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200233 - MERCHANT BANKING AND FINANCIAL SERVICES

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10233/12533 - MERCHANT BANKING AND FINANCIAL SERVICES

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1.1 INTRODUCTION

The term merchant banking is used differently in different countries and so there is no precise definition for it. In London, merchant banker refers to those who are members of British Merchant Banking and Securities House Association who carry on consultation, leasing, portfolio services, assets management, euro credit, loan syndication, etc. In America, merchant banking is concerned with mobilising savings of people and directing the funds to business enterprise.

DEFINITION

Merchant banking

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So, merchant banking may be defined as, 'an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance, etc.'

The Notification of the Ministry of Finance defines a merchant banker as, 'any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

Financial services

Financial services has also been called “Financial intermediation”. The 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 customer.And it is very vital for industry development. As well developed financial service industry is absolutely necessary to mobilize the saving to allocate them to various investable channels and there by to promote industrial development country.

1.2 ORIGIN OF MERCHANT BANKING

Merchant banking originated through the entering of London merchants in financing foreign trade through acceptance of bill. Later, the merchants assisted the government of underdeveloped countries in raising long-term funds through flotation of bonds in London money market. Over a period, they extended their activities to domestic business of syndication of long-term and short-term finance, underwriting of new issues, acting as registrars and share transfer agents, debenture trustees, portfolio managers, negotiating agents for mergers, takeover, etc. The post-war period witnessed the rapid growth of merchant banking through the innovative instrument like Euro, Dollar and the growth of various financial centers like Singapore, Hong Kong, Bahrain, Kuwait, Dubai, etc.

1.3 MERCHANT BANKING IN INDIA

In India prior to the enactment of Indian Companies Act, 1956, managing agents acted as issue houses for securities, evaluated project reports, planned capital structure and to some extent provided venture capital for new firms. Few share broking firms also functioned as merchant bankers.

The need for specialised merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The merchant banking services were started by foreign banks, namely the National Grindlays Bank in 1967 and the Citibank in 1970. The Banking Commission in its report in 1972 recommended the setting up of merchant banking institutions by commercial banks and financial institutions. This marked the beginning of specialised merchant banking in India.

To begin with, merchant banking services were offered along with other traditional banking services. In the mid-eighties, the Banking Regulations Act was amended permitting commercial banks to offer wide range of financial services through the subsidiary route. The State Bank of India was the first Indian Bank to set up Merchant Banking Division in 1972. Later ICICI set up its Merchant Banking Division followed by Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO Bank. The merchant banking gained prominence during 1983-84 due to new issue boom.

1.4 MERCHANT BANKS AND COMMERCIAL BANKS

There are differences in approach, attitude and areas of operations between commercial banks and merchant banks. The differences between merchant banks and commercial banks are summarised below:

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1. Commercial banks basically deal in debt and debt-related finance and their activitiesare appropriately arrayed around credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant bankers is 'equity and equity- related finance'. They deal with mainly funds raised through money market and capital market.

2. Commercial banks are asset-oriented and their lending decisions are based on detailed credit analysis of loan proposals and the value of security offered against loans. They generally avoid risks. The merchant bankers are management-oriented. They are willing to accept risks of business.

2. Commercial bankers aremerely financiers. The activities of merchant bankers includeproject counselling, corporate counselling in areas of capital restructuring, amalgamations, mergers, takeover, etc., discounting and rediscounting of short-term paper in money markets, managing, underwriting and supporting public issues in new issue market and acting as brokers and advisors on portfolio management in stock exchange. Merchant banking activities have impact on growth, stability and liquidity of money markets.

1.5 SERVICES OF MERCHANT BANKS(Development)

The financial institutions in India could not meet the demand for long-term funds required by the ever expanding industry and trade. The corporate sector enterprises, therefore, meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering multifarious services. The merchant bankers also advise the investors regarding incentives available in the form of tax reliefs and other statutory obligations.

The services of merchant bankers are described in detail in the following section.

1. Corporate Counseling

Corporate counselling covers the entire field of merchant banking activities, viz., project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit, etc. The scope of corporate counselling is limited to giving suggestions and opinions to the clients and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

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2. Project counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions The projects are appraised, as to the location, technical, commercial and financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

3. Loan syndication

Loan syndication refers to assistance rendered by merchant banks to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant Bankers help corporate clients to raise syndicated loans from commercial banks.

Merchant banks help clients approach financial institutions for term loans. The decision as to which financial institution should be approached depends on industry, location of the unit and size of project cost. The Merchant Bankers, first, make an appraisal of the project to satisfy that it is viable. The next step is designing capital structure, determining the promoter's contribution and arriving at a figure of approximate amount of term loan to be raised. The merchant banker has to ensure that the project adheres to the guidelines for financing industrial projects. After verifications that the project would be eligible for term loan, a preliminary meeting is fixed with financial institution. If the financial institution agrees to consider the proposal, the application is filled in and submitted along with other documents. The Merchant Bankers involvement enables the company to state that it has exercised due diligence in the exercise of obligations under various regulations.

4. Issue management

Management of issue involves marketing of corporate securities, viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided into pre-issue management and post-issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

The pre-issue management is divided into:

(i) Issue through prospectus, offer for sale and private placement.

(ii) Marketing and underwriting.

(iii) Pricing of Issues.

(i) Public issue through prospectus

(a) The most common method of public issue is through prospectus.

(b) Offers for sale are offers through the intermediary of issue house or firm of stock broker. The company sells the entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value.

(c) The direct sale of securities by a company to investors is called private placement. The investors include LIC, UTI, GlC, SFC, etc.

To bring out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the Companies Act and SEBI are furnished in the prospectus and get it vetted by reputed solicitor.

The copies of consent of experts, legal advisor, attorney, solicitor, bankers, bankers to the issue, brokers and underwriters are to be obtained from the company making the issue, to be filed along with prospectus to the Registrar of Companies. After the prospectus is ready, it has to be sent to SEBI for vetting. It is only after clearance by SEBI, the prospectus can be filed with the Registrar of Companies.

Brokers to the issue canvass subscription by mailing the literature to the clients undertaking wide publicity. Members of stock exchange are appointed as brokers to the issue.

Principal brokers, in addition to the functions of brokers assist merchant bankers to devise strategy for success of the public issue, keep liaison between merchant banker and stock exchanges and canvass support for the issue among stock brokers. Sometimes, they undertake centralised mailing of prospectus, application forms and other publicity material at the instant of the merchant banker.

Bankers to the issue accept applications along with subscriptions tendered at their designated branches and forward them to the Registrar.

The brokers to the issue, principal agent and bankers to the issue are appointed by merchant bankers.

(ii) Marketing

After despatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions.

Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the press, radio. TV, investors' conference, etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

The merchant banker's role is limited to deciding the number of copies to be printed, checking accuracy of statements made and ensure that the size of the application form and prospectus conform to the standard prescribed by the stock exchange. The merchant banker has to ensure that the material is delivered te the stock exchange at least 21 days before the issue opens and to brokers to the issue, branches of brokers to the issue and underwriters on time.

Security issues are underwritten to ensure that in case of under-subscription the issues are taken up by the underwriters. SEBI has made underwriting mandatory for issues to the public. The underwriting arrangement should be filed with the stock exchange. Particulars of underwriting arrangement should be mentioned in the prospectus.

The various activities connected with pre-issue management are a time- bound programme which has to be promptly attended to. The execution of the activities with clockwork efficiency would lead to a successful issue.

(iii) Pricing of issues

The SEBI Guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre-issue management.

An existing listed company and a new company set up by existing company with five- year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with two-and-a-half years track record of constant profitability an freely price the issue. The premium has to be decided after taking into account can net asset value, profit earning capacity and market price. Justification of price has to be stated and included in the prospectus.

(iv) Post-issue management

The post-issue management consists of collection of application forms and statement of account received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in post-issue management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the board, the auditor/ company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent within 70 days of the close of the issue. The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by coordinating the above activities.

(v) Underwriting of public issue

Underwriting is a guarantee given by the underwriter that in the event of undersubscription, the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of undersubscription. The issues packed by well- known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully underwritten. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5 per cent of the issue or 2.5 lakh whichever is less. Banks/merchant banking subsidiaries cannot underwrite more than 15 per cent of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

(vi) Managers, consultants or advisors to the issue

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies are free to appoint one or more agencies as managers to the issue. SEBI guide lines insist that all issues should be managed by at least one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over 100 crore, up to a maximum of four merchant bankers could be associated as managers.

5. Portfolio management

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Today, the investoris very prudent. Every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard. They have to conduct regular market and economic surveys to know:

(i) Monetary and fiscal policies of the government.

(ii) Financial statements of various corporate sectors in which the investments have to be made by the investors.

(iii) Secondary market position, i.e., how the share market is moving.

(iv) Changing pattern of the industry

(v) The competition faced by the industry with similar type of industries.

The merchant bankers have to analyse the surveys and help the prospective investors in choosing the shares. The portfolio managers generally will have to classify the investors based on capacity and risk; they can take and arrange appropriate investment. Thus, portfolio management plans successful investment strategies for investors.

The portfolio management service is very important need of the day since one-eighth of our investment at present comes from rural areas. Even though there are 23 stock exchanges in our country, 28 nationalised banks with network of about 50,000 branches, only one-eighth of the savings is mobilised from the rural areas. By establishing portfolio management centres at various areas, more investments can be augmented from villages. Instead of concentrating on large investors, there is immediate need to develop small investors which could be done through portfolio management.

The role which can be played by non-resident Indians in the economic development of a country is not small. With their technical skill and foreign exchange and also with their knowledge of foreign market, they can contribute much for the country. In order to utilise this opportunity, government is offering number of facilities and incentives. But the NRI investment is not showing any signs of substantial improvement for corporate sector. This is due to the NRJ accounts being scattered with various branches of banks throughout the country and no institution is taking action to pool these resources. The non-resident themselves for investment will have to follow many rules and regulations which are complicated. In this regard, merchant bankers should help the NRI in selecting right type of securities and offering expertise guidance in fulfilling government regulations. By this service to NRI accountholders, merchant bankers can mobilise more resources for the corporate sector.

6. Advisory service relating to mergers and takeovers

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert, they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

7.Off shore finance

The merchant bankers help their clients in the following areas involving foreign currency.

(i) Long-term foreign currency loans,

(ii) Joint venture abroad,

(iii) Financing exports and imports, and

(iv) Foreign collaboration arrangements.

The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

8. Non-resident investment

The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management, etc. They also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

1.6 PROCESS OF MERCHANT BANKING IN INDIA

Up to 1970, there were only two foreign banks which performed merchant banking operations in the country. SBI was the first Indian commercial bank ICICI the first financial institution to take up the activities in 1972 and 1973 respectively. As a result of buoyancy in the capital market in 1980s some commercial banks set up their subsidiaries to operate exclusively in merchant banking industry .In addition, a number of large stock broking firms and financial consultants also entered in to business. Thus, by the end of the 1980, there were 33 merchant bankers belonging to three major segments, *viz*., commercial banks, all India financial institutions, and private firms. Merchant banking functions of these institution was related only to management of new capital issues.

Merchant banking industry which remained almost stagnant and stereotyped for over two decades, witnessed an astonishing growth after the process of economic reforms and deregulation of Indian economy in 1991.The number of merchant banks increased to 115 by the end of 1992-93, 300 by the end of 1993-94 and 501 by end of august 1994.All merchant bankers registered with SEBI under four different categories include 50 commercial banks,6 all India financial institutions-ICICI,IFCI,IDBI,IRBI, tourism finance corporation of India ,Infrastructure Leasing and financial services Ltd., and private merchant bankers.

The number of registered intermediaries operating in India is shown in the following Table.

NOTES

REGISTERED INTERMEDIARIES OTHER THAN STOCK BROKERS AND SUB-BROKERS

Type of Intermediary	2015-2016	2016-2017
Registrar to issue and share transfer	71	73
Agents	189	189
Merchant bankers	2	2
DPs-NSDL	585	588
DPs-NSDL	7	7
Credit Rating Agency	62	64
Debenture Trustees	31	32
Debenture Trustees KYC (Know your client) Registration Agencies(KRA)	5	5

Source: SEBI Annual Report 2016-2017.

In addition to Indian merchant bankers, a large number of reputed international merchant bankers like Merrill lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming , Kleinwort Benson, etc., are operating in India under authorisation of SEBI. As a result of proliferation, Indian merchant bankers re faced with severe competition not only among themselves but also with the well- developed global players.

1.7 MAIN FUNCTIONS OF FINANCIAL SYSTEM:

- The financial system works as on effective conduit for optimum allocation of financial resource in an economy.
- It helps in establishing a link between the savers and investors.
- The financial system allows “asset-liability transformation” banks create a claims against themselves when they accept deposit from the customers then also creates assets they provide loans to clients.
- Economic resources(fund)are transferred from one party to another through financial system.
- The financial system ensures the efficient functioning of the payment mechanism in an economic.
- All transaction between the buyers and sellers of

goods and services are effected smoothly because of financial system.

NOTES

- The financial system helps in risk transformation by diversification as in case of mutual funds.
- The financial system enhances liquidly of financial clients.
- Financial system helps price discovery of financial assets resulting price from the interaction of buyers and sellers.
  Ex:

The prices of security are determined by demand and supply forces in the capital market.

- The Financial system helps reducing the cost of transaction.
- as discussed above the financial market play a significant role in economic growth through there role of allocation of capital, monetary managers, mobilizing savings and promoting technological changes among others.
- financial development can be designed as the ability of the financial sector acquired effectively information enforce contract, facilitate transaction and create incentives for the emergence of financial contracts, markets and intermediataries and all should be and low cost.
- the financial function or services may influences savings and investment decisions of an economic through capital accumulation and technological innovation and hence economic growth.

1.8 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT:

The financial system plays a significant role in the process economic development of a country. The financial system comprise of a network of commercial bank. Non banking companies development banks and other financial institutions of a varieties of financial product and services suit to the varied requirements of different category of people.

The economic growth in the following ways

1. Mobilizing savings
2. Promoting investments
3. Encouraging investments in financial assets
4. Allocating savings on the basis of national priorities.
5. Creating credit
6. Providing a spectrum of financial assets.
7. Financing trade, industry, and agriculture
8. Encouraging entrepreneurial talents.

9. Providing financial services.
10. Developing backward areas.

1.Mobilising savings:

The financial system mobilizes the savings of the people by offering appropriate incentives and by deepening and widening in the financial structure. In another words the financial systems creates varieties of forms of savings. So that savings can take place according to the varying asset preferences of different classes of savers.

2.Ppromoting investments:

For the economic growth of nation, investment is absolutely essential. The investments has to flow from the financial system.

Infact the levels of investment determines the increase in output o goods and services income in the countries. The investment which contribute positively economic power.

