advance. The factor pays clients only when he receives funds (collection of credit sales) from the customers or when the customers guarantee full payment.

4. Advance Factoring: Here the factor makes advance payment of about 80% of the invoice value to the client.

5. Invoice Discounting: Under this arrangement the factor gives advance to the client against receivables and collects interest (service charge) for the period extending from the date of advance to the date of collection.

6. Undisclosed Factoring: In this case the customers (debtors of the client) are not at all informed about the factoring agreement between the factor and the client. The factor performs all its usual factoring services in the name of the client or a sales company to which the client sells its book debts. Through this company the factor deals with the customers. This type of factoring is found in UK.

7. Cross boarder factoring: It is similar to domestic factoring except that there are four parties, viz,

a) Exporter,

b) Export Factor,

c) Import Factor, and

d) Importer.

It is also called two-factor system of factoring. Exporter (Client) enters into factoring arrangement with Export Factor in his country and assigns to him export receivables. Export Factor enters into arrangement with Import Factor and has arrangement for credit evaluation & collection of payment for an agreed fee. Notation is made on the invoice that importer has to make payment to the Import Factor. Import Factor collects payment and remits to Export Factor who passes on the proceeds to the Exporter after adjusting his advance, if any. Where foreign currency is involved, factor covers exchange risk also.

Process of Factoring (Factoring Mechanism)

The firm (client) having book debts enters into an agreement with a factoring agency/institution. The client delivers all orders and invoices and the invoice copy (arising from the credit sales) to the factor. The factor pays around 80% of the invoice value (depends on the price of factoring agreement), as advance. The balance amount is paid when factor collects complete amount of money due from customers (client's debtors). Against all these services, the factor charges some amounts as service charges. In certain cases the client sells its receivables at discount, say, 10%. This means the factor collects the full amount of receivables and pays 90% (in this case) of the receivables to the client. From the discount (10%), the factor meets its expenses and losses.

The balance is the profit or service charge of the factor.

Thus there are three parties to the factoring. They are the buyers of the goods (client's debtors), the seller of the goods (client firm i.e. seller of receivables) and the factor. Factoring is a financial intermediary between the buyer and the seller.

Features (Nature) of Factoring

From the following essential features of factoring, we can understand its nature:

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash.

Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.

2. The factor purchases the credit/receivables and collects them on the due date. Thus the risks associated with credit are assumed by the factor.

3. A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).

4. A factor specialises in handling and collecting receivables in an efficient manner.

5. Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.

6. Factoring is a technique of receivables management. It is used to release funds tied up in receivables (credit given to customers) and to solve the problems relating to collection, delays and defaults of the receivables.

Functions of a Factor

Factor is a financial institution that specialises in buying accounts receivables from business firms. A factor performs some important functions. These may be discussed as follows:

1. Provision of finance: Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally a factor gives about 80% of the value of receivables as advance to the client. Thus the nonproductive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.

2. Administration of sales ledger: The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables and the amount received from customers. Thus the factor undertakes the responsibility of entire sales administration of the client.

3. Collection of receivables: The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.

4. Protection against risk: If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.

5. Credit management: The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc. In this way the factor advocates the best credit and collection policies suitable for the firm (client). In short, it helps the client in efficient credit management.

6. Advisory services: These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide experience in the field of finance. It is a specialised institution for managing account receivables. It possesses extensive credit information about customer's creditworthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

Advantages of Factoring

A firm that enters into factoring agreement is benefited in a number of ways. Some of the important benefits of factoring are summarised as follows:

1. Improves efficiency: Factoring is an important tool for efficient receivables management.

Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.

2. Higher credit standing: Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.

3. Reduces cost: The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.

4. Additional source: Funds from a factor is an additional source of finance for the client.

Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

5. Advisory service: A factor firm is a specialised agency for better management of receivables.

The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.

6. **Acceleration of production cycle**: With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.

7**. Adequate credit period for customers**: Customers get adequate credit period for payment of assigned debts.

8. **Competitive terms to offer**: The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

Limitations of Factoring

The main limitations of factoring are outlined as below:

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.

2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.

3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.

4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.

5. Factoring may impose constraints on the way to do business. For non - recourse fac–oring most factors will want to pre- approve customers. This may cause delays. Further ,the factor will apply credit limits to individual customers.

FORFAITING

Generally there is a delay in getting payment by the exporter from the importer. This makes it difficult for the exporter to expand his export business. However, for getting immediate payment, the concept of forfeiting shall come to the help of exporters.

The concept of forfaiting was originally developed to help finance German exports to Eastern block countries. In fact, it evolved in Switzerland in mid 1960s.

Meaning of Forfaiting

The term 'forfait' is a French world. It means 'to surrender something' or 'give up one's right'. Thus forfaiting means giving up the right of exporter to the forfaitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without recource' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money. Under forfaiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount.

Here the exporter passes to the forfaitor all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately. Thus he gets the benefit of cash sale. However, the forfaitor deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfaitor. The forfaitor may be a bank or any other financial institution.

In short, the non-recourse purchase of receivables arising from an export of goods and services by a forfaitor is known as forfaiting.

Forfaiting is not the same as international factoring. The tenure of forfaiting transaction is long. International factoring involves short term trade transactions. In case of forfaiting, political and transfer risks are also borne by the forfaitor. But in international factoring these risks are not borne by the factor.

Characteristics of Forfaiting

The main characteristics of forfaiting are:

1. It is 100% financing without recourse to the exporter.

2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'aval').

3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.

4. Finance can be arranged on a fixed or floating rate basis.

5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.

6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

Advantages of Forfaiting

The following are the benefits of forfaiting:

1. The exporter gets the full export value from the forfaitor.

2. It improves the liquidity of the exporter. It converts a credit transaction into a cash transaction.

3. It is simple and flexible. It can be used to finance any export transaction. The structure of finance can be determined according to the needs of the exporter, importer, and the forfaitor.

4. The exporter is free from many export credit risks such as interest rate risk, exchange rate risk, political risk, commercial risk etc.

5. The exporter need not carry the receivables into his balance sheet.

6. It enhances the competitive advantage of the exporter. He can provide more credit. This increases the volume of business.

7. There is no need for export credit insurance. Exporter saves insurance costs. He is relieved from the complicated procedures also.

8. It is beneficial to forfaitor also. He gets immediate income in the form of discount. He can also sell the receivables in the secondary market or to any investor for cash.

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