Lesson No. 1 AUTHOR: SALONY KANSAL

THE FINANCIAL SYSTEM

STRUCTURE

1.0 OBJECTIVES

After studying this lesson, student should be able to:

- Understand the meaning of the term Financial System;
- Understand the functions and structure of Financial System.

1.1 INTRODUCTION

The economic development of any country depends upon the existence of a well-organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promotes the wellbeing and standard of living of the people of a country. In other words, it plays a crucial role in the functioning of the economy because it allows transfer of resources from savers to investors. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The word system' in the term 'Financial System' implies a set of complex and closely connected or intermixed instructions, agents, practices, markets, transactions, claims and liabilities in the economy. Finance is the study of money, its nature, creation, behaviour, regulations and administration. Therefore, Financial System includes all those activities dealing in finance, organized into a system The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. A functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development. The financial system consists of financial institutions, financial markets, financial instruments and the services provided by the financial institutions.

1.2 FUNCTIONS OF THE FINANCIAL SYSTEM

As we know, financial system is very important for the economic and all-round development of any country, its major functions can be explained as following:

1. Promotion of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. In other words, the liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity - either provision of liquidity or trading in liquidity.

2. Mobilization of Savings

Another important activity of the financial system is to mobilize savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

1.3 STRUCTURE OF FINANCIAL SYSTEM

Figure (i) gives a bird's eye view of the financial system of an economy. The financial system comprises of four major components. These components are:

1.3.1 Financial Institutions
1.3.2 Financial Markets
1.3.3 Financial Instruments
1.3.4 Financial Services

1.3.1 Financial Institutions

Financial Institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They are business organizations which act as mobilizers and depositories of savings and as purveyors of credit or finance. The activities of different financial institutions may overlap, or these may be specialized, and their classification is normally done on the basis of the degree of their specialization, with relation to savers and borrowers with whom they customarily deal with. In this spirit, one classification of financial institutions is into banking and non-banking ones. The important difference between these two types of financial institutions is, that while banks can advance credit by creating claims against themselves, the non-banking institutions can lend only out of resources at their disposal. The distinction between these two types has perhaps best been highlighted by

Sayers, who refers to banks as 'creators of credit", and to non-bank institutions as "purveyors of credit Banking institutionsinclude Central Bank, Commercial Bank, Co-operative Banks, and Regional Rural Banks.

Central bank,the apex institutions act as the monetary authority of the country and serves as the government bank as well as the banker's bank. It undertakes major financial operations of the government; by its conduct of these operations and by ocher means, it influences the behavior of financial institutions to ensure that they support the economic policy of the government. Central bank is controlled by the people who are more or less closely connected with the organs of the government and its does not exist to secure maximum profit. Central Bank must have a special relation with the commercial banks whereby it mayinfluence the operations of these institutions in the implementation of the government's economic policy. The major functions of Central bank include assuring of currency notes, acting as agent and advisor to the state, Banker's and lender of last resort.

Commercial banksare concerned with accepting deposits of money from the public at large, repayable on demand or otherwise and withdraw able by cheques, draft or otherwise, and employing the deposits so pooled in the form of loans and investment to meet the financial needs of business and other classes of Society. So commercial banks act as mobilisers of public savings for their productive utilization. As depository of savings, commercial banks provide to their customers a range of financial investment to choose from Current deposits repayable on demand and savings deposits for various firms, apart from a variety of deposits tailored to the individual deposits needs. Another function which commercial banks perform is the employment of funds in different sectors of the economy. Commercial bank utilizes their funds by way of granting loans and advance investing them in industrial securities and by underwritings industrial issues.

Cooperative banks basically set up in villages to promote thrift and savings of the farmers and to meet their credit needs for cultivation. The funds of central bank meant for the agriculture sector actually pass thought the state cooperative banks and central cooperative banks.

The Regional Rural Banks came into existence with the specific objective of providing credit and deposit facilities, particularly to the small and marginal farmers, agriculture laborers and artisans and small entrepreneurs. The Regional Rural banks have the responsibility to develop agriculture, trade, commerce and industry in the rural areas. The RRBs are essentially commercial banks but their area of operation is limited to a district.

Other financial institutions like development banks, engaged in the promotion, development of industry, agriculture and other key sectors. These banks differ from commercial banks in the sense that they do not mobilize savings of the people but invest the resources in the productive manner. Additionally, these banks provide all the development services, so as to accelerate to growth of the economy.

The non-banking financial institutionsare the Life Insurance Corporation |LIC), Unit Trust of India (UTI), and Industrial Development Bank of India (IDBI) etc.

Another way of classifying financial institutions is to term these as intermediary and non-intermediary institutions. Intermediary institutions intermediate between savers and investors, i.e., they lend money as well as mobilize savings. Their liabilities are towards the ultimate savers, while their assets are from the investors or borrowers. On the other hand, no intermediary institutions lend money, but do not obtain their resources directly from the savers. All banking institutions are intermediaries. Many non-banking institutions also act as intermediaries and hence are called non-banking financial intermediaries or NBFIs.The UTI, LIC, GIC are some NBFIs in India. Non-Intermediary institutions are those that have come into existence mainly because of governmental efforts to assist for specific purposes. Examples of such institutions are IDBI, NABARD, IFCl, etc. These are also called Non-Banking Statutory Financial Organisations (NBSFO) because these have been set up by the government.

However, the classification of financial institutions as intermediary and no intermediary is no longer watertight, as most financial institutions which were earlier classified as non-intermediary have started mobilizing savings, and are thus taking on therole of intermediaries between savers and borrowers.

1.3.2 Financial Markets

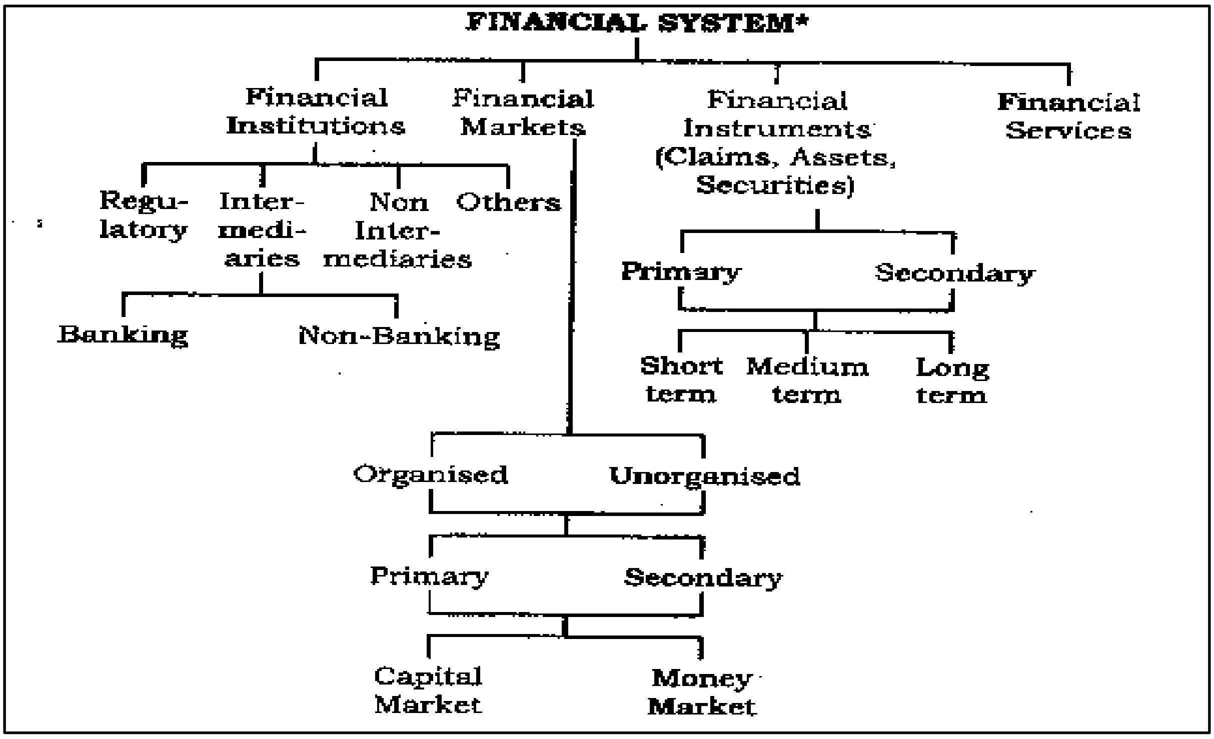
This is a place or mechanism where funds or savings are transferred from surplus units to deficit units. These markets can be broadly classified into money markets and capital markets. Money market deals with short-term claims or financial assets (less than a year) whereas capital markets deal with those financial assets which have maturity period of more than a year This classification is artificial as both these markets perform the same function of transferring surplus funds to needy units. Another classification could be primary markets and secondary markets. Primary markets deal in new issue of securities whereas secondary markets deal with securities which are already issued and available in the market. Primary markets by issuing new securities mobilise the savings directly. Secondary markets provide liquidity to the securities and thereby indirectly help in mobilising the savings.

1.3.3 Financial Instruments

The commodities that are traded or dealt in a financial market are financial assets or securities or financial instruments. There is a variety of securities in the financial markets as the requirements of lenders and borrowers are varied. Financial assets represent a claim on the repayment of principal at a future date and/or payment of a periodic or terminal sum in the form of interest or dividend. Some of the examples of these financial instruments are equity shares, preference shares debentures, bonds, etc.

Figure: (i): Financial System-Various Parts and Types of Classification

FINANCIAL SYSTEM*



1.3.4 Financial Services

Financial services include the services offered by both types of companies Asset Management Companies and Liability Management Companies. The former include the leasing companies, mutual funds, merchant bankers, issue/portfolio managers. The latter comprises the bill discounting houses and acceptance houses. The financial services help not only to raise the required funds but also ensure their efficient deployment. They help to decide the financing mix and extend their services up to the stage of servicing of lenders. In order to ensure an efficient management of funds, services such as bill discounting, factoring of debtors, parking of short-term funds in the money market, e-commerce and securitization of debts are provided by the financial services firms. Besides banking and insurance, this sector provides specialized services such as credit rating, venture capital financing, lease financing, factoring, mutual lending, depository, credit cards, housing finance, book building, etc. These services are provided by stock exchanges, specialized and general financial institutions, banks and insurance companies, and are regulated by the Securities and Exchange Board of India (SEBI), Reserve Bank of India and the Department of Banking and Insurance, Government of India, through a plethora of legislations.

Financial institutions and financial markets facilitate the functioning of the financial system through financial instruments. In order to fulfil the tasks assigned, they require a number of services of financial nature. Financial services are, therefore, regarded as the fourth element of the financial system. An efficient and well-ordered functioning of the financial system depends a great deal on the range of financial services extended by the providers and their efficiency and effectiveness.

1.4 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT:

Money and finance cannot bring about economic development by themselves, but they can play a significant role in bringing about economic development. The financial system helps production, capital accumulation and growth by encouraging, mobilising and allocating them among alternative uses/users.

In every economy, in a given period of time, there are some people whose current expenditure is less than current income, while for some people, current expenditure is more than current income. These two categories of people arc called the 'ultimate savers and ultimate investors' respectively. The function of a financial system is to establish a bridge between the savers and investors and thereby help mobilisation of savings and fructification of investment ideas into realities.

The financial system promotes savings by providing a wide choice of financial assets as stores of values, with attractive combinations of income, safety and yield. Thus, it is said ihat. saving-income ratio is positively elastic with respect to both financial assets and financial institutions. Again, all the individual savings need to be collected or mobilised before they can be spent by the deficit spenders (i.e., investors). Here too, a financial system is a highly efficient mechanism for mobilising savings. Mobilisation of savings takes place when savers move into financial assets- With institutionalisation of savings, it becomes possible for the deficit, spending units to undertake more investment expenditures because the financial system enables them to command more capital.

Further, a financial system not only encourages investment, it also efficiently allocates resources in different investment channels. It helps to sort out and rank investment projects by sponsoring and encouraging business units or borrowers through project appraisal and monitoring. The moneylenders and indigenous bankers to provide credit, but there are several deficiencies in their allocation of finance. But the; allocative role of financial institutions are very important. For example, only corporations can go to the stock market for raising funds through public issue of equity shares and bonds. Non-corporate borrowers cannot issue marketable liabilities, and have to depend on bank finance or private finance, since there is credit rationing, the financial institutions (subject to the policy of the govt, and the RBI) determine the allocation of institutional finance among various competing borrowers. The financial institutions can make firms grow faster by providing them easy credit. They can also hinder the development of firms by denying them adequate credit. Thus, the allocative role of financial system cannot be ignored while discussing its function in economic development.

Apart from merely encouraging investments that are based on prior saving, the financial system plays a positive role by providing finance or credit through creation of credit in anticipation of savings. This makes investment independent of saving in a given period of time. However, investment out of created credit should not be faulty and should promptly result in income generation.

A financial system also enhances the efficiency of the function of medium of exchange and thereby helps in economic development. It facilitates the normal production process and exchange of goods, and enlarges markets over space and time.

To conclude, the relationship between economic development and financial development is mutually reinforcing. The financial system accelerates development, and in turn, grows with economic development. The relationship between the two is, thus, symbiotic.

However, it is better to take a cautionary view of the role of financial markets in development. First, it has been argued that the financial sector can perform the developmental role if it functions efficiently, but it is not so in practice. According to Tobin, although the financial system might serve us well, but its functioning should never be viewed in a complacent manner. Financial activities generate high private reward disproportionate to their social productivity. Secondly, the role of capital formation and finance even in development has been unduly stressed. Better composition of capital and appropriate technology can reduce the need for a lot of finance-Empirically it has been found that the rale of capital formation increased without raising the growth rate, and capital accumulation could account for at most one-fourth of the rate of economic growth in the 19th "and 20th centuries. Increase in capital without suitable social, economic, political conditions cannot cause growth. Thus, finance is not the be all and end all of development.

1.5 WEAKNESSES OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. Yet, it suffers from one weakness as following:

(i) Lack of Coordination Between Different Financial Institutions

There are numerous financial intermediaries. Most of the vital financial institutions are owned by the Government, Moreover, the Government is also the controlling authority of these institutions. In that situation the problem of coordination arises.

(ii) Monopolistic Market Structures

In India, some financial institutions are so large that they have created a monopolistic market structure in the financial system. The weakness of this large structure is that it could leads to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the foundation of the Indian financial system occupying an important place is the capital market. These development banks act as distributive agencies only, since they derive most of their funds from their sponsors. As such, they fail to mobilized the savings of the public. This can be a serious bottleneck in the efficient financial system in the country.

(iv) Imprudent Financial Practices

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So, there is a preponderance of debt in the financial structure of corporate enterprises. To make matters worse, when corporate enterprises face any financial crisis, these financial institutions permit a greater use of debt than is warranted

(v) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. As far as industrial finance ii India its concerned, corporate customers are able to raise their financial resources through development banks. So they need not go to the capital market. Moreover, they don't resort to capital market since it is erratic and inactive.

1.6 SELF-ASSESSMENT QUESTIONS

1.6.1 What is the primary function of a central bank in a financial system?

A. Profit generation for the government

B. Conducting monetary policy and regulating the money supply

C. Facilitating international trade

D. Managing fiscal policy

1.6.2 What is the role of commercial banks in the financial system?

A. Issuing currency

B. Implementing monetary policy

C. Accepting deposits and providing loans

D. Regulating the stock market

1.6.3 What does the term "liquidity" refer to in the context of the financial system?

A. The ability to convert assets into cash quickly

B. Total value of assets held by an individual

C. The level of government debt

D. The interest rate on loans

1.6.4 What is the function of a stock exchange in the financial system?

A. Regulating interest rates

B. Facilitating the buying and selling of stocks

C. Issuing currency

D. Controlling inflation

1.6.5 In the context of financial markets, what does the term "diversification" mean?

A. Concentrating investments in a single asset

B. Spreading investments across different assets

C. Investing only in stocks

D. Avoiding investments in the bond market

1.7 SUMMARY

Financial system includes all those activities dealing in Finance, organized into a system. The functions of a financial system are to establish a bridge between savers and investors and thereby to encourage saving and investment, to provide finance in anticipation of savings, to enlarge markets over space and time. The financial system consists of Financial Institutions, Financial Markets, Financial Instruments and the Financial Services. Financial Institutions include both regulatory and intermediary institutions. Financial markets include both primary and secondary markets.

1.8 SHORT QUESTIONS

1. Define financial intermediaries and provide an example of one.
2. Explain the concept of risk management in the context of the financial system. Why is it important for financial institutions?
3. Briefly describe the role of credit rating agencies in the financial system and how they impact investors and lenders.
4. What is the significance of regulatory bodies in overseeing the financial system? Provide an example of a regulatory body and highlight its key functions.

1.9 LONG QUESTIONS

1. What is the primary purpose of a financial system, and how does it contribute to the overall economic development of a country?
2. Differentiate between the money market and the capital market, highlighting their key functions and the types of financial instruments traded in each.
3. Explain the role of financial institutions in the financial system. Provide examples of different types of financial institutions and briefly describe their functions.
4. Define the term "financial instrument" and give examples of both money market and capital market instruments. How do these instruments facilitate the flow of funds in the financial system?

1.10REFERENCES

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1.12 SELF-ASSESSMENT QUESTIONS ANSWER KEY

1.6.1 Answer: B

1.6.2 Answer: C

1.6.3 Answer: A

1.6.4 Answer: B

1.6.5 Answer: B

Lesson No. 2 **AUTHOR: SALONY KANSAL**

THE FINANCIAL MARKETS

STRUCTURE

2.0 OBJECTIVES

After reading this lesson, student should be able to:

- Understand the role of financial markets
- Know about major classification of financial market

2.1 INTRODUCTION

The basic function of financial market is to exchange funds, from one party to another. In business world, the demand for funds arises for different purposes and periods. For example, funds for working capital may be required for short period ranging from one month to one year whereas, for fixed assets the funds maturing ten to twenty years may be needed. Hence, there are, in fact, dozens of financial markets; markets for corporate bonds and equity shares, Government and semi-Government securities, mutual funds, markets like; foreign securities, public sector bonds and equities, etc. In fact, the markets in which these funds or securities are traded reflect difference in purposes, maturities and risks.

2.2 FUNCTIONS OF FINANCIAL MARKETS

Functions of a financial market can be classified into two categories: Economic Functions and Financial Functions.

(a) **Economic Functions**

- It facilitates the transfer of real economic resources from lenders to ultimate borrowers.

- Lenders earn interest/dividend on their surplus invisible funds, thereby increasing their earnings, and as a result, enhancing national income finally.
- Borrowers will have to use borrowed funds productively, if invested in new assets, and hence increasing their income and gross national products finally.
- By facilitating transfer of real resources, it serves the economy and finally the welfare of the general public
- It provides a channel through which new savings flow into capital formation of a country.

(b) Financial Functions

- It provides the borrowers with funds which they need to carry out their plans.
- It provides the lenders with earning assets so that their wealth may be held in a productive form without the necessity of direct ownership of real assets.
- It provides liquidity in the market through which the claims against money can be resold at any time, and thus, reconverting them into current funds.

In addition to the above, the financial markets perform three more economic functions:

First, the interaction of buyers and sellers in a financial market determines the price of the traded asset; or equivalently, the required return on a financial asset is determined. The inducement for firms to acquire funds depends on the required rate of return that investors demand, and it is this feature of financial markets that signals how the funds in the economy should be allocated among financial assets. This is called the price discovered process.

Second, financial markets provide a mechanism for an investor to sell a financial asset. Because of this feature, it is said that a financial market offers liquidity, an attractive feature when circumstances either force or motivate an investor to sell. In the absence of liquidity, the owner will be forced to hold a debt instrument till it matures and an equity instrument till the company is, cither voluntarily or otherwise, liquidated. While all financial markets provide some form of liquidity, the degree of liquidity is one of the factors that characterize different markets.

The third economic function of a financial market is that it reduces the search and information costs of transacting. Search costs represent explicit cost, such as the money spent to advertise the desire to sell or purchase a financial asset, the implicit costs such as the value of time spent in locating a counterpart. The presence of some form of organised financial market reduces search costs. Information costs are those entailed with assessing the investment merits of a financial asset, that is, the amount and the likelihood of the cash flow expected to be generated. In an efficient market, prices reflect the aggregate information collected by all market participants. The financial markets not only help in transfer of savings from new industry/ production, but also provide opportunities for financial investment, to earn income on surplus. In other words, these markets perform both financial and non- financial functions. The financial markets enable financing of not only physical capital formation, i.e., tangible fixed assets and inventories, but also of consumption expenditure. That's why, financial markets manage the flow of funds not only between individual savers and investors but also between institutional savers and investors.

2.3 ROLE OF FINANCIAL MARKETS

All the countries, irrespective of their state of development, need funds for their economic development and growth. In the economy, these funds are obtained from the savers or 'surplus units (the units which have more income than their consumption) which may be household individuals, business firms, public sector units, Central Government., State Governments, Local Governments, Semi-Governments, etc. There are certain investors or deficit units whose consumption or investment is more than their current income. Therefore, Financial markets play a significant role in transferring this surplus from savers (lenders) to 'borrowers (investors). This process is known as 'transmission mechanism'. In an economy, flow of surplus funds from surplus units to deficit units is essential for desired achievement of national goals and priorities. Thus, this flow must be in right direction and for productive purposes. For this, appropriate financial instruments and opportunities must be available. The financial markets provide the platform for such flow' where each saver can find and exchange the appropriate financial assets as per his requirement. So, the efficiency of financial market depends upon how efficiently the flow' of funds is managed in an economy. Further, the financial market must induce people to become producers/entrepreneurs and motivate individuals and institutions to save more. The financial markets not only help in the fast growth of industry and economy but also contribute to the society s wellbeing and raising of the standard of living. So financial markets should grow at a fast rate. Moreover, they should be efficient and more diversified. As rightly pointed out by a financial expert, "The more varied the vehicle by which savings can flow from ultimate savers to ultimate users of funds, the more efficient the financial markets or an economy tend to be". In brief, the financial market plays a significant role in the allocation of the economy's savings in efficient production of goods and services, and thus, assist in achieving the desired national objectives.

2.4 CLASSIFICATION OF FINANCIAL MARKETS

The classification of financial markets in India can be as following:

2.4.1 Unorganized Markets

In unorganized markets, there are a number of money lenders, indigenous bankers, traders, etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc whose activities are not controlled by the RBI. The RBI has already taken some steps to bring unorganized sector under the organized fold.

2.4.2 Organized Markets

In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. These organized markets can be further classified into two. They are

2.4.2.1 Capital Market and

2.4.2.2 Money Market.

2.4.2.1 Capital Market

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year.

Capital market may be further divided into three, namely:

1. Industrial Securities Market
2. Government Securities Market and
3. Long-term Loans Market.

1. Industrial Securities Market

As the very name implies, it is a market for industrial securities, namely: (i) equity shares (ii) Preference shares and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are

a. Primary market or New Issue Market,
b. Secondary market or Stock Exchange.

(a) Primary Market: Primary market is a market for new issues or new financial claims. Hence it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are (i) Public issue (ii) Right issue and (iii) Private placement. The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

(b) Secondary Market: Is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

2. Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where government securities are traded. In India there are many kinds of Government securities short term and long term. Long-term securities are traded in this market while short term securities are traded in money market. The secondary market for these securities is very most of the institutional investors tend to retain these securities until maturity.

3. Long-term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into - (i) Term loans, (ii) Mortgages and (iii) Financial Guarantees markets.

2.4.2.2 Money Market

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below

1. Call/Notice Money
2. Treasury Bills
3. Term Money
4. Certificate of Deposit
5. Commercial Papers

1. Call /Notice-Money Market

Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "CallMoney". When money is borrowed or lent for more than a day and up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.

2. Inter-Bank Term Money

The inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call/Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

3. Treasury Bills

Treasury Bills are short-term (up to one year) borrowing instruments of the union government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e., less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

4. Certificate of Deposits

Certificates of Deposit (CDs) is a negotiable money market instrument nd issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

5. Commercial Paper

CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory' note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement, and delivery. A company shall be eligible to issue CP provided - (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crores; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrower account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies

2.4 SIGNIFICANCE OF FINANCIAL MARKETS

All the countries, irrespective of their state of development, need funds for their economic development and growth. In the economy, these funds are obtained from the savers or surplus units (the units which have more income than their consumption) which may be household individuals, business firms, public sector units, Central Government, State Governments, Local Governments, Semi-Governments, etc. There are certain investors or deficit units whose consumption or investment is more than their current income. Therefore, Financial markets play a significant role in transferring this surplus from savers (lenders) to 'borrowers (investors). This process is known as 'transmission mechanism". In an economy, flow of surplus funds from surplus units to deficit units is essential for desired achievementof national goals and priorities. Thus, this flow must be in right direction and for productive purposes. For this, appropriate financial instruments and opportunities must be available. The financial markets provide the platform for such flow' where each saver can find and exchange the appropriate financial assets as per his requirement. So, the efficiency of financial market depends upon how efficiently the flow of funds is managed in an economy. Further, the financial market must induce people to become producers/entrepreneurs and motivate individuals and institutions to save more.