3. Encouraging investment in financial assets

The dynamic role of the financial system the economic development is that encourages savings to flow into financial assets. Such as money and monetary assets, physical assets land, gold & other goods & services.

4. Allocating savings on the basis of national priorities.

The larger the proportion of the financial assets, greater is the scope for economic growth of the allocating savings on the basis of national priority above all the financial system allocates the savings a more efficient manner so that the scarce capital may be more efficiently utilized among various alternative investments.

5. Creating credit:

Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash bur also in the form of created money (or) deposit money by creating credit and there by making available large resources to finance trade, production distribution etc.. on a large scale.

6. providing a spectrum of financial assets

The financial system provides a spectrum of financial assets. so,as to meet the varied requirements and preferences of households and there asset portfolios in such a way as to achieve a preferred mix of return, liquity and risk. Thus, with contributes to the economic development of the country.

7.financing trade, industry and agriculture

All the financial institution operating in a financial system take all efforts to ensure that no worth while project be with trade or agriculture or industries suffers due to lack of funds. Thus the promote industrial and agricultural development which have greater say on the economic development of a country.

8. encouraging entrepreneurial talents:

The financial institution encourage the managerial and entrepreneurial talents in the economy by promoting spirit of enterprise and risk title capacity. They also furnish necessary technical consultancy services to the entrepreneurs so that they may succeed in there innovative ventures.

9. providing financial services:

Sophistication and innovations now started appearing in the arena of financial intermediaries as well. The financial institution play a very dynamic role in the economic development of a country not only provided of finance but also offering verities of innovative financial product and services to meet the ever increasing demands both corporate and individuals.

10.developing backward areas

The integral policy of the national Government plans of every country concentrates on the development of relatively less developed areas called “Backward areas”. The financial institution provides a package of services, infrastructure in and incentives & conducive to a healthy growth of industries in such backward areas, the uniform development of all regions in a country

1.9 WEAKNESSES OF INDIAN FINANCIAL SYSTEMS:

After the introduction of planning rapid industrialization has taken place. It has in turn led to the growth at the corporate sector and the government sector. In order to meet the growing requirements of the Government and the industries many innovative financial instruments have been introduced.

The growth of the financial intermediatiaries to meet the ever growing financial requirements of different types of customers. Hence,the Indian financial system is more developed and integrated. Today, then what it was 50 years ago. yet it suffers from some weaknesses as listed.

1. Lack of co ordination between different financial institution.
2. Monopolistic market structures.
3. Dominance of development banks in industry financial.
4. In active and erratic capital market.
5. Imprudent financial practice.

Lack of coordination between different financial institution:

There are a large number of financial intermediataries.most of the vital financial institutions owned by the Government. At the same time the Government is also the controlling authority of these institution. In these circumstances the problem of coordination arises. As there is multiplicity of institution in the financial system, there is lack of coordination in the working in this institution.

Monopolistic market structure:

In india some financial institution are large that they have created a monopolistic market structures in the financial system.

For ex:

A major shares of life insurance business is in the hands of lic. the uti has more or less monopolistic the mutual fund industry.

The weakness of the large structure is would lead inefficiency in there working management or lack of referred in mobilizing savings of the public and so on.

Dominance of development bank in industry financial:

The development banks constitute the backbone of the Indian financial system occupying on important place in the capital market. The industry financing today in india is largely through the financial institution created by the Government both a national and regional levels. As such they fail to mobilize the savings of the puplic. However,reason times attempt are being made to raise funds from the public through the issue of bonds, unites and debentures and so on.

Inactive and errabic capital market:

The important functions of any capital market it should promote economic development through mobilization of savings and there distribution productive ventures. As for as industrial finance in india is concerned the corporate customers are able to raise there financial resources through development banks. so,they need not go to the capital market.

Moreover they do not resort to capital market since it is very erective and inactive.

Imprutent financial practice:

The dominance of development banks has developed imprudent financial practices among corporate customers. The development banks provide most of the funds in the form of termloan. When corporate enterprisesface any financial prises. These financial institution permit a greater use of debt then warranted. It is a against a traditional concept of a sound capital structure.

However,in recent times all efforts have been taken who activate the capital market. The integration is also taking place between the different financial institution.

The refinance and rediscounting facilities provided by the IDBI aim at integration. Thus the Indian financial system has become a developed one.

1.10 GUIDELINES FOR MERCHANT BANKERS

Merchant banking has been statutorily brought within the framework of the Securities and Exchange Board of India under SEBI (Merchant Bankers) Regulations, 1992.

1. In terms of the guidelines issued during April 1990, all merchant bankers will require authorisation by SEBI to carry-out business.

The criteria for authorisation include:

(i) Professional qualification in finance, law or business management;

(ii) Infrastructure like adequate office space, equipment and manpower;

(iii) Employment of two persons who have the experience to conduct business of merchant bankers;

(iv) Capital adequacy;

(v) Past track record, experience, general reputation and fairness in all transactions.

2. SEBI issued further guidelines classifying the merchant bankers into four categories based on the nature and range of activities and their responsibilities to SEBI investors and issuers of securities. SEBI has issued revised guidelines on December 22, 1992 classifying the activities of merchant hankers as follows:

The first category consists of merchant bankers who carry on any activity of issue management which will inter alia consists 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 and to act in the capacity of managers, advisor or consultant to an issue, portfolio manager and underwriter.

The second category consists of those authorised to act in the capacity of co manager/advisor, consultant, underwriter to an issue or portfolio manager.

The third category consists of those authorised to act as underwriter, advisor or consultant to an issue.

The fourth category consists of merchant bankers who act as advisor or consultant to an issue.

Minimum net worth for first category is 1 crore, second category 50 lakh, third category 20 lakh and fourth category is nil.

The above classification was valid up to December 1997 only.

3. An initial authorisation fee, an annual fee and renewal fee may be collected by SEBI

4. All issues must be managed at least by one authorised banker, functioning as the solemanager or the lead manager. Ordinarily, not more than two merchant bankers should be associated as lead managers. But, for issues over 100 crore and above, the number of lead managers may go upto a maximum of four. The specific responsibilities of each lead manager must be submitted to SEBI prior to the issue.

5. The lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or 25 lakh whichever is less.

6. Each merchant banker is required to furnish to the SEBI half-yearly unaudited financial results when required by it with a view to monitor the capital adequacy of the merchant banker.

7. SEBI has prescribed a code of conduct to the merchant bankers. The banker must perform his duties with highest standards of integrity and fairness in all his dealings. He will render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement. The merchant banker and his personnel will act in an ethical manner in all his dealings with the investors, clients and fellow bankers. All merchant bankers must adhere to the code of conduct.

8. The above guidelines will be administered by SEBI and it will supervise the activities of merchant bankers.

9. SEBI has been vested with power to suspend or cancel the authorisation in case of violation of the guidelines.

10. To ensure transparency and accountability in the operation of merchant bankers and to protect the investors, a number of obligations and responsibilities have been imposed on them. It has been decided to ask merchant bankers to enter into an agreement with corporate body setting out their mutual rights, liabilities and obligations relating to an issue particularly on disclosure, allotment and refund, maintenance of books of accounts and submission of half-yearly reports to SEBI.

11. Inspections will be conducted by SEBI to ensure that provisions of the regulations are properly complied with and to investigate the complaints from customers. It is obligatory on the part of merchant bankers to furnish all the details sought by the investigating team. The regulations, however, indicate that the board would give reasonable notice to merchant bankers before undertaking inspection. On the basis of inspection report, the board will communicate the contents of the report to the concerned merchant banker to give him/her an opportunity to put forth his/her submissions. On receipt of the explanations, if any, of the merchant bankers the SEBI would advise merchant bankers to take any measures that it may deem fit, and to comply with the provisions of the regulations.

The notification procedure relating to action to be initiated against merchant banks in case of default has been detailed out. The regulations empower SEBI to take action against defaulting banker such as suspension/cancellation of registration. In case of deliberate manipulation, or price rigging or cornering activities or deterioration in the financial position, the board is empowered to cancel the registration of the merchant banker. Under the regulation, the SEBI is empowered to suspend a registration of a member banker in case the merchant banker furnishes wrong or false information, fails to resolve the complaints of the investors, etc. The penalty or suspensation or cancellation of registration can be imposed by SEBI only after holding heard. Any merchant banker aggrieved by an enquiry and giving sufficient opportunity to the merchant banker of being an order of SEBI, can, however, appeal to the Union Government.

In September 1997, SEBI brought about some major changes in SEBI (Merchant Bankers) Rules and Regulation,1992. Accordingly, only corporate bodies will be allowed to function as merchant bankers. Moreover, the multiple categories of merchant bankers shall be abolished and there will be just one entity, *viz.*, Merchant banker. The merchant bankers presently functioning as merchant Bankers category II,III and IV shall have n option to either upgrade themselves as merchant Bankers (presently merchant banker category I) or seek separate registration as underwriters or portfolio managers under the respective regulations. The merchant bankers will be prohibited from carrying out fund- based activity other than those related ex from carrying out fund- based activity other than those related ex from carrying out fund- based activity other than those related exclusively to the capital markets .In effect, the activities undertaken by NBFCs such as accepting deposits, 1easing and bill discounting would not be undertaken by a merchant banker.

1.11 TERMINOLOGIES

1) Bank 2) Financial 3) Merchant4) System 5) Development 6) Market

1.12 MODEL QUESTIONS

1. Explain the Merchant Banking in India?
2. Explain the Process of Merchant banking in India?
3. Explain the Origin of Merchant Banking?
4. State the services of Merchant Banking?
5. Bringout the Financial System and Economic Development?

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UNIT- II ISSUE MANAGEMENT

Structure

2.1Introduction
2.2 Pre- issue Management
2.3 Post- issue Management
2.4 Merchant Bankers as Lead Manager
2.5 Duties and Responsibilities of Lead Managers
2.6 Qualities Required for Merchant Bankers
2.7 Terminologies
2.8 Model Questions
2.9 Reference Books

2.1 INTORDUCTION

Management of issue involves marketing of corporate securities, viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided into pre-issue management and post-issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

2.1 PRE-ISSUE MANAGEMENT

(i) Issue through prospectus, offer for sale and private placement.
(ii) Marketing and underwriting.

(iii) Pricing of Issues.

(i) Issue through prospectus

(a) The most common method of public issue is through prospectus.

(b) Offers for sale are offers through the intermediary of issue house or firm of stock broker. The company sells the entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value.

(c) The direct sale of securities by a company to investors is called private placement. The investors include LIC, UTI, GlC, SFC, etc.

To bring out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the Companies Act and SEBI are furnished in the prospectus and get it vetted by reputed solicitor.

The copies of consent of experts, legal advisor, attorney, solicitor, bankers, bankers to the issue, brokers and underwriters are to be obtained from the company making the issue, to be filed along with prospectus to the Registrar of Companies. After the prospectus is ready, it has to be sent to SEBI for vetting. It is only after clearance by SEBI, the prospectus can be filed with the Registrar of Companies.

Brokers to the issue canvass subscription by mailing the literature to the clients undertaking wide publicity. Members of stock exchange are appointed as brokers to the issue.

Principal brokers, in addition to the functions of brokers assist merchant bankers to devise strategy for success of the public issue, keep liaison between merchant banker and stock exchanges and canvass support for the issue among stock brokers. Sometimes, they undertake centralised mailing of prospectus, application forms and other publicity material at the instant of the merchant banker.

Bankers to the issue accept applications along with subscriptions tendered at their designated branches and forward them to the Registrar.

The brokers to the issue, principal agent and bankers to the issue are appointed by merchant bankers.

(ii) Marketing

After dispatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalize arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions.

Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the press, radio. TV, investors' conference, etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

The merchant banker's role is limited to deciding the number of copies to be printed, checking accuracy of statements made and ensure that the size of the application form and prospectus conform to the standard prescribed by the stock exchange. The merchant banker has to ensure that the material is delivered te the stock exchange at least 21 days before the issue opens and to brokers to the issue, branches of brokers to the issue and underwriters on time.

Security issues are underwritten to ensure that in case of under-subscription the issues are taken up by the underwriters. SEBI has made underwriting mandatory for issues to the public. The underwriting arrangement should be filed with the stock exchange. Particulars of underwriting arrangement should be mentioned in the prospectus.

The various activities connected with pre-issue management are a time- bound programme which has to be promptly attended to. The execution of the activities with clockwork efficiency would lead to a successful issue.

(iii) Pricing of issues

The SEBI Guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre-issue management.

An existing listed company and a new company set up by existing company with five- year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with two-and-a-half years track record of constant profitability an freely price the issue. The premium has to be decided after taking into account can net asset value, profit earning capacity and market price. Justification of price has to be stated and included in the prospectus.

(iv) Post-issue management

The post-issue management consists of collection of application forms and statement of account received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in post-issue management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the board, the auditor/ company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent within 70 days of the close of the issue. The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by coordinating the above activities.

(v) Underwriting of public issue

Underwriting is a guarantee given by the underwriter that in the event of under subscription, the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well- known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully underwritten. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5 per cent of the issue or 2.5 lakh whichever is less. Banks/merchant banking subsidiaries cannot underwrite more than 15 per cent of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

(vi) Managers, consultants or advisors to the issue

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies are free to appoint one or more agencies as managers to the issue. SEBI guide lines insist that all issues should be managed by at least one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over 100 crore, up to a maximum of four merchant bankers could be associated as managers.

2.3 POST-ISSUE MANAGEMENT

The post-issue management consists of collection of application forms and statement of account received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in post-issue management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the board, the auditor/ company secretary has to certify that the allotment has been made by the company as per the basis of allotment

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approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent within 70 days of the close of the issue. The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by coordinating the above activities.

3.4 MERCHANT BANKERS AS LEAD MANAGERS

As per SEBI guidelines, it is mandatory that all public issues should be managed by merchant bankers in the capacity of lead managers. Only in the case of right issues not exceeding 50 lakh, such an obligation is not necessary. The number of lead managers to be appointed by a company depends upon the size of the issue as shown below

APPOINTMENT OF LEAD MANAGERS

Sl. No.	Size of the Issue	Maximum Number of Lead Managers
1	Less than50 crore	2
2	50 crore to100 crore	3
3	100 crore to 200 crore	**4**
4	200 crore to 400 crore	**5**
5	Above 400 crore	**5** or more asprescribed by SEBI

2.5 DUTIES AND RESPONSIBILITIES OF LEAD MANAGERS

The most important aspect of merchant banking business is to function as lead managers to the issue management. As lead managers, they have to exercise reasonable care and diligence in issue management by paying attention to the following:

(i) It is the duty of every lead manager to enter into an agreement with the issuing companies stating the details regarding their responsibilities, liabilities, mutual rights, functions, disclosures, refund, allotment, etc. A copy of this agreement should be submitted to the SEBI at least one month before the opening of the issue for subscription.