2.6 SELF-ASSESSMENT QUESTIONS

2.6.1 Where do companies raise capital by issuing new stocks for the first time?

a) Primary market
b) Secondary market
c) Tertiary market
d) Quaternary market

2.6.2 In the secondary market, securities are traded:

a) Between the company and investors
b) Among institutional investors only
c) Among individual investors only
d) Among investors who already own the securities

2.6.3 What is the primary purpose of the secondary market?

a) To raise capital for companies
b) To facilitate the initial sale of securities
c) To provide liquidity and a platform for trading existing securities
d) To issue government bonds

2.6.4 Which market is associated with the buying and selling of financial instruments directly from the issuer?

a) Primary market
b) Secondary market
c) Tertiary market
d) Quaternary market

2.6.5 What type of transactions typically occur in the secondary market?

a) Initial Public Offerings (IPOs)
b) Buying and selling of existing securities among investors
c) Issuing new bonds
d) Underwriting of stocks

2.7 SUMMARY

Financial Markets can be classified as money markets and capital markets. The money market can be defined as a market for short-term money and financial assets (hat are near substitutes for money. The term short-term means generally a period upto one year. The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year.

2.8 SHORT QUESTIONS

1. What is the role of a stock exchange in financial markets, and how does it contribute to the overall economy?
2. Briefly explain the concept of market liquidity and why it is important for efficient financial markets.
3. Differentiate between a bull market and a bear market, highlighting key characteristics of each.
4. How do interest rates impact financial markets, and what are the implications for borrowers and investors?

2.9 LONG QUESTIONS

1. What is the primary market, and how does it differ from the secondary market? Provide a simple example of a transaction that occurs in the primary market.
2. Who are the main participants in the secondary market? Briefly explain the role of buyers and sellers in secondary market transactions.

3. What does IPO stand for, and what happens during an Initial Public Offering? Explain why a company might choose to go public through an IPO.

4. What is the primary function of a stock exchange in the secondary market? How does it contribute to the trading of stocks among investors?

2.10REFERENCES

- Bhole L.M., Financial Institutions and Markets, Tata McGraw Hill Publishing - Company Ltd., New Delhi.
- Gordon and Natarajan, Financial Markets and Services, Himalaya Publishing House, Mumbai.

2.11ANSWER TO SELF-ASSESSMENT QUESTIONS

2.6.1 Primary market

2.6.2 Among investors who already own the securities

2.6.3 To provide liquidity and a platform for trading existing securities

2.6.4 Primary market

2.6.5 Buying and selling of existing securities among investors

Lesson No. 3 AUTHOR: SALONY KANSAL

MONEY MARKET

STRUCTURE

3.0 OBJECTIVES

After reading this lesson, students will be able to:

- Understand the meaning of Money Market.
- Know about the composition of Money Market
- Know about major Reforms in Indian Money Market

3.1 MEANING

The money market is the place or mechanism where short term instruments that mature in a year or earlier are traded. The money market facilitates short-term financing and assures the liquidity of short-term financial assets. The money market is a main place for Central bank activities. The money market is significant in indicating changes in short-term interest rates, monetary policy and availability of short-term credit. The focus of money market is on providing a means by which individuals, institutions and government are able to rapidly adjust their actual liquidity position to the amount desired. It is a medium through which holders of temporary cash surpluses meet those with temporary cash deficits. Hence, an individual with a temporary excess of investible funds is able to use the money market as a place, where his funds may be stored/invested for a short period of time and yield return on them. Similarly, individuals, institutions and government with a temporary shortfall of liquidity can raise funds in the money market for a short period of time. The money market assures borrowers that they can obtain short-term funds quickly and it assures lenders that they can convert their short-term financial assets into cash. The central bank which 'is responsible for regulating and controlling the money supply in economy conducts most of its operations in the money market. The risk of capital losses (money risk) and risk of default are minimised in the money market. Money risk is low because the money market instruments are short-term in nature. This is so, because a change in interest rates does not affect their prices very much as the assured maturity is discounted over a short period of time. The risk of default or credit risk is low because money market instruments are mostly the liabilities of the government, central bank and commercial banks.

3.2 CHARACTERISTICS OF A DEVELOPED MONEY MARKET

A developed money market is one which is comparatively efficient in the sense that it is responsive to changes in demand for and supply of funds in any of its segments. The effects initiated in any part of it, quickly spreads to others without significant time lag. In order to satisfy these criteria, it should have the following characteristics:

(a) Presence of Central Bank

Central bank has a greater capacity of judging the needs of the market as regards its financial requirements and can-devise its monetary policy to suit the objectives. It can vary the supply of cash and easily meet the seasonal variations in demand for liquidity by rediscovering the commercial paper. It- can supplement this task by varying the minimum reserves to be maintained by the banks, the bank rate and use of selective credit controls etc.

(b) A Developed Commercial Banking System

For a developed money market not only, the banks should be well- developed and organised, but the public should also have widespread banking habit. Widespread banking habits of the public enable banks to operate on low fractional reserves.

(c) Variety and Quantity of Financial Assets

It is essential that there should be an adequate supply of a variety of short maturity financial assets. In developed money markets there is an abundance of commercial bills, bills of exchange, treasury bills and so on.

(d) Sub-markets

A developed money market will have developed and sensitive sub- markets. Absence of such markets or lack of their responsiveness to small changes in interest and discount rates, does not make it a developed money market.

(e) Existence of Specialized Institution

The existence of institutions specializing in particular types of assets help in making the money market competitive and efficient. acceptance houses and discount houses are important examples.

(f) Contributory Legal and Economic Factors

Appropriate legal provisions go a long way in the development of money market. The transaction costs of commercial bills should be quite nominal- In India, one of the reasons for non-development of bill market happens to be the high stamp duty payable on them. Similarly, the dealers in bills should have a legal protection against default of payment and remedial provisions should not be very time-consuming.

3.3 COMPOSITION OF MONEY MARKET

The money market is not a single homogeneous market. It consists of a number of sub market which collectively constitute the money market. The following are the main sub markets of a money market.

1. Call /Notice-Money Market

Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is Call Money". When money is borrowed or lent for more than a day and up to 14 days, it is "Notice Money'. No collateral security is required to cover these transactions.

2. Treasury Bills Market

The market which deals in treasury bills is termed as treasury bill market. These bills are short-term liability of the government. They are issued to meet temporary needs for funds of the government arising from temporary excess of expenditure over receipts. Treasury bills are of two kinds: adhoc and regular. Adhoc means for the particular end or case at hand. Adhoc treasury bills are issued for providing investment outlets to state governments, semi- government departments etc. They are sold to general public and banks. They are freely marketable. In India, their buyers are almost entirely commercial banks. Treasury bills are bought and sold on discount basis. The amount of interest due on it is paid in the form of discount in the price charged for the bill. This price is, thus, lower than its face value by the amount of interest due on the bill. For the government, treasury bills are an important source of raising funds. In India, treasury bill rates are very low, which in turn, keep the interest cost of treasury bill debt to the government very low.

3. Commercial Bills Market

The market dealing in commercial bills is known as commercial bill -market. These bills axe issued by firms engaged in business. Generally, they are of three months' maturity. They are like post-dated cheques drawn by sellers of goods on the buyers of goods for value received.

3.4 MONEY MARKET INSTRUMENTS

A variety of instruments are available in a developed money market. In India, till 1986, only a few instruments were available. They were:

(i) Treasury Bills in the treasury Bills market
(ii) Money at call and short notice in call loan Market.
(iii) Commercial bill in the bill market

Now, in addition to the above, the following new instrument are available:

(i) Commercial Paper
(ii) Certificate of deposit
(iii) Repo instruments

The new instruments are discussed below:

(i) Commercial Paper

CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided - (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crores; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CR1SILor such equivalent rating by other agencies.

(ii) Certificates of Deposits (CDs)

A CD is a document of title to a time deposit. A certificate of deposit is a certificate given by a commercial bank that certifies that a deposit has, in fact, been made. The certificate stipulates that the deposit cannot be withdrawn before a certain date and that, upon that date, the bank will repay the deposit plus interest. This period is generally three months. Certificates of deposit arc of two kinds: non-negotiable and negotiable. A non-negotiable certificate of deposit must be redeemed by the original depositors. A negotiable certificate of deposit, however, may be resold by the depositor in the money market and may change hands several times before it matures. Whosoever owns the negotiable certificate of deposit on its maturity date, of course, claims the deposit and interest from the bank.

(iii) Repo Instrument

Repo stands for Repurchase. Under Repo transaction the borrower parts with securities to the lender with an agreement to repurchase them at the end of the fixed period at specified price. At the end of the period, the borrower will repurchase the securities at the predetermined price. The difference between the purchase price and the original price is the cost for the borrower. This cost of borrowing is called a Repo Rate' which is little cheaper than pure borrowing.

3.5 PARTICIPANTS IN MONEY MARKETS

On the basis of specialised sub-markets, the important participants in the money market are:

(i) Central Bank

The Central Bank of any country is the apex monetary institution in the money market. It regulates and makes policy relating to monetary management in the country. It serves as the government bank because it performs the major financial operations of the government. It is one of the major participants in the money market because it also participates in a big w-ay in the market to purchase and sell various securities, specifically those issued by the Government. In brief, the Central bank is an organ of the government which participates in financial markets in different ways.

These are:

(a) By issuing of currency notes which is directly and solely under the purview of the Central Bank.

(b) By working as the agent and adviser of the Government specifically concerning to the financial matters, such as loans, advances, servicing of debts, etc.

(c) By acting as bankers' bank in the financial market the Central Bank regulates the banking operations in the country.

(d) By maintaining adequate foreign exchange reserve for meeting the requirements of foreign trade and servicing of foreign debts.

(ii) Commercial Banks

Another significant participant in the money market of a country is commercial bank. A major portion of the total operations of the money markets is conducted through the commercial banks. The basic functions of commercial banks are borrowing and lending ofmoney. They borrow money by accepting all kinds of deposits from the public at large, by cheques, drafts, pay order or otherwise. The banks employ these pooled funds in the form of loans and advances to those who are in need of them. The commercial banks assist in mobilising the public savings which are normally in the form of small holdings and then combining the same into a huge lot for the purpose of investment into business sector. They undertake the payment, of subscription, insurance premium, rent, royalty, interest dividend, etc. on behalf of their clients. They also collect the amounts arisen due to interest, dividend, rent, salary and wages, commission for their customers. These banks also, sometimes, advise their clients relating to sale and purchase of various securities and in designing their investment portfolio. This service is popularly known as 'Portfolio Management Service'.

(iii) Indigenous Financial Agencies

Indigenous financial agencies are important participants in money market, especially in unorganised sector. They comprise of money lenders (Village Sahukars) and indigenous bankers. The basic function of these agencies is to provide usually short-term loans to both urban as well as rural borrowers. Normally they finance in land trade including the movement of agricultural commodities such as cotton, oil seeds, sugar and others. The main technique of their financing is discounting of hundies and bills. Sometime, they also lend money by mortgaging immovable property like houses, land, fixed assets, etc. The rate of interest charged by them is normally very high in comparison to the banks.

(iv) Discount Houses

Discount houses are important constituents of the money market. The major function of these houses is to discount trade bills of traders so as to provide adequate liquidity in the market. Discount houses play a significant role in business world specifically in money- market. They assist the market making more liquid by discounting the trade bills. Further, by endorsing these bills, they sell these bills to commercial banks to raise funds so that they can facilitate this service further to the traders. Besides this, they also provide guarantee to the bankers for payment of bills on maturity by the traders. In case of default, they take the responsibility of payment. In this way, discount houses provide very flexible instrument whereby the bankers are able to adjust their cash positions through these houses.

(v) Acceptance Houses

Another important participant in the money market is Acceptance house. They play a significant role in providing more liquidity in the money market through borrowing short-term loans from the banks and lending the same to the traders. In other words, the acceptance houses accept the bills of exchange which are drawn on them either by the seller or the buyer of the goods so that the accepted bill can further be discounted from the discount house. Acceptance house is an important organ of a developed money market. They not only accept the bills which are drawn on them, but also performs some other functions like normal banking facilities; both domestic and foreign, short-term loans to the traders, regulating their clients' open credit, advising on shipping and insurance problems arising out of the financing of trade, etc. Further, it has been noticed that some acceptance houses have also started medium as well as long term financing for major projects.

3.6 MAJOR REFORMS IN INDIAN MONEY MARKET

A systematic review of the Indian money market was undertaken by the Vaghul working group in 1987. Since then, a number of steps have been taken to improve the efficiency of the Indian money market. Some of these steps are as follows

1. Ceiling on call money rate has been withdrawn. All money market interest rates arc, by and large, determined by market forces.
2. Selected institutions are allowed to borrow from the money market on a term basis.
3. The base of call money market has been widened by selective increase in the participants as lenders.
4. CDs were introduced in 1989, CPs in 1990, and guidelines relating to them are modified from time to time.
5. A number of institutions have been set up like Discount and Finance House of India (DFHI), Securities Trading Corporation of India (STCI) to promote orderly development of money market. They are allowed to participate both as lenders and borrowers in the call money market.

   The DFHI was set up in January, 1988 jointly by the Reserve Bank, Public Sector Banks, and the All-India Financial Institutions to deal in short term money market instruments, enlarge the number of participants in the call, short notice, and term money market by allowing financial institutions and mutual funds to participate as lenders. It moderates the volatility in the in.er bank call money market by providing liquidity in the market as and when required. The STCI was set up on June 7, 1994 to develop an institutional infrastructure to act as base for an active secondary market in govt, dated securities and public sector bonds. It can also hold short-term money market assets like TBs.

   Issue of adhoc 91-day TBs to finance the budget deficit of the government was discontinued, and a scheme of Ways and Means Advances (WMA) by the RBI to the Central Govt, was introduced with effect from April 1, 1997. Auction of 91- days TBs commenced from 1993. Also, TBs of various maturities such as 14-days, 28-days have been introduced.

7. In April 1991, RBI announced the introduction of Money Market Mutual

Funds (MMMFs). The main objective was to provide small investors an investing opportunity yielding market related returns, help in broad basing money market by providing more participants, and help in mobilising household savings. The private sector was allowed to set up MMMFs in 1995. Also, UTI, IDBI, ABN Amro Bank and Bank of Madura Ltd. have been given clearance to set up MMMFs. Since march 2000, MMMFs have been brought under the purview of SEBI regulation.

8. The minimum lock-in period for Money market instruments was brought down, to 15 days.
9. The 182 day and 14-day treasury bills were discontinued w.e.f. May, 2001. Despite these reforms, the Indian money market is yet to acquire depth. Interest rates continue to be highly volatile. Moreover, the grand scheme of liberalisation and globalisation of money market has brought up many distortions without enhancing efficiency of institutions and allocation of resources. In our economywhere the rural sector dominates, and the unorganised money market still plays an important role, money market reforms should start from reorganising rural financial structure.

3.7 SELF-ASSESSMENT QUESTIONS

3.7.1 What is the primary characteristic of instruments traded in the money market?

a) Long-term maturity
b) High risk
c) Low liquidity
d) Short-term maturity

3.7.2 Which of the following is a common instrument in the money market?

a) corporate bonds
b) Mortgage-backed securities
c) Treasury bills
d) Preferred stocks

3.7.3 What is the main purpose of the money market?

a) Long-term capital appreciation
b) Facilitating short-term borrowing and lending
c) Trading of company stocks
d) Real estate investment

3.7.4 Which institution typically issues Commercial Paper in the money market?

a) Central banks
b) Corporations
c) Retail banks
d) Mutual funds

3.7.5 What role do money market instruments play in the broader financial system?

a) Long-term investment growth
b) Providing short-term financing and liquidity
c) Speculative trading of assets
d) Funding major infrastructure projects

3.8 SUMMARY

The money market is the place or mechanism where short term instruments that mature in a year or earlier are traded. The money market facilitates short-term financing and assures the liquidity of short-term financial assets. The money market is not a single homogeneous market. It consists of a number of sub market which collectively constitute the money market. These are Treasure bill market, Call money market and Commercial bill market on the basis of specialized sub-markets, the important participants in the money market are Central Bank, Commercial Bank and Discount houses.

3.9 SHORT QUESTIONS

1. What is the primary purpose of the money market, and how does it differ from the capital market?
2. Name one key characteristic of money market instruments and provide an example of such an instrument.
3. How do interest rates in the money market impact borrowing and lending activities, and what role does the central bank play in influencing these rates?
4. Briefly explain the concept of liquidity in the context of the money market and why it is essential for participants in this market.

3.10 LONG QUESTIONS

1. Explore key money market instruments like Treasury bills and commercial paper. Discuss how these instruments contribute to liquidity and financial system stability.
2. Analyse the role of central banks in the money market, focusing on tools like open market operations and their impact on short-term interest rates and economic stability.
3. Identify key participants in the money market and discuss how they use it for short-term funding and investment. Explore risk management strategies employed by these participants.
4. Compare and contrast the money market and capital market, highlighting differences in traded instruments, participants, risk profiles, and investment durations. Discuss the complementary roles these markets play in meeting diverse financing and investment needs.

3.11 REFERENCESS

- Bhole L.M., Financial Institutions and Markets, Tata McGraw Hill Publishing - Company Ltd., New Delhi.
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3.12 ANSWER TO SELF-ASSESSMENT QUESTIONS

3.7.1 Answer: d) Short-term maturity

3.7.2 Answer: c) Treasury bills

3.7.3 Answer: b) Facilitating short-term borrowing and lending

3.7.4 Answer: b) Corporations

3.7.5 Answer: b) Providing short-term financing and liquidity

Lesson No. 4 **AUTHOR: SHAMINDER KAUR**

CAPITAL MARKET

STRUCTURE

4.0 OBJECTIVES

The main objectives of the chapter are:

- To understand the meaning and functions of Capital market.
- To know the recent developments of Capital Market.

4.1 INTRODUCTION

An efficient capital market is a pre-requisite of economic development. An organized and well-developed capital market operating in a free market economy, (i) ensures best possible coordination and balance between the flow of the savings on the one hand and the flow of investment leading to the capital formation on the other; (ii) directs the flow of savings into most profitable channels and thereby ensures optimum utilization of financial resources.

Thus, an ideal capital market is one where finance is used as a hand-made to serve the needs of industry. The capital market must facilitate the movement of the capital to the point of highest yield., thus, a capital market strives for- (i) the mobilization or concentration of national savings for economic development, and (ii) the mobilization and import of foreign capital and investment to augment the deficit in the required financial resources so as to maintain the expected rate of economic growth.

4.2 MEANING AND CONCEPT

The term 'capital market' refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In the widest sense, it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and public authorities. It is concerned with those private savings, individual as well as corporate, that are turned into investments through new capital issues and also new public loans floated by government and semigovernment bodies.

A capital market may be defined as an organized mechanism for effective and efficient transfer of money-capital or financial resources from investing parties, i.e., individuals or institutional savers to the entrepreneurs (individuals or institutions) engaged in industry or commerce in the business either be in the private or public sectors of an economy.

4.3 FUNCTION OF CAPITAL MARKET

The major functions performed by a capital market are:

(i) Mobilization of financial resources on a nation-wide scale.

(ii) Securing the foreign capital and know-how to fill up the deficit in the required resources for economic growth at a faster rate.

(iii) Effective allocation of the mobilized financial resources, by directing the same to projects yielding highest yield.

4.4 STRUCTURE OF THE INDIAN CAPITAL MARKET

The capital market in India may be classified into two categories viz., organized and unorganized. The structure of any capital market is composed of the sources of demand for and supply of long-term capital. The organized sector of capital market demand for long-term capital comes from corporate enterprises, public sector enterprises, government and semi government, institutions. The unorganized sector of capital market consists of indigenous bankers and private money-lenders. The main demand in the unorganized capital market comes from the agriculturists, private individuals for consumption rather than production and even small traders.

4.5 CONSTITUENTS OF CAPITAL MARKET

The following are the three main components of a capital market:

1. New issue Market or Primary Market.

2. Stock market or secondary Market.

3. Financial Institutions.

The new issue market represents the primary market where new securities, i.e., shares or bonds that have never been previously issued, are offered. Both the new companies and the existing ones can raise capital on the new issue market. The prime function of the new issue market is to facilitate the transfer of funds from the willing investors to the entrepreneurs setting up new corporate enterprises or going in for expansion, diversification, growth or modernization. Besides, helping corporate enterprises in securing their funds, the new issue market channelizes the savings of individuals and others into investment Stock market represents the secondary market where existing securities are traded Stock exchange provide an organized mechanism for purchase and sale of existing securities. By now, we have 24 approved stock exchanges in our country. Stock exchange provide such a place where securities of different companies can be purchased and sold. Stock exchange is a body of persons, whether in corporate or not, formed with a view of helping, regulating and controlling the business of buying and selling of securities. Some of the definitions of Stock Exchange are as follow:

> Securities Contract (Regulation) Act, 1956."Stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling in securities'

Hartely Withers "A Stock Exchange is something like a vast warehouse were securities are taken away from the shelves and sold across the countries at a fixed price in a catalogue which is called the official list.

Financial Institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobiles saving of the surplus units and allocate them in productive activities promising a better rate of return. Financial institution also provides services to entities seeking advice on various issues ranging from restricting to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere.

Financial Institutions are also termed as financial intermediaries because they act as middleman between the savers and borrowers. banks also act as intermediaries because they accept. deposits from a set of customers and lend these funds to another set of customers. Like-wise investing institutions such as GIC, LIC, mutual funds etc. also accumulate saving and lend these to borrowers, thus performing the role of financial intermediaries.

4.6 CAPITAL MARKET REFORMS

A number of developments have taken place in the Indian capital market with the launching of financial reforms since July 1991. Some of the important developments that have place in the Indian market axe as below:

4.6.1 From July 1991 to 1995-96

1. Setting up of SEBI with autonomous power as a regulatory authority in a capital market.
2. Launching of OTCEI a second-tier bourse permitting smaller companies to raise funds.
3. CCI abolished and free pricing introduced.
4. Insider trading made an offence.
5. New Industrial Policy and a package of measures to boost industrial investment.
6. Guidelines for disclosures and investor's protection issued.
7. New guidelines issued for preferential offers, rights and bonus shares.
8. Minimum subscription for public issue has been raised.

9. Proportionate allotment of shares for all public issues cleared by SE13I after January 1, 1994 has been mandatory.
10. Capital adequacy norms for brokers, announced: For brokers belonging to BSE and CSE minimum deposit required is Rs. 5 lakhs each, for Delhi and Ahmedabad Rs.
    3.5 lakhs etc.; for remaining stock exchanges Rs. 2 lakh each.
11. Rules relating to portfolio managers and mutual funds announced. A number of private sector mutual funds launched schemes to mobilize funds for investment.
12. Relaxation in the provisions of Foreign Exchange Regulation Act. 1973 (FER A) and MRTP Act, 1969.
13. Foreign Institutional Investors (Fils) registered by SEBI and private placement of issues with FIIs.
14. National Stock Exchange (NSE) began on line scripless trading in India,
15. Abolition of licensing system.
16. Promoters required to subscribe to at least 25 per cent of the equity in each class of instrument when more than one instruments is offered to the public.
17. Indian companies have been permitted to float Global depository Receipts, EuroEquity Issues, floating Rate or Interest Notes in various foreign countries.
18. Clearance for financial institutions and banks for their capital Issues has been made mandatory.
19. Full convertibility of rupee on trade as well as on current account announced.
20. Forward trading was banned and a new trading system called the twin-track' system was introduced.
21. Foreign Investments of MNCs increased to 51 percent of equity capital in their subsidiary companies in India.

4.6.2 Capital Market Reform from April 1996 to March 2002

The process of capital Mark reforms was carried forward during 1996-2002. A number of reforms, both in the primary as well as secondary markets for equity, debt and foreign institutional investment were made, the following arc some of the important reforms made during this period:

1. The Depositories Act, 1996 was enacted in July 1996 and SEBI Regulations, 1996 notified.
2. To provide greater flexibility, SEBI gave up vetting of public issue documents.
3. To encourage the development of debt market, debt issues not accompanied by an equity component permitted to be sold entirely by the book-building' process subject to Section 19(2) (b) of the Securities Contracts (Regulation) Rules.
4. Stock exchanges asked to modify the listing agreement to provide for lot payment of interest by companies to investors from the 30th day after the closure of a public issue.
5. Uniform good-bad delivery norms and procedure for time bound resolution of bad deliveries through Bad Delivery Cells, prescribed.
6. Several restrictions including limits on the size of issues proposed to be listed

on OTCEI relaxed.