(ii) One merchant banker cannot have association with another merchant banker whodoes not hold a certificate of registration with the SEBI.

(iii) Similarly, a lead manager cannot undertake the work of issue management if the issuing company is its associate.

(iv) In case there are more than one lead managers to an issue, the responsibilites of each of them should be clearly defined in the agreement.

(v) A lead manager is under an obligation to accept a minimum underwriting obligation of 5 per cent of the total underwriting commission or 25 lakh whichever is less. If he is not able to comply with the above provision, it is his duty to make managements with another merchant banker associated with that issue to underwrite the said amount. Of course, it must be duly intimated to the SEBI.

(vi) A lead manager has to exercise due care and diligence in the verification of prospectus or letter of offer.

(vii) He has to submit due diligence certificate rating that the prospectus or letter of offer is in conformity with the documents relevant to the issue, the disclosures are true, fair and adequate and all legal requirements connected with the issue have been duly complied with.

(viii) Every lead manager has to submit all the particulars of an issue, draft prospectus or letter of offer, etc., to the SEBI at least two weeks before the date of filing with the Registrar of Companies or regional stock exchanges or both.

(ix) In case of any suggestions or modifications given by the SEBI, he has to ensure that they are properly incorporated in the appropriate areas.

x) In the case of development, the lead manager has to ensure the collection of the specified amount from the underwriters.

(xi) Every lead manager is responsible for ensuring timely refund of excess application money received from the applicants.

(xii) It is his duty to mail the share/debenture certificate immediately on allotment or inform it to the depository participant.

2.6 QUALITIES REQUIRED FOR MERCHANT BANKERS

Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures. They help promotion of the enterprise by undertaking various activities such as market surveys, choice of suitable location and its size, preparation of documents and obtaining consent from various authorities. They help in taking important decisions such as financing mix, management of public issues, credit syndication, etc. The success of the merchant bankers depends on the quality of service and soundness of advice to clients. To perform these services effectively, the merchant bankers are expected to possess certain qualities which are described below:

1. Ability to analyse various aspects such as technical, financial and economic aspects concerning the formation of an industrial project.

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2. Knowledge about the various aspects of capital markets, trends in stock exchange, psychology of investing public, change in the economic and technological environment in the country.

3. Ability to build-up the bank-client relationship and live up to the clients' expectations with total involvement in the project assigned to them.

4. Innovative approach in developing capital market instruments to satisfy the ever- changing needs of investing public.

5. Integrity and maintenance of high professional standards are the essential requisites for the success of merchant bankers in the present scenario.

2.7 TERMINOLOGIES

1) Issue Management2)Pre-issue 3) Post- issue 4)Activities 5) Merchant Banks

2.8 MODEL QUESTIONS

1. Explain the Pre- issue Management?
2. State the Post- issue Management?
3. Bring out the Merchant Bankers as Lead Manager?
4. Explain the Duties and Responsibilities of Lead Managers?
5. Explain the Qualities Required for Merchant Bankers?

2.9 REFERENCE BOOKS

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UNIT- III UNDERWRITING AND BROKERAGE

Structure

3.1 Introduction
3.2Different Roles played by Underwriters
3.3 Advantages of Underwriting
3.4 Underwriters in India may be classified into two categories
3.5 Methods of floating New issues
3.6 Distinction between public offer and offer for sale on stock exchange
3.7 General guidelines for New issues
3.8 Terminologies
3.9 Model Questions
3.10 Reference Books

3.1 INTRODUCTION

Underwriting is an agreement, whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

3.2 DIFFERENT ROLES PLAYED BY UNDERWRITERS

An underwriting agreement may take any of the following three forms:

(i) Standing behind the issue: Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public do not subscribe to the specified amount of issue, the underwriter buys the balance in the issue.

(ii) Outright purchase: The underwriter, in this method, makes outright purchase of shares and resells them to the investors.

(iii) Consortium method: Underwriting is jointly done by a group of underwriters in this method. The underwriters form a syndicate for this purpose. This method is adopted for large issues.

3.3 ADVANTAGES OF UNDERWRITING

Underwriting assumes great significance as it offers the following advantages to the issuing company

1. The issuing company is relieved from the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.

2. The company is assured of getting the minimum subscription within the stipulated time, a statutory obligation to be fulfilled by the issuing company.

2. Underwriters undertake the burden of highly specialised function of distributing securities.

4. They provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued, etc.

5. public confidence on the issue is enhanced when underwriting is done by reputed underwriters.

3.4 UNDERWRITERS IN INDIA MAY BE CLASSIFIED INTO TWO CATEGORIES:

I) Institutional underwriters.
II) Non-institutional underwriters.

I) The institutional underwriters are:

(a) Life Insurance Corporation of India (LIC), (b) Unit Trust of India (UTI), (c) Industrial Development Bank of India (IDBI),(d) Industrial Credit and Investment Corporation of India (ICICI), (e) Commercial Banks and General Insurance Companies. The pattern of underwriting of the above institutional underwriters differ vastly in India. LIC and UTI have purchased industrial securities from the new issue market with a view to holding them on their own portfolio. They have a preference for underwriting shares in large and well established firms. The development banks have given special attention to the issues in backward states and industries in the priority list. The thrust of the development banks is also towards small and new issues which do not have adequate support from other institutions. General insurance companies have shown preference in underwriting the securities of fairly new issues.

II) Non-Institutional Underwriters Are Brokers.

They guarantee shares only with a view to earning commission from the company floating the issue. They are known to off-load the shares later to make a profit. The brokers work with profit motive in underwriting industrial securities. After the elimination of forward trading, stock exchange brokers have begun to take an underwriting business. The percentage of securities underwritten to the total private capital between 72 per cent and 97 per cent.

3.5 METHODS OF FLOATING NEW ISSUES

The various methods which are used in the floatation of securities in the new issue market are:
(i) Public issues.

(ii) Offer for sale.

(iii) Placement.

(iv) Rights issues.

Public issues

Under this method, the issuing company directly offers to the general public/institutions a fixed number of shares at a stated price through a document called prospectus. This is the most ommon method followed by joint stock companies to raise capital through the issue of securities. The prospectus must state the following:

1. Name of the company.

2. Address of the registered office of the company.

3. Existing and proposed activities.

4. Location of the industry.

5. Names of directors.

6 Authorised and proposed issue capital to the public.

7, Dates of opening and closing the subscription list.

8. Minimum subscription.

9. Names of brokers/underwriters/bankers/managers and registrars to the issue.

10. A statement by the company that it will apply to stock exchange for quotations

of its shares.

According to the Companies Act, 1956, every application form must be accompanied by a prospectus. Now, it is no longer necessary to furnish a copy of the prospectus along with every application form as per the Companies Amendment Act, 1988. Now, an abridged prospectus, is being annexed to every share application form.

Merits

1. Sale through prospectus has the advantage of inviting a large section of the investing public through advertisement.

2. It is a direct method and no intermediaries are involved in it.

3. Shares, under this method, are allotted to a large section of investors on a non-discriminatory basis. This procedure helps in wide dispersion of shares and to avoid concentration of wealth in few hands.

Demerits

1. It is an expensive method. The company has to incur expenses on printing of prospectus, advertisement, bank's commission, underwriting commission, legal charges, stamp duty, listing fee and registration charges.

2. This method is suitable only for large issues.

Offer for sale

The method of offer of sale consists in outright sale of securities through the intermediary of issue houses or share brokers. In other words, the shares are not offered to the public directly. This method consists of two stages: The first stage is a direct sale by the issuing company to the issue house and brokers at an agreed price. In the second stage, the intermediaries resell the above securities to the ultimate investors. The issue houses or stock brokers purchase the securities at a negotiated price and resell at a higher price. The difference in the purchase and sale price is called turn or spread. It is otherwise called Bought Out Deals (BOD).

Let us take a simple example. X, a small company has a turnover of 2 crore a year. It requires additional funding of 8 crore to expand its capacity. The merchant banker sees potential business for the company. He asks the promoters of the company to sell 8 lakh shares of its capital to it. The company gets 8 crore to expand its business. The merchant banker/issue house is now holding 80 per cent of the company's entire capital. In 12 month's time the company expanded its operations marketed its products successfully and earned sufficient profit. Now, the issue house decides to off-load the 80 per cent capital to the public at a premium of 30 per share. In a period of 18 months, the merchant bank/issue house has earned a profit of 2.4crore.

Advantages

Bought out deal enables an issuer with good project to obtain funds with a minimum cost without the fear of under subscription. The intermediary, i.e., merchant bankers/issue house get higher return than the conventional merchant banking services.

Indian bank Merchant Banking had gone in for a buyout agreement with Madhya Pradesh based distillery to buy shares worth 2.5 crore each at60. After six months, the shares were sold at 71.50 per share with a assured return of 38.33 per cent for the sponsor.

The advantage of this method is that the company is relieved from the problem of printing and advertisement of prospectus and making allotment of shares. Offer for sale is not common in India. This method is used generally in two instances:

(i) Offer by a foreign company of a part of it to Indian investors.

(ii) Promoters diluting their stake to comply with requirements of stock exchange at the time of listing of shares.

Placement

Under this method, the issue houses or brokers buy the securities outright with the intention of placing them with their clients afterwards. Here, the brokers act as almost wholesalers selling them in retail to the public. The brokers would make profit in the process of reselling to the public. The issue houses or brokers maintain their own list of clients and through customer contact sell the securities. There is no need for a formal prospectus as well as underwriting agreement.

Advantages

1. Timing of issue is important for successful floatation of shares. In a depressed market conditions when the issues are not likely to get public response through prospectus placement method is a useful method of floatation of shares.

2. This method is suitable when small companies issue their shares.

3. It avoids delays involved in public issue and it also reduces the expenses involved in public issue.

4. There are no entry barriers for a company to access the private placement market. This route is also available to unlisted and closely held public companies.

5. A private placement deal can be successfully executed much faster than a public offering. The procedural formalities for a private placement are minimal. A private placement deal can be successfully closed in 4 to 6 weeks.

6. There is greater flexibility in the working out the terms of the issue. The issues deals with only a few institutional investors and hence renegotiating the terms of issue is easy.

7 .This method is also suitable to first generation entrepreneurs who are less known to the public which makes the public issue less successful.

8. The issue expenses in case of private placement is low. The absence of several statutory and non-statutory expenses associated with underwriting, brokerage, printing, promotion, etc., makes the transaction cost of private placement approximately to 2 per cent of the total cost of issue.

The main disadvantage of this method is that the securities are not widely distributed to the large section of investors. A selected group of small investors are able to buy a large number of shares and get majority holding in a company.

This method of private placement is used to a limited extent in India. The promoters sell the shares to their friends, relatives and well-wishers to get minimum subscription which is a precondition for issue of shares to the public.

Rights issue

Rights issue is a method of raising funds in the market by an existing company.

A right means an option to buy certain securities at a certain privileged price within a certain specified period. Shares, so offered to the existing shareholders are called rights shares.

Rights shares are offered to the existing shareholders in a particular proportion to their existing share ownership. The ratio in which the new shares or debentures are offered to the existing share capital would depend upon the requirement of capital. The rights themselves are transferable and saleable in the market.

Section 81 of the Companies Act deals with rights issue. According to this section, where a company increases its subscribed capital by the issue of new shares either after two years of its formation or after one year of its first issue of share whichever is earlier, these have to be first offered to the existing shareholders with the right to reserve them in favour of a nominee.

A company issuing rights is required to send a circular to all existing shareholders. The circular should provide information on how additional funds would be used and their effect on the earning capacity of the company. The company should normally give a time limit of at least one month to two months to shareholders to exercise their rights. If the rights are not fully taken up, the balance is to be equitably distributed among the applicants for additional shares. Any balance still left over may be disposed of in the market in a way which is most beneficial to the company.

Advantages

1. The cost of issue is minimum. There is no underwriting, brokerage, advertising and printing of prospectus expenses.

2. It ensures equitable distribution of shares to all existing shareholders and so control of company remains undisturbed as proportionate ownership in the company remains the same.

3. It prevents the directors from issuing new shares in their own name or to their relatives at a lower price and get controlling right.

Auction based offer-for-sale

The SEBI has introduced a new 'Auction based offer-for-sale' method to allow promoters in leading listed companies to off-load small trenches of their shares through a fast-tracked offer made via the stock exchanges. Under this method, the issuer has to simply auction shares at different prices subject to a floor, with the flexibility to allocate additional shares to investors

placing higher bids. It does not require any reservation for retail investors, tedious process of preparing a red-herring prospectors, fixing a price brand mandatory for public offers and hiring investment bankers which are normal under book-building route. It is very much preferable to other options such as getting these companies to buyback only the shares of the government or draining them of their cash hoard through hefty divided payouts. This new method can be quickly executed at minimal cost, while allowing limited opportunity for speculation in the secondary market.

3.6 DISTINCTION BETWEEN PUBLIC OFFER AND OFFER-FOR-SALE ON STOCK EXCHANGES

The conventional method, i.e., follow on public offer is different from 'offer-for-sale on stock exchange' or 'auction method' in the following ways:

SL No.	Follow-on public offer	Offer-for-sale on stock exchange
1.	One has to comply with an elaborate process with lot of documentations.	The process is very simple requiring less than one week and the duration of offer for sale will not exceed one trading day.
2.	It requires filling of the requisite number of independent directors with the regulators.	No such filings is required.
3.	There is overhand of extra liquidity into the market through FPO.	Since the process is very short there is no overhand, no hammering of shares in the secondary market.
4	Allotment is made at one price on proportionate basis.	Allotment is made on price priority or at one proportionate basis.
5.	Institutional investors can not get huge chunk of shares despite their willingness.	A minimum of 25 per cent is reserved for mutual funds, insurance companies. One fund or an insurance company may get the entire 25 per cent.

3.7 GENERAL GUIDELINES FOR NEW ISSUE

All issues by a new company have to be made at par and for existing companies the issue price should be justified as per Malegam Committee's recommendations which are as follows:

The issue price should be justified by:

(i) The Earnings Per Share (EPS) for the last three years and comparison of pre-issue price to earnings ratio to the Price to Earnings (P/E) of the industry.

(ii) The latest Net Asset Value (NAV).

(iii) The minimum return on increased net worth to maintain pre-issue EPS. A company may also raise funds from the international markets by issuing Global Depository Receipts (GDRs) and American Depository Receipts (ADRS).

The SEBI does not play any role in price fixation. In fact, the issuers in consultation with the merchant bankers will decide the price. However, they are required to give full disclosures of the parameters which they had considered while deciding the issue price. In actual practice, there are two types of issue pricing namely:

(i) In the first type, the company and the lead manager fix the price which is called fixed price.

(ii) In the second type, the company and the lead manager stipulate a floor price or a price band and leave it to market forces to determine the final price which is called book building price.

3.8 TERMINOLOGIES

1) Underwriting 2) Unit 3) Agents 4) Issue 5) Management

3.9 MODEL QUESTIONS

1. What are the Advantages of Underwriting?
2. Explain the Underwriters in India may be classified into two categories?
3. Explain the Methods of floating New issues?
4. Distinction between public offer and offer for sale on stock exchange?
5. Bring our the General guidelines for New issues?

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UNIT –IV RAISING CAPITAL

Structure

4.1 Introduction
4.2 Raising Capital from International Markets
4.3 Sources of funding are available to Companies
4.4 Different types of Foreign Bonds
4.5 Evaluation - American Depository Receipts
4.6 Evaluation – Global Depository Receipts
4.7 Evaluation – Foreign Currency Convertible Bond(FCCB)
4.8 Evaluation – Foreign Currency Exchangeable bonds
4.9 FCCB vs. FCEB
4.10 Terminologies
4.11 Model Questions
4.12 Reference Books

4.1 INTRODUCTION

Corporations often need to raise external funding, or capital funding, to expand their businesses into new markets or locations, to invest in research & development, or to fend off the competition. And, while companies do aim to use the profits from ongoing business operations to fund such projects, it is often more favorable to seek external lenders or investors. Despite all the differences among the thousands of companies in the world across various industry sectors, there are only a few sources of funds available to all firms.

4.2 RAISING CAPITAL FROM INTERNATIONAL MARKETS

1. Retained Earnings

Companies exist to make a profit by selling a product or service for more than it costs to produce. This is the most basic source of funds for any company and hopefully the method that brings in the most money, and is known as retained earnings. These funds can be used to reward shareholders in the form of dividend payments or share buybacks, but are also used to invest in projects and grow the business.

2. Debt Capital

Like individuals, companies can and borrow money. This can be done privately through bank loans, or it can be done publicly through a debt issue. These debt issues are known as corporate bonds, which allows a wide number of investors to become lenders (or creditors) to the company. The drawback of borrowing money is the interest that must be paid to the lender, where a failure to pay interest or repay the principal can result in default or bankruptcy. But, the interest paid on debt is typically tax-deductible and costs less than other sources of capital.

3. Equity Capital

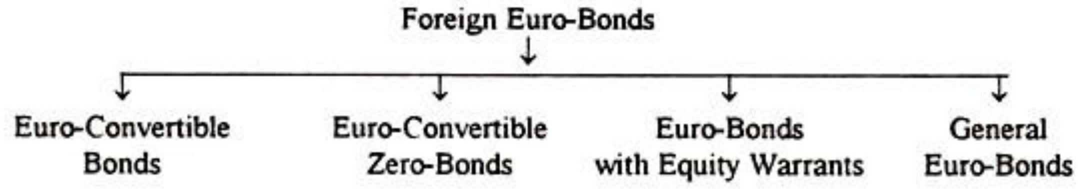
A company can generate money by selling part of itself in the form of shares to investors, which is known as equity funding. The benefit of this is that investors do not require interest payments like bondholders do. The drawback is that further profits are divided among all shareholders. Furthermore, shareholders of equity have voting rights, which means that a company forfeits or dilutes some of its ownership control as it sells off more shares.

4.3 SOURCES OF FUNDING ARE AVAILABLE TO COMPANIES

In an ideal world, a company would bring in all of its cash simply by selling goods and services for a profit. But, as the old saying goes, "you have to spend money to make money," and just about every company has to raise funds at some point to develop products and expand into new markets.

When evaluating companies, it is most important to look at the balance of the major sources of funding. For example, too much debt can get a company into trouble. On the other hand, a company might be missing growth prospects if it doesn't use money it can borrow. Financial analysts and investors often compute the weighted average cost of capital(WACC) to figure out how much a company is paying on its combined sources of financing.

4.4 DIFFERENT TYPES OF FOREIGN BONDS



They are explained as under:

Euro – Convertible Bonds:
We know that a convertible bond is a debt instrument that provides the holder of the bond an option to convert the bond into equity shares of the company. Normally, at the time of conversion, the price of the equity shares is inclusive of certain premium money although the bonds carry fixed percentage of interest. Now, the bonds may contain two options, of course, if the issuer company so desires.

They are:

(i) Call options (or Issuer's option) and

(ii) Put options.

(i) Call options:
The issuer company has the option of calling the bonds for redemption before its maturity date if the terms of the bond contain such a call provision. But if it found that the issuer s share price has largely increased, the company can exercise such option. Practically, it induces the investors to convert their bonds into equity shares.

(ii) Put options:
It provides the holder of the bonds a right to sell his bonds back to the issuer company at a pre-determine rate price, e.g. : the payment (for redemption of the bonds along with the amount of interest) must be made in U.S. dollars in the case of Euro-Convertible Bonds. From latter half of 1994, Indian companies find their interest very much at Euro-Convertible Bonds instead of GDRs.

Euro-Convertible Zero-Bonds:
These bonds also are similar to convertible bonds. Interest is not paid on the bonds. At the same time conversion of bonds is made on marketing at pre-determined price. Normally the period of maturity is taken for 5 years.

Euro-Bonds with Equity Warrants:
These bonds contain a coupon rate/prices which has been determined by the market rate/ price. Pure bonds are transacted at a discount. The investors who prefer to create a fixed income funds may use these bonus for their purposes.

General Euro-Bonds:
It has already been explained that bonds are debt instruments. Thus a plain Euro-Bond is also a debt instrument. Investor who wants to invest his investment for the purpose of adding/increasing his investments do not prefer it.

4.5 EVALUATION OF VARIOUS TYPES OF DEPOSITORY RECEIPTS

AMERICAN DEPOSITORY RECEIPT (ADR)

American Depository Receipt (ADR) is a certified negotiable instrument issued by an American bank suggesting the number of shares of a foreign company that can be traded in U.S. financial markets.

American Depository Receipts provide US investors with an opportunity to trade in shares of a foreign company. When the ADRs did not exist, it was very difficult for an American investor to trade in shares of foreign companies as they had to go through many rules and regulation. To ease such hardship faced by American investors, the regulatory body Securities Exchange Commission (SEC) introduced the concept of ADR which made it easier for an American investor to trade in shares of foreign companies. **American depository receipt fee** varies from one cent to three cents per share depending upon the ADR amount and its timing.

AMERICAN DEPOSITORY RECEIPT (ADR) EXAMPLE

Volkswagen, a German company trades on New York Stock Exchange. The investor in America can easily invest into the German company, through the stock exchange. Volkswagen is listed on the American stock exchange after complying the required laws. On other hand if the shares of Volkswagen are listed in stock markets of countries other than US then it is termed as GDR.

AMERICAN DEPOSITORY RECEIPT (ADR) PROCESS

- The domestic company, already listed in its local stock exchange, sells its shares in bulk to a U.S. bank to get itself listed on U.S. exchange.
- The U.S. bank accepts the shares of the issuing company. The bank keeps the shares in its security and issues certificates (ADRs) to the interested investors through the exchange.
- Investors set the price of the ADRs through bidding process in U.S. dollars. The buying and selling in ADR shares by the investors is possible only after the major U.S. stock exchange lists the bank certificates for trading.
- The U.S. stock exchange is regulated by Securities Exchange Commission, which keeps a check on necessary compliances that need to be complied by the foreign company.

ADVANTAGES OF AMERICAN DEPOSITORY RECEIPT (ADR)

- The American investor can invest in foreign companies which can fetch him higher returns.
- The companies located in foreign countries can get registered on American Stock Exchange and have its shares trades in two different countries.
- The benefit of currency fluctuation can be availed.
- It is an easier way to invest in foreign companies as there are no restrictions to invest in ADR.
- ADR simplifies tax calculations. Trading in shares of foreign company in ADR would lead to tax under US jurisdiction and not in the home country of company.
- The pricing of shares of foreign companies in ADR is generally cheaper. Hence it provides additional benefit to investors.

DISADVANTAGES OF AMERICAN DEPOSITORY RECEIPT (ADR)

The following are the disadvantages of American Depository Receipts:

- Even though the transactions in ADR take place in US dollars, still they are exposed to the risk associated with foreign exchange fluctuation.

- The number of options to invest in foreign companies is limited. Only a few companies feel the necessity to register themselves through ADR. This limits the choice available to US investor to invest.
- The investment in companies opting for ADR often becomes illiquid as an investor needs to hold the shares for the long term to generate good returns.
- The charges for the entire process of ADR are mostly transferred on investors by foreign[1]companies.
- Any violation of compliance can lead to strict action by the Securities Exchange Commission.

Conclusion

ADRs provide the US investors with ability to trade in foreign companies shares. ADR makes it easier and convenient for the domestic investors in US to trade in foreign companies shares. ADR provides the investors an opportunity to diversify their portfolio by investing in companies which are not located in America. This eventually leads to investors investing in companies located in emerging markets, thereby leading to profit maximization for investors.

4.6 EVALUATION OF GLOBAL DEPOSITORY RECEIPT

Global depository receipt (GDR and sometimes spelled depositary) is a general name for a depository receipt where a certificate issued by a depositorybank, which purchases shares of foreign companies, creates a security on a local exchange backed by those shares.

DEFINITION OF GLOBAL DEPOSITORY RECEIPT

Global Depository Receipt (GDR) is an instrument in which a company located in domestic country issues one or more of its shares or convertibles bonds outside the domestic country. In GDR, an overseas depository bank i.e. bank outside the domestic territory of a company, issues shares of the company to residents outside the domestic territory. Such shares are in the form of depository receipt or certificate created by overseas the depository bank.

Issue of Global Depository Receipt is one of the most popular ways to tap the global equity markets. A company can raise foreign currency funds by issuing equity shares in a foreign country.

GLOBAL DEPOSITORY RECEIPT EXAMPLE

A company based in USA, willing to get its stock listed on German stock exchange can do so with the help of GDR. The US based company shall enter into an agreement with the German depository bank, who shall issue shares to residents based in Germany after getting instructions from the domestic custodian of the company. The shares are issued after compliance of law in both the countries.

GLOBAL DEPOSITORY RECEIPT MECHANISM

- The domestic company enters into an agreement with the overseas depository bank for the purpose of issue of GDR.
- The overseas depository bank then enters into a custodian agreement with the domestic custodian of such company.
- The domestic custodian holds the equity shares of the company.
- On the instruction of domestic custodian, the overseas depository bank issues shares to foreign investors.
- The whole process is carried out under strict guidelines.
- GDRs are usually denominated in U.S. dollars

advantages of GDR

The following are the advantages of Global Depository Receipts:

- GDR provides access to foreign capital markets.
- A company can get itself registered on an overseas stock exchange or over the counter and its shares can be traded in more than one currency.
- GDR expands the global presence of the company which helps in getting international attention and coverage.
- GDR are liquid in nature as they are based on demand and supply which can be regulated.
- The valuation of shares in the domestic market increase, on listing in the international market.
- With GDR, the non-residents can invest in shares of the foreign company.
- GDR can be freely transferred.
- Foreign Institutional investors can buy the shares of company issuing GDR in their country even if they are restricted to buy shares of foreign company.
- GDR increases the shareholders base of the company.
- GDR saves the taxes of an investor. An investor would need to pay tax if he purchases shares in the foreign company, whereas in GDR same is not the case.

disadvantages

Violating any regulation can lead to serious consequences against the company.

- Dividends are paid in domestic country's currency which is subject to volatility in the forex market.
- It is mostly beneficial to High Net-Worth Individual (HNI) investors due to their capacity to invest high amount in GDR.
- GDR is one of the expensive sources of finance.

Characteristics

1. it is an unsecured security
2. it may be converted into number of shares
3. interest and redemption price is public in foreign agency
4. it is listed and traded in the stock exchange

usage

If for example an Indian company which has issued ADRs in the American market wishes to further extend it to other developed and advanced countries such as in Europe, then they can sell these ADRs to the public of Europe and the same would be named as GDR. GDR can be issued in more than one country and can be denominated in any freely convertible currency.

Conclusion

GDR is now one of most important source of finance in today's world. With globalization, every company is willing to expand its wings. GDR makes it possible for such companies to reach and tap international markets. GDR provides companies in emerging markets with opportunities for rapid growth and development.

4.7 EVALUATION OF FOREIGN CURRENCY CONVERTIBLE BOND (FCCB)

Foreign currency convertible bond is a special type of bond issued in the currency other than the home currency. In other words, companies issue foreign currency convertible bonds to raise money in foreign currency.

In today's scenario of globalization, FCCBs hold high significance especially for multi-national companies wherein they are constantly dealing with different currencies of the world. Let us look at some peculiar features of FCCBs that make them a luring investment option for investors.

FEATURES OF FCCBS

- Like any other type of bond, an FCCB makes regular coupon and principal payments till a certain date, after which it can be converted into equity.
- FCCBs retain all the features of a convertible bond and hence remain attractive to both issuers and investors.
- Another attractive feature of FCCBs is that these are equity-linked debt securities which give the holder the right to convert the bond into equity or a depository receipt (DR) after a certain period of time.
- FCCBs are tradable on the stock exchange.
- Like any other debt raising instrument, FCCBs appear on the liabilities side of the balance sheetof the company issuing them.

Let us look at the merits and demerits of FCCB to understand this investment option in detail.

ADVANTAGES OF FCCB

- FCCBs issuance allows companies to raise money outside the home country there by enabling tapping new markets for investment options
- FCCBs are generally issued by companies in the currency of those countries where interest rates are usually lower than the home country or the foreign country economy is more stable than the home country economy.
- FCCB holders may choose to convert the bonds into equity to benefit out of the equity price appreciation that may have taken place.

  - FCCB holders enjoy the safety of guaranteed payments on the bond and may opt to continue with the bond if equity or depository receipt if conversion isn't more beneficial.
- Since these bonds come with an advantage to the bond holder, the coupon payments on these bonds are usually lower than a straight coupon bearing plain vanilla bond. This helps the issuer to reduce the cost of borrowing.
- Exchange rate fluctuations in favour of the issuer can further reduce the cost of debt capital.
- The conversion of FCCBs into equity usually happens at a price already decided at the time of issuance and is usually at a premium, so dilution of the company is lower.

DISADVANTAGES OF FCCB

- Companies that borrow funds via FCCB in foreign currency shall have to make the repayment in foreign currency on the maturity of the bond. The exchange rate prevailing on the day of maturity, if has moved considerably as compared to the rate prevailing on the day of the borrowing, may result in losses for the company. The exchange rate in a volatile scenario may cause cash outflows on repayment to be much higher than the saving in the interest rate. Thus, a cost-saving motive may be totally taken off if home currency depreciates beyond the interest rate saving.
- If the stock prices do not appreciate and instead depreciate, the bond holders might refrain from converting bonds to equity and the money might have to be repaid by the issuer on bond maturity. Hence, if the company is going through a bad phase, the stocks may not do well and therefore, may not be converted to equity by FCCB holders. In such a scenario, the already troubled company may face an additional burden of interest and principal repayment to be made to the bondholders. Hence, an FCCB may be suitable in a bull market scenario and may be affected by bear market phases.
- Issuing bonds in foreign currency in a foreign market may always be exposed to a legal, political and economic risk of that foreign country. One may have much better idea about the macro-economic conditions of the home country compared to those in a foreign country.

- FCCBs continue to remain on the books of accounts as a debt until the time it is converted and continues to hamper the debt to equity ratio and other debt and interest service coverage ratios.

Conclusion:

A foreign currency convertible bond these days have been in vogue primarily due to interest rate differential between different economies of the world and lower regulations for raising money via this route. The FCCBs can be issued along with call option (whereby the right of redemption lies with the bond issuer) or put options (whereby the right of redemption lies with bond holder). The coupons on the bond can be zero coupons or usually lower coupons, also, the bonds can be issued at a premium or discount depending on the coupon provided. Given these flexibility and cost saving attributes the volumes on the issuance of foreign currency convertible bonds have gone up considerably with more and more investors trying to get into this option.

4.8 EVALUATION OF FOREIGN CURRENCY EXCHANGEABLE BONDS

FCEB involves at least two companies — the bonds are usually of the parent company, while the shares are of the operating company. The Union Finance Minister in his budget speech of 2007-08 had proposed the introduction of foreign currency exchangeable bonds (FCEBs). Pursuant to the announcement, the RBI (Reserve Bank of India) initially issued guidelines with respect to such bonds in form of a scheme being the issue of Foreign Currency Exchangeable Bonds Scheme, 2008 (Scheme). Thereafter, the Scheme was notified in February 2009 by amendments to the Foreign Exchange Management Regulations with retrospective effect from September 2008.

Under the said Regulations, prior approval of the RBI would be required for issue of FCEB. Let's understand what are foreign currency exchangeable bonds, who regulates them and their maturity, among others.

Issue of foreign currency exchangeable bonds (FCEB) are regulated by Foreign Currency Exchangeable Bond

Scheme 2008 issued by Ministry of Finance, Department of Economic Affairs.

What is FCEB?

- A bond expressed in foreign currency.
- The principal and the interest of which is payable in foreign currency.
- The issuer of the bond is an Indian company.
- The bonds are subscribed by a person resident outside India.
- The bonds are exchangeable into equity shares of another company which is also called the offered company.

It may be noted that issuing company is to be the part of promoter group of offered company and the offered company is to be listed and be eligible to receive foreign investment.

The launch of the FCEB scheme affords a unique opportunity for Indian promoters to unlock value in group companies. FCEBs are another arrow in the quiver of Indian promoters to raise money overseas to fund their new projects and acquisitions, both Indian and global, by leveraging a part their shareholding in listed group entities.

An FCEB involves three parties: The issuer company, offered company (OC) and an investor.

Under this option, an issuer company may issue FCEBs in foreign currency, and these FCEBs are convertible into shares of another company (offered company) that forms part of the same promoter group as the issuer company. For example, company ABC Ltd issues FCEBs, then these FCEBs will be convertible into shares of company XYZ Ltd that are held by company ABC

Ltd and where companies ABC Ltd and XYZ Ltd form part of the same promoter group.

Thus FCEBs are exchangeable into shares of offered company. They have an inherent advantage that it does not result in dilution of shareholding at the offered company level.

4.9 FCCB vs FCEB

Foreign currency convertible bonds (FCCBs) are issued by a company to non-residents giving them the option to convert them into shares of the same company at a predetermined price. On the other hand, foreign currency exchangeable bonds are issued by the investment or holding company of a group to non-residents which are exchangeable for the shares of the specified group company at a predetermined price.

The key difference, therefore, is while FCCB involves just one company, FCEB involves at least two companies — the bonds are usually of the parent company while the shares are of the operating company which must be a listed company.

Issue of Foreign Currency Exchangeable Bonds (FCEB) Scheme, 2008

In financial year 2007-08, the Indian Government notified the Foreign Currency Exchangeable Bonds Scheme, 2008 for the issue of FCEBs. The provisions of the scheme is as under:

Eligibility conditions and subscription

- The issuing company should be part of the promoter group of the offered company and should hold the equity share/s being offered at the time of issuance of foreign currency exchangeable bond.

- The offered company should be a listed company which is engaged in a sector eligible to receive foreign direct investment and eligible to issue or avail of foreign currency convertible bond.
- The subscriber to the foreign currency exchangeable bond should comply with the foreign direct investment policy and adhere to the sectoral caps at the time of issuance of FCEB.

End-use requirements:

Issuing company

- The proceeds of FCEB may be invested by the issuing company overseas by way of direct investment including in joint ventures or wholly owned subsidiaries abroad.
- The proceeds of FCEB may be invested by the issuing company in the promoter group companies.

Operational procedure

Prior approval of the Reserve Bank of India is required for issuance of foreign currency exchangeable bond.

Maturity

The minimum maturity of the FCEB is five years for purpose of redemption. The exchange option can be exercised at any time before redemption. While exercising the exchange option, the holder of the bond should take delivery of the offered shares. Cash (net) settlement of these bonds is not permissible.

Taxation on exchangeable bonds

1. Interest payments on the bonds, until the exchange option is exercised, is subject to deduction of tax at source as per the provisions of Section 115 AC of the Income Tax Act, 1961.
2. Tax on dividend on the exchanged portion of the bond is in accordance with the provisions of Section 115 AC of the Income Tax Act, 1961.

3. Exchange of foreign currency exchangeable bonds into shares shall not give rise to any capital gains liable to income-tax in India.
4. Transfers of these exchangeable bonds made outside India by an investor who is a person
5. resident outside India to another investor who is a person resident outside India shall not give rise to any capital gains liable to tax in India.

4.10 TERMINOLOGIES

1) Capital 2) International Markets 3) Markets 4) Depository 5) Foreign

4.11 MODEL QUESTIONS

1. Explain the Raising Capital from International Markets?
2. Explain the Sources of funding are available to Companies?
3. State the Different types of Foreign Bonds?
4. Explain the Evaluation - American Depository Receipts
5. Bringout the Evaluation – Global Depository Receipts

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BLOCK - II FINANCIAL SERVICES, DEPOSITARY SYSTEM IN INDIA-MUTUAL FUND

UNIT –V FINANCIAL SERVICES

Structure

5.1 Introduction
5.2 Financial Services
5.3 Financial Institution
5.4 Types of Financial Services
5.5 Financial Services of India
5.6 Importance of Financial Services
5.7 Online Trading
5.8 Modus Operandi of E-Trading
5.9 Dematerialization and Rematerializations
5.10 Terminologies
5.11 Model Questions
5.12 Reference Books

5.1 INTRODUCTION

Financial services has also been called “Financial intermediation”. The 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 customer.And it is very vital for industry development. As well developed financial service industry is absolutely necessary to mobilize the saving to allocate them to various investable channels and there by to promote industrial development country.

5.2 FINANCIAL SERVICES

1.FINANCIAL ASSETS

2. FINANCIAL MARKET

1) FINANCIAL ASSETS

The financial assets or near-money assets are the clients to money and perform some function of money. They have high degree of liquidity but are not a liquid as money. The financial assets are of two types.

a. primary/direct assets

primary assets the primary assets are the financial claims against real-sector units created by real sector units as ultimate borrowers for raising funds to finance there deficit spending.

FOR EX:

bills
bonds
equity
book debt

b.secondary/indirect assets

secondary asset are financial claims issued by financial institutions against themselves to raise funds from the public. These assets are the applications of the financial institution.

FOR EX:

BANK DEPOSIT
LIC
UTI UNITS

2) FINANCIAL MARKET

Financial markets deals with the financial assets of different types, currency deposits, cheques, bills, bond. The financial market performed following functions.

They create and allocate the credit.

They serve as intermediataries in the process of mobilization of savings.

They provide convenience and benefits to the lenders and borrowers.

They promote economic development through a balanced regional and scattorl allocation of investible fund.

5.3 FINANCIAL INSTITUTION

The financial institution or financial intermediateries act as half way houses between the primary lenders and the final borrowers .The borrow funds from those who are willing to give up their current purchasing power and lend to those who require funds for metting current expenditure.

EXAMPLE:

Financial institution divided into 2 types.

Bank
Non- Bank

Features of financial services:

Financial services are customer oriented
Financial services are intangible.
The production and delivery of a service are simultaneous functions therefore are inseparable.
They are perishable in nature as a financial services various with the changing requirements of the customer, social economic changes, disposable income.
They are pro active in nature and help to visualized the expections of the market.
They acts as link between the investor and borrower.
They aid in distribution of risks.

5.4 TYPES OF FINANCIAL SERVICES

1. Capital market services
2. Money market services
3. Retail services
4. Whole sale services

FINANCIAL SYSTEM STRUCTURE

The following is the structure of financial system.

I. Financial institutions.
II. Financial market.
III. Financial instruments.

I) Financial Instituions:

The financial institutions or business organizations the act as mobilise of savings and credit finance they also provided various financial services the community. The deal in financial assets such a deposits, loans and securities. The types of financial institutions.

a. Intermediataries and non Intermediataries.

b. Banking and non banking institution.

a. Intermediataries and non intermediataries:

The intermediaries between "Savers" and "Investors" .The lend money as well as mobilize savings. There liabilities towards the ultimate savers while the assets are from the "investors" or "borrower".

Non intermediataries to that loan business but there resources are not directly obtained from the savers. There non- intermediataries institutions are IDBI, IFCI and NABARD.

b. banking and non banking institution:

The banking system in india comparises the commercial banks and co-operative banks. They provided transaction services.

There deposit liabilities constitute a major part of national money supply. The non banking financial institutions are life corporation of india , (LIC) UTI, IDBI.

II) Financial market

The financial markets are center or arrangements that provides facilities for buying and selling financial claims and services. The participants in the financial markets are financial institutions, agent ,brokers, borrowers, dealers, lenders, savers and others.classification of financial markets:

a. Unorganised markets
b. Organized markets

a. unorganised markets

There are a number of money lenders, indigenous bankers, traders etc… who lend money to the puplic. indigenous bankers also collect deposits from the public. There are also private finance company, chit fund etc…whose activities are not controlled by RBI.

Recently, the RBI taken steps to bring private finance company and chit fund under its strict control by issuing non financial banking companies(RESERVE BANK DIRECTIONS 1998).

b. organised markets

There are standardized rules and regulations governing there financial dealings. There is also a high degree of institutionalization and instrumentalization. This markets are subject to strict supervision and control by the RBI.THIS ORGANISED MARKETS can be further classified into two.

b.1 Capital market

b.2 Money market

b.1 capital market:

The capital market is a market for financial assets which have a long or indefinite maturity. Generally it deals with term securities which have a maturity period of above one year. Capital markets may be further divided into three namely,

b.1.1 Industrial securities markets
b.1.2 Government securities markets
b.1.3 Long term loan market

b.1.1 Industrial Securities Market:

It is a market for industrial securities namely,

1. Equity/ordinary shares
2. Preference share
3. Debentures/bonds

It is a market where industrial concerns raise there capital or debt by issuing appropriate instruments. It can be further sub divided into two,

a. Primary market/new issue market
b. Secondary market/stock exchange

a. primary/ new issue market

Primary market is a market for new issues (or) new financial claims. The primary market deals with those securities which ae issued to the public for first time. The borrower's exchange new financial securities for long term funds. Thus, the primary market facilitates raise capital formation.

i. Public issues
ii. Rights issues
iii. Private placement

public issues:

The most common methods of raising capital by new companies is through the sale securities to the public.

rights issues

When an existing company wants to rights additional capital, securities are first offered to the existing shareholders on pre-emptive basis.

private placement

The private placement is a way of selling securities privately to a small group of investors.

b. Secondary market

Secondary market is a market for secondary sale of securities in other wards, securities which have already passed through the new issue of market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides continuous. Regular market buying and selling of securities. This market consists of all stock exchanges recoganised by the Government of india.

The secondary market for this securities is narrow since, most of the institutional investors tend to retain this securities until maturity. The Government securities are in the many forms. This are as follows,

- Stock certificates
- Promissory note
- Bearer bonds

Which can be discounted.

The Government securities are sold through the public depth office of the RBI while treasury bills are sold through the Government.

b.1.2 government securities market:

It is a market where Government securities are traded in india. There are many kind of Government securities like short term and long term. The long term securities are traded in this market and short term securities are traded in the money market.

The securities issued by the central Government, state Government, semi Government authorities like city corporation port trust etc.

The Government securities are issued denominations of Rs.100 interest is payable half yearly and they carry tax exemption.

b.1.3 long term loan markets

Development banks, long term market and commercial bank play a significant loan in this market by supplying long term loans to corporate customers. The long term loan market may further be classified into,

a) Term loan market

b) Mortagges
c) Financial guarantee’s

a) term loan market:

In india many industrial financing institutions have been created by the Government both at the national, Regional levels to supply long term and medium term loan to corporate customer directly as well as indirectly.

b) mortagages market

It is a refers to those centres which supply mortagages loan mainly to individual customers. A mortage loan is a loan against the security of immovable properly like real estate etc..

c) financial guarantee’s market

A guarantee’s market is a center where finance is providing against the guarantee reputed the person in the financial circle.

Guarantee’s is a contract to discharge the liability of a third party in case of his default.

The guarantee’s act as a security from the creditors point of view.

Importance of capital market:

- Options of capital market acts as a different factors to capital formation and economic growth.
- The importance of capital market can be discussed below:-
- The capital market serves as all important source for the productive use of the economic savings. It mobilizes the savings of the people further investment and avoids there wastage in unproductive uses.
- It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.
- It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.
- It facilitates increase in production and productivity in the economy and thus enhance the economic welfare of the society.
- The operations of different institution in the capital market induce economic growth and bring rational allocation of scare resources.
- A healthy capital market consisting of expert intermediataries promotes stability in values o securities representing capital funds.

- Moreover, it serves as on important sources technological upgradation in the industrial sector by utilizing the funds invested by the public.

b.2 Money market

Money market is a market for dealing with for financial assets and securities which have a maturity period of "upto one year".

In otherwards, it is a market for purely short term funds.

The money market may be sub divided into four

1) Call money market
2) Commercial bills market
3) Treasury bills market
4) Short term loan market

1) Call money market:

The call money market is a market for extremely short period loans say one day to 14 days. So it is highly liquid assets.

The loans are repayable on demand option of either the lender or the borrower. The call money market associated with the presence of stock exchange and located in major industrial town like Mumbai, Calcutta, Chennai, Delhi and Ahamathabad.

It is very sensitive changes in demand and supply of call loans.

2) Commercial bills market/ discount market

It is a market for bills of exchanges arising out of genuine trade transactions in the case of credit sale, the seller may draw a bill of exchanges and the buyer. The buyer accepts such a bill , promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead of, he can kept immediate payment by discounting the bill in india the bill market is under development.

The RBI is taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market.

3)Treasury bill markets

It is a market for treasury bills which have short term maturity. A treasury bill is a promissory note (or) a finance bill issued by the Government.

It is highly liquid because it is repayment is guaranteed by the Government. It is an important instruments for short term borrowing of the Government. There are two types of treasury bills.

1) Ordinary (or) regular
2) Ad hoc treasury bill

Ordinary treasury bills are issued to the public, banks and other financial institutions to raising resources for the central Government to meet its short term financial needs.

Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auctions. They can be purchased by the RBI only. Ad hoc are not marketable in india but holders of these bills can sell them back to RBI. This bills have a maturity period of 91days (or) 182 days (or) 364days only.

4) Short term loan market:

It is a market where short term loans are given to corporate customers for meeting there working capital requirements. Commercial banks play a significant roll in these market.

Commercial banks provide short term loans in the form of cash credit & overdraft.

Overdraft is purely temporary accommodation and cash credit is for a period of 1 year and it is sanctioned in a separate a/c.

III. Financial instruments:

The financial instruments are those which are used to mobilize the funds from the savers. To raise capital, companies issue shares & debentures.

To mobilize savings bank deposit receipts and insurance policy are issued bill of exchange promissory note, treasury bill etc.,

The innovative instruments introduced in India have been discussed in the chapter of financial services. They are classified into two financial instruments.

1) Primary/ Direct Securities
2) Secondary/Indirect securities

1) primary securities

These are securities directly issued by the ultimate investor o the ultimate savers. Ex:- Shares & Debentures issued directly to the public.

2) Secondary securities

These are securities issued by some intermediataries called financial intermediataries to the ultimate savers. Ex:- UTI & Mutual funds issued securities in the form of units to the public. The securities may be classified on the bases of duration as follows:

- Short term securities
- Medium term securities
- Long term securities

Short Term Securities

- Bill of exchange
- Treasury bill

Characteristics of Financial Instruments:

- ✓ It can be easy transfer from one hand to another.
- ✓ They can be bought and sold frequently.
- ✓ They can be converted into cash readily.
- ✓ They can be given as security for the purpose of raising loan.
- ✓ The investments in these securities are exempted from income tax , wealth tax subject to certain limit.
- ✓ This instruments facilities futures training so as to cover risks due to raise fluctuation and interest rate fluctuations.
- ✓ These instruments involve less handling costs since expenses involves in buying and selling these securities are generally much less.
- ✓ The return on this instruments is directly in proportion to the risk undertaken.
- ✓ These instruments may be short term or medium term or long term depending upon the maturity period of these securities.

Significance/utility of financial services:

- Channelizing the funds for economic growth and development of a country.
- Implementing monetary and dent management policies of the Government.

- It helps in making good financial decision generates the employment.
- It links entrepreneurs to investors and business organization to lending institutions.

5.5 FINANCIAL SERVICES OF INDIA

- ➢ Ministry of finance
- ➢ Securities and exchange board of india.
- ➢ Insurance regulatory and development authority(IRDA)
- ➢ RBI
- ➢ Association of mutual funds in india
- ➢ Institute for developments and research in banking technology.
- ➢ India Bank Association.

5.6 IMPORTANCE OF FINANCIAL SERVICES

The financial services cader to the requirements of both individual and corporate customers.

Infact , the successful functioning of any financial system depends upon the range of financial services offered by vendors or service.

The importance of financial service can be realized from the following:

1.Economic growth
2.promotion of savings
3.capital formation
4.provisions for liquidity
5.financial intermediation
6.the contribution of GNP
7.The creation of employment opportunities.

1.Economic growth:

The financial service industry mobilizes the savings of the people and channels them into productive investment by providing various services to the people. Infact, the economic development of a nation depends upon those savings and investment.

2.Promotion of Savings:

The financial service industry savings in the country by providing transformation of services.

It provides liabilities & assets & size transformation service by providing large loans on the basis of numerous small deposits. It also provides maturity transformation services by maturity transformation services by offering short term claims to savers on there liquid deposit and providing long term loans to borrowers.

3.Capital Formation:

The financial service industry facilitates capital formation by rendering various capital market intermediatary services. The capital formation is the very basis for economic growth. It is a principal mobiliser of surplus funds to finance productive activities and it promotes capital accumulation.

4. provision for liquidity:

The financial service industry promotes liquidity in the system by allocating and reallocating savings and investment into various avenues of economic activities. It facilitates easy convertion of financial assets to liquid cash at the discretion of the holder of such assets.

5. The financial intermediation:

Financial service industry the facilitates the functions of intermediation between savers and investors by providing a means and a medium of exchange and by undertaking innumerable services.

6.Contribution to GNP

The contribution of financial services to GNP has been going on increasing year after year in almost all countries in recent times.

7. Creation of employment opportunities:

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

.5.7 ONLINE TRADING

The Information Technology has brought out revolutionary changes in the operations of stock exchanges in India. The traditional method of trading without the use of technology was time-consuming and inefficient. Further, it imposed limits on trading volumes and efficiency. To overcome those defects and to provide efficient and transparent services, the NSE has introduced a nationwide online fully automated Screen Based Trading System (SBTS). Now, other stock exchanges have been forced to adopt SBTS and today India can boast that almost 100 per cent trading take place through electronic order matching.

Under SBTS, a member can punch into the computers quantities of securities and the prices at which he likes to transact the transaction. It is executed as soon as it finds a matching sale or buy order from a counter- party. Thus, technology is used to carry the trading platform from the trading hall of the exchanges to the premises of the brokers. NSE has carried the trading platform further to the PCs at the residence of the investors through the internet and the handheld devices through WAP for the convenience of the mobile investors.

5.8 MODUS OPERANDI OF E-TRADING

The typical trading network is shown in the following diagram:
As shown in the picture, the NSE has a main computer which is connected through Very Small Aperture Terminal (VSAT) installed at its office. The main computer runs on a fault tolerant STRATUS main computer at the exchange. Brokers have terminals (identified as PCs in the figure) installed at their premises which are connected through VSATS/Leased Lines/ Modems.

When investors inform their brokers to place orders either for purchase or sales, the brokers enter the orders through their PCs which run under Windows NT and send signal to the satellite via VSAT/Leased Line/Modem. The signal is then directed to mainframe computer kept at NSE

via VSAT at NSF office. A message relating to order activity is broadcast to the respective member. The order confirmation message is immediately displayed on the PC of the broker. This order will be executed if it matches with the existing passive order(s). Otherwise, it will wait for the active orders to enter the system till it is matched.

On order matching, a message is broadcast to the respective member. The trading system operates on a Strict Price/Time priority. All orders received on the system are sorted with the best priced order getting the first priority for matching. In other words, the best buy order should match with the best sell order. If more orders are similar priced, then orders are sorted on time priority basis, i.e., the first come gets the top priority.

All dealings are transparent, objective and fair since all orders are matched automatically by the computer. In case an order does not find a match, it remains in the system displaying itto the whole market till a fresh order comes in or the earlier order is cancelled or modified.

This trading system provides greater flexibility to the investors since various kinds oforders with quantity or price conditions can be placed according to the discretion of investors. Similarly, several time-related conditions can be easily built into an order.

This system also provides complete market information online. The market screens at any point of time provide complete information as to:

(i) Total order depth in a security

(ii) The best five buys and sells in the market.

(ii) The quantity traded during the day in that security.

(iii) The high and the low price for each security.

(iv) The last traded price for a security, etc.

BSE-bolt system

Similarly, the BOLT System (Bombay Online Trading) has been introduced in the Bombay Stock Exchange. Now, all scrips on BSE are being traded through BOLT.

The brokers and their agents conduct trading under the BOLT system from their Trading Work Stations (TWS). At every TWS, the BOLT system displays touchline' which will share the best bid and offer prices presently available in the market. The BOLT system also displays at every TWS Market view' which will provide a detailed market information on each listed stock.

Mobile trading

The mobile trading was recently introduced in the Indian market to make stock market trading easier. One has to approach any mobile service provider for securing internet connectivity with adequate bandwidth on his phone. He is also required to register for an online amount offer which he is automatically entitled to services under the mobile platform.

For the mobile trading, most brokers offer two options now -

(i) Using the handset's browser, and

(ii) Using a downloadable application

In both cases, one can reach the broker's server for trading by using internet connectivity. if one has GPRS activated in his phone, he can log on to his online trading account through his phone, just as he would with his desktop. One can follow a URL and log in with the given 'username' and 'password' which can be subsequently changed and thereafter this new ID can be used for connecting one's trading account. Once it is connected, it is similar to an online trading account. This mobile trading platform lets one to have an easy access to live stock quotes and check on his margins, order-book status and real-time net position.

Features

The special features of mobile trading platform are:

- Facility to create a market-watch window
- Watching best buy/sell bids for a scrip
- Checking the margin status and the client's buying power
- Placing orders with options to view pending orders
- Modifying and cancelling those orders
- Viewing of Intra-day stock charts
- Getting of stock advice through SMS
- Instant transferring of funds

The mobile-based trading has gained so much popularity that from a daily average turnoverof1.66 crore in 2010, it has zoomed to a daily average turnover of 1,780 crore in the beginning of 2014 on the NSE.

Merits of online trading

The following are the important merits of online trading:

(i) Faster trading: Technology driver trading is faster than manual trading. Once the order is matched, it is executed immediately.

(ii) Accessible to all: It provides full anonymity by accepting orders from members irrespective of the size of the orders - whether big or small without disclosing their identity. Thus, it provides equal access to all.

(iii) Faster incorporation of price-sensitive information: The SBTS allows faster incorporation of price-sensitive information into the prevailing prices and thus, it increases the information efficiency of the markets.

(iv) Widening the market: It also widens the market by enabling the market participants to trade with one another simultaneously irrespective of their geographical locations. Thus. it improves the depth and liquidity of the market.

(v) Saving of time and cost: The SBTS electronically matches orders on a strict price condition as well as on time priority basis. Hence, it cuts down cost as well as time in executing orders.

(vi) Fully transparent: Online trading is fully automated and screen-based. Everything is transparent on the screen and hence, there is no possibility to play any hide and seek game.

(vii) No errors and frauds: The price conditions, quantity conditions, etc., are punched into the computers by the members themselves. So, the risk of error is very less. Moreover, the trading is fully automated and screen-based and hence, frauds cannot enter into the system.

(viii) Perfect audit trail: It also provides perfect audit trail which helps to resolve disputes by logging in the trade execution on entirety. Thus, online trading ensures efficiency, liquidity and transparency in the trading on stock exchanges.

5.9 DEMATERIALIZATION AND REMATERIALIZATION

Dematerialization can be defined as the process in which, at the request of the investor, the company takes back the traditional share certificates of the investor, and same number of securities are credited to his/her trading account in the electronic form.Shares in dematerialised form do not contain the distinctive number. Moreover, the shares are fungible in the sense that all the shareholdings are identical and interchangeable. First of all, the investor needs to open the account with the Depository Participant (DP), after which the investors request dematerializing the shareholdings through the DP so that the dematerialised shares are credited to the account.

Dematerialization is not compulsory, the investor is allowed to hold the securities in physical form, but when the investor wants to sell it in the stock exchange, he/she needs to dematerialize the same. Likewise, when an investor buys shares he/she gets the shares in electronic form. As and when the shares are dematerialized, their independent identity is lost. Further, separate numbers are allocated for the dematerialized securities.

Rematerialization may be understood as the process of mutating the electronic holdings in a demat account, into paper form, i.e. conventional certificates. For this purpose, one needs to fill the Remat Request Form (RRF), and submit it to the Depository Participant (DP), with whom he/she has a demat account.The rematerialization of the securities can be done at any point of time. In general, the completion of the dematerialization process takes 30 days. Those securities which are under rematerialization cannot be traded in the stock exchange.

NOTES

Process of Dematerialization

This is how you can dematerialize your share certificates:

- Fill a request form for dematerialization from the Depository Participant.
- Submit the share certificates
- The certificates are then submitted to the registrar by the Depository Participant
- You might need to write 'surrendered for demat' on you certificated as asked by the DP.
- Once the certificates are dematerialized, the registrar updates the depository of the completion.

Different between Dematerialization and Rematerialization

- **Meaning**
  Dematerialization is the process of converting all physical security documents into an electronic form.
  Rematerialization is when the converted electronic security documents are re-converted into physical documents.
- **Level of Security**
  The level of security in dematerialization is high as there is very less chance of online theft or forgery etc.
  Rematerialization involves physical paperwork, so there is a low rate of security and a high chance of forgery and damage to the documents.
- **Mode of transaction**
  Dematerialization involves an online transaction through an online demat account.
  Rematerialization transactions take place physically.
- **Share Identification**
  Dematerialized have a unique number called ISIN number for share identification.
  Rematerialized shares need a distinct number which is issued by the RTA.
- **Cost of Maintenance**
  Dematerialization involves maintenance charges of the demat account. The price varies from bank to bank.
  Rematerialization involves zero maintenance charges.
- **Account Authority**
  In dematerialization, the account authority lies with the depository participant.
  In Rematerialization the account authority for securities lies with the com

5.10TERMINOLOGIES

1) Financial 2) Services 3) Importance 4) Online trading 5) Materialization

5.11 MODEL QUESTIONS

1. Explain the Types of Financial Services?

2.Discuss the Financial Services of India?

3. What are the Importance of Financial Services?

4.Bringout the Online Trading?

5. Explain the Modus Operandi of E-Trading?

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UNIT –VI DEPOSITORY SYSTEM IN INDIA

Structure

6.1 Introduction
6.2 Objectives of a Depository
6.3 Trading in a Depository System
6.4 Depositories in the International Market
6.5 Depository System in India
6.6 SEBI (Depository and Participants) Regulation Act 1996
6.7 Depository Process in India
6.8 Benefits of Depository System
6.9 National Securities Depository Ltd., (NSDL)
6.10 Central Depository Services (India) Ltd., CDSL
6.11 Drawbacks
6.12 Terminologies
6.13 Model Questions
6.14 Reference Books

6.1 INTORDUCTION

A depository is a nominee who keeps the scrips on behalf of the investors. He under takes the custodian role. The depository leads the capital market towards a Scrip less system through immobilisation and dematerialisation of share certificates. Immobilisation of securities means stopping the physical movement. The number physical certificates that pass between company and customers becomes negligible as lodged and the immobilised certificates are registered in the name of depository nominee. Dematerialisation means issue of one certificate in favour of the Depository Nominee or not issuing the certificates. The depository operates the computerised the book entry transfer for the securities. This results in a speedier and more liquid trading environment. The depository also undertakes the trade and settlement processing through its subsidiary as a part of its function.

Definition and meaning

The term depository is defined as 'a central location for keeping securities on deposit. It is also defined as 'a facility for holding securities, either in certificated or uncertificated form to enable book entry transfer of securities.

lt is understood from the above two definitions that the depository is a place where securities are stored, recorded in the books on behalf of the investors.

In recent times, the volume of securities and the size of the business handled have increased manifold. Hence, the present-day depositories are fully automated to serve the customers faster and with accuracy.

Therefore, a depository can be defined as, 'an institution which transfers the ownership of securities in electronic mode on behalf of its members'.

6.2 0BJECTIVES OF A DEPOSITORY

A depository enables the capital market to achieve the following objectives:

1. Reduce the time for transfer of securities.

2. Avoid the risk of settlement of securities.

3. Enhance liquidity and efficiency.

4. Reduce cost of transaction for the investor.

5. Create system for the central handling of all securities.

6. Promote the country's competitiveness by complying with global standards.

7. Provide service infrastructure in a capital market.

activities of the depository

The main activities of the depository are as follows:

1. Accepting deposit of securities for custody.

2. Making computerised book entry deliveries of securities which are immobilised in its Custody.

8. Creating computerised book entry pledges of securities in its custody.

4. Providing for withdrawal of securities.

5. Undertaking corporate actions like distribution of dividend and interest.

6. Redemption of securities on maturity.

Interacting institutions

There are three institutions that are interacting in a depository system.

1. The Central Depository

2. Share Registrar and Transfer Agent.

3. Clearing and Settlement Corporation.

NOTES

1. Central depository

The central depository is a nominee who holds the securities on behalf of the investors and maintains records related to that in an electronic mode.

2. Share registrar and transfer agent

The registrar is an institution that controls the issuance of securities. The transfer agent 1s one who retains the names and addresses of registered securities Owners and re-register traded securities in the names of new owners.

3. Clearing and settlement corporation

It is a centre to do trade matching and settle the funds and exchange securities.

DEPOSITORY PROCESS

1. Immobilisation of shares

Immobilisation of shares is the first step in the depository process. In the immobilisation process, the share certificates are submitted to the dep0sitory which converts the physical certificates into electronic data and starts 18SU1ng statement of accounts for the holdings of the investors or shareholders.

The immobilisation process is illustrated in the following figure:

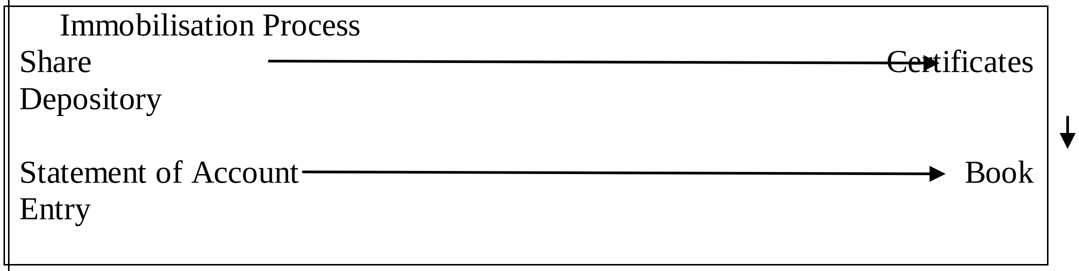

Fig. 8.1: Immobilisation Process

The steps involved in the process of converting the existing paper certificates into an electronic mode are as follows:

1. The stock exchange will notify through an advertisement after which the investors may deposit their shares into the Central Depository through an Authorised Depository Agent with whom the investors' account will be maintained.

2. On receipt of the share certificate, the Depository or the Depository's Agent sends the certificate to the Registrar and Transfer Agent for registering Depository Nominee's name.

3. Within a prescribed period, the Registrar will transfer the scrips, after confirming that the shares are good for disposition, in the name of the Depository Nominee and return it for safe custody with the Depository. The depository will credit the account of the investor with the number of shares deposited

Thereafter the shares get traded through a book entry system.

In the case of fresh issues, the applicant will have to give dep0sitory account particulars in the application form. Successful applicants will have their account credited directly. Those who do not have any account will have to open an account with any of the Authorised Depository to enable the allotment and future trade.

Withdrawal of shares

The shares which are held in the depository can be withdrawn by the investor. The withdrawn scrip takes physical form as in the case of pre-immobilised model.

6.3 TRADING INA DEPOSITORY SYSTEM

When the investor sells his share, the depository debits the 'Free Balance' of the seller and credits the 'Available Balance' of the buyer for the scrip traded on the settlement day. After the payment has been made by the buyer, the available balance will be converted into free balance which can be traded by the buyer. It is like, a Share Bank where the balances are in the form of different corporate entities' shares instead of currency. Confirmation statements are sent to the investors after the accounts are adjusted or at stipulated intervals. The delivery and settlement process will be the same as at present except that physical delivery will be replaced by a book entry. The clearing and settlement process will take place in the separate wing of the depository or in the different entity.

Transfer of ownership

In the case of trade, ownership in the shares are transferred from one account to another. Other than trade settlement, the transfer can also take place between the same investor's accounts with the same depository agent. The investor may also transfer the shares to another account within the same depository agent. Transfer of securities to immediate family member is also possible. The transfer of shares can take place on account of the investor offering the shares as collateral security for a loan. In this process, the institution's lien can be marked in the accounts. In case the lien is marked, the share will not be treated as a 'Free' and could not be available for trade. When the loan is repaid, the lien is cancelled and thereafter the shares will be available for trade.

Declaration of dividend/bonus/rights

Though the shares are in the names of the depository nominee, the real owners are individuals or institutions. When a company declares dividend/rights or bonus issues, the depository will prepare the record of investors as on the record date and submit it to the Registrar of Company. The dividend will be sent by the Registrar after calculating the dividend payable to each investor directly. When a company declares bonus shares, the Registrar will calculate the bonus entitlement and advise the depository about the number of shares to be credited to each accountholder. In the case of the rights offer, based on the record of depositories, the Registrar will prepare a letter of offer and send it to the investor. The Registrar will advise the depository the number of shares to be credited to each account on the basis of the application and allotment. Based on this advise, the investor's account will be credited by the depository reporting system.

The Depository is functioning in an advanced automated environment. So, the reporting system is fast and highly superior. The investors get the following statements regularly: (i) Contract statements with details of trade, (ii) Confirmation statements with details of trade, (ii) Monthly traded particulars, and (iv) Quarterly statements showing the security balances.

6.4 DEPOSITORIES IN THE INTERNATIONAL MARKET

Group of thirty, a private sector group concerned with the working of International Financial System, convened a symposium in London during 1989, to discuss the state of clearance and settlement practices in the world's principal markets. This symposium formed a group to suggest:
A set of international standards with regard to world capital markets and also (ii) A specified time limit for their implementation. The committee recommended, among other things, that the clearance and settlement process be improved through the usage of depositories.

The G30 recommendations, as commonly referred to, suggested that the Central Depository should perform the functions of settlement of securities and the ancillary service of safe custody and administration of securities held in its custody .

Following this, many countries have set up depositories. The concept of depositories has transformed the capital markets on account of speed and accuracy of trade settlement. They have also resulted in attracting a number of global players into the economy because the participants are confident about the genuineness of the securities and the transfer process completed within minimum timeframe.

6.5 DEPOSITORY SYSTEM IN INDIA

The agenda for capital market reform was set in motion by the government in tandem with the policy of economic liberalisation. Modernisation of stock exchanges and related system and procedures constituted an integral part of this programme. The stock exchanges in India were characterised by lack of transparency, complex trading procedure and age-old settlement system resulting in inordinate delays and manifold risks.

The settlement system called for physical movement of share certificates in recording Ownership changes in the company books. The serious risks associated with the paper-based settlement system were bad deliveries, delays in transfer and registration, mutilation, loss, forgery and theft of certificates. The share transfer in India takes place on an average about2 months while in other countries it takes just a few days. The inadequacies of the settlement mechanism were brought into sharp focus and highlighted on several investors, forums. There was a pressing demand to modernise the infrastructure and introduce automated trading to bring Indian capital market at par with world standards.

Promulgation of the Depository Act, 1996 is one of the series of steps taken by the government for removing the shortcomings of the present system.

The depository system aims at replacing the manual system of share transfer, settlement of transactions and physical delivery of shares by a method of simple book entries. The system is envisaged to reduce the total time taken to complete a transaction and ensure greater liquidity

6.6 SEBI (DEPOSITORIES AND PARTICIPANTS) REGULATION ACT, 1996

The depositories ordinance was ordinance, the SEBI circulated a consultative paper seeking views from the public on the framework of depository system. This was followed by issue of the SEBI (Depositories and Participants) Regulations which was promulgated in September 1995. Following the issue of promulgated by the government in May 1996.

The features of the act and the regulations are briefed hereunder:

Scope of the act

The scope of the legislation extends to the issue of scrip less trading, transfer of ownership by means of book entries through electronic media and holding of securities through depository system as also fungibility of shares.

Features of the act

Depository institutions: The act provides for creation of one or more institutions registered under the Companies Act and predominantly owned by the market participants.

The SEBI has proposed that the minimum net worth of a depository should be 100 crore.

Depository participants: The act envisages that a depository will interface with the through a set of Depository Participants (DPs). They are persons dealing directly with the depository for their clients. The DP is a crucial link between the investor and the depository. The DP will deemed as an agent of the depository. The depository will therefore be responsible for the acts of omission and commission on the part of the depository participants.

The SEBI has proposed that the following entities could be permitted to be registered depository participants, namely commercial banks, financial institutions, stock exchanges, financial services companies owned to the extent of 75 per cent by any of the above mentioned institutions as well as companies registered abroad providing custodial, clearing services in the securities market and approved by the Central Government.

Investors' choice: An investor is given the option between holding physical securities as present and having a depository based ownership record. Such an option can be exercised byt he investor either at the time of an initial offer of securities by a company indicating his choice in the application form or at any subsequent time. The investor will have also the freedom to switch from the depository mode to non-depository mode and vice versa.

Free transferability: The Act has made free transferability of shares. The Act has taken away the companies' right to use their discretion in effecting transfer of securities by deleting Sec. 22A from the Securities Contracts Regulation Act and inserting Sec. 111A in the Companies ct. This would mean that, once the agreed consideration is paid by the buyer, he is automatically entitled to all the rights associated with the security. As soon as the intimation regarding delivery of security is received, the transfer will be effected by a depository participant on delivery payment basis. In the depository mode, no transfer deed is required and the procedural requirements under Sec. 108 of the Companies Act have been dispensed with.

Rights of transferee: The Act provides that the transferee of a security will be entitled to all the rights including voting rights associated with the security. However, if any transfer is made in contravention of any provisions of SEBI Act or Sick Industrial Companies Act, the issuer company or SEBI can make and depository application to the Company Law Board(CLB). Pending the completion of enquiry, the CLB can suspend the voting rights in respect of the securities so transferred. However, the transferee in such

CLB is satisfied about the contravention, it can direct the depository to make rectification in ownership records.

Fungibility: Section 83 of the Companies Act requires that each share in a company shall be distinguished by an appropriate number. This section is deleted now and the Act has made that the securities held by a depository are fungible. As per the Act, share certificates need not carry distinctive numbers and all shares will form part of a fungible mess. All share certificates will become interchangeable like withdrawing money from a bank account without being concerned about the number printed on the currency notes at the time of deposit into the bank and at the time of withdrawal of money.

No stamp duty: The Act has done away with stamp duty on secondary market transactions in the depository mode. At the time of issue of securities, the issuer company shall pay stamp duty on the total amount of securities issued, whether through a depository or direct to investors in the form of physical certificates. Where an investor opts to exit from a depository and seeks to issue of physical certificates from the issuer, the issue of such certificates shall attract stamp duty as is payable on the issue of duplicate certificates. All transactions outside the depository made will attract stamp duty as at present.

Depository records as legal evidence:

The ownership records maintained by the depository or the participants will be accepted as prima facie evidence in legal proceedings. The depository records will receive the same treatment as available to banks under the Bankers' Book Evidence Act.

Pledge or hypothecation: A depository shall allow for the creation of pledge or hypothecation in respect of securities left in the depository mode.

The Depositories Related Laws (Amendment) Ordinance of 1997 makes consequential changes in the Companies Act, 1956; the Industrial Development Bank of India, 1954; the State Bank of India Act, 1955; the State

Bank of India (Subsidiary Banks) Act, 1959; the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970 and 1980 and the Indian Stamp Act, 1899. It enables shares of statutory bodies like the Industrial Development Bank of India, the State Bank of India, other public sector banks and the units of mutual funds including those of UTI to be traded by means of the depository system.

6.7 DEPOSITORY PROCESS IN INDIA

The depository process can be described as under:

There are four constituents in this system. They are: (i) The depository, (ii) The depository

participant, (iii) The beneficial owner, and (iv) The issuer.

The depository: The depository is entrusted with the securities for effecting the transfer of ownership of the securities. He is the custodian of his clients' securities. The depository has no right over the security except with the transfer of it.

The depository participant: The depository participant (DP) is the link between the depositors and the owner of securities. He is deemed as an agent of the depository. The depository, t here fore, is responsible for the acts of omission and commission on the part of the DP. The depository and DP are registered with SEBI which regulates their functioning.

Clearing houses of recognised stock exchanges, non-banking financial companies with minimum networks and banks including foreign banks are eligible to become DP.

The beneficial owner: The beneficial owner is the real owner of the security. He lodge his securities with the depository in the form of book entries. He has all rights and liabilities associated with the securities.

The issuer: It is the company which issues the security.

The issuer first gives the investors a choice of holding their securities either in the physical form or the scrip less form (through the depository). The investors make their choice and communicate to the issuing company at the time. of initial offer itself. Thereafter, the issuing company intimates the depository details about the allotment of securities. The depository in turn records the names of allottees of the securities in their records as the beneficial owners. The name of the depository is entered by the issuer as the registered holder of the securities.

The investor is free to exercise his option either at the time of applying for the securities or at any time thereafter. The investor is free to alter his choice subsequently.

When the owner changes his choice to the depository system, he is required to surrender the certificates to the issuing company. The issuer cancels them and substitutes the name of the depository as the registered owner in the place of the name of the allottee. Thereafter, the depository records in the book the name of the allottee as beneficial owner. Subsequent transfer under depository system is denoted by means of book entry on receipt of intimation in the prescribed form.

An investor who wishes to avail himself of the services will have to open an account with the depository through a depository participant. The investor has to enter into an agreement with the DP after which he is issued a client number.

To convert his physical holding of securities into a dematerialised form, the investor should make an application to the DP in a Dematerialisation Request Form (DRF). The DP forwards! the DRF within seven days of receipt along with share certificates to the issuer or to its Registrar and Share Transfer Agent (RTA) after electronically registering the request with the depository. The depository at the same time electronically intimates the dematerialisation request to the respective issuer company or the Registrar and Share Transfer Agent. The issuer or the RTA verifies the validity of the share certificate as well as the signature of the investor appearing in DRE. There upon.it intimates its authorisation to credit the shares in the name of the investor On receipt of the intimation, the depository causes the entry to be made in the account of the client at the DP.

To withdraw his securities balance, the investor makes an application to the depository through the DP in a dematerialisation Form Request (RFR). Upon receipt of the request, the DP verifies the balance available to the extent of the request contained in the RFR and electronically intimates the request to the depository. The depository thereupon blocks the balance of the DP and intimates the RFR to the issuer or the RTA. Upon the acceptance of the RFR, the issuer company or the RTA issues share certificates within 30 days.

6.8 BENEFITS OF DEPOPSITORY SYSTEM

The depository system confers the following benefits:
Benefits to investors

1. The system will eliminate paperwork as the book entry system does not need physical movement of certificates for transfer process.

2. The risk of bad deliveries, fraud and misplaced, mutilated and lost share certificates will not exist.

3. The electronic media will shorten settlement time and hence the investor can save time and increase the velocity of security movement.

4. Investors will be able to change portfolio more frequently.

5. The distribution of dividends, interest and other benefits will be speedier as the ownership can be easily identifiable.

6. The cost of transfer is less as the share transfers are exempt from stamp duty.

7. Faster payment is in the ensured case of sale of shares.

Benefits to companies

1. The companies will be able to know the particulars of beneficial owners and their holdings periodically.

2. At the time of declaration of dividends, bonus, etc., there will not be any rush for transfer related activities for the companies.

3. Investor complaints will be reduced substantially as majority of the present-day complaints relate to signature difference, time lapse during the transfer and mutilated certificates.

The financial institutions will not have the problem of processing and storing huge volume of scrips. They can depute their team for other productive business development-oriented purposes.

4. It would be possible to send notices and annual reports without delay because all securities of the company with the participant are accumulated and held in the name of the participant in the Depository's book.

• Benefits to the capital market

1. The capital market will be more transparent as the trading, clearing and settlement mechanism have to be highly automated and interlinked with the depository among themselves.

2. The market will be highly automated and efficient due to the usage of computing and telecommunication technology for the back office activities for all the capital market players.

3. The investors' confidence will improve due to the above two aspects.

4. The foreign investors will start participating in the market resulting in a more buoyant capital market.

5. The existence of depository will result an increase in the volume of trade both by number and value.

6. It will attract more number of the Indian middle income group within the ambit of the capital market players either through direct involvement or through mutual funds.

6.9 NATIONAL SECURITIES DEPOSITORY LTD. (NSDL)

The first depository in India --- The National Securities Depository Limited (NSDL) was established in 1996. It has been promoted by the Industrial Development Bank of India, Unit Trust of India and National Stock Exchange. NSDL started operations in November 1996 and has made significant progress since then.

NSDL performs a wide range of securities related functions through the DPS:

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

2. Dematerialisation and Rematerialisation of securities.

2. Account transfer for settlement of trade in electronic shares.

4. Allotments in the electronic form in case of initial public offerings.

5. Distribution of non-cash corporate actions.

6. Facility for freezing/locking of investor accounts.

7. Facility for pledge and hypothecation of securities.

6.10 CENTRAL DEPOSITORY SERVICES (INDIA) LTD. (CDSL)

The CDSL has been set up by Bombay Stock Exchange and cosponsored by SBI, Bank of India, Bank of Baroda and HDFC Bank. It commenced its operation on March 22, 1999.

The depository statistics of NSDL and CDSL are given in the following Table

DEPOSITORY STATISTICS FOR LISTED COMPANIES

Particulars	NSDL	CDSL
	2014-15 2013-	2014-15
1	14	2015-16
	2 3	4
		5
No. of Investor Accounts (lakh)	137.1	96.1
No. of Companies Signed up	145.7	107.0
(listed and unlisted)		
No. of Companies Available for	13,992	9,39910,021
Demat	15,638	9,39910,021
Quantity of Securities in demat	13,992	
form	15,638	20,60,12322,75,489
(lakh) (at the end of the period]		
Value of securities in demat form	92,73,570	13,94,26413,26,797
(crore)	1,10,02,089	
[at the end of the period]		7,38,7816,22,416
No. of Shares Settled in	1,17,48,315	
Demat (lakh) (during the year]	1,17,15,667	5,48,51195,55,796
Value of Shares Settled in		
Demat crore) (during the year)	9,94,044	1,02,66,671
Market Capitalisation of	9,04,610	95,55,796
Companies in Demat crore)		
Ratio of dematerialised equity	20,69,409	13.6 12.8
shares to	20,09,725	
total outstanding shares listed (per		
cent)	1,02,20,679	
	96,04,113	
	85.085.4	

Note: Securities includes common equity shares, preferential shares, mutual fund units, debentures and commercial papers.

Source: NSDL and CDSL.

6.11 DRAWBACKS

In spite of the progress made, introduction of demat trading has not been an unqualified success. The subsequent paragraphs explain the drawbacks or issues of the existing system and the steps to be taken to make the Depository System in India an efficient one.

1. **Multiple depositories:** A depository is a service institution like any other basic infrastructural institutions. It is expected to provide service at minimum cost to customers and investors. But, it requires capital investment of about 100 crore. This cost has to be borne by the participating investors and investors attached to the depository over a period of time. In case there are more than one depository, the capital cost will have to be distributed among the investors.

Thus, multiple depositories result an increased cost rather than reducing it to the depository users. In USA though there are three depositories, the Depository Trust Corporation accounts for more than 90 per cent of the trade volume. In Germany, the system has been integrated operationally into almost a single system.

A single depository structure instead of the present multi depository model will result in a number of benefits such as lower transaction cost, reduced inter-depository movements of messages and transfers, better service from depository participants and easy interaction with stock exchange.

2. Clearing and settlement corporations: The depository legislation and SEBI regulations have overlooked the activities of the clearing and settlement corporation which is a vital factor for the success of the depository. There has to be a centralised clearing and settlement corporation to handle the trade in all the exchanges. The clearing and settlement corporation has to be an integral part of the depository so that the back office activities related to the settlement can be executed effectively with speed. In USA, the National and Clearing Corporation acts as the centralised institution for coordinating settlement activities regardless of the market where the trade takes place.

In India, there is a need to set up a clearing and settlement corporation as a part of the depository to have interface with the various exchanges.

3. The depository regulation provides for the selection of the company for immobilisation of securities rather than making it a process to start from the companies. The choice of admitting the security is that of the depository. If the company wants to sever its relationship with depository on a future date, the investors will be put to lot of inconvenience and hardship Similarly, the depositories will be vying with one another to garner business resulting in inter depository competition which will affect the service industry concept in the long run.

4. In India, the retail investores hold about 30 per cent of the market capitalisation. These investors have not yet shown any interest for demat trading. This may be due to lack of awarenessor old habits or the fear of being caught in the tax net.

Even in the US, where dematerialisation of shares is in practice over 25 years, many investors prefer to hold their equity in scrip form.

As long as shareholding in demat form is not made compulsory by n suitable regulation, there will be a large number of shareholders who will opt to hold their equity in scrip form.

5. There are two rates for the securities of the companies that have joined the depository one for the immobilised shares and another one for the physical ones. The existence of different rates will be deterrent to the smooth trade and settlement process.

The depository participants act on an accountholder's written instructions to give effect to his change of address, change of signature and again rely upon matching the signature. This system is susceptible to misuse. Again it is possible that the cancelled shares are presented to the company for dematerialising, find in the absence of proper checks and controls, which will make it unique, non-duplicable and non-payable, these get dematted. Once dematted, a share loses its individual identity and the company may not be in a position to reverse its action Counterfeiting of shares and introducing them in the market is relatively easy in the absence of duplication proof security features. This is particularly relevant in case of companies that are old and have issued shares from time to time.

SEBI should issue guidelines laying down security features to make share certificate! counterfeit-proof. These should be enforced on companies by suitable amendments to model listing agreements

6.12 TERMINOLOGIES

1)Depository 2) System 3) Participants 4) Benefits 5) Companies

6.13 MODEL QUESTIONS

1. Explain the Depository System in India?
2. Explain the SEBI (Depository and Participants) Regulation Act 1996?
3. State the Depository Process in India?
4. What are the Benefits of Depository System?
5. Explain the National Securities Depository Ltd., ?

6.14 REFERENCE BOOKS

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UNIT –VII MUTUAL FUND

Structure

7.1 Introduction
7.2 Scope of Mutual Fund
7.3 Origin of the Fund
7.4 Types of Funds/ Classification of Funds
7.5 Importance of Mutual Funds
7.6 Advantages and Disadvantages of Mutual Funds
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7.1 INTRODUCTION

Of late, mutual funds have become hot favorites of millions of people all over the world. The driving force of mutual funds is the 'safety of the principal' guaranteed, plus the added advantage of capital appreciation together with the income earned in the form of interest or dividend. People prefer mutual funds to bank deposits, life insurance and even bonds because with a little money, they can get into the investment game. One can own a string of blue chips like ITC,TISCO, Reliance, etc., through mutual funds . Thus , mutual funds act as a gateway to enter into big companies hitherto inaccessible to an ordinary investor with his small investment.

Meaning of Mutual fund

To state in simple words, a mutual fund collects the savings from small investors, invest them in government and other corporate securities and earn income through interest and dividends, besides capital gains. It works on the principle of 'small drops of water make a big ocean'. For instance, if one has Rs 1,000 to invest, it my not fetch very much on its own. But when it is pooled with Rs 1,000 each from a lot of other people, then , one could create a 'big fund' large enough to invest in a wide varieties of shares and debentures on a commanding scale and thus, to enjoy the economies of large-scale operations. Hence, a mutual fund is nothing but a form of collective investment. It is formed by the coming together of a number of investors who transfer their surplus funds to a professionally qualified organisation to mange it. To get the surplus funds from investors, the fund adopts a simple technique. Each fund is dividend into a small fraction called 'units' of equal value. Each investor is allocated units in proportion to the size of his investment. Thus, every investor, whether big or small, will have a stake in the funds and can enjoy the wide portfolio of the investment held by the fund. Hence, mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emerged as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk.

7.2 SCOPE OF MUTUAL FUND

As stated earlier, a mutual fund is nothing but a pool of the investors' funds. The special feature of a mutual fund is that the contributors and the beneficiaries of the fund are one and the same class of people, *i.e.*, investors. Nobody else can claim that fund. Since the investors themselves contribute to the pool of fund and enjoy it and its fruits, the term 'Mutual' has been employed.

The important features of mutual fund are the following:

(i) A mutual fund belongs to these who have contributed to that fund and thus, the ownership of the fund lies in the hands of the investors.

(ii) Since all investor cannot take part in the management of the fund, it is left in the hands of investment professionals who earn a fee for their services.

(iii) The pool of funds collected is invested in portfolio of marketable securities.

(iv) The investors' share in the fund is represented by 'units' just like share capital of company. The unit value depends upon the value of the portfolio held by the fund. Hence, the value changes almost every day and it is called Net .Asset value.

(v) Generally, the investment portfolio of the mutual fund is created according to the objective of the fund. For example, a sector mutual fund invests its funds in a specific sector like IT sector, etc.

DEFINITION

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

These mutual funds re referred to as Unit Trusts in the UK and s open-ended investment companies in the USA. Therefore, Kamm, J.O. defines an open-ended investment company s 'an organization formed for the investment of funds obtained from individuals and institutional investors who in exchange for the funds receive shares which can be redeemed at any time at their underlying asset values'.

According to Weston J. Fred and Brigham, Eugene, F., Unit Trust are ‘corporations which accept dollars from savers and then use these dollars to buy stocks, long- term bonds, short- term debt instruments issued by business or government units; these corporations pool funds and thus reduce risk by diversification’.

Thus, mutual funds are corporations which pool funds by selling their own share and reduce risk by diversification.

Fund unit vs. share

Just like shares , the price of fund is also quoted in the market. This price is governed basically by the value of the underlying investments held by that fund. At this juncture, one should confuse a mutual fund investment on units with that of an investment on equity shares. Investment on equity share represents investment in a particular company alone. On the other hand, investment on an unit of a fund represents in investment in the parts of shares of a large number of companies. This itself gives an idea how safe the units are. If a particular company fails, the shareholders of that company are affected very much, whereas the unit holders of that company are able to withstand that risk by means of their profitable holding in other companies shares.

Again, investment on equity shares can be used as a tool by speculators and inveterate stock market enthusiasts with a view of gaining abnormal profits. These people play an investment game in the stock market on the basis of daily movement of prices. But , mutual funds cannot be invested for such purpose and the mutual fund is not at all concerned with the daily ebbs and flows of the market. In short, mutual fund is not the right investment vehicle for speculators. Mutual funds are, therefore, suitable only to genuine investors, whereas shares are suitable to both the genuine investors and the speculators.

7.3 ORIGIN OF THE FUND

The origin of the concept of mutual fund dates back to the dawn of commercial history. It is said that Egyptians and Phoenicians sold their shares in vessels and caravans with view of spreading the risk attached with these risky ventures. However, the real credit of introducing the modern concept of mutual fund goes to the foreign and colonial government Trust of London established in 1868. Thereafter, a large number of close- ended mutual funds were formed in the USA in 1930s followed by many countries in Europe, the Far East and Latin America. In most of the countries, both open-ended and close-ended types were popular. In India, It gained momentum only in 1980, though it began in the year 1964 with the Unit Trust of Indi launching its first fund, the unit scheme 1964.

7.4 TYPES OF FUNDS/CLASSIFICATION OF FUNDS

In the investment market, one can find a variety of investors with different needs, objectives and risk-taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risks than a person who is just on the verge of his retiring ge. So, it is very difficult to offer one fund to satisfy all the requirements of investors. Just as one shoe is not suitable for all legs, one fund is not suitable to meet the vast requirements of all investors. Therefore many types of funds are available to the investor. It is completely left to the discretion of the investor to choose any available to the investor. It is completely left to the discretion of the investor to choose any one of them depending upon his requirement and his risk-taking capacity.

Mutual fund schemes can broadly be classified into many types as given in the chart given below:

- **On the basis of execution and operation**

(A) Close- ended funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the predetermined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unitholders in proportion to their holding. Thus , The fund ceases to be a fund ,after the final distribution.

Features: The main features of the close-ended funds are:

(i) The period and/or the target amount of the fund is definite and fixed beforehand.

(ii) Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.

(iii) These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.

(iv) The main