7. The promoter s contribution for public issues has been made uniform at 20 per cent irrespective of the issue size.
8. The SEBI (Registrars to an Issue and Share Transfer Agents) Rules and Regulations, 1993 have been amended to provide for an arm's length relationship between the Issuer and the Registrar.
9. Only body corporates are now allowed to act as merchant bankers.
10. Companies are now required to make their partly paid-up shares fully paid up or forfeit the same before making a public or rights issue.
11. SEBI regulations enabling companies to buy back their shares have been framed.
12. Requirement to publish unaudited results by listed companies in quarterly basis.
13. Introduction of rolling settlement in respect of demat securities.
14. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 issued and subsequently amended in 1988.
15. Compulsory trading of shares in dematerialized form in specified scrips by institutional investors.
16. Companies have been given freedom to determine the par value of shares issued by them.
17. SEBI modified the framework for book-building.
18. Securities Laws (Amendment) Bill, 1999 incorporating derivative instruments inthe definition of securities.
19. Introduction of rolling settlement for 10 select scrips from January 10,2000.
20. Insurance Regulatory and Development Authority (IRDA) Bill passed by Parliament in December, 1999.
21. SEBI's Regulations for Collective Investment Schemes (CIS) were notified on October 15, 1999.
22. SEBI accepted a system envisaging the use of existing infrastructure of stock exchanges for marketing initial public offers (IPOs),
23. Investors can now place buy/sell orders through the internet.
24. The SEBI Committee on Venture Capital, set up in July 1999 examine impediments to the growth of Venture Capital Funds and suggested several measures to facilitate the growth of Venture Capital activity in India.
25. Introduction of derivatives trading ill June 2000.
26. Introduction of compulsory rolling settlement
27. Compulsory trading of shares of all companies listed in stock exchanges in demat form with effect from 2nd January 2002.

4.6.3 Recent Developments of Secondary Market

(1) Restrictions on short sales have been withdrawn w.e.f. July 2, 2001.

(2) Stock exchanges were allowed to use the SGF for meeting shortfalls caused by non-fulfilment/ partial fulfilment of obligations by members, before declaring them defaulters.

(3) Government amended Securities Contracts Rules, 1975 to standardize listing requirements on stock exchanges. The main provisions that are amended include:
   (i) Public Company shall issue at least 10% of securities issued by it to the public for subscription and allot securities to those who supply for the same.
   (ii) Minimum 20 lakh securities were offered to the public.
   (iii) The size of the offer to the public was a minimum Rs. 100 crores.
   (iv) If a company is unable to fulfil the above conditions it has to satisfy the exchange that at least 25% of each class/kind of securities issued by it was offered to the public for subscription through advertisement in newspapers for a period of not less than two days and that, the applicants in pursuance of such offer were allotted securities.

(4) All included in the ALBM/BLESS or MCFS in any stock exchange or in the BSE 200 list were brought under rolling settlement w.e.f. July 2, 2001.

(5) SEBI issued notifications regarding the investment Advice by Intermediaries Amendment Regulation, 2001. SEBI requires the appointment of compliance officer by market intermediaries like bankers to an issue, Credit Rating Agencies etc. These Compliance officers are required to report to SEBI on noncompliance with rules and regulations issued by Government and regulations and restrictions on investment advice by intermediaries and their employees on any security in the publicly accessible media.

4.7SELF-ASSESSMENT QUESTIONS

4.7.1 What is the primary function of a capital market?

a) Buying and selling goods

b) Raising and investing long-term funds

c) Short-term borrowing and lending

d) Currency exchange

4.7.2 Which of the following securities represents ownership in a company?

a) corporate bonds

b) Preferred stock

c) Treasury bills

d) Municipal bonds

4.7.3 What is the role of an investment bank in the capital market?

a) Facilitating stock trading for individual investors

b) Providing loans to small businesses

c) Advising companies on mergers and acquisitions

d) Issuing government bonds

4.7.4 What is the purpose of the secondary market in the capital market system?

a) Initial public offerings (IPOs)

b) Buying and selling existing securities among investors

c) Long-term financing for companies

d) Government debt issuance

4.7.5 Which term is commonly used to describe the measure of risk associated with an investment in the capital market?

a) Interest rate

b) Dividend yield

c) Beta

d) Inflation rate

4.8 SUMMARY

Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country. The development of a good capital market in a country is dependent upon the availability of savings, proper organization of its constituent units and the entrepreneurship qualities of its people. Before independence, the capital market of India was ill-developed because of its certain defects. But, in recent years since independence, the capital market of India had substantially changed and has been changing for the better.

4.9 SHORT QUESTIONS

1. Define the term "IPO" in the context of capital markets.
2. What is the key function of the primary market in the capital market system?
3. Explain the difference between a bull market and a bear market in the context of financial markets.
4. What role do credit rating agencies play in the capital market, and why are their assessments important for investors?

4.10 LONG QUESTIONS

1. Discuss primary and secondary markets, emphasizing liquidity, transparency, and price discovery. Provide examples.

2. Identify and explain key participants, including investors, issuers, and intermediaries. Explore their roles in shaping capital market dynamics.

3. Examine how stock exchanges contribute to trading, liquidity, and price discovery. Discuss regulatory functions.

4. Explore the impact of information technology on capital markets, including electronic trading, algorithmic trading, and digital communication. Assess benefits and challenges.

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4.12ANSWER TO SELF-ASSESSMENT QUESTIONS

4.7.1b) Raising and investing long-term funds

4.7.2b) Preferred stock

4.7.3c) Advising companies on mergers and acquisitions

4.7.4b) Buying and selling existing securities among investors

4.7.5c) Beta

Lesson No. 5 **AUTHOR: SHAMINDER KAUR**

NEW ISSUE MARKET

STRUCTURE

5.0 OBJECTIVES

The main objective of a lesson is:

- To understand the meaning of primary market.
- To know the methods of raising capital from primary market and regulations regarding primary market.

5.1 INTRODUCTION

The new issue market represents the primary market where new securities, i.e., shares or bonds that have never been previously issued, are offered. Both the new companies and the existing ones can raise capital on the new issue market. The prime function of the new issue market is to facilitate the transfer of funds from the willing investors to the entrepreneurs setting up new corporate enterprises or going in for expansion, diversification, growth or modernization. Besides, helping corporate enterprises in securing their funds, the new issue market channelizes the savings of individuals and others into investments.

The two facets of this market, i.e., supply and demand, are represented by the issuing companies and the investors respectively. But the organization of the new issue market is not complete without the specialized agencies, intermediaries and institutions etc. which promote issues of new securities and help in selling, transferring, underwriting etc. These agencies include financial institutions, underwriters, brokers, merchant bankers, etc.

As the new issue market directs the flow of savings into long-term investments, it is of paramount importance for the economic growth and industrial development of a country. The availability of financial resources for corporate enterprises to a great extent depends upon the status of the new issue market of the country.

5.2 CAPITAL MARKET INTERMEDIARIES

Primary market is a market for raising long-term sources of finance by the issue of new corporate securities. The corporate securities that are dealt in primary market can be classified under two categories:

1. Ownership securities or Capital Stock.
2. Creditorship Securities or Debt Capital.

The term 'ownership securities' also known as 'capital stock' represent shares. Shares are the most universal form of raising long-term funds from the market. Every company, except a company limited by guarantee, has a statutory right to issue shares. The capital of a company is divided into a number of equal parts known as shares. Section 2(46) of the companies act, 1956 defines it as "a share in the share capital of a company, includes stock except where distinction between stock and shares is expressed or implied". There are various kinds of ownership securities

1. Equity Shares.
2. Preference Shares.
3. Deferred Shares.
4. No par Stock/Shares.
5. Shares with differential Rights.
6. Sweat Equity Shares.

The term 'creditorship securities' also known as debt capital, represents debentures and bonds. They occupy a very significant place in the financial plan of the company. A debenture or a bond is an acknowledgement of a debt. It is a certificate issued by a company under its seal acknowledging a debt due by it to its holders. In India, there is no such distinction between debentures and bonds. According to the companies Act 1956, the term debentures include,' debentures stock, bonds and many other securities of a company whether contributing a charge on the assets of a company or not". The use of such creditorship securities in financing of a company generally tends to reduce the cost of capital and consequently helps it to improve the earnings for its shareholders.

5.3 MODES OF RAISING CAPITAL FROM PRIMARY MARKET

There are various methods/techniques of raising capital from primary market. A company may adopt any one or more than one of these methods. The various methods are as follows:

5.3.1 Public Issue by Prospectus

This is the most popular method of raising capital for public limited companies. Under this method, a public limited company issues a document, called prospectus, containing information about the company and inviting public to apply for shares or debentures of the company. If the promoters are confident of raising the required funds through private contracts, it may issue a statement in lieu of prospectus. A prospectus gives details about the company and proposed issue to the prospective investors. The company ties to convince the public that it offers best opportunity for their investment. The company as well as the directors signing this document is personally liable for any false statement or misrepresentation of material facts in the prospectus.

A company may issue a prospectus inviting applications direct from the public or through some intermediaries such as brokers, investment bankers and underwriters, etc. Thus, these methods include (a) Direct selling of securities by the company, (b) Underwritten placement, (c) Sale through investment intermediaries.

5.3.2 Offer for Sale

This method is generally adopted in case of large issues by companies. Under this method, the issuing companies sell or agrees to sell the securities for sale to certain issue houses or the specialized financial institutions at a fixed price. The objective of this method is to ensure success in sale of securities. The issue house may retain the securities for some time and may not offer the entire stock in one lot.

5.3.3 Placement Method

Under this method the securities are sold by the issuing companies to certain intermediaries such as brokers, issue houses or financial institutions, etc. so as to be privately placed to their clients and associates. The issuing company may also use their service for private placement to certain individuals or institutions without having sold such securities to the intermediaries. Usually, the companies reserve certain number of securities for private placement.

5.3.4 Tender Method

Under this method, the issue price is not determined like any other method. The company announces the public issue without indicating the issue price inviting bids from various interested parties. The parties participating in the tender submit their maximum offers indicating the maximum price they are willing to pay as well as the number of shares they are interested to buy.

5.3.5 Rights Issue

Rights issue is an invitation to the existing shareholders to subscribe for further shares to be issued by a company. A right simply means an option to buy certain securities at a certain privileged price within a certain specified period. Section 81 of the companies act, 1956 has provided a pre-emptive to the existing shareholders of a company to purchase shares in further issues of the company. In recent years, many companies up with further issues of capital and the practice of issuing securities to the existing investors of the company has increased over the period of time. In terms of values, rights issues account for 10 to 25 percent of the new issues.

5.3.6 Over The Counter Placement

It is the recent development in the Indian securities market. The over-the-Counter Exchange began its operations as a second-tier bourse only in 1992. It permits smaller companies to raise funds. A company may place its issue through OTC Exchange. The procedure involved under these methods that the company wishing to raise capital through OTC exchange appoints a member of the OTCEI as sponsor. The share proposed to be offered for public trading by the company are placed by the sponsor with itself and other member and dealers of the OTCEI.

5.3.7 Bonus Issue

A company having free reserves built out of genuine profits or share premium collected in cash may issue bonus shares to its existing shareholders. Usually, the companies which have huge accumulated profits and reserves but not so good liquidity position prefer to capitalize profits by the issue of bonus shares. Bonus issue does not bringin fresh capital for the company, it only enables a company to restructure its capital.

5.4 SEBI GUIDELINES RELATING TO PRIMARY MARKET

SEBI has issued detailed guidelines in respect of issue of securities to public. The guidelines were first issued on 11th June, and were amended subsequently from time to time. SEBI has now issued consolidated guidelines as SEBI (Disclosure and Investor Protection) Guidelines, 2000 vide its circular No.1 dated 19-1-2000. These guidelines shall apply to all public issues by listed and unlisted companies, all offers for sale and rights issues by listed companies whose equity share capital is listed, except in case of rights issues where the aggregate value of securities offered does not exceed Rs. 50 lacs. Broadly, there are three methods for issuing securities to the public, (a) conventional mode of receiving applications through bankers, (b) book building, and (c) on line system of stock exchange (e-IPO).

5.5SELF-ASSESSMENT QUESTIONS

5.5.1 What is the primary purpose of the new issue market?

a) Trading existing securities

b) Facilitating the buying and selling of stocks

c) Issuing and distributing new securities

d) Secondary market regulation

5.5.2 Which term is commonly used to describe the first sale of stock by a private company to the public in the new issue market?

a) Secondary offering

b) Initial Public Offering (IPO)

c) Private placement

d) Rights issue

5.5.3 What role do investment banks typically play in the new issue market?

a) Stock trading for individual investors

b) Facilitating mergers and acquisitions

c) Underwriting and managing the issuance of new securities

d) Regulating stock exchanges

5.5.4 What is a "book-building" process in the context of the new issue market?

a) Assessing the financial books of a company

b) Determining the fair value of an existing stock

c) Price discovery and demand assessment for new securities

d) Managing financial records of an IPO

5.5.5 What is a "Green Shoe Option" related to in the new issue market?

a) Environmental regulations for new issuers

b) Option to oversell in case of excess demand during an IPO

c) A sustainable investing strategy for IPOs

d) Option for companies to issue additional shares after an IPO

5.6 SUMMARY

The new issue market represents the primary market where new securities i.e., shares and bonds that have never been previously issued are offered. The primary function of the new issue market is to facilitate the transfer of funds from the willing investors to the entrepreneurs setting up new enterprises. As the market directs the flow of savings into long term investments, it is of paramount importance for the economic growth and industrial development of a country.

5.7 SHORT QUESTIONS

1. Define the term "new issue market" and briefly explain its primary function.
2. What is an Initial Public Offering (IPO), and why is it significant in the context of the new issue market?
3. How does the book-building process contribute to the pricing of securities in the new issue market?
4. Explain the role of investment banks in the new issue market, particularly in the process of bringing
5. new securities to the public?

5.8 LONG QUESTIONS

1. What is a "Green Shoe Option" in the new issue market, and how does it work during an Initial Public Offering (IPO)?

2. Briefly explain the concept of "underwriting" and its role in the new issue market.

3. How does the secondary market differ from the new issue market, and what role does the new issue market play in the overall capital market ecosystem?

4. Discuss the potential advantages and challenges associated with a company's decision to go public through an IPO in the new issue market.

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5.10ANSWER TO SELF-ASSESSMENT QUESTIONS

5.5.1 c) Issuing and distributing new securities

5.5.2 b) Initial Public Offering (IPO)

5.5.3 c) Underwriting and managing the issuance of new securities

5.5.4 c) Price discovery and demand assessment for new securities

5.5.5 b) Option to oversell in case of excess demand during an IPO

FINANCIAL SERVICES

STRUCTURE

6.0 OBJECTIVES

After reading this lesson, students will be able to:

- Understand the meaning and classification of Financial Services
- Know about New Financial Products and Services

6.1 INTRODUCTION TO PROJECT FINANCING

In general, all types of activities, which are of a financial nature, could be brought under the term 'financial services'. The term financial services in a broad sense means "mobilizing and allocating savings. Thus, it includes all activities involved in the transformation of savings into investment. The financial services can also be called financial intermediation'. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key area and it is very vital for industrial developments. A well-developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various invest able channels and thereby to promote industrial development in a country.

6.2 CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

The financial intermediaries in India can be traditionally classified into two:

i. Capital Market intermediaries and

ii. Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short-term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

6.3 SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities. They can be broadly classified into two, namely:

i. Traditional Activities
ii. Modern activities.

Traditional Activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads, viz.

a. Fund based activities and
b. Non-fund-based activities.

Fund based activities: The traditional services which come under fund-based activities are the following:

i. Underwriting or investment in shares, debentures, bonds, etc. of new issues (primary market activities).
ii. Dealing in secondary market activities.
iii. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
iv. Involving in equipment leasing, hire purchase, venture capital, seed capital.
v. Dealing in foreign exchange market activities.

Non-fund-based activities: Financial intermediaries provide services on the basis of non-fund activities also. This can be called 'fee based' activity. Today customers, whether individual or corporate, are not satisfied with mere provisions of finance. The}' expect more from financial services companies. Hence a wide variety of services, are being provided under this head. They include:

i. Managing the capital issue - i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.
ii. Making arrangements for the placement of capital and debt instruments with investment institutions.
iii. Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.
iv. Assisting in the process of getting all Government and other clearances.

Modern Activities

Beside the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund-based activity. In view of the importance, these activities have been in brief under the head 'New financial products and services’. However, some of the modern services provided by them are given in brief hereunder.

i. Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approvals.
ii. Planning for M&A and assisting for their smooth carry out.
iii. Guiding corporate customers in capital restructuring.
iv. Acting as trustees to the debenture holders.
v. Recommending suitable changes in the management structure and managementstyle with a view to achieving better results.
vi. Structuring the financial collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements.
vii. Rehabilitating and restructuring sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.
viii. Hedging of risks due to exchange rate risk, interest rate risk, economic risk, and political risk by using swaps and other derivative products.
ix. Managing the portfolio of large Public Sector Corporations.
x. Undertaking risk management services like insurance services, buy-back options etc.
xi. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.
xii. Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.
xiii. Undertakingservices relating to the capital market, such as
    a. Clearing services
    b. Registration and transfers,
    c. Safe custody of securities
    d. Collection of income on securities
xiv. Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

Sources of Revenue

There are two categories of sources of income for a financial services company, namely: (i) Fund based and (ii) Fee - based. Fund based income comes mainly from interest spread (the difference between the interest earned and interest paid), lease rentals, income from investments in capital market and real estate. On the other hand, fee-based income has its sources in merchant banking, advisory services, custodial services, loan syndication, etc. In fact, a major part of the income is earned through fund-based activities. At the same time, it involves a large share of expenditure also in the form of interest and brokerage. In recent times, a number of private financial companies have started accepting deposits by offering a very high rate of interest. When the cost of deposit resources goes up, the lending rate should also go up. It means that such companies have to compromise the quality of its investments. Fee based income, on the other hand, does not involve much risk. But it requires a lot of expertise on the part of a financial company to offer such fee-based services.

6.4 NEW FINANCIAL PRODUCTS AND SERVICES

In these days of complex finances, people expect a financial service company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the opening of the economy to multinationals, the free-market concept has assumed much significance. As a result, the clients both corporate and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect this financial services company to innovate new products and services so as to meet their varied requirements. As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened anddeepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have their activities in: he financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly explained hereunder:

1. **Merchant Banking:** A merchant banker is a financial intermediary' who helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customer securities, portfolio management, project counselling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporate, and thus promote industrial development in the country.

ii. **Loan Syndication:** This is more or less similar to consortium financing. But this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

iii. **Leasing:** A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called 'rental charges'. In countries like USA, the UK and Japan, equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business.

iv. **Mutual Funds:** A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing the risk The fund provides investment avenues for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capitalization in the long run.

v. **Factoring:** Factoring refers to the process of managing the sales register of a client by a financial services company. The entire responsibility of collecting the book debts passes on to the factor.

vi. **Forfaiting:** Forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pays ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

vii. **Venture Capital:** A venture capital is another method of financing in form of equity participation.

viii. **Custodial Services:** Under this a financial intermediary mainly provides services to clients, for a prescribed fee, like safe keeping of financial securities and collection of interest and dividends

ix. **Corporate advisory services:** Financial intermediaries particularly Banks have setup specialized branches for this. As new avenues of finance like Euro loans,GDRs etc. are available to corporate customers, this service is of immense help to the customers.

x. **Securitization:** securitization is a technique whereby a financial company converts its ill-liquid, non-negotiable and high-value financial assets into securities of small value which are made tradable and transferable.

xi. **Derivative Security:** A derivative security is a security whose value depends upon the values of other basic variable backing the security. In most cases, these variables are nothing but the prices of traded securities.

xii. **New products in Forex Markets:** New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them are:

   a. **Forward contract:** A forward transaction is one where the delivery of foreign currency takes place at a specified future date for a specified price. It may have a fixed or flexible maturity date.

   b. **Options:** As the very name implies, it is a contract where in the buyer of options has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his options.

   c. **Futures:** It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange.

   d. **Swaps:** A swap refers to a transaction wherein a financial intermediary buy and sells a specified foreign currency simultaneously for different maturity dates.

xiii. **Letter of Credit:** It is an innovative funding mechanism for the import of goods and services on deferred payments terms. LOC is an arrangement of a financing institution of one country with another to support the export of goods and services to as to enable the importer to import on deferred payment terms.

6.5 CHALLENGES FACING THE FINANCIAL SERVICES SECTOR

Though financial services sector is growing very fast, it has its own set of problems and challenges. The financial sector has to face many challenges in its attempt to fulfil the ever-growing financial demands of the economy. Some of the important challenges are briefly explained hereunder:

i. **Lack of qualified personnel:** The financial services sector is fully geared to the task of financial creativity*. However, this sector has to face many challenges. The dearth of qualified and trained personnel is an important impediment in its growth.

ii. **Lack of investor awareness:** The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments.

iii. **Lack of transparency:** The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner.

iv. **Lack of specialization:** In the Indian scene, each financial intermediary seems to deal in a different financial service line without specializing in one or twoareas. In other countries, financial intermediaries specialize in one or two areas only and provide expert services.

v. **Lack of recent data:** Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon financial creativity'.

vi. **Lack of efficient risk management system:** With the opening of the economy to multinationals and exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi-currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

6.6 PRESENT SCENARIO

The Indian economy is in the process of rapid transformation. Reforms are taking place in every field / part of economy. Hence financial services sector is also witnessing changes. The present scenario can be explained in following terms:

i. **Conservatism to dynamism:** The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. At present numerous new FIs have started functioning with a view to extending multifarious services to the investing public in the area of financial services.

ii. **Emergence of Primary Equity Market:** The capital markets, which were very sluggish, have become a very popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. After the lowering of bank interest rates, capital markets have become a very popular mode of channelizing the savings of medium class people.

iii. **Concept of Credit Rating:** The investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company s point of view, Equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Now it is mandatory for mthe nonbanking financial companies to get credit rating for their debt instruments.

iv. **Process of Globalization:** The process of globalization has paved the way for the entry of innovative and sophisticated products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative, international financial products in India are very great. Moreover, our country is likely to enter the full convertibility era soon. Hence, there is every possibilityOf introduction of more and more innovative and sophisticated financial services in our country.

v. **Process of Liberalization:** Our government has initiated many steps to reform the financial services industry. The government has already switched over to free pricing of issues by the CCI. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. SEBI has liberalized many stringent conditions so as to boost the capital and money markets.

6.7SELF-ASSESSMENT QUESTIONS

6.7.1 What is the primary function of a commercial bank in the realm of financial services?

a) Stock trading

b) Facilitating mergers and acquisitions

c) Accepting deposits and providing loans

d) Insurance underwriting

6.7.2 Which financial institution typically assists individuals and businesses in managing investment

portfolios, retirement planning, and wealth management?

a) Commercial bank

b) Investment bank

c) Hedge fund

d) Asset management firm

6.7.3 What is the purpose of a credit union in the financial services sector?

a) Providing investment advisory services

b) Offering insurance products

c) Facilitating peer-to-peer lending

d) Offering financial services to a specific group of members

6.7.4 Which financial service involves pooling funds from multiple investors to invest in a diversified portfolio of stocks, bonds, or other securities?

a) Retail banking

b) Mutual funds

c) Venture capital

d) Derivatives trading

6.7.5 What is the primary role of an insurance company in the financial services industry?

a) Issuing credit cards

b) Risk mitigation through underwriting insurance policies

c) Providing investment advice

d) Managing pension funds

6.8 SUMMARY

The term financial services mean "mobilizing and allocating savings". A well-developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various invest able channels and thereby to promote industrial development in a country. The traditionally financial intermediaries in India classified into two market intermediaries i.e., Capital Market intermediaries and Money market intermediaries. The capital market and the money market are getting widened and deepened. As a result of innovations, new instruments and new products are emerging in the capital market Like Merchant Banking, Leasing, Mutual Funds. Factoring, Venture Capital etc.

6.9 Short Questions

1. What role do investment banks play in financial services?
2. How do credit unions differ from traditional banks in providing financial services?

3. Define the term "mutual funds" in the context of financial services.
4. What is the primary function of an asset management firm in the financial industry?

6.10 LONG QUESTIONS

1. Explain how financial services contribute to capital formation, risk management, and economic growth.
2. Discuss the significance of commercial banking, investment banking, and retail banking in providing diverse financial services.
3. Explore the transformative impact of fintech on traditional financial services, focusing on innovations and their implications.
4. Describe the roles of insurance and investment services, highlighting their importance in risk mitigation and wealth accumulation.

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6.12ANSWER TO SELF-ASSESSMENT QUESTIONS

6.7.1 c) Accepting deposits and providing loans

6.7.2 d) Asset management firm

6.7.3 d) Offering financial services to a specific group of members

6.7.4 b) Mutual funds

6.7.5 b) Risk mitigation through underwriting insurance policies

Lesson No. 7 **AUTHOR: SALONY KANSAL**

LEASING

STRUCTURE

7.0 OBJECTIVES

After studying this chapter, the student should be able to:

- Understand the concepts and features of leasing;
- Distinguish between the various types of leases;
- Understand standard clauses in a lease agreement; and
- Explain the role and importance of lease financing

7.1 CONCEPT OF LEASE FINANCING

Lease financing denotes procurement of assets through lease. The subject of leasing falls in the category of finance. Leasing has grown as a big industry in the USA and UK and spread to other countries during the present century. In India, the concept was pioneered in 1973 when the First Leasing Company was set up in Madras and the eighties have seen a rapid growth of this business. Lease as a concept involves a contract whereby the ownership, financing and risk taking of any equipment or asset are separated and shared by two or more parties. Thus, the lessor may finance and lessee may accept the risk through the use of it while a third party may own it. Alternatively, the lessor may finance and own it while the lessee enjoys the use of it and bears the risk. There are various combinations in which the above characteristics are shared by the lessor and lessee.

7.2 LEASING: DEFINITION AND MAIN FEATURES

A lease is a contract whereby the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset for an agreed period of time, in return for the payment of a rent (called lease rental). Capital assets like land, buildings, equipment's, machinery, vehicles are the usual assets which are generally acquired on lease basis. The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee.

Main Elements of Leasing

The essential features of a leasing contract are as follows:

(a) A Valid Contract of Leasing: A leasing arrangement is undertaken by entering into a valid contract between the lessor and the lessee. Both the parties must be competent to contract. The lessor must have clear and undisputed title to the assets to be leased. The agreement must satisfy the essentials of a valid contract as per the Indian Contract Act.

(b) Delivery of Goods: The movable property, generally termed as 'goods' must be delivered by the lessor to the lessee. Delivery of the goods may be either actual delivery or constructive delivery-. In the former case physical possession of the goods is handed over to the lessee, but in the latter case, there is no change in the physical possession, but some instruction or direction is given to the possessor of the goods to hold the same on behalf of the lessee rather than the lessor.

(c) Purpose: Goods are delivered to the lessee with the specific purpose of using them for his specified lawful activity throughout the lease period.

(d) Consideration: The lessee undertakes to pay to lessor regularly lease rental, as consideration for the use of the goods.

(e) Return of the Goods: The goods must be returned to the lessor exactly in the same form, after the lease period is over.

(I) Ownership: The lessor, after handing over possession of the leased asset, remains owner of the asset throughout the lease period and even thereafter.

(g) Methodology: The prospective lessee identifies the equipment to be leased and its supplier and enters into a lease arrangement with a leasing company. He furnishes certain particulars, such as his name, address, details about his business, name and address of the guarantor, if any, description of the equipment (model, make, size, specification etc.), the name and address of the supplier and the price quoted by the supplier, place of installation, duration of the lease, etc. examines the lease proposal and evaluates the credit-worthiness of the applicant, his past performance in the business and his capacity to pay the periodical rentals, taking into account the profitability and projected cash flows of his business and his reputation, etc.

7.3 TYPES OF LEASE AGREEMENTS

Leases are classified into the following categories:

1. Financial Lease

A financial Lease is also known as Capital Lease, Net lease and close 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 therefrom 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, financial leases are very popular with high-cost and high technology equipment.

2. Operating Lease

In case of operating lease, the lessor not only leases the asset of which he remains the owner throughout, but also undertakes to provide services attached to such assets, e.g., maintenance, repairs, technical advice, etc. Such lease is also called service lease. Computers, office equipment's, automobiles and trucks are the typical capital assets which are leased under operating lease arrangement. The main features of an operating lease are as follows:

(i) The lease contract is generally for a period which is considerably shorter than the useful life of the leased asset. For example, a machine may be acquired on lease for a period of 5 years, while its useful life may be 10 years.

(ii) The lessor does not, therefore, recover the full cost of the asset from one lessee only. The leased asset is returned back to the lessor at the end of the lease period and is, thereafter, leased again to another lessee for another lease period. After its useful life is over, it is sold off and its scrap value is realized by the lessor.

(iii) Operating lease generally contains a cancellation clause also, wherein the lessee retains the right to cancel the lease any time before the lease period is over. Such clause is beneficial to the lessee as he may terminate the lease, if the asset becomes obsolete or his need for the asset is over.

(iv) The lease agreement contains a maintenance clause whereby the lessor is required to maintain the leased assets. Thus, necessary repairs, fuel, support staff may be provided by the lessor, as agreed upon.

(v) The lease rental includes: (a) a part of the amortization of the cost of the equipment, (b) cost of the maintenance services provided, and (c) profit of the lessor

3. Sale and Lease Back

This is another type of lease arrangement wherein the lessee who already owns the assets, sells the same to the lessor, and thereafter takes the same asset from him on lease basis. This is called 'Sale and Lease Back arrangement'. Under this arrangement, the lessee immediately recovers the value of his already owned assets from the lessor. Thereafter, the lessee makes payment of the lease rentals periodically as usual. Such a lease arrangement enhances the liquid resources of the lessee immediately, which can be utilized otherwise to meet his working capital requirements or to purchase another asset on cash payment basis. This type of lease is an alternative to a mortgage of the assets.

4. Leveraged Lease

In case of an ordinary lease, the lessor purchases the asset with an appropriate mix of debt and equity. But the creditor (i.e., supplier of the debt funds) does not have recourse to the lessee. In other words, in case the lessor defaults in making repayment of the debt, the creditor cannot claim the same from the lessee. He will have recourse to the lessor only. Leveraged lease is just opposite to the above. In such case, the creditor remains entitled to have recourse to the lessee, i.e., he can recover his claims from the lessee also. The lease rental is assigned to the creditor. The lessee is required to pay the lease rental directly tothe creditor of the lessor. Generally, this transaction is undertaken through a trustee, who receives the lease rental and appropriates it as debt service component to the creditor and the balance amount to the lessor.

4. Domestic Lease and International Lease

This classification is based on the domicile of the parties to a lease contract. If all the parties, viz. equipment supplier, lessor and the lessee are residing in the same country, the lease is called domestic lease. If they are residing in different countries, it is called international lease. If the lessor and the lessee are domiciled in the same country and equipment is imported from another country, it is called import lease. If the lessor and lessee are domiciled in different countries, the lease is called cross-border lease. In such cases, the equipment supplier may be the resident of any country. In case of international lease, there are two additional risks, i.e., country risk and currency risk.

7.4 LEGAL ASPECTS OF LEASING

As there is no separate statute in India to govern the contracts of leasing, which is akin to a contract of bailment, the provisions of the Indian Contract Ac: apply to it. According to Section 146 of the Indian Contract Act, 1872 bailment is "the delivery of goods by one person to another person for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of 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 fall in the category of a bailment contract, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (unless expressly specified otherwise in the lease agreement) as given in the Indian Contract Act. Briefly, these may be stated as follows:

(1) The lessor has the duty to deliver the asset to the lessee, to legally authorize the lessee to use the asset and to leave the asset in peaceful possession of the lessee during the lease period.

(2) The lessor has the obligation to paj' the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and

7.5 MAIN CLAUSES IN THE LEASE AGREEMENT

After the lease transaction is finalized, lease agreement is prepared and executed by the parties. The lease agreement incorporates the legal rights and obligations of the lessor and the lessee so as to bind them and serve the purpose of evidence, if any dispute arises during the lease period. The main clauses which are usually incorporated in a lease agreement are as follows:

(1) Nature of the Lease: This clause specifies the nature of the lease (i.e., operating lease, financial lease or a leveraged lease) and the names of the parties to the Agreement.

(2) Description of the Asset: This clause gives the description of the equipment to be leased, its make, model, size, specification etc.

(3) Duration of Lease Period: This clause specifies the period for which the asset is leased, which is called the primary period. The clause generally also gives an option to the lessee to renew the agreement for a further period. The second termof the lease is known as secondary period.

(4) Lease Rentals: This clause specifies the lease rental payable by the lessee, which is fixed by taking into consideration the cost of funds, depreciation, repairs, profit expected, and risk involved in the lease transaction etc. The rent may be payable monthly or quarterly. The quantum of such rental, the time within which it is payable and the consequences of failure to pay the same are stipulated in this clause.

(5) Delivery and Re-delivery: This clause mentions when and how the leased equipment would be delivered to the lessee and how it will be delivered back to the lessor on the completion of the lease period.

(6) Right to Use: This clause allows the lessee to make proper and lawful use of the equipment.

(7) Repairs and Maintenance: Usually this clause states that the lessee shall maintain and repair the equipment and keep it in good and working condition. The cost of such maintenance shall be borne by the lessee.

(8) Alterations/Additions to Equipment: This clause states that the lessee shall not make any alterations or additions to the equipment or remove it from the premises without the written consent of the lessor.

(9) Right to Inspect Equipment: This clause gives the lessor the right to enter the premises of the lessee and to inspect the equipment as and when he desires.

(10) Damage to Equipment: It is usual to stipulate that the lessee will bear all risks, losses, damages, theft or destruction of the equipment as long as it is in his custody.

(11) Prohibition of Sub-leasing: This clause prohibits the lessee from sub-leasing the equipment or selling it to any party.

(12) Default by Lessee and Remedies: It is usual to include a clause indicating the specific events of default by the assessed and the remedies available to the lessor in such cases. The remedies may be:

(a) to declare that all unpaid rentals are due and payable immediately and to sue the lessee for the recovery of the same,

(b) to terminate the lease agreement, and

(c) to seize the equipment given on lease.

(13) Insurance: This clause requires the lessee to take out a fire insurance policy in respect of the equipment in the joint names of the lessee and the lessor (named therein as the owner). Lessee shall pay the premium and renew the policy every year.

(14) Other Charges: This clause shall specify which party will pay the various expenses and charges in connection with the purchase and installation of equipment.

7.6 ACCOUNTING TREATMENT OF LEASE

Presently the accounting treatment of lease transactions in India is as follows:

1. The leased asset is shown on the balance sheet of the lessor.
2. Depreciation and other tax shields associated with the leased asset are claimed by the lessor. The entire lease rental is treated as income in the books of the lessor and as expense in the books of the lessee.

In nut shell, from the point of view of the lessee, a lease transaction represents an off-the-balance-sheet transaction and this appears to be an important advantage associated with the leasing.

7.7 INCOME TAX PROVISION RELATING TO LEASING

The principal tax provisions relating to leasing are as follows:

1. The lessee can claim lease rentals as tax-deductible expenses.
2. The lease rentals received by the lessor are taxable under the head of Profits and Gains of Business or Profession.
3. The lessor can claim investment allowance (this may be doubtful) and deprecation the investment made in leased assets.

7.8 SALES TAX PROVISIONS PERTAINING TO LEASING

The major sale tax provisions relevant for leasing are as follows:

The lessor is not entitled for the concessional rate of central sales tax because the asset purchased for leasing is meant neither for resale nor for the use of manufacture,the 46th Amendment Act has brought lease transitions under the purview of sale' and has empowered the central and state government to levy sales tax on lease transactions. While the central Sales tax has yet to be amended in this respect, several state governments have amended their sales tax laws to impose sales tax on lease transactions.

7.9 ADVANTGES OF LEASING

Several benefits are derived by the lessee by acquiring the assets on lease basis, as compared to buying the same. The benefits are as follows:

(a) Convenience In case of short-term need: If the capital asset is needed for a short period only, say a year or two, leasing is a very convenient and appropriate method of acquiring. It dispenses with the formalities and expenses incurred in purchasing the asset and selling it soon after the need is over.

(b) Saving of Capital: Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes e.g., purchase of inventories.

(c) **No Risk of Technological Obsolescence:** In case of owning the asset, the firm bears the risk of the asset becoming obsolete. In the present age cf technological innovations, risks in owning an asset with outdated and old technology cannot be ignored. With such equipment's, the firm cannot compete with its competitors and will incur heavy losses. Leasing provides a shield against all these hazards by shifting the risk of obsolescence of equipment to the lessor. This is true of operating leases which are for short duration and cancellable at the option of the lessee. The lessee can cancel an old lease agreement and enter into a new one in case a technologically superior product is available in the market. It is truethat lease rentals for such equipment's tend to be higher, but this disadvantage is more than off-set by the benefits the lessee derives by passing on the risk of obsolescence to the lessor.

(d) **Improvement in Liquidity:** Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

(e) **Efficient Maintenance Services:** Under operating or full-service lease, the lessee avails of the maintenance and other services provided by the lessor, who is well equipped, qualified and experienced to provide such services efficiently. Of course, the lessee pays for such services in the form of higher rentals.

(f) **Low Administrative and Transactions Costs:** Many leasing companies specialize in leasing a few types of equipment's, machines or vehicles only. They can easily bargain with the suppliers/manufacturers etc. and acquire the assets at better prices and can economies in other administrative expenses also. The lessee may get a concession in lease rent on the basis of the economies derived by the lessor.

(g) **Benefit of Tax Shield:** The lessee claims lease rentals as tax deductible expenses every year during the lease period. Thus, his tax liability is reduced to that extent. In case he buys the asset with borrowed funds, he can claim (i) depreciation, and (ii) interest on borrowed funds as tax deductible expenses. To the extent the lease rental exceeds the depreciation and interest burden, his deductible expenses are larger and his tax liability is lower. The net burden, in such cases, is neutralized by the benefits derived by the lessee as enumerated above. In the books of the lessor, lease rentals received are taxable, under the head 'Profits and Gains from Business or Professions', after deducting: (i) depreciation on the assets, and (ii) interest on the borrowed funds, if any.

7.10SELF-ASSESSMENT QUESTIONS

7.10.1 What is the primary characteristic that distinguishes a lease from a purchase?

a) Ownership

b) Duration

c) Interest rate

d) Tax implications

7.10.2 In a finance lease, who typically owns the asset during the lease term?

a) Lessee

b) Lessor

c) Both parties jointly

d) Government

7.10.3 What is the purpose of an operating lease?

a) Long-term ownership of an asset

b) Short-term use of an asset without ownership transfer

c) Immediate purchase of an asset

d) Tax evasion strategy

7.10.4 How are lease payments treated in an operating lease compared to a finance lease for accounting

purposes?

a) Both are treated as expenses

b) Operating lease payments are expenses; finance lease payments are part depreciation and part interest

c) Finance lease payments are expenses; operating lease payments are part depreciation and part interest

d) Neither are considered expenses

7.10.5 What is a "capital lease" also known as?

a) Operating lease

b) Finance lease

c) Short-term lease

d) Sublease

7.11 SUMMARY

A lease is an agreement for the use of the asset for a specified rental. The owner of the asset is called the lessor and the user the lessee. Lease financing has several advantages. In India, the First Leasing Company Ltd. was set up in Madras in 1973. As per the industrial investment, lease finance in India just like a newborn baby. Two important categories of leases are operating leases and financial leases. The other sub-parts of finance lease are sale and lease back and leveraged financing, direct lease. Leasing plays an important role in the economic development of a country by providing money incentives to lessee.

7.12 SHORT QUESTIONS

1. What is the key distinction between a finance lease and an operating lease?
2. In leasing, who typically retains ownership of the asset during the lease term?
3. What is the primary purpose of an operating lease in business operations?
4. How are lease payments treated differently in accounting between operating and finance leases?

7.13 LONG QUESTIONS

1. How does a finance lease differ from an operating lease, and what factors contribute to a company's decision to choose one over the other?
2. Explain the accounting treatment of lease payments in the context of finance leases, emphasizing the recognition of interest and depreciation.
3. Discuss the advantages and disadvantages of leasing as a form of financing for businesses, considering factors such as flexibility, ownership, and tax implications.
4. In what ways does leasing impact the balance sheet and income statement of a lessee, and how do these financial statements reflect the economic reality of a lease transaction?

7.14REFERENCESS

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7.15ANSWER TO SELF-ASSESSMENT QUESTIONS

7.10.1 a) Ownership

7.10.2 a) Lessee

7.10.3 b) Short-term use of an asset without ownership transfer

7.10.4 c) Finance lease payments are expenses; operating lease payments are part depreciation and part interest

7.10.5 b) Finance lease

Lesson No. 8 **AUTHOR: SHAMINDER KAUR**

HIRE PURCHASE AND BILL DISCOUNTING

STRUCTURE

8.0 OBJECTIVES

The main objectives of the study are:

- To understand the basic characteristics of hire-purchase and bill discounting.
- To illustrate the framework of financial evaluation of a hire-purchase deal.

8.1 INTRODUCTION

Historically, hire-purchase finance has been associated with the financing of commercial vehicles for road transport operators. It has emerged as a source of equipment financing in recent years as an alternative to lease financing. Consumer credit includes all asset-based financing to individuals to acquire consumer durables. This chapter explains the salient features/basics of hire-purchase transactions. The evaluation framework of hire-purchase transactions from the viewpoint of the hirer as well as the intermediary (finance company) is explained.

Meaning and Characteristics

Hire-purchase is a mode of financing the price of the goods to be sold on a future date. In a hire-purchase transaction, the goods are let on fire, the purchase price is to be paid in instalments and the hirer is allowed an option to purchase the goods by paying all the instalments. A hire-purchase agreement is defined as a peculiar kind of transaction in which the goods are let on fire with an option for the hirer to purchase them, with the following stipulations:

(a) Payment to be made in instalments over a specified period.

(b) The possession is delivered to the hirer at the time of entering into the contract;

(c) The property in the goods passes to the hirer on payment of the last instalment;

(d) Each instalment is treated as hire charges so that if a default is made in payment of any instalment, the seller becomes entitled to take away the goods; and

(e) The hirer/purchaser is free to return the goods without being required to pay any further instalment falling due after the return.

Thus, a hire-purchase agreement has two aspects, firstly, an aspect of bailment of goods subject to the hire-purchase agreement, and secondly, an element of sale which fructifies when the option to purchase is exercised by the intending purchaser. Though the option to purchase is allowed in the very beginning, it can be exercised only at the end of the agreement. The essence of the agreement is that the property in the goods does not pass at the time of the agreement but remains in the intending seller, and only passes later when the option is exercised by the intending purchaser.

8.2 PARTIES TO HIRE-PURCHASE CONTRACT

Basically, there are two parties in a hire-purchase contract, namely, the intending seller and the intending purchaser or the hirer. Nowadays, however, hire-purchase contracts generally involve three parties, namely, the seller, the financier, and the hirer. With the acknowledgment of the finance function as a separate business activity and the substantial growth of finance companies in recent times, the sale element in a hire-purchase contract has been divorced from the finance element. A dealer now normally arranges a hire-purchase agreement through a finance company with the customer. It is, therefore, a tripartite deal. A tripartite hire-purchaser contract is arranged with the following modalities:

1. The dealer contracts a finance company to finance hire-purchase deals submitted by him. For this purpose, they enter into a contract drawing out the terms, and warranties that the dealer gives with each transaction and so on.
2. The customer selects the goods and expresses his desire to acquire them on hire-purchase.
3. The customer then makes a cash down payment on completing the proposal form, the down payment is generally retained by the dealer itself.
4. The dealer then sends the documents to the finance company requesting them to purchase the goods and accept the hire-purchase transactions.

5. The finance company, if it decides to accept the transactions, signs the agreement and sends a copy to the hirer along with the instructions as to the payment of the instalments.
6. The dealer delivers the goods to the hirer against acknowledgments and the property in the goods passes on to the finance company.
7. The hirer makes payment of the hire instalment periodically.
8. On completion of the hire term, the hirer pays the last instalment and the property in the goods passes to him on the issue of a completion certificate by the finance company.

8.3 FINANCIAL EVALUATION

The framework of financial evaluation of a hire-purchase deal vis-a-vis a finance lease which covers both the hirer's as well the finance company's viewpoint.

8.3.1 From the point of view of the hirer(hire-purchaser)

The tax treatment given to hire-purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire-purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire instalment.

Decision-criterion

The decision criterion from the point of view of a hirer is the cost of hire-purchase vis-a-vis the cost of leasing. If the cost of hire-purchase is less than the cost of leasing, the hirer should prefer the hire-purchase alternative and vice-versa.

Cost of Hire-purchase

1. Down payment.
2. Plus, Service charges.
3. Plus, the Present value of hire purchase payments is discounted by cost of debt (Kd).
4. Minus Present value of depreciation tax shield discounted by cost of capital (Kc).
5. Minus Present value of net salvage value discounted by cost of capital (Kc)

Cost of Leasing

1. Lease management fee.
2. Plus, the Present value of lease payments is discounted by Kd.
3. Less Present value of tax shield on lease payments and lease management fee discounted by Kc.
4. Plus, Present value of interest tax shield on hire-purchase is discounted by Kc.

8.3.2 From the Viewpoint of the Finance Company (Hire-Vendor)

Hire-purchase and leasing represent two alternative investment decisions of finance company/financial intermediary/hire-vendor. The decision criterion is based on a comparison of the net present values of the two alternatives, namely, hire-purchase and lease financing. The alternative with a higher net present value would be selected otherwise vice versa*

Net present value of Hire-purchase plan (NPV (HPP)

1. Present Value of hire-purchase instalments.
2. Plus: Documentation and service fee.
3. Plus: Present value of tax shield on initial direct cost
4. Minus: Loan amount.
5. Minus: Initial cost
6. Minus: Present Value of interest tax on finance income
7. Minus: Present Value of income tax on finance income meted for interest tax.
8. Minus: Present Value of income tax on documentation and service fee.

Net present Value of Lease Plan (NPV (LP))

1. Present value of lease rentals.
2. Add: Lease management fee.
3. Add: Present value of tax shield on initial direct costs and depreciation.
4. Add: Present value of net salvage value.

8.4 LEGAL FRAMEWORK

There is no exclusive legislation dealing with the hire-purchase transactions in India. The Hire-purchase Act was passed in 1972. An Amendment Bill was introduced in 1989 to amend some of the provisions of hire-purchase Act. However, the Act has not been enforced so far. The Act contains provisions for regulating (1) the format/contents of the hire-purchase agreement, (2) warrants and the conditions underlying the hire-purchase agreement, (3) ceiling on hire-purchase charges, (4) rights and obligation of the hirer and the owner. In the absence of any specific law, the hire-purchase transactions are governed by the general laws. The hire-purchase transaction has two aspects:

1. an aspect of bailment of goods which is covered by the contract Act,
2. An element of sale when hen the option to purchase is exercised by the hirer/ intending purchaser which is covered by the sales of Goods Act

The provisions of the contract Act in sofaras they relate to leasing and hire-purchase transactions.

From legal point of view, A hire-purchase agreement is a kind of bailment whereby the owner of the goods lets them on hire to another person called hirer, on payment of certain stipulated periodical payments as hire charges or rent if the hirer makes the payment regularly, he gets an option to purchase the goods on making full payment. Before this option is exercised, the hirer may return the goods without any obligation to pay the balance rent. The hirer is, however, under no compulsion to exercise the option and purchase the goods at the end of the agreement period. A hire-purchase contract, therefore differs from sale in the sense that:

(1) In a hire-purchase the possession of the goods is with the hirer while the ownership vests with the original owner;
(2) There is no agreement to buy but only an option is given to the hirer to buy the goods under certain conditions; and
(3) The ownership in the goods passes to the hirer when he exercises his option by making the full payment.

8.5 BILL DISCOUNTING

Bill Discounting is described as an asset-based financial service that emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India. In the post-1992(scam) period, its importance has substantially declined primarily due to restrictions imposed by the Reserve Bank of India. The development of bill discounting as a financial service depends upon the existence of full full-fledged bill market. The RBI has constantly endeavoured to develop a market for commercial bills. Although a bill market scheme was launched in 1952, a real commercial bill market grew in India after 1970. Subsequently, the RBI practically withdrew from the market but permitted banks to rediscount bills amongst themselves and with other eligible financial institutions and finance companies. Now, Bill discounting emerged as a lucrative fund-based activity in India after the mid-eighties. The finance companies acted as bill-brokers between the banks and business houses. It includes the meaning of bills of exchange, creation of bills of exchange, Discounting of bills of exchange, types of bills, advantages, bill market schemes, the procedure of rediscounting, present position of bills discount. The various characteristics of bill discounting are as follows:

(i) The bills are not accommodation bills but are genuine trade bills.

(ii) Bills are drawn on the places where the finance company is operating or has a branch office as it would facilitate tact with the drawee in case of exigencies.

(iii) The goods covered by the documents are those in which the party deals.

(iv) The amount of the bills commensurate with the volume of business turnover of the party.

(v) Bills are drawn on a place where the goods have been consigned

(vi) The credit report on the drawee is satisfactory.

(vii) The description of goods mentioned in the invoice.

(viii) The goods are not consigned directly to the buyer.

(ix) The goods are properly insured.

(x) The usance bill is properly stamped.

(xi) Bills offered for discount do not cover goods whose prices fluctuate too much.

(xii) The goods covered under the bill are not of perishable nature.

(xiii) The bills are drawn in the favour of the finance company and have been accepted by the drawee.

8.6 CONCEPT OF BILL OF EXCHANGE

Bill of exchange is an instrument in writing containing an unconditional order to pay a certain amount of money to a specified person. According to the Indian Negotiable Instruments Act, 1888: " The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument. The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Creation of Bill of Exchange

Suppose a seller sells goods or merchandise to a buyer. In most cases, the seller would like to be paid immediately but the buyer would like to pay only after some time, that is buyer would wish to purchase on credit. To solve this problem, the seller draws a B/E cf a given maturity on the buyer. The seller has now assumed the role of creditor; and is called the drawer of the bill. The buyer, who is the debtor, is called the drawee. The seller then sends the bill to the buyer who acknowledges his responsibility for the payment of the amount on the terms mentioned on the bill by writing his acceptance on the bill. The acceptor could be the buyer himself or any third party willing to take on the credit risk of the buyer.

Discounting a Bill of Exchange

Discounting of B/E is a lucrative fund-based service provided by the finance-companies. The act of handing over an endorsed B/E for ready money is called 'discounting of bills', the seller, who is the holder of an accepted B/E has two options:

1. Hold on to B/E till maturity and then take the payment from the buyer.
2. Discount the B/E with a discounting agency.

The seller can take over the accepted B/E to a discounting agency (Bank, NBFC, company etc and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E. Discount is the margin between the ready money paid or the face value of the bill and is calculated at a rate percentage per annum on the maturity value. The maturity a B/E is defined as the date on which payment will fall due. Normal maturity periods are 30, 60, 90, and 120 days but bills maturing within 90 days seem to be the most popular.

TYPES OF BILLS

There are various types of bills. They can be classified on the basis of when they are due for payment, whether the documents of title of goods accompany such as bills or not, the type of activity they finance, and so on. Some of these bills are:

1. Demand bill: This is payable immediately "at sight" or "on presentment" to the drawee. A bill on which no time of payment or "due date' is specified.
2. Usance bill: This is also called a time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.
3. Documentary bills: These are bills accompanied by documents confirming trade between buyers and sellers. It can be further divided into two parts:
4. D/A Bills: In this case, the documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee.
5. D/P Bills: In case a bill is a "document against payment" bill and has been accepted by the drawee, the documents of title will be held by the bank or the finance company till the maturity of the B/E.
6. Clean Bills: These bills are not accompanied by any documents that show that a trade has taken place between the buyers and sellers. The interest charged on such bills is higher.

8.7 ADVANTAGES

The advantages of bill discounting to investors and banks and finance companies are as follows:

To Investors

1. Short-term sources of finance;
2. bills discounting being in the nature of a transaction is outside the purview of section 370 of the Indian companies act 1956, that restricts the amount of loans that can be given by group companies;
3. Since it is not a lending, no tax at source is deducted while making the payment charges which is very convenient.
4. Rates of discount are better than those available on ICDs; and
5. Flexibility, not only in the quantum of investments but also in the duration of investments.

To Banks

1. Safety of Funds: the greatest security for a banker is that a B/E is a negotiable instrument for bearing signatures of two parties considered good for the amount of a bill; so, he can enforce his claim easily.
2. Certainty of Payment: A B/E is a self-liquidating asset with the banker knowing in advance the date of its maturity.
3. Profitability: Since the discount on a bill is front-ended; the yield is much higher than in other loans and advances, where interest is paid quarterly or half-yearly.
4. Evens out inter-bank Liquidity Problems: The development of a healthy parallel bill discounting market would have stabilized the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.
5. Discount Rate and Effective Rate of Interest: Banks and finance companies discounting bills prefer to discount letters of credit-backed bills compared to clean bills. The rate of discount applicable to clean bills is usually higher than the rate applicable to L/C-based bills. The bills are generally discounted upfront, that is, the discount is payable in advance.

8.8 BILL MARKET SCHEME

A developed bill market is essential for the development of the money market. It is a market for short-term bills. The bills could be trade bills, finance bills, or treasury bills. The bill market enables the constituents of the money market to invest short-term funds in a profitable way while maintaining liquidity. The importance of a good bill market was recognized by RBI way back in 1952. So, the RBI has constantly endeavored to develop the commercial bill market. Several committees set up to examine the system of bank financing and money market had strongly recommended a gradual shift to bill finance and phase out of the cash-credit system. The most notable of these were: (i) Dehejia Committee, 1969, (ii) Tandon Committee, 1974, (iii) Chore Committee, 1980 and (iv) Vaghul Committee, 1985. this topic outlines the efforts made by the RBI in the direction of the development of a full-fledged bill market.

8.8.1 Bill Market Scheme, 1952

The RBI introduced the bill market scheme by undertaking to provide funds to commercial banks against trade bills within the prescribed limits. The scheme becomes popular with commercial banks, especially during the busy season. The scheme failed to serve the purpose beyond refinancing to commercial banks. The reason was the lack of a sufficient number of dealers.

8.8.2 The New Bill Market Scheme 1970

A committee headed by M. Narasimham went into the question of developing a genuine bill market on the recommendations of the committee a new bill market scheme was introduced in 1970. It was essential for making bank rates an effective instrument of monetary- control the scheme was a major step towards developing a bill market. The trade and industry slowly- responded to the measures and the bills market became active. After the introduction of the scheme, the RBI has been encouraging the use of bills as a source of finance by imposing charges on alternative methods like cash credit.

8.8.3 Working Group on Cash Credit System (1993)

Working Group on Cash Credit System (1993) headed by R.Jilani also recommended that steps should be taken to promote bill culture to a greater extent in respect of both purchases and sales. Vigorous efforts should be made to persuade Government departments; public sector undertakings and large industrial units to accept bills drawn on them.

In fact, a developed bill market and money market can reduce the dependence of business units on bank credit. The RBI discourages large use of cash credit. All these efforts have positive effect on the growth of bills market. However, it still provides only a small portion of 6-7 percent of the total bank credit.

8.9 PRESENT POSITION OF BILLS DISCOUNTING

Financial services companies had been acting till the early nineties as bill brokers for sellers and buyers of bills arising out of business transactions. They were acting as links between banks and business firms. At times they used to take up bills on their own account, using their own funds or taking short-term accommodation from banks working as acceptance/discount houses. Bills discounting, as a fund-based service, made available funds at rates 1% lower than on ash credit finance, and bill finance constituted about a of bank finance.

However, the bill re-discounting facility was misused by banks as well as the bill-brokers. In order to stop misuse of the bill discounting facility by banks, the RBI issued guidelines to banks in July 1992. The main elements of these guidelines are as follows:

(i) No fund/non-fund-based facility should be provided by banks outside the consortium arrangement;
(ii) Bill finance should be the part of the working capital/credit limit;
(iii) Accommodation bills should not be discounted.
(iv) Bill re-discounting should be restricted to usance bills held by other banks.
(v) Funds accepted by banks for portfolio management should not be deployed for discounting bills.
(vi) Overall credit limit to finance companies should not exceed three times the net worth of such companies; and
(vii) For discounting LC-backed bills by NBFCs, the bill must be accompanied by

no objection certificate from the beneficiary bank.

As a result, there was a substantial decline in the volume of bill discounting. Presently, the volumes are on an average of Rs 80-100 crore per month and Rs 800-900 crore per year.

8.10 Self-Assessment Questions

8.11.1 The New Bill Market Scheme was introduced in ______.

8.11.2 The Hire-purchase Act was passed in _____.

8.11 Short Questions

1. What do you mean by Bill of Exchange?
2. Discuss Types of Bills.

8.12 Long Questions

(1) Discuss the main characteristics of hire-purchase. How does it differ from (a) instalment payment, and (b) finance lease?

(2) Briefly explain the evaluation framework of hire-purchase transaction vis a vis leasing

(3) Briefly explain the features of a bill of exchange, its types and advantages.

8.13 References

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8.14 Answer to Self-Assessment Questions

8.11.1 1970.

8.11.2 1972.

Lesson No. 9 AUTHOR: SHAMINDER KAUR

FACTORING AND FORFEITING

STRUCTURE

9.0 OBJECTIVES

After studying the lesson, the students would enable:

- To understand the concept and mechanism of factoring
- To compare and contrast factoring with the forfeiting
- To illustrate the evaluation framework of factoring

9.1 INTRODUCTION

Factoring, as a fund based financial service, provide resources to finance receivables as well facilitate the collection of receivables. Although such services constitute a critical segment of the financial services scenario in the advanced countries, they appeared on the Indian financial scene only in the early nineties as a result of RBI initiatives. At present, factoring in India is rendered by only a few financial institutions on a recourse basis.

9.2 MEANING AND DEFINITION

According to the Webster Dictionary, 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. Thus, factoring means an arrangement between a factor and his client which includes at least two of the following services provided by the factor:

- Finance
- Maintenance of Accounts
- Collection of Debts
- Protection against credit risks

According to V.A. Avadhni, "Factoring is a service of a financial nature involving the conversion of credit bills into cash."

1. Thus, factoring is a financial service whereby a company sells its trade debts at a discount to a financial institution. The factor purchases the client's trade debts including account receivables either with or without recourse to the client and exercise control over the credit granted to a customer and administers the sales ledger of his client. The business concerns can take immediate pre-payment upto 80% of their credit sales. When the credit customer repays the due, the factor will make payment of the remaining 20% amount to the business concern. Factors render services varying from bill discounting facilities offered by commercial banks to a total takeover of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control and protection from bad debts, provision of finance and rendering of advisory services to their clients. Factoring, may be on a recourse basis, where the risk of bad debts is borne by the client, or on a non-recourse basis, where the risk of credit is borne by the factor.

9.3 TERMS AND CONDITIONS

(i) Assignment of debt in favour of the factor
(ii) Setting limits for the client
(iii) Conditions within which the factor will have recourse to the client in case of non-payment of the trade customer.
(iv) Details regarding the payment of the factor for his services.
(v) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier,
(vi) Limit of any overdraft facility and rate of interest to be charged by the factor.

9.4 MECHANISM

A schematic view of the factoring mechanism explaining the interaction between the different parties and the flow of information between them is summarized:

(a) The client gives an undertaking to sell in the factor and agrees to purchase receivables.
(b) The client warrants that the receivables are valid, undisputed, and recoverable.
(c) The client agrees to serve notices of assignments in the prescribed form whose receivables have been factored.

(d) The client agrees to provide copies of all invoices, credit notes, etc. relating to factored accounts to the factor.

(e) The factor acquires power of attorney to assign the debts further and to draw negotiable instruments.

(f) the time frame for the agreement and mode of termination arc specified in the agreement.

(g) The legal status of the factor is that of an assignee.

(h) The factor will sometimes need to act quickly to recover money due on an invoice. The agreement must provide for the factor to act swiftly in his own name whenever necessary.

(i) The factoring will set out in detail how the firms are to be paid.

(j) The factor may require the customer to notify it immediately in case of disputed debts.

(k) The factor power to inspect the firm's book and accounts and the period of the factoring arrangement is usually laid down in the agreement.

(1) The factor undertakes:

(i) To purchase bonafide accounts receivables that it has previously approved.

(ii) To advance against the purchase price, at its discretion, a percentage there of and to remit the balance on the monthly average due date of receivables assigned plus 5 to 10 days for collection.

(iii) To charge interest on sums advance at a certain defined interest rate.

(iv) To render a statement of account monthly.

The Buyer

(a) Buyer negotiates term of purchasing the material with the seller

(b) Buyer receives delivery of goods with the invoice and instructions by the seller to make the payment on the factor on due date.

(c) Buyer makes payment to factor in time.

The Seller

(a) MOU with the buyer in the form of letter exchanged between them.

(b) Sells goods to the buyer as per MOU.

(c) Delivers copies of invoice, delivery challan to the buyer.

(d) Seller receives 80% or more payment in advance from factor on selling the receivables from the buyer.

(e) Seller receives balance payment from the factor after deduction of factor's service charges etc.

The Factor

(a) The Factor enters into agreement with the seller for rendering factor services to it;

(b) On receipt of copies of sale documents as referred to above make payment to the seller of 80% of the price of the debt;

(c) The factor receives payment from the buyer on due dates and remits the money to the seller after usual deductions.

9.5 FUNCTIONS OF FACTORING

(i) Purchase and Collections of Debts

The factor purchases the trade debts and becomes a holder for value and not an agent. After this, collection of these debts becomes his duty.

(ii) Credit Risk

When factoring is entered into without recourse, the factor will be very careful while taking up customers of the client. For this reason, factor will examine the financial soundness and past track record of the customer. Thus, factor assumes debt insurance risk. Where factoring is with recourse, credit risk is not undertaken by the factor.

(iii) Maintenance of Sales Ledger

The function of administration includes verification of authenticity of traded transactions, maintaining sales ledger scientifically so as to disclose up to date data and timely collection of dues coupled with remittance to the client.

(iv) Consultancy Services

The factor provides managerial services to the client by informing his about additional business opportunities available, changing business scenario and financial profits of the customer.

9.6 TYPES OF FACTORING

(i) Full Factoring: A factor provides all services including finance, administration sales ledgers, collection of debts at his risk, and consultancy services. If the customer does not pay, the factor cannot go back to the client and recover the said amount.

(ii) Recourse Factoring: The factor does not undertake credit risk. If the debtors do not repay their dues in time or for an extended period, such debts are automatically assigned back to the client.

(iii) Maturity Factoring: The factor acts as a collection agent. The amount is not said to the client in advance. The amount collected less the factoring fee is paid to the client immediately.

(iv) Advance Factoring: The amount is paid in advance on submission of necessary documents. Generally, factoring is advance factoring and about 70-80% of invoice amount is paid in advance on submission of necessary documents.

(v) Bulk Factoring: The factor provides finance after disclosing the fact of the assignment of debts to the debtors concerned. This is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, and collection work has to be done by the client himself and the factor simply collects the debts on behalf of the client. This is also called 'Disclosed Factoring'.

(vi) Invoice Factoring: The factor simply provides a finance facility against invoices without assuming any other function. The client is generally a reputed firm that deals with the customers directly for collection and keeps factoring arrangement confidential. This is also called 'undisclosed factoring'.

(vii) Export Factoring: Factoring services are provided to exporting companies and factor collects the amount due from the importer in other countries.

(viii) Bank Participating Factoring: In this type of factoring banks finance that portion which the factor holds as reserve. Since this is the transferred receivable for the suppliers, the bank takes the factoring charge over the suppliers equally. The bank participates because the factor makes active follow-up for debt collection.

9.7 LEGAL ASPECTS OF FACTORING: FACTORING CONTRACT

There is no codified legal framework/code to regulate factoring services in India. The legal relationship exists between a factor and a client which is largely determined by the terms of the factoring contract entered into before the factoring process starts. Some of the contents of a factoring agreement and legal obligations of the parties are listed below:

The client gives an undertaking to sell and the factor agrees to purchase receivables subject to terms and conditions mentioned in the agreement

9.8 FINANCIAL EVALUATION FRAMEWORK

The distinct advantages of factoring notwithstanding, as a financial service, it involves costs. The evaluation framework should be on a consideration of the relative costs and benefits associated with the two alternatives to receivable management. They are: (i) in-house management by the firm itself, (ii) factoring services, either recourse or nonrecourse

Costs associated with In-house Management

(i) Cash discount,
(ii) Cost of funds invested in receivables
(iii) Bad debts,
(iv) Lost contribution on forgone sales and
(v) Avoidable costs of sales ledger administration and credit monitoring.

Costs associated with the Recourse and Non-Recourse Factoring

(i) Factoring Commission,
(ii) Discount charge and
(iii) Cost of long-term funds invested in receivables.

9.9 FORFEITING

Forfaiting has been defined as the non-recourse purchase by a bank of any other accepts financial institution, of receivables arising from as export of goods and services".

Thus, forfaiting is a form of debt discounting for exporters in which a forfaiter accepts at a discount and without recourse, a promissory note, bill of exchange, letter of credit etc. received from a foreign buyer by an exporter. Maturities are normally from one to three years. The exporter receives payment without risk at the cost of the discount. The Salient features of forfaiting:

1. Commercial contract between an exporter and importer.
2. Commitment to forfeit bills of Exchange.
3. Delivery of goods by the Indian exporter to the foreign buyer.
4. Delivery of debt instrument
5. Endorsement of debt instrument without recourse in favor of the forfeiter.
6. Cash payment of discounted debt instrument

7. Presentation of a debt instrument on maturity
8. Payment of debt instrument on maturity.

9.10 FACTORING VS FORFAITING

1. Factoring is always used as a tool for short-term financing whereas forfaiting is used for medium-term financing at a fixed rate of interest.
2. Factoring is employed for financing both domestic and export business whereas forfaiting is invariably employed in export business only.
3. The purpose of factoring is the purchase of the invoice of the client whereas it is only the purchase of export bill under forfeiting.
4. Factoring is wider in the sense that it includes a gamut of activities, such as administration of the sales ledger, assumption of credit risk, recovery of debts whereas forfaiting mainly deals with financing aspects relating to a particular import bill.
5. Forfaiting is without recourse and all the risks of the importer are taken over by the forfaiter whereas factoring may be with or without recourse.
6. The cost of forfaiting is passed on to the importer whereas the cost of factoring is borne by the seller.
7. Under factoring, the client is able to get only 80% of the total invoice as credit facility, whereas 100% of the value of the export bill (service charges being deducted) is granted as credit under forfaiting.
8. The bills under forfaiting may be held by the forfaiter till the due date or they can be sold in the secondary market or to any investor for cash. Such a possibility does not exist under factoring.
9. Forfaiting is specific in the sense that it is based on a single export bill arising out of an individual transaction only. But factoring is based on the whole turnover i.e., bulk finance is provided against a number of unpaid invoices.

9.11 MECHANISM OF FORFAITING

There is no restriction in the use of any instrument of credit sales, yet forfaiter always favors bills of exchange and promissory notes. Forfeiters always want that the instruments used should embody the claims in an easily comprehensible manner, without any additional documents. The instruments should be readily negotiable.

In a forfeiting transaction, the exporter is the 'client' the financial institution is called the 'forfeiture' and the importer is the debtor'. The exporter enters into negotiations with a potential buyer in the importing country for delivery of capital goods. The exporter approaches the forfeiture for quailing the forfeiting facility. The exporter gives full details of his likely export dealing such as the name of the importer, his country, the currency in which the import of goods would be invoiced, the price of goods and services, etc. For first-class buyers like the government or well-reputed MNC, the operandi of forfeiting can be explained as a guarantee from an international bank that is not insisted upon. For other buyers, a guarantee is mandatory, which should be unconditional and irrevocable during the currency of the contract.

After assessing all details, the forfeiter indicates his consent for granting finance along with offering the possible price. After executing the forfaiting contract between the forfeiter and the exporter, delivery of goods takes places. Later on, delivery of bills of exchange/promissory notes, payment of value less discount charges is made by the forfeiter to the exporter. On maturity, the bills/notes are presented by the forfeiter to the guarantor bank which reimburses the amount to the forfeiter.

Cost of Forfaiting

The cost of forfaiting finance is always at a fixed rate of interest which is normally included in the face value of the bills or notes. It depends upon the duration of the arrangements, credit worthiness of the party, country of the importer, value of currency in which the export deal is to be executed and the overall political, economic and monetary conditions in the importer's country.

9.12 ADVANTAGES OF FORFAITING

1. Profitable and Liquid
2. Simple and Flexible
3. Avoids Export Credits Risk
4. Suitable for all kinds of export deals
5. Finance provided at a fixed rate

9.13 Limitations

1. Non-availability for short and long periods.
2. Non-availability for financially weak countries as the risk and corresponding price would be higher.
3. Dominance of western currencies.
4. Difficulty in processing international bank's guarantee.

9.14 SUMMARY

As we know, Factoring, as a fund based financial service, provide resources to finance receivables as well facilitate the collection of receivables. At present, factoring in India is rendered by only a few financial institutions on a recourse basis. Factoring is still in a nascent stage in India. Forfaiting is a form of financing of receivables in international trade. All the risks and collection problems are fully the responsibility of the buyer who pays cash to the seller after discounting the bills/notes.

9.15 Self-Assessment Questions

9.15.1 What is forfaiting?

9.15.2 What do you mean by Full Factoring?

9.16 Short Questions

1. Describe different types of Factoring.

2. Discuss Advantages of Forfaiting.

9.17 Long Questions

1. What is Factoring? Explain its various types.

2. Define forfaiting. How it is different from factoring?
3. Explain the mechanism of forfaiting. Describe the advantages of forfaiting?

9.18 References

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9.19 Answer to Self-Assessment Questions

9.15.1 The non-recourse purchase by a bank of any other accepts financial institution, of receivables arising from as export of goods and services.

9.15.2 A factor that provides all services including finance, administration sales ledgers, collection of debts at his risk and consultancy services.

Lesson No. 10 **AUTHOR: SHAMINDER KAUR**

MERCHANT BANKING

STRUCTURE

10.0 OBJECTIVES

The main objective of the lesson is:

- To explain the meaning of merchant banking.
- To understand the main functions and SEBI regulations of Merchant banking.

10.1 INTRODUCTION

The origin of merchant banking can be traced back to the 13th century when a few family-owned and managed firms engaged in the sale and purchase of commodities were also found to be engaged in banking activity. These firms not only acted as bankers to the kings of European states, financed coastal trade but also borne exchange risk. In order to earn profits, they invested their funds where they expected higher returns despite a high degree of risk involved. So, for the purpose, the merchant banking survived and continued during 13th century. Now, merchant banking points at the merchant bank as an institution or an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures.

10.2 MEANING AND CONCEPT

The term merchant banking' has been used differently in different parts of the world. While in the UK, a merchant banking refers to the 'accepting and issuing houses', in USA it is known as 'investment banking'. The word merchant banking has been so widely used that sometimes, it is applied to banks who are not merchants, sometimes to merchants who are not banks and sometimes to those intermediaries who are neither merchants nor banks. In UK, the term merchant banking originated from merchants in London who started financing of foreign trade through the acceptance of bills. In USA, investment banking is concerned with ’garnering savings and directing the flows of funds to the business enterprises, investment bankers are primarily the intermediaries who provide specialized service in the marketing of securities. Thus, the merchant banking can be defined as a non-banking financial activity resembling banking, originated, grown and sustained in Europe, got enriched under American influence and now being performed all over the world by both banking and nonbanking institutions.

In India, merchant banking services were started only in 1967 by National Grindlays Bank followed by Citibank in 1970. The State Bank of India was the first Indian commercial bank having set up a separate merchant banking division in 1972. Since then, a number of other banks, financial institutions and other organizations are also engaged in providing merchant banking services. But merchant banks in India have been primarily operating as issue houses than full-fledged merchant banks as in other countries.

In view of above, we can define merchant bank as an institution or an organization which provides a number of services including management of securities issues, portfolio services, underwriting of capital issues, insurance, credit syndication, financial advisers and project counseling etc.

10.3 COMMERCIAL BANKS AND MERCHANT BANKING

Merchant Banking differs from commercial Banking with regard to the services provided by them to the clients.

10.3.1 Services provided by the Commercial banks

(1) Accepting deposits of various kinds and maturities for the purpose cf lending;
(2) Providing working capital finance;
(3) Meeting the short-term credit needs of the commercial enterprises;
(4) Allowing customers to withdraw money by cheques;
(5) Availing of cash credit, overdraft, discounting of bills of exchange;
(6) Issuing of credit cards; and
(7) Providing medium-term loans to SSIs or medium scale industries in syndication with financial institutions etc.

10.3.2 Services provided by Merchant Banks

Merchant banks offer a number of services incidentals to the promotion and development of the industrial projects which include:

(i) Corporate Counselling.
(ii) Project advisory services like identification, preparation, appraisal and implementation

(iii) Corporate restricting
(iv) Issue Management
(v) Managing mergers/amalgamations and takeovers
(vi) Loan Syndication
(vii) Portfolio Management
(viii) Corporate advisory services
(ix) Leasing Services
(x) Providing assistance for technical for technical and financial collaborations etc.

All these services are offered to determine the funds requirements and procuring the same for the client and ensuring their optimum utilization. Thus, advancing loans is not the function to be performed by a merchant bank.

10.4 FUNCTIONS OF MERCHANT BANKER

Setting up of new industrial units, expansion, diversification and modernization of existing units have been the central plank of the rapid industrialization in any economy. This process besides adequate financial resources requires sound technical and managerial inputs. Though, a number of financial agencies are instituted to cater to the needs of rapid industrialization, the task of financing has become more complicated, thus requiring a fresh look. In view of increasing specialization in every sphere the process of industrialization from the primary planning stages of setting up a new unit to that of research and development including expansion, diversification or modernization requires the services of specialists or professionals. Thus, the need for having expert advice, guidance of specialists or professionals in the field has become an absolute necessity with rapid economic growth and spectacular industrial development in India. It has also been necessitated by the plethora of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, Companies Act, SEBI, Government policy regarding backward area development, export promotion and import substitution etc. A few agencies are able to provide expert advice in the diversified areas mentioned above. But it is inconvenient to entrepreneurs/industrialists to knock at the doors of several agencies in getting the guidance of specialists and professionals. Hence, it is highly essential to provide expert advice in diversified areas under a single roof to provide a comfortable cushion to entrepreneurs to accelerate industrial development. This is where merchant bankers come to picture. Although it is very difficult to spell out all the areas where merchant bankers can interact, yet, some important areas where merchant bankers have decisive role are discussed here. These roles can broadly be divided into two parts. One is service based another is fund based.

10.4.1 Service Based Functions

(1) Project Counselling

The first step to launch business units is selection of a viable project. Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counselling covers a variety of sub-assignments. Illustrative list of services which can be rendered under this category are:

1. Guidance in relation to project viability, i.e., project identification and counselling. It may be for setting up new units, expansion or improvement of existing facilities.
2. Selection of consultants for preparation of project reports/ market surveys etc. Sometimes merchant bankers also engage in preparation of project reports or market surveys.
3. Advice on various procedural steps including obtaining of governmental approvals clearance etc., e.g., for foreign collaboration.
4. Proposing a suitable capital structure laying broad as well as specific features.
5. Techno economic soundness of the project and marketing aspects. Financial engineering, i.e., selection of right mix of financing pattern specifically for short-term requirements.
6. Organization and management set up for a strong base and efficient working of the project.

(ii) Credit Syndication

Normally, every project has to raise debt funds for different sources as per need. Substantial debt raising may be required for a new and capital-intensive project. For such projects merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are:

1. Preparing applications for financial assistance to be submitted to financial institutions and banks.
2. Monitoring the sanction of funds while acting as a specialized liaison agency.
3. Negotiating the term of assistance on behalf of client.
4. Post-sanction formalities with these institutions and banks.
5. Assistance in grant of term loans and or bridging loans.
6. Assessing working Capital requirements and arranging it.

Need of syndication arises due to the fact that especially in big projects one institution may hesitate to meet the whole debt requirement of the project. They want to spread the risk. Further shortage of funds availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The modus operandi of syndication is really quite simple. The borrower approaches several banks that might be willing to syndicate a loan, specifying the amount and the tenor for which the amount and the tenor for which the loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower; all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a firm commitment basis or on a best-efforts basis. The former is akin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility.

Best efforts, as the name suggests, limits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan. However, more often than not, the syndicator would try to fulfill his commitments for the inability to do so would tarnish his reputation.

Once the syndicator has been awarded a mandate, the borrower has to sign a 'clear market clause* which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three to four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicate the loan. It can do this on a 'broadcast' basis, by sending telexes to the concerned banks inviting participation. If the company is well-known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporation tends to keep a low profile and the loan structure is complicated, the syndicate manager would have to woo the participant banks with offer documents or an information memorandum on the company. The document is similar to a prospectus but less detailed. Nevertheless, drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts."

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

(iii) Issue Management

Traditionally, this is one of the main functions of a merchant banker. Whenever an issue is made whether it is a public issue or private placement and whether it is for equity shares, preference shares, or debentures, the merchant banker has a crucial role to play. Raising funds from the public has many dimensions and formalities that are not possible for the concerned companies to comply with, so merchant banker comes to their rescue. Marketing effort to convince the prospective investor needs special attention. Here again, merchant bankers are specialists. The points which are covered under this are as follows:

1. Advise the company about the quantum and terms of raising funds.
2. Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.
3. Advise as to whether a fresh issue is to be made or the right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from the government or other authorities.
4. Advice on the appointment of bankers, and brokers to the issue.
5. Advice on the selection of issue house or Registrar to the issue, printer

advertising agency etc.

6. Fixing the terms of the agencies engaged to facilitate making a public issue.
7. Preparation of a complete action plan and budget for the total expenses of the issue.
8. Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.
9. Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.
10. Advise the company for the issue period and days of opening and closing the issue.
11. Monitoring the collection of funds in public issue.
12. Coordination with underwriters, brokers, and bankers to the issue and stock exchange etc.
13. Strict compliance of post-issue activities.

(iv) Corporate Counselling

Although the functions discussed up till now are also covered under corporate counseling but here other dimensions will be deliberated. Corporate counseling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency, and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercises smooth. They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant bankers are:

1. Rejuvenating old line and ailing/sick units or appraising their technology and process, assessing their requirements and restructuring their capital base.
2. Evolving rehabilitation programs/packages which can be acceptable to the financial institutions and banks.
3. Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BIFR) and other authorities under the Sick Industrial Companies (special provisions) Act 1985 (SICA).
4. Monitoring implementation of schemes of rehabilitation.
5. Advice on financial restructuring involving redeployment of corporate assets to refocus companies' line of business.
6. Advice on rearranging the portfolio of business assets through acquisition etc.
7. Assisting in valuing the assets and liabilities.
8. Identifying potential buyers for disposal of assets, if required.
9. Identify the candidates for takeover
10. Advice on tactics in approaching potential acquisition.
11. Assisting in deciding the mode of acquisition whether friendly, or unfriendly or hostile.
12. Designing the transaction to reap the maximum tax advantages.
13. Acting as an agent for leveraged Buyout (LBO) involving heavy use of borrowed funds to purchase a company or division of a company.
14. Facilitating Management Buyouts (MBO), i.e., selling a part of business to their own managers by a company.

15. Clearly spelling out organization goals.
16. Evolving corporate strategies to achieve the laid down goals.
17. Designing or restructuring the organizational pattern and size.
18. Evolving Management Information System.

Corporate advisory services should offer real value addition to the client. Highly specialized in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire-purchase. In India corporate advisory has a good potential and Merchant bankers have a great role to play.

(v) Portfolio Management

Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practiced as an investment management counselling in which the investor is advised to seek financial assets, like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and/or provide income. The investors whether local or foreigners with substantial amount for investment in securities seek portfolio management services of authorized merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include:

1. Advising what and when to sell and buy.
2. Arranging sale or purchase of securities.
3. Communicating changes in investment market to the client investors.
4. Compliance of regulations of different regulating bodies for sale of purchase of portfolio.
5. Collection of returns and reinvest as per directions of clients.
6. Evaluating the portfolio at regular intervals or at direction of investors.
7. Advising on tax matters pertaining to income from and investment in portfolio.
8. Safe custody of securities.

(vi) Stock broking and Dealership

The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for Over-the-Counter trading. To venture into this area, it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub-brokers and sub-dealers to ensure wider network of their operations. They can be broker for inland as well as foreign stock exchanges. In India the merchant bankers who desire to act as brokers are regulated by SEBI (Stock Broker and Sub brokers) Rules 1992.

(vii) Foreign Joint Ventures

Depending on economic and political considerations many countries may permit joint ventures by local businessmen abroad. Here again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno economic surveys, legal documentations under local as well as foreign legal provisions etc.

(viii) Debenture Trusteeship

The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redressal of grievances of debenture holders They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call for periodical reports from the body corporate. They charge fee for such services.

10.4.2 Fund Based Functions

(i) Bill Discounting

Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and Merchant bankers can specify what types of bills they entertain. They charge commission for these services.

(ii) Venture Capital

Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type cf investment. Since certain ingredients necessary for success of such projects are missing in the beginning but are added later on. Merchant bankers undertake to arrange anc if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study such proposals before releasing the money. At opportune time such investment can be disinvested to keep the cycle of venture capital more on.

(iii)Bought out Deals

When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and place the shares of company initially with him which are offered to public at a later stage, this route is known as bought out deal. Many times, a syndicate of merchant bankers jointly sponsor a bought-out deal to spread the risk involved. In contrast to venture capital, there is no role to be played by non-traditional technology. Such bought shares by a sponsor can be disposed of at an opportune time on 'over the counter' or other stock exchanges.

(iv) Lease Financing and Hire-Purchase

Depending on the funds available merchant bankers can also enter the field of lease or hire-purchase financing. A lease is an agreement whereby the lessor (merchant banker in this case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand, in hire-purchase the user at the end of the agreed period has an option to purchase the asset that he has used to date. The merchant bankers can advise the client to go in for a leasing or hire-purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on a merchant banker to acquire the needed asset and comply with all formalities.

(v) Factoring

Factoring is a novel financing innovation. It is a mixed service having financial as well as non-financial aspects. On one hand, it involves management and collection of book debts which arise in the process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit, etc. On the other hand, there is involvement of finance. Against factored debts the merchant banker may provide advance with a certain margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to

1. Maintain the books of accounts pertaining to credit sales.
2. Make a systematic analysis of relevant information for credit monitoring and control.
3. Provide full or partial protection against bad debts and accepting the risk of nonrealization.
4. Provide financial assistance to the client.
5. Provide information about prospective buyers.
6. Provide financial counseling and assist in managing the liquidity.

(vi) Underwriting

It refers to a contract by means of which a merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating, viz:

1. Company's standing and its past record.
2. Competence of the management.
3. Purpose of the issue.
4. Potentials of the project being financed.
5. Offer price and terms of the issue.
6. Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission.

These are some of the prominent activities being undertaken by merchant bankers' world over. The practices may differ from country to country depending on maturity of financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalization of economies, merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways

10.5 ROLE OF A MERCHANT BANKER

From the above-mentioned services rendered by a merchant Baker, it can be observed that he is the most critical link between a company raising funds and the investors. He plays the role of a promoter, advisor, rehabilitator and an agent or intermediary for corporate enterprises. He translates the ideas into ventures by providing a number of promotional services.

After the project is promoted, the merchant banker acts as a corporate advisor and renders a number of services for the successful running of the enterprise. He also renders useful advice to the investors.

As a managerial economist. He guides the client on the aspects of organizational goals, locational factors, cost analysis, allocation of resources, investment decisions, pricing methods and marketing strategy, etc.

As a Financial and investment expert, a merchant banker has to guide the corporate clients in areas covering financial reporting, project measurement, working capital management, financial requirements and the sources of finance, rate of return and cost of capital besides basic corporate changes of financial rearrangement, reorganization etc.

Merchant banker, acting as 'Manager' to the issue settles the fee for advocate/ solicitors' advice, accountant’s certification, broker's and bank's charges, printers' charges, advertising and publicity expenses etc. the responsibility for all this rests upon the merchant banker.

A merchant banker also plays the role of a rehabilitator at the time of acquisition, merger, and take over, amalgamation, etc. Many merchant banks also act as agents for their client companies for maintaining registers of shareholders and debenture holders and to act as transfer agents and paying agents for interest and dividend etc.

At last, Merchant bankers are masters in all trading activities including company formation, syndication of project finance, working capital management, FERA activities etc.

10.6 SEBI GUIDELINES RELATING TO MERCHANT BANKING

SEBI (Merchant Bankers') Regulations 1992 define 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, adviser or rendering corporate advisory service in relation to such issue management." Thus, regulations are applicable only to limited activities undertaken by merchant banker. On the basis of regulations, merchant banking activities can be categorized as authorized' and not authorized' activities. The merchant bankers are required to get themselves registered under regulations only for authorized activities. The authorized activities are undertaking issue management assignment, as manager, consultant, adviser, underwriter portfolio manager.

(a) Merchant Banking Activities not requiring SEBI's registration are:

1. Project Counselling
2. Corporate Counselling
3. Factoring
4. Credit Rating
5. Bill acceptance and discounting
6. Loan syndication
7. Merger and amalgamation.

(b) Merchant Banking Activities requiring SEBI's registration under different regulations but not under Merchant Banking regulations.

1. Venture Capital
2. Mutual Funds
3. Depository
4. Portfolio Management
5. Trusteeship of debentures
6. Share Broking
7. Custodian Service
8. Foreign Institution of Investors
9. Share Transfer.

Another angle from which authorized activities can be identified is the activities specified for each category of merchant banker.

Categories of Merchant Bankers

The merchant banking regulations require that anybody seeking registration as merchant banker has to apply in one of the following four categories:

Category I

These merchant bankers can carry on any activity of the issue management, which will inter alia consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie-up of financiers and final allotment and refund of subscription. They can also act as adviser, consultant, manager, underwriter, portfolio manager.

Category II

Such merchant bankers can act as adviser, consultant, co manager, underwriter and portfolio manager. This means they cannot undertake issue management of their own.

Category III

These merchant bankers can neither undertake issue management nor act as co manager. They cannot conduct business of portfolio management. Thus, the area of their operation restricts to act as underwriter, adviser and consultant to the issue.

Category IV

Such merchant bankers do not undertake any activities requiring funds. They can act only as adviser or consultant to an issue.

Registration

Any agency to operate as merchant banker has to register itself under SEBI Regulations. Application is to be submitted in the prescribed format 'Form A'. To get registration and certificate to operate as merchant banker, the agency has to fulfil two. sets of criteria.

(i) Operational capabilities,

(ii) Capital adequacy.

(i) Operational Capabilities

As mentioned earlier, the regulations desire the merchant banker to be professional, fair and competent to serve investors. In this context SEBI before granting certificate to operate as merchant banker' makes sure that concerned agency is competent on these parameters. To be more specific these are:

(a) It is necessary that to serve the clients and investors the merchant banker should have sufficient physical infrastructure. It is desired that the applicant has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities.

(b) To ensure that services rendered are the best, SEBI desires the applicant to have at least two persons who have the experience to conduct the business of the merchant banker.

(c) In order to avoid excessive registration SEBI makes sure that a person directly or indirectly connected with the applicant has not been already granted registration. Such persons include an associate, subsidiary, interconnected or group company of the applicant.

The applicant or his partner or director should be man of integrity. SEBI requires that applicant or its main officials should not he involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant. They should not at any time be convicted for any offence involving moral turpitude or has been found guilty of any economic offence. The applicant is to have professional qualification from any recognised institution. SEBI is to make sure that such registration should be in the interest of investors. Only those applicants who qualify on all these points are granted registration.

(ii) Capital Adequacy

In the categories wherein fund based activities are involved, SEBI desires them to have sufficient capital. The concept of adequate capital is expressed in terms of 'net worth'. 'Net worth' means the value of capital contributed to the business plus free reserves. At the time of registration as well as subsequently following pattern of 'net worth' should be at least maintained.

Those applicants who qualify on both fronts are granted registration. The registered applicants are granted certificate of registration in Form B' in which SEBI specifies for which category registration has been granted. If the applicant is granted a category lower than applied for, the applicant is free to approach SEBI for higher category but within one year from the date of such registration. When certificate is finally granted the registered merchant bankers are to submit required fees. Registration is granted for three years at one time. To keep the registration operative, merchant bankers are to pay registration fee. The registration fee pattern is as under:

Category	**Fee for first two years**	**Third year**
Category I	Rs. 1 lakh per year	Rs. 0.2 lakh
Category II	Rs. 0.75 lakh per year	Rs. 0. 1 lakh
Category III	Rs. 0.50 lakh per year	Rs. 0.05 lakh
Category IV	Rs. 0.05 lakh per year	Rs. 0.02 lakh
[illegible]	[illegible]	[illegible]
Category IV	Rs. 5,000 per year	Rs. 1,000.

Once registration granted is about to expire, merchant bankers are to get this registration renewed. Application for such renewal is again to be made. To ensure that there is no break in registration, such application has to be made within 3 months before the expiry of the certificate. Although it is termed as renewal, but application is processed as for new registration, that is why application is again made in Form A'. Once

Category of Merchant Banker	**Minimum Net worth**
Category I	Rs. 5,00,00,000
Category II	Rs. 50,00,000
Category III	Rs. 20,00,000
Category IV	NIL

registration is renewed due fee is to be paid which is as under:

Code of Conduct

Once merchant bankers are registered to ensure that they maintain high standard of sendees, Regulations require them to adhere to a code of conduct specified in Schedule III of the Regulations. While acting as merchant bankers some important provisions of code are as under:

1. Maintain high standard of service.
2. Exercise due diligence, ensure proper care and exercise independent professional judgement.
3. Disclose to the clients, possible sources of conflicts of duties and interests while providing unbiased services.
4. Conduct business observing high standard of integrity and fairness in all his dealings with clients and other merchant bankers.
5. Maintain secrecy about client.
6. Do not engage in unfair competition.
7. Not to make misrepresentation.
8. Provide true and adequate information to investors.
9. Not to create false market or engage in price rigging.

Lead Manager

It is required under regulations that every issue should be managed by at least one merchant banker acting as 'lead manager.' Such lead manager is not required if the issue is right issue and if the size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead managers can be appointed but their number is subject to norms laid down by SEBI.

Size of issue	Maximum number of lead managers
(a) Less than rupees fifty crores	Two
(b) Rupees 50 crores but less than Rs. 100 crores	Three
(c) Rs.100 crores but less than Rs.200 crores	Four
(d) Rs.200 crores but less than Rs.400 crores	Five
(e) Rs.400 crores and above	Five or more as agreed by SEBI

Duties of Merchant Banker/Lead Manager

(a) In case more than one merchant bankers are engaged as lead managers, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibilities of lead manager for a particular activity, a coordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on 'pre issue activities' and 'post-issue activities'. SEBI requires that post-issue activities should be the responsibility of one lead manager. It involves essential follow up steps like finalization of basis of allotment/weeding out multiple applications, listing of instruments, dispatch of certificates and refunds etc.

(a) A merchant banker cannot be a lead manager to an issue made by anybody corporate which is an associate of the lead merchant banker.

(b) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

(c) A lead manager who is category I merchant banker has to accept a minimum und commitment or Rs. 25 lakh whichever is less. This is to ensure his financial involvement in the issue.

(d) It is his duty to submit SEBI a due diligence certificate in 'Form C. This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

(f} SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

(g) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

(h) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

(i) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referred to insider trading.

(j) SEBI is to be informed by merchant banker about the acquisition of securities of the body corporate whose issue is being managed by that merchant banker, within 15 days from the date of entering into such transaction.

(k) A merchant banker has to disclose to SEBI the following information namely:

(i) his responsibilities with regard to the management of the issue.

(ii) any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.

(iii) the name of body corporate whose issues he has managed or has been associated with.

(iv) any default in capital adequacy requirements.

(v) his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

(l) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance-sheet, income statement, auditors report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half-yearly unaudited financial results when required by SEBI with a view to monitor the capital adequacy of the merchant banker.

(m) When SEBI initiates inspection of the said records, the merchant banker has to co-operate. SEBI shall give notice before inspection.

10.7 LIABILITIES OF MERCHANT BANKERS

Many provisions are incorporated in the MB Regulations to regulate the activities of merchant bankers. To make them more responsible and accountable SEBI has provisions to impose penalty in case of defaults by them. The merchant bankers are subject to penalty, if they:

(a) fail to comply the conditions subject to which certificate has been granted.

(b) fail to comply with the provisions of the concerned rules and regulations.

Two Types of penalties can be imposed by SEBI on defaulting merchant bankers. One is suspension of registration and second is cancellation of registration.

10.8 SUMMARY

The merchant banks mainly offer financial services for a fee, while commercial banks accept deposits and grant loans. The merchants do not act as repositories for savings of an individual. Even when merchant banks engage themselves in fund-based activities and act as commercial banks, they function only as wholesale bankers for a few selected industrial houses and not as retail banks for the general public. The merchant banks mainly deal in new issues while the dealers, traders and brokers deal mainly in secondary market. At last, it is concluded that merchant bankers are masters in all trading activities including company formation, syndication of project finance, working capital management, FERA activities etc.

10.9 Self-Assessment Questions

10.9.1 How many categories are there of merchant bankers?

10.9.2 When did merchant banking services start in India?

10.10 Short Questions

1. Write down services provided by commercial banks.

2. What is Hire-purchase and Lease Financing?

10.11 Long Questions

1. Discuss in detail the nature and functions of Merchant Banker.
2. What do you mean by Merchant Banking? Examine the role of a merchant Banker in the corporate enterprises.
3. Describe the main provisions of the recent code of conduct prescribed by SEBI for merchant Banker.

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10.13 Answer to Self-Assessment Questions

10.9.1 Four.

10.9.2 In India, merchant banking services were started only in 1967 by National Grindlays Bank followed by Citibank in 1970.

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VENTURE CAPITAL

STRUCTURE

11.0 OBJECTIVES

The main objective of chapter:

- To understand the meaning, features and stages of venture capital financing.
- To explain the SEBI regulations of venture capital financing.

11.1 INTRODUCTION

Venture capital institutions, which emerged the world over to fill gaps in the conventional financial mechanism, focused on new entrepreneurs, commercialization of new technologies and support to small and medium enterprises in the manufacturing and the service sectors. Over the year, the concept of venture capital has undergone significant changes. The modus operandi has shifted from technology-oriented manufacturing organizations to being very close to "private equity class" for unlisted new companies in all sectors of the economy, irrespective of the nature of their projects. They also maintain a close rapport and a hands - on approach in nurturing investments during their association with the assisted/ investee companies as active partners rather than as passive investors.

11.2 MEANING AND CONCEPT

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital's very old, the recent liberalization policy of the government appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions, in addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

A young, high-tech company that is in the early stage of financing and is not yet ready to make a public offer of securities 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 gains. In fact, the venture capitalist acts as a partner with an entrepreneur. Venture capital financing involves a high degree of risk. Moreover, the guidelines issued by the government for the setting up of venture capital growth. Venture capital includes:

1. Venture Capital Scheme of IDBI.
2. Venture Capital Scheme of ICICI.
3. Risk Capital and Technology Corporation Ltd. (RCTC).
4. Infrastructure Leasing and Financial Services Ltd. (IL and FS).
5. Stock Holding Corporation of India Ltd. (SHCIL) to provide Help in the transfer of share and debentures.
6. The Credit Rating Information Services of India Ltd. (CRISIL) to undertake the rating of fixed deposit scheme, debenture/bonds and provide credit assessment of companies.

11.3 FEATURES OF VENTURE CAPITAL

Venture capital is away in which investors support entrepreneurial talent with the finance and business skills to exploit market opportunities and thus to obtain long-term capital gains. It is the provision of risk-bearing capital, usually in the form of participation in equity, to companies with high-growth potential.

In addition, it provides some value addition in the form of management advice and contribution to overall strategy. The relatively high risks are compensated by the possibility of high return, usually through substantial capital gains in the medium term. According to a very widely-accepted definition, venture capital is described as a separate asset class often labeled as private equity.

Based on the above description of venture capital, then, some of its d.stinguishing features as against other capital investments are :

1. Venture capital is basically equity finance in relatively new companies when it is too early to go to the capital market to raise funds. However, such investment is not exclusively equity investment.
2. It is a long-term investment in growth-oriented small/medium firms. The acquisition of outstanding shares from other shareholders cannot be considered venture capital investment.

3. There is a substantial degree of active involvement of the venture capital institutions with the promoters of the venture capital undertakings. It means such finance also provides business skills to the investee firms which is termed as hands on approach/ management activity is fairly wide.
4. Venture capital financing involves high-risk spectrum. The returns in such financing are essentially through capital gains at the time of exists from disinvestments in the capital market.
5. Venture capital is not technology finance though technology finance may form a sub-set of venture capital financing. The concept of venture capital embraces much more than financing new, high technology-oriented companies. The scope of venture capital is far wider.

11.4 STEPS IN VENTURE CAPITAL

Selection of investment for venture capital includes

(i) Stages of Financing.

(ii) Methods to evaluate deals and finances.

(iii) Instruments to structure a deal.

11.4.1 Stages of Financing

There are two stages of financing (i) early stage, (ii) later stage

Early-Stage Financing

(i) Pre-startup capital or seed capital: Before initializing a project, the promoter conducts research where his ideas and concepts form the base of the commercialization project. This stage is full of risk related to marketing however very few invest in this seed capital stage.

(ii) Start up: In this stage commercial manufacturing has to commence. It includes several types of new projects based on highly advanced technology, new business in which entrepreneur has experience & knowledge, new projects by established companies.

(iii) Second Round Financing: At this stage product has been already launched but business is not profitable to attract public offerings. The promoter has invested funds but infusion of funds by venture capital institutions is necessary which is provided in second round.

Later Stage Financing

(i) Mezzanine/ development Capital: Arrangement of capital by venture capital institutions is done for developmental purpose like purchase of new equipment/ plants, expansion, distribution, marketing facilities penetrating in new market.

(ii) Bridge/ Expansion: For expansion of business by growth of their own asset or by acquisition of other firms, these funds are required.

iii) Buyouts and turnarounds: Venture capital institutions provide funds to enable the current operating management to acquire an existing product line/business.

11.4.2 Methods to Evaluate Deals

Basically, there are three methods to evaluate deals:

1. **Conventional venture capitalist valuation methods**

This method of valuation considers time period of starting the venture capital and exiting the venture capital at the time of liquidation. It involves following steps:

— Compute the annual revenue at the time of liquidation of the investments, the present annual revenue in the beginning is compounded by an expected annual growth rate for the holding period.

— Compute the expected earning level, that is equal to future earnings level multiplied by after tax margin percentage at the time of liquidation.

— Compute the further market valuation which is equal to earning level multiplied by expected P/E ratio on date of liquidation.

— Obtain the present value of Investor company by using suitable discount factor, e. g. If the present value of venture capital undertaking is Rs. 50 lakhs and entrepreneur want Rs. 20 lakhs as venture capital then minimum % of ownership required is two fifths i.e., 40%.

2. **The Chicago Method**

Three business scenarios are developed:

— Success

— Sideway survival

— Failure

And each possible scenario is assigned probability.

— Using the discount rate, discounted present value of venture capital undertaking is obtained.

— Then discounted present value is multiplied by respective probabilities. The expected present value of venture capital undertaking is equal to the total of these in the three alternatives.

3. **Revenue Multiplier Method**

$$M = V - \frac{(1 + r)n\ (a)\ (p)}{R\ (1 + d)n}$$

V = Present value of venture capital undertaking

R = Annual revenue level

r = expected annual rate of growth of revenue

n = holding period

a = expected after tax profit margin %age at exit

P = P/E ratio at exit

d = appropriate discount rate

Financial Instruments to structure deal, venture capital Institutions can choose among the following instruments:

Equity Instruments: It includes ordinary equity shares, non-voting equity shares, deferred ordinary shares, preferred ordinary shares, pReferencess shares, cumulative convertible, PReferencess shares and participating pReferencess shares.

— Debt instruments: It. includes conventional loans, conditional loan, Income notes, non-convertible debentures, Party convertible debentures, zero interest debentures secured premium notes *deep discount bonds.

11.5 STRUCTURAL ASPECTS

This includes:

- Limited Partnership: This form of structure emerged in USA to cater to the needs of venture capital industry. It can be structured as limited partnership and one more partnership acting as general partner can be formed.
- Investment Company: This is organized as limited company and liable for double taxation (both investment Co. and shareholder).
- Investment Trust: This is a company, not liable to tax on chargeable gains/ dividends.
- Offshore Investment Company: This is incorporated in country other than the country' in which offshore company makes an investment. The tax liability depends on residential status of company.

11.6 DISINVEST MECHANISM

The objective of venture capitalist is to sell off the investment made by him at substantial capital gains. The disinvestments options available in developed countries are:

(i) Promoter's buyback
(ii) Public Issue
(iii) Sale to other Venture Capital Funds
(iv) Sale in OTC (Over the Counter) Market
(v) Management Buyouts

In India, the most popular investment route is promoter's buyback, which permits the ownership and control of the promoter intact.

The Risk Capital and Technology' Finance Corporation CAN-VCF ctc, in India allow promoters to buyback equity of their enterprise.

The public issue would be difficult and expensive since first generation entrepreneurs are not known in the capital market. The option involves high transaction costs and also less feasible for small ventures on account of high listing requirements of the stock exchange.

The OTC exchange in India has been set up in 1992, which would provide disinvestments opportunities to venture capital firms.

11.7 REGULATORY SYSTEM

Venture Capital in India is governed by SEBI.

SEBI Regulations for Venture Capital.

A venture capital fund means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which

— has a dedicated pool of capital
— raised in manner specified in the regulations

— invests in venture capital undertaking in accordance with regulations.

Venture capital means a domestic company

— Whose shares are not listed on a recognized Stock exchange.

— Which is engaged in business and does not include sectors/ activities specified in negative list by SEBI. Negative list includes

— Real Estate, NBFC, Gold financing, activity not permitted under industrial policy of Govt.

Any company or trust or body corporate proposing to carry activity as a VC fund must apply to SEBI for grant of certificate of carrying out venture capital activity in India. An application for grant of certificate must be in form A and fee of Rs. 25,000. Registration fee for grant of certificate is Rs. 5, 00,000.

Procedure for Grant of Certificate

The certificate granted shall be subject to the following conditions:

— The VC shall abide by the provisions of the SEBI act and these regulations.

— The VC fund shall not carry out any other activity other than that of VC fund. The VC fund shall inform SEBI in writing of any information or details previously submitted to SEBI which changed after grant of certificate.

— If the information/ details are found to be false or are misleading in any particular manner, suitable penal action can be taken.

If SEBI is of the opinion that the certificate cannot be granted under, law, it may reject the application after giving reasonable opportunity to applicant of being heard and the effect of non-granting of certificate by SEBI is that applicant cannot carry out the activity of venture capital.

Investment conditions and restrictions

A VC may raise money from any source Indian/foreign or NRI by way of issue of units. No VC fund shall accept any investment from any investor less than Rs. 5, 00,000. However, this condition is not applicable to.

11.8 SUMMARY

Venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs take an active interest in guiding the assisted firms. It involves high degree of risk, equity participation, long-term investment, participation in management. Venture capital combines the qualities of banker, stock market investor and entrepreneur in one.

11.9 Self-Assessment Questions

11.9.1 Name two stages of Financing.

11.9.2 Venture Capital in India is governed by ______.

11.10 Short Questions

1. What is Venture Capital?

2. Discuss methods to evaluate deals in Venture Capital.

11.11 Long Questions

1. Describe briefly the distinguishing features of venture capital financing as against other capital investments.
2. Explain briefly the framework of the scheme of regulation of venture capital funds by the SEBI.

11.12 References

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3. Gupta, S. & Aggarwal, N. & Gupta, N., 2004, Financial Institutions and Markets.
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11.13 Answer to Self-Assessment Questions

11.9.1 (i) Early stage, (ii) Later stage

11.9.2 SEBI.

Lesson No. 12 **AUTHOR: SALONI KANSAL**

CREDIT RATING

STRUCTURE

12.0 OBJECTIVES

After reading this lesson, students will be able to:

- Understand the meaning, scope, benefits and limitations of credit rating;
- Know about the profile of credit rating agencies in India and their rating symbols.

12.1 ORIGIN OF CREDIT RATING

Credit Rating had its origin in financial crisis of U.S. in 1837. The first Credit Rating agency was set up in 1841 in New York to rate the ability of merchandise agents to pay financial obligations. It published its first rating guide in 1859. John Bradstreet setup second agency in 1849. In 1933 these two agencies were merged to form Dun &. Bradstreet. In 1900 John Moody established Moody's Investor Service. In 1916 Poor's publishing co published their first rating followed by Standard Statistics Company in 1922. These two were merged to form Standard & Information Services of India Ltd. (CRISIL) was set up in 1987, followed by 1CRA Ltd. Poois in 1941. In India first credit rating agency credit Rating & CARE in 1994. In 1996 Duff & Phelps Credit Rating (P) Ltd. was set up.

12.2 MEANING OF CREDIT RATING

According to CRISIL, "Credit rating is an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

Moody's: "Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities."

From the above definitions it is understood that:

(i) Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per terms of issue of debt. The rating given is based on an objective judgement of a team of experts from the rating agency.

(ii) The rating is expressed in code number which can be easily comprehended even by the lay investors.

(iii) The ratings are the quickest way of understanding a company's financial standing without going into the complicated financial reports.

(iv) Credit rating, as it exists in India, is done for a specific debt security and not for accompany as a whole.

(v) A debt rating is not a onetime evaluation of credit risk, which can be regarded as valid for the entire life of the security. It is ongoing appraisal.

(vi) A credit rating does not create fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationship.

So, credit rating is essentially giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of debt instrument to meet the debt servicing obligation in time and in full. It provides risk evaluation which is one of the several factors in his investment decision making. Rating process is based on certain 'givens'. The rating agency depends on the information provided by issuer and collected by analysis from different sources.

12.3 FUNCTIONS OF A CREDIT RATING AGENCY

A credit rating agency serves following functions:

1. Provides unbiased opinion: An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:

(i) It has no vested interest in an issue unlike brokers, financial intermediaries.

(ii) Its own reputation is at stake.

2. Provides quality and dependable information: A credit rating agency is in a position to provide quality information on credit. risk which is more authenticate and reliable because:

(i) It has highly trained and professional staff who has better ability to assess risk.

(ii) It has access to a lot of information which may not be publicly available.

3. Provides information at low cost: Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment, of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

4. Provide easy to understand information: Rating agencies first of all gather information, then analyze the same. At last, these interpret and summarize complex information in a simple and readily understood formal manner. Thus, in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.
5. Provide basis for investment: An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.
6. Healthy discipline on corporate borrowers: Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/ discipline on corporate.
7. Formation of public policy: Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different, kinds of institutional portfolio.

12.4 CREDIT RATING AGENCIES IN INDIA

At present in India there are five credit rating agencies which rate debt instruments as well as corporates.

(1) Credit Rating Information Services of India (CRISIL Ltd.)

This is the first rating agency in India. It was set-up in 1987 jointly by the erstwhile ICICI Ltd. and UTI. Other shareholders include: Asian Development Bank (ADB), LIC, State Bank of India, and HDFC, etc. The CRISIL Ltd. is the world's fourth largest rating agency. The activities of CRISIL Ltd. are as under:

- To provide credit rating service in respect of ratings of corporate debt issuances, banks, non-banking finance companies, micro-finance institutions
- To provide analytical tools for management of risk such as market risk, credit and operational risk and valuation services

  To undertake research on economy, industry and company performance and publish such reports

  To provide corporate as well as market advisory services to corporate and noncorporate clients.

The CRISIL Ltd. has rated over 4700 debt instruments issued by 2200 companies.

(2) Investment Information and Credit Rating Agency of India Ltd. (ICRA Ltd.)

This company was promoted by the IFCI Ltd. to meet the requirements of the companies based in the north India. Along with IFCI, State Bank of India, Unit Trust of India, PNB and LIC were other promoters of the company. The objective of the ICRA Ltd. are as follows:

To rate rupee denominated debt instruments issued inter alia, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and local bodies, etc.

To take-up assignments for credit assessment of companies/undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, non-bank financial services companies.

- It provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. It does not assign any specific symbols in respect of such general assessments. It provides a report on various aspects of the functioning of companies such as operations, quality of management etc.

  To undertake research-based study reports to address the unique needs and requirements of an individual client. The assignments include (1) due diligence studies, (2) equity assessment/valuation, (3) industry analysis, and (4) market study etc.

  To offer advisory services to banks, finance companies, manufacturing companies, government, regulatory authorities and local bodies in the following areas:

  (a) strategic consulting

  (b) risk management

  (c) inputs for policy formulation

(3) CARE Ltd.

Credit Analysis and Research (CARE) Ltd. is a credit rating and information services company. This company was promoted by the Industrial Development Bank of India (IDBI) jointly with investment institutions, banks and finance companies. It commenced its credit rating operations in October 1993. The functions of CARE Ltd. are as under:

- To undertake credit rating of all types of debt instruments, both short term and long term.
- To make available information on any company, industry or sector required by a business enterprise,
- To undertake equity research study of listed or to be listed companies on the major stock exchanges.

(4) Duff and Phelps Credit Rating (India) Private (DCR) Ltd.

This credit rating company was set-up in 1996. It was promoted by JM Financial and Alliance Group jointly with international rating agency Duff and Phelps. The activities of the company are as under:

To undertake credit rating of debt instruments including rating of commercial papers.

To evaluate company performance and give rating to them.

To provide country rating.

12.5 BENEFITS OF CREDIT RATING

The rating of debt instruments offers benefits to the interested parties such as investors, issuers and intermediary agencies like brokers etc. These benefits are described below:

(A) Benefits to Investors

(i) Safeguards against Bankruptcy: Credit rating of an instrument given by the credit rating agency gives an idea to the investors about the degree of financial strength of the Highly rated instrument of a company gives an assurance to the investors of safety of their investment and the interest (or return) on their investments with least risk of bankruptcy.

(ii) Recognition of Risk: Credit rating provides investors with rating symbols which carry information in easily recognizable manner for the benefit of investors to perceive risk involved in investment. It becomes easier for the investors by looking at the symbol to understand the worth of the issuer company because the instrument is rated by scientifically and professionally analyzing the financial position of the company. In view of this, there is no need for the investors to incur cost for collecting credit information and to carry out analysis. The investors without any knowledge of financial analysis can easily use rating symbols for investment decisions.

(iii) Credibility of Issuer: Rating symbol assigned to a debt instrument gives an idea about the credibility of the issuer company. The rating agency is quite independent of the issuer company and has no business connections or otherwise any relationship with it or its Board of Directors, etc. Due to absence of business links between the rating agency and the issuer company the confidence of investors is enhanced in such rating symbol.

(iv) Rating Facilitates Quick Investment Decisions: Investor can take quick decisions about the investment to be made in various instruments with the help of credit rating assigned to various instruments. In view of this, there is no need for investors to undertake fundamental analysis of a company based on financial strength of the company, quality of management, as well as other parameters.

(v) No Need to Depend on Investment Advisors or Professionals: For making investment decisions, investors with no knowledge of investment may have to seek advice of financial intermediaries such as, the stock brokers, the portfolio managers, or financial consultants while investing funds in debt instruments. However, investors need not depend upon the advice of these financial intermediaries as the rating symbol assigned to a particular instrument suggests the credit worthiness of the instrument and indicates the degree of risk involved in it. Thus, investors can make direct investment decisions.

(vi) Choice of Investment: Several alternative credit rated instruments are available at a particular point of time for deploying investible funds. The investors can make choice of various instruments depending upon their own risk profile and diversification plan.

(vii) Benefits of Rating Surveillance: Investors get the benefit of credit rating agency's on-going surveillance of the rated instruments of different companies. The Credit Rating Agency downgrades the rating of any instrument if subsequently the company's financial performance is not so good or financial position has suffered because of happening of internal or external events which necessitates consequent dissemination of information on its position to the investors. To sum up, credit rating of debt instruments helps the investors in managing credit risk in investment decisions.

(B) Benefits of Credit Rating to Issuer Company

A company which has obtained credit rating from rating agency for its issue of debt security enjoys various advantages. Few of these advantages are given below:

(i) Lower Cost of Borrowing: A company, whose debt instrument or public deposits programme, is highly rated, will be in a position to reduce the cost of borrowing by quoting lesser interest rate on fixed deposits or debentures or bonds as the investors will prefer low rate of interest because of lower credit risk.

(ii) Wider Audience for Borrowing: A company having very good rating for its debt instrument can approach various categories of investors for resource mobilisation using the press media. Investors in different strata of the society could be attracted by higher rated instruments as the investors understand the degree of certainty about timely payment of interest and principal on a debt instrument with better rating.

(iii) Rating as Marketing Tool: Companies with rated instruments improve their own image and can use credit rating as a marketing tool to create better image in dealing with its customers, lenders and other creditors. Even consumers feel confident in using products manufactured by the companies carrying higher rating for their credit instruments.

(iv) Self-Discipline by Companies: Rating encourages the companies to come out with more disclosures about their accounting system, financial reporting and management pattern, etc. The company gets opportunity and motivation to improve upon its existing practices to match to the competitive standard and maintain the standard of rating attained by it or make improvement upon the rating.

(v) Reduction of Cost in Public Issues: A company with higher rated instrument is able to attract the investors and raise the funds with least efforts. Thus, the company whose debt instrument is highly rated can minimise cost of public issues by controlling expenses on media coverage, conferences and other marketing expenditures.

(vi) Motivation for Growth: Rating provides motivation to the company for growth as the promoters of the company feel confident in their own efforts and are encouraged to undertake expansion of their existing operations or new projects. With better image created through higher credit rating the company can mobilize funds from the public and institutional lenders like banks and financial institutions.

(C) Benefits to Financial Intermediaries

Highly credit rated instruments put the brokers at an advantage to make less efforts in studying the company's credit position to convince their clients to select a particular investment proposal. Rated instruments speak themselves about the financial soundness of the company and the strength of the instrument rated by the credit rating agency. This enables brokers and other financial intermediaries to save their time, cost, energy and manpower in convincing their clients about investments in any particular instruments. They utilize their resources in expanding their clientele and intensifying their business activities.

12.6 LIMITATIONS OF CREDIT RATING

While recognizing the benefits of credit rating, it is necessary to keep in mind certain limitations of the credit rating. Few of these are explained below:

(1) Biased Rating and Misrepresentations

In the absence of quality rating based on objectivity analysis credit rating is a curse for the capital market. To avoid biased rating or subjectivity in the credit rating process, executives working with Credit Rating Agency, who are involved in the process of credit rating, should have no links with the company or the persons interested in the issuer company so that they can make their report impartial and judicious recommendations for rating committee.

(2) Static study

Rating is done on the basis of present and past data of the company and this is only a static study. Disclosure about the company's health through credit rating is one time exercise and anything can happen after assignment of rating symbols to the company. Dependence for future results on the rating, therefore defeats the very purpose of risk inductiveness of rating.

(3) Concealment of material information

The company which has approached for credit rating may not provide all material information to the credit rating agency. In such cases, credit rating given by the credit rating agency may not reflect true picture of credit risk.

(4) Rating is no guarantee for soundness of the company

Credit rating is done for a particular instrument to assess the credit risk. And therefore, it cannot be construed as a rating for the quality of management of the company or its sound financial position.

12.7 SUMMARY

Credit rating is a technique of rating the borrower s expected capability and worth or reputation of solvency and ability and inclination of pay back the principal duty and interest when the obligation falls due. Credit rating is only a risk evaluation of a credit assignment and presently the debt instruments rated include debentures, fixed deposits and commercial papers. It is highly useful to investors, issuers, intermediaries and regulators. A number of factors contribute to the success of credit rating. The most dominating factor is the reputation and analytical credibility of the credit rating agency. Credit rating is an interactive process that involves a number of steps on the basis of assessment on which rating is assigned. Such rating, which is expressed in symbols, is subject to an upward or downward change. The recent developments in credit rating have brought in its fold the rating of equity, structured obligations, utilities, sovereign and municipalities. In India, credit rating business is regulated by SEBI.

12.8 Self-Assessment Questions

12.8.1 When did 1st credit rating company started in India?

12.8.2 Name any two credit rating companies in India.

12.9 Short Questions

1. What do you mean by Credit Rating?
2. Give some Details about CRISIL.

12.10 Long Questions

(1) Write down the functions of Credit Rating agency.

(2) Are there any limitations of credit rating? If yes, explain various limitations.

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12.12 Answer to Self-Assessment Questions

12.8.1 In 1994.

12.8.2 CRISIL and ICRA.

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UNDERWRITING

STRUCTURE

13. OBJECTIVES

After studying the lesson, the students would enable:

- To understand the meaning, forms and significance of underwriting.
- To know the regulations and recent development of underwriting.

13.1 INTRODUCTION

Underwriting in the context of the company means undertaking a responsibility or giving a guarantee that the securities offered to the public will be subscribed for. The firms which undertake the guarantee are called underwriters. Underwriting is similar to insurance in the sense that it provides protection to the issuing company against the failure of an issue of capital to the public. Underwriting is therefore an act of undertaking the guarantee by an underwriter of buying the shares or debentures placed before the public in the event of non-subscription.

13.2 CONCEPT OF UNDERWRITING

Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 percent on shares and 2.5 percent in case of debentures. Underwriters get their commission irrespective of whether they have to buy a single security or not.

Underwriting refers to the process that a large financial service provider (bank, insurer, investment house) uses to assess the process of providing acccss to their product like providing equity capital, insurance or credit to a customer. The name derives from the Lloyd's of London insurance market in London, United Kingdom. Financial bankers, who would accept some of the risk on a given venture (historically a sea voyage with associated risks of shipwreck) in exchange for a premium, would literally write their names under the risk information which was written on a Lloyd's slip created for this purpose.

In banking, underwriting is the detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history, which is detailed in a credit report; and the lender's evaluation of the borrower’s credit needs and ability to pay. Underwriting can also refer to the purchase of corporate bonds, commercial paper, Government securities, and municipal general obligation bonds by a commercial bank or dealer bank for its own account, or for resale to investors. Bank underwriting of corporate securities is carried out through separate holding company affiliates, called securities affiliates, or Section 20 affiliates.

13.3 TYPES OF UNDERWRITING

The nature and form of underwriting transactions depends mainly upon the nature of the project, the state of the capital market, the general response of the investors to the new issues, the reputation of the promoters and capacity of the underwriters. It may be undertaken on a commission basis. Thus, an underwriting agreement may take any of the following forms:

13.3.1 Syndicate Underwriting

Syndicate Underwriting is one in which, two or more agencies or underwriters jointly underwrite an issue of securities.

Such an arrangement is entered into when the total issue is beyond the resources of one underwriter or when he does not want to block up large amount of funds in one issue.

13.3.2 Sub-Underwriting

Sub-Underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting. The name of every under-writer is mentioned in the prospectus along with the number of securities underwritten by him.

13.3.3 Firm Underwriting

Firm Underwriting is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters. The underwriter need not take up the whole of the securities with them. For example, if the underwriter has underwritten the entire issue of 5 lakh shares offered by a company and has in addition applied for 1 lakh shares for firm allotment. If the public subscribes to the entire issue, the underwriter would be allotted 1 lakh shares even though he is not required to take up any of the shares.

13.3.4 Insurance Underwriting

Underwriting may also refer to insurance; insurance underwriters evaluate the risk and exposures of the prospective clients. They decide how much coverage the client should receive, how much they should pay for it, or whether to even accept the risk and insure them. Underwriting involves measuring risk exposure and determining the premium that needs to be charged to ensure that risk. The function of the underwriter is to acquire-or to "write"- business that will make the insurance company money, and to protect the company's book of business from risks that they feel will make a loss.

In simple terms, it is the process of issuing insurance policies.

13.3.5 Other

Underwriting may also refer to financial sponsorship of a venture, and is also used as a term within public broadcasting (both public television and radio) to describe funding given by a company or organization for the operations of the service, in exchange for a mention of their product or service within the station's programming. For more on underwriting in public broadcasting, please see underwriting spot.

13.4 SIGNIFICANCE OF INSTITUTIONAL UNDERWRITING

Underwriting is the safer way of marketing securities for new issues of capital as it provides protection against risks. Thus, it is a very useful method of raising finance through issue of securities (shares and debentures). The analysis of underwriting of issues indicates that almost lOOpercent of the issues of pReferencess share capital and debentures are underwritten in India. Thus, underwriting plays a very significant role in corporate financing. The importance of underwriting can further be highlighted from the following functions performed by the underwriters:

1. Assurance of Adequate Finance: Through underwriting, an issuing company is assured of procuring the required funds from the issue of shares or debentures.
2. Supplying Valuable Information to Companies: In addition to the protection of risk of the issuing companies with regard to the success of the issue, the underwriters supply valuable information in regard to capital market conditions, general response of the investors etc. to the issuing companies.
3. Distribution of Securities: After purchasing securities, underwriters distribute the same to the real investors. Thus, underwriting helps promoters to retain control over the management of the company.

4. Increase in Goodwill of the Issuing Company: The underwriting of capital issues by prestigious institutions generates confidence among investors and improves their response to the issues. It ultimately led to an increase in Goodwill of the Issuing Company.
5. Service to prospective investors: Underwriters provide essential information about the issuing companies to the prospective investors and also advise them about various issues. They encourage people to save more and direct their savings in corporate securities.
6. Financial and development corporations: They also follow an objective policy while underwriting capital issues.
7. Investment and insurance companies and stock-brokers: They put primary emphasis on the short-term prospects of the issuing company as they cannot afford to block large amount of money for long periods of time.

13.5 RECENT DEVELOPMENTS AND SEBI REGULATIONS

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters.

Under it, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

Underwriting services have been traditionally provided by financial institutions, banks, brokers who are members of stock exchanges, merchant bankers, mutual funds and persons with adequate financial capacity, appropriate standing and experience. As per rule 3(1) of the Securities and Exchange Board of India (Underwriters) Rules, 1993 no person can act as underwriter unless he holds a certificate granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. Rule 3(2) exempts every stockbroker or merchant banker holding a valid certificate of registration under section 12 of Securities and Exchange Board of India Act, 1992 to obtain separate certificate for underwriting. As per rule 4(b) of the Securities and Exchange Board of India (Underwriters) Rules, 1993, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity.

In the Securities and Exchange Board of India (Underwriters) Regulations, 1993-(i) in regulation 2:

a. after the opening part and before clause (b), the following clauses shall be inserted, namely:

(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(aa) "body corporate" shall have the meaning assigned to it in or under clause (7) of section 2 of the Companies Act, 1956 (1 of 1956);

(ab) "certificate" means a certificate of registration issued by the Board;

(ac) “change of status or constitution" in relation to an underwriter means any change in its status or constitution of whatsoever nature and includes -

(i) In case of a body corporate -

(A) amalgamation, demerger, consolidation or any other kind of corporate restructuring falling within the scope of section 391 of the Companies Act, 1956 (1 of 1956) or the corresponding provision of any other law for the time being in force;

(B) change in its managing director or whole-time director; and

(C) any change in control over the body corporate;

any change between the following legal forms - individual, partnership firm, Hindu Undivided family, private company, public company, unlimited company or statutory corporation and other similar changes;

(ii) in case of a partnership firm any change in partners not amounting to dissolution of the firm; "change in control", in relation to an underwriter being a body corporate, means:

(1) if its shares are listed on any recognized stock exchange, change in control within the meaning of regulation 12 of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997;

(ii) In any other case, change in the controlling interest in the body corporate; Explanation: For the purpose of sub-clause (ii), the expression "controlling interest” means an interest, whether direct or indirect, to the extent of at least fifty one percent, of voting rights in the body corporate;"

b. after clause (c), the following clause shall be inserted, namely: "(ca) 'issue' means an offer of sale of securities by anybody corporate or by any other person or group of persons on its or his or their behalf, as the case may be, to the public, or, the holders of securities of such body corporate or person or group of persons;"

c. for clause (f), the following clauses shall be substituted, namely

"(f) 'Underwriter' means a person who engages in the business of underwriting of an issue of securities of a body corporate;

(fa) 'Underwriting' means an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them;”

d. in clause (g), the words "and the rules" occurring after the words "defined in the Act" and the words "or the rules, as the case may be" occurring at the end shall be omitted;

(ii) Regulation 3 shall be renumbered as regulation 3A and before the regulation so renumbered, the following regulation shall be inserted, namely:

Registration as underwriter

3. (1) No person shall act as underwriter unless he holds a certificate granted by the Board under these regulations.

(2) Notwithstanding anything contained in sub-regulation (1), every stock broker or merchant banker holding a valid certificate of registration under section 12 of the Act, shall be entitled to act as an underwriter without obtaining a separate certificate under these regulations.

(3) A stock broker or merchant banker acting as an underwriter under sub-regulation (2) shall be governed by these regulations in other respects."

(iii) In regulation 3A, so renumbered, after sub-regulation (1), the following sub regulation shall be inserted, namely:

(1A) an application for registration made under sub-regulation (1) shall be accompanied by a non-refundable application fee as specified in Schedule II."

(iv) in regulation 4, in sub-regulation (2), for the words "regulation 3" occurring at the

end, the words 'regulation 3A" shall be substituted;

(v) in regulation 5, for the words "sub-regulation (2) of regulation 3“, the words "sub-regulation (2) of regulation 3A” shall be substituted.

(vi) In regulation 9, after sub-regulation (1), the following sub-regulation shall be inserted, namely:

“(1A) An application for renewal made under sub-regulation (1) shall be accompanied by a non-refundable application fee as specified in Schedule II."

(vii) after regulation 9, the following regulations shall be inserted, namely

Conditions of registration

Any registration granted under regulation 8 or any renewal granted under regulation 9 shall be subject to the following conditions, namely:-

(a) where the underwriter proposes to change its status or constitution, it shall obtain prior approval of the Board for continuing to act as such after the change;

(b) it shall enter into a valid agreement with the body corporate on whose behalf it is acting as underwriter;

(c) it shall pay the fees for registration or renewal, as the case may be, in the manner provided in these regulations;

(d) it shall maintain capital adequacy requirements specified in regulation 7 at all times during the period of the certificate or renewal thereof;

(e) it shall abide by the regulations made under the Act in respect of the activities carried on by it as underwriter.

(2) Nothing contained in clause (a) of sub-regulation (1) shall affect the obligation to obtain a fresh registration under section 12 of the Act in cases where it is applicable.

Period of Validity of Certificate

9B. The certificate of registration granted under regulation 8 and its renewal granted under regulation 9, shall be valid for a period of three years from the date of its issue to the applicant."

(viii) In regulation 14,

a. in the opening paragraph, for the words, brackets and figures clause (b) of rule 4", the words, brackets and figures "clause (b) of sub-regulation (1) of regulation 9A" shall be substituted;

b. after clause (i), the following clause shall be inserted, namely:

"(ia) the allocation of duties and responsibilities between the underwriter and the client;"

(ix) in regulation 15, in sub-regulation (3), for the words, brackets and figures 'clause

(b) of rule 4", the words, brackets and figures "clause (b) of sub-regulation

(1) of regulation 9A" shall be substituted;

(x) in regulation 16, in sub-regulation (3), for the words, brackets and figures "clause (b) of rule 4" wherever they occur, the words, brackets and figures 'clause

(b) of sub-regulation (1) of regulation 9A" shall be substituted;

(xi) in Schedule II -

a. in paragraph 1, for the words "Rupees five lacs', the words "ten lakh rupees" shall be substituted;

b. in paragraph 2, for the words and figures "Rs. 2 lacs", the words "five lakh rupees" shall be substituted;

c. after paragraph 3, the following paragraph shall be inserted, namely

"3A. The non-refundable fee payable along with an application for registration under sub-regulation (1A) of regulation 3A or an application for renewal of registration under sub-regulation (1A) of regulation 9 s rupees."

d. in paragraph 4, for the words and figures "paragraphs 1 and 2" the words and figures "paragraphs 1, 2 and 3A" shall be substituted.

The Securities and Exchange Board of India (Underwriters) Regulations, 1993, the Principal Regulations were published in the Gazette of India on October 8, 1993.

The Securities and Exchange Board of India (Underwriters) Regulations, 1993 was subsequently amended

- On November 28, 1995 by the Securities and Exchange Board of India (Payment of Fees) (Amendment) Regulations, 1995.
- On January 17, 1997 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1997.
- On January 5, 1998 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1998.
- On September 30, 1999 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1999.
- On March 28, 2000 by the Securities and Exchange Board of India (Appeal to the Securities Appellate Tribunal) (Amendment) Regulations, 2000.
- On May 29, 2001 by the Securities and Exchange Board of India (Investment Advice by Intermediaries) (Amendment) Regulations, 2001.

- On September 27, 2002 by the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.
- On December 10, 2002 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2002.
- On March 10, 2004 by the Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004.

13.6 SUMMARY

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the number of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 percent on shares and 2.5 percent in case of debentures. Underwriters get their commission irrespective of whether they have to buy a single security or not. To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters.

13.7 Self-Assessment Questions

13.7.1 Write down any 2 names of types of underwriting.

13.7.2 What is Insurance Underwriting?

13.8 Short Questions

1. What is Syndicate underwriting?
2. Discuss the functions performed by the underwriters?

13.9 Long Questions

1. How does underwriting boost performance of financial system? Discuss.
2. What is underwriting? What are its various types? Discuss.
3. Differentiate between Sub-Underwriting and Firm Underwriting.
4. Discuss recent developments in the area of Underwriting.
5. Write and discuss major SEBI Regulations.
6. What is the significance of underwriting in our financial system? Discuss.

13.10 References

- *Khan, M. Y., Financial Management*

- Pickle, H. B. & Abrahamson, R. L., 1990, Business Management, John Wiley & Sons, Inc.
- *Khan, M. Y., Financial Services*
- *Gupta, S. & Aggarwal, N. & Gupta, N., 2004, Financial Institutions and Markets.*

13.11 Answer to Self-Assessment Questions

13.7.1 Sub-Underwriting, Firm Underwriting.

13.7.2 Insurance underwriters evaluate the risk and exposures of the prospective clients.

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DERIVATIVES

STRUCTURE

14.1 MEANING OF DERIVATIVES

Derivatives are financial contracts, which derive their value off a spot price time-series, which is called "the underlying". The underlying asset can be equity, index, commodity or any other asset. Some common examples of derivatives are Forwards, Futures, Options and Swaps. Derivatives help to improve market efficiencies because risks can be isolated and sold to those who are willing to accept them at the least cost. Using derivatives breaks risk into pieces that can be managed independently. From a market-oriented perspective, derivatives offer the free trading of financial risks.

14.2 OPERATORS IN THE DERIVATIVES MARKET

- Hedgers - Operators, who want to transfer a risk component of their portfolio.
- Speculators - Operators, who intentionally take the risk from hedgers in pursuit of profits.
- Arbitrageurs - Operators who operate in the different markets simultaneously, in pursuit of profit and eliminate mis-pricing.

14.3 KINDS OF FINANCIAL DERIVATIVES

Derivatives can be classified into four types:

14.3.1 FORWARDS

In a forward contract, two parties agree to do a trade at some future date, at a price and quantity agreed today. No money changes hands at the time the deal is signed.

Features of Forward Contract

The main features of forward contracts are:

- They are bilateral contracts and hence exposed to counter-party risk.
- Each contract is custom designed, and hence is unique in terms of contract size, expiration date and the asset type and quality.
- The contract price is generally not available in public domain.
- The contract has to be settled by delivery of the asset on expiration date.

In case, the party wishes to reverse the contract, it has to compulsorily go to the same counter party, which being in a monopoly situation can command the price it wants.

14.3.2 FUTURES

In finance, a futures contract is a standardized contract., traded on a futures exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price. The future date is called the delivery date or final settlement date. The pre-set price is called the futures price. The price of the underlying asset on the delivery date is called the settlement price. The settlement price, normally, converges towards the futures price on the delivery date. A futures contract gives the holder the obligation to buy or sell, which differs from an options contract, which gives the holder the right, but not the obligation. In other words, the owner of an options contract may exercise the contract. If it is an American-style option, it can be exercised on or before the expiration date; a European option can only be exercised at expiration. Thus, a Futures contract is more like an European option. Both parties of a "futures contract" must fulfill the contract on the settlement date. The seller delivers the commodity to the buyer, or, if it is a cash-settled future, then cash is transferred from the futures trader who sustained a loss to the one who made a profit. To exit the commitment prior to the settlement date, the holder of a futures position has to offset his position by either selling a long position or buying back a short position, effectively closing out the futures position and its contract obligations. Futures contracts, or simply futures, arc exchange traded derivatives. The exchange's clearinghouse acts as counterparty on all contracts, sets margin requirements, etc.

Futures vs. Forwards

While futures and forward contracts are both a contract to deliver a commodity on a future date, key differences include:

- Futures are always traded on an exchange, whereas forwards always trade over- the-counter, or can simply be a signed contract between two parties.

- Futures are highly standardized, whereas each forward is unique
- The price at which the contract is finally settled is different: Futures are settled at the settlement price fixed on the last trading date of the contract (i.e., at the end) Forwards are settled by the delivery of the commodity at the specified contract price.
- The credit risk of futures is much lower than that of forwards: Traders are not subject to credit risk because the clearinghouse always takes the other side of the trade. The day's profit or loss on a futures position is marked-to-market in the trader's account. If the mark to market results in a balance that is less than the margin requirement, then the trader is issued a margin call. The risk of a forward contract is that the supplier will be unable to deliver the grade and quantity of the commodity, or the buyer may be unable to pay for it on the delivery day.
- In case of physical delivery, the forward contract specifies to whom to make the delivery. The counterparty on a futures contract is chosen randomly by the exchange.
- In a forward there are no cash flows until delivery, whereas in futures there are margin requirements and a daily mark to market of the traders' accounts.

14.3.3 OPTIONS

Options are contracts that confer on the buyer of the contract certain rights (rights to buy or sell an asset) for a predetermined price on or before a pre-specified date. The buyer of the option has the right but not the obligation to exercise the option. Options come in a variety of forms. Some Option contracts, which have been standardized, are traded on recognized exchanges. Other Option contracts exist that are traded "over-the-counter", i.e., a market where financial institutions and corporates trade directly with each other over the phone. Besides these, options also exist in an embedded form in several instruments.

They popular basic instruments/variables underlying options are:

- Equity - Index Options, Options on individual stocks, Employee Stock Options
- Interest rates - Bond Options, Interest rate Futures Options, Options embedded in bonds, caps & floors, etc
- Foreign exchange - Plain vanilla calls and puts, barrier Options, various kinds of exotic Options
- Others - including commodities, weather, electricity, etc.

Classification

- Option Seller - One who gives/writes the option. He has an obligation to perform, in case option buyer desires to exercise his option.
- Option Buyer - One who buys the option. He has the right to exercise the option but no obligation.
- Call Option - Option to buy.
- Put Option - Option to sell.
- American Option - An option, which can be exercised anytime on or before the expiry date.

- European Option - An option, which can be exercised only on expiry date.
- Strike Price/ Exercise Price - Price at which the option is to be exercised.
- Expiration Date - Date on which the option expires.
- Exercise Date - Date on which the option gets exercised by the option holder/ buyer.
- Option Premium - The price paid by the option buyer to the option seller for granting the option.

Call Options

A call option gives the holder (buyer/ one who is long call), the right to buy specified quantity of the underlying asset at the strike price on or before expiration date. The seller (one who is short call) however, has the obligation to sell the underlying asset if the buyer of the call option decides to exercise his option to buy.

Put Options

A Put option gives the holder (buyer/ one who is long Put), the right to sell specified quantity of the underlying asset at the strike price on or before a expiry date. The seller of the put option (one who is short Put) however, has the obligation to buy the underlying asset at the strike price if the buyer decides to exercise his option to sell.

Covered and Naked Calls

A call option position that is covered by an opposite position in the underlying instrument (for example shares, commodities etc.), is called a covered call. Writing covered calls involves writing call options when the shares that might have to be delivered (if option holder exercises his right to buy), are already owned. E.g., A writer writes a call on Reliance and at the same time holds shares of Reliance so that if the call is exercised by the buyer, he can deliver the stock.

Covered calls are far less risky than naked calls (where there is no opposite position in the underlying), since the worst that can happen is that the investor is required to sell shares already owned at below their market value. When a physical delivery uncovered/ naked call is assigned an exercise, the writer will have to purchase the underlying asset to meet his call obligation and his loss will be the excess of the purchase price over the exercise price of the call reduced by the premium received for writing the call.

Intrinsic Value of an option

The intrinsic value of an option is defined as the amount by which an option is in-the-money, or the immediate exercise value of the option when the underlying position is marked-to-market.

- For a call option: Intrinsic Value = Spot Price - Strike Price
- For a put option: Intrinsic Value = Strike Price - Spot Price

The intrinsic value of an option must be a positive number or 0. It cannot be negative. For a call option, the strike price must be less than the price of the underlying asset for the call to have an intrinsic value greater than 0. For a put option, the strike price must be greater than the underlying asset price for it to have intrinsic value.

Players in the Options Market

Developmental institutions, Mutual Funds, FIs, FIIs, Brokers, Retail Participants are the likely players in the Options Market.

14.3.4 SWAPS

A swap is nothing but a barter or exchange but it plays a very important role in international finance. A swap is the exchange of one set of cash flows for another. A swap is a contract between two parties in which the first party promises to make a payment to the second and the second party promises to make a payment to the first. Both payments take place on specified dates. Different formulas are used to determine what the two sets of payments will be.

Classification of swaps is done on the basis of what the payments are based on. The different types of swaps are as follows.

- Interest rate swaps
- Currency Swaps
- Commodity swaps
- Equity swaps

Interest Rate Swaps

The interest rate swap is the most frequently used swap. An interest rate swap generally involves one set of payments determined by the Eurodollar (LIBOR) rate. Although, it can be pegged to other rates. The other set is fixed at an agreed-upon rate. This other agreed upon rate usually corresponds to the yield on a Treasury Note with a comparable maturity. Although, this can also be variable. Additionally, there will be a spread of a pre-determined amount of basis points. This is just one type of interest rate swap. Sometimes payments tied to floating rates are used for interest rate swaps. The notional principal is the exchange of interest payments based on face value. The notional principal itself is not exchanged. On the day of each payment, the party who owes more to the other makes a net payment. Only one party makes a payment.

Currency Swaps

A currency swap is an agreement between two parties in which one party promises to make payments in one currency and the other promises to make payments in another currency. Currency swaps are similar yet notably different from interest rate swaps and are often combined with interest rate swaps.

Currency swaps help eliminate the differences between international capital markets. Interest rates swaps help eliminate barriers caused by regulatory structures. While currency swaps result in exchange of one currency with another, interest rate swaps help exchange a fixed rate of interest with a variable rate. The needs of the parties in a swap transaction are diametrically different. Swaps are not traded or listed on exchange but they do have an informal market and are traded among dealers. A swap is a contract, which can be effectively combined with other type of derivative instruments. An option on a swap gives the party the right, but not the obligation to enter into a swap at a later date.

Commodity Swaps

In commodity swaps, the cash flows to be exchanged are linked to commodity prices. Commodities are physical assets such as metals, energy stores and food including cattle. E.g., in a commodity swap, a party may agree to exchange cash flows linked to prices of oil for a fixed cash flow.

Commodity swaps are used for hedging against:

- Fluctuations in commodity prices or
- Fluctuations in spreads between final product and raw material prices (e.g., Cracking spread which indicates the spread between crude prices and refined product prices significantly affect the margins of oil refineries)

A Company that uses commodities as input may find its profits becoming very volatile if the commodity prices become volatile. This is particularly so when the output prices may not change as frequently as the commodity prices change. In such cases, the company would enter into a swap whereby it receives payment linked to commodity prices and pays a fixed rate in exchange. A producer of a commodity may want to reduce the variability of his revenues by being a receiver of a fixed rate in exchange for a rate linked to the commodity prices.

Equity Swaps

Under an equity swap, the shareholder effectively sells his holdings to a bank, promising to buy it back at market price at a future date. However, he retains a voting right on the shares.

Components of Swap Price

There are four major components of a swap price.

- Benchmark price
- Liquidity (availability of counter parties to offset the swap).
- Transaction cost
- Credit risk

Benchmark price: Swap rates are based on a series of benchmark instruments. They may be quoted as a spread over the yield on these benchmark instruments or on an absolute interest rate basis. In the Indian markets the common benchmarks are MIBOR, 14, 91, 182 & 364 day T-bills, CP rates and PLR rates.

Liquidity: Liquidity, which is function of supply and demand, plays an important role in swaps pricing. This is also affected by the swap duration. It may be difficult to have counterparties for long duration swaps, especially so in India.

Transaction Costs: Transaction costs include the cost of hedging a swap. Say in case of a bank, which has a floating obligation of 91-day T. Bill. Now in order to hedge the bank would go long on a 91-day T. Bill. For doing so the bank must obtain funds. The transaction cost would thus involve such a difference.

Yield on 91-day T. Bill - 9.5%

Cost of fund (e.g.- Repo rate) - 10%

The transaction cost in this case would involve 0.5%

Credit Risk: Credit risk must also be built into the swap pricing. Based upon the credit rating of the counterparty a spread would have to be incorporated. Say for e.g., it would ben0.5% for an AAA rating.

14.4 DERVATIVE MARKET IN INDIA

Starting from a controlled economy, India has moved towards a world where prices fluctuate every day. The introduction of risk management instruments in India gained momentum in the last few years due to liberalization process and Reserve Bank of India's (RBI) efforts in creating currency forward market. Derivatives are an integral part of liberalization process to manage risk. NSE gauging the market requirements initiated the process of setting up derivative markets in India. Chronology of instruments are as follow:

In less than three decades of their coming into vogue, derivatives markets have become the most important markets in the world. Today, derivatives have become part and parcel of the day-to-day life for ordinary people in major part of the world.
Until the advent of NSE, the Indian capital market had no access to the latest trading methods and was using traditional out-dated methods of trading. There was a huge gap

1991	Liberalization process initiated
14-Dec-95	NSE asked SEBI for permission to trade index futures.
18-Nov-96	SEBI setup L.C.Gupta Committee to draft a policy framework for index futures.
11-May-98	L.C.Gupta Committee submitted report.
07-Jul-99	RBI gave permission for OTC forward rate agreements (FRAs) and interest rate swaps.
24-May-00	SIMEX chose Nifty for trading futures and options on an Indian index.
25-May-OO	SEBI gave permission to NSE and BSE to do index futures trading.
09-Jun-00	Trading of BSE Sensex futures commenced at BSE.
12-Jun-00	Trading of Nifty futures commenced at NSE.
25-Sep-OO	Nifty futures trading commenced at SGX.
02-Jun-01	Individual Stock Options & Derivatives

between the investors' aspirations of the markets and the available means of trading. The opening of Indian economy has precipitated the process of integration of India's financial markets with the international financial markets. Introduction of risk management instruments in India has gained momentum in last few years thanks to Reserve Bank of India’s efforts in allowing forward contracts, cross currency options etc. which have developed into a very large market.

14.5 IMPORTANCE OF DERIVATIVES

(a) A Tool for Hedging

There are several risks inherent in financial transactions. Derivatives are used to separate risks from traditional instruments and transfer these risks to parties willing to bear these risks. The fundamental risks involved in derivative business includes: Credit Risk This is the risk of failure of a counterparty to perform its obligation as per the contract. Also known as default or counterparty risk, it differs with different instruments. Market Risk: Market risk is a risk of financial loss as a result of adverse movements of prices of the underlying asset/ instrument Liquidity Risk: The inability of a firm to arrange a transaction at prevailing market prices is termed as liquidity risk. Legal Risk: Derivatives cut across judicial boundaries, therefore the legal aspects associated with the deal should be looked into carefully. Derivatives provides an excellent mechanism to hedge the future price risk. Think of a farmer, who doesn't know what price he is going to get for his crop at the time of harvest. He can sell his crop in the futures' market & lock in the price. If the future spot price is more than the futures price, he can take the offsetting position & can get out of the market (with a marginal loss). Otherwise, he will get the locked in price.

(b) Risk Management

Derivatives provide an excellent mechanism to Portfolio Managers for managing the portfolio risk and to Treasury Managers for managing interest rate risk. The importance of index futures & Forward Rate Agreement (FRA) in this process can't be overstated.

(c) Better Avenues for Raising Money

With the introduction of currency & interest rate swaps, Indian corporate will be able to raise finance from global markets at better terms,

(d) Rice Discovery

These derivative instruments make the spot price discovery more reliable using different models like Normal Backwardation hypothesis. These instruments will cause any arbitrage opportunities to disappear & will lead to better price discovery.

(e) Increasing the depth of financial markets

When a financial market gets such sort of risk-management tools, its depth increases since the Institutional Investors get better ways of hedging their risks against unfavorable market movements.

(f) Derivatives market on Indian underlying elsewhere

These days, with the advent of technology, Indian prices are available globally on Reuters & Knight rider. Nothing prevents any foreign market from launching derivatives on these Indian underlying. This will put Indians in a disadvantageous position as they can't take the advantages of derivatives of securities or commodities traded in India but someone else can take. So, we will have to move fast in this direction.

14.6 INHIBITING FACTORS

(a) Speculation: Many people fear that these instruments will unnecessarily increase the speculation in the financial markets, which can have far reaching consequences. The recent Barings Bank incident is the classic case in point.

(b) Market efficiency: Many people fear that the Indian markets are not mature & efficient enough to introduce these instruments. These instruments require a well-functioning & mature spot market. Like recently The Economic Times reported the strong correlation of Indian equity markets to the NASDAQ. Such type of market imperfections makes the functioning of derivatives market all the more difficult.

(c) Volatility: The increased speculation & inefficient market will make the spot market more volatile with the introduction of derivatives.

(d) Counter party risk: Most of the derivative instruments are not exchange traded. So, there is a counter party default risk in these instruments. Again, the same Barings case, Barings declared itself bankrupt when it faced huge losses in these instruments.

(e) Liquidity risk: Liquidity of a market means the ease with which one can enter or get out of the market. There is a continued debate about the Indian market's capability to provide enough liquidity to derivative trade

14.7 SUMMARY

Derivatives are the instruments which make payments calculated using price of interest rates derived from on balance sheet or cash instruments, but do not actually employ those cash instruments to fund payments. Derivative are becoming increasingly important in world markets as a tool for risk management. Derivatives are used to separate the risks and transfer them to parties willing to bear these risks.

14.8 Self-Assessment Questions

14.8.1 who are Hedgers?

14.8.2 How many different swaps are there?

14.9 Short Questions

1. What is the importance of Derivatives?

2. Differentiate between Future and Forward contracts.

14.10 Long Questions

1. Define the term Derivatives and bring out its importance.
2. Discuss the various kinds of financial derivatives and bring out their features briefly.

14.11References

- Gordon and Natarajan, Financial Markets and Services, Himalaya Publishing House, Mumbai.
- Khan M. Y., Financial Services, Tata McGraw Hills, New Delhi.

14.12 Answer to Self-Assessment Questions

14.8.1 Operators, who want to transfer a risk component of their portfolio.

14.8.2 Four i.e., Interest rate swaps, Currency Swaps, Commodity swaps, Equity swaps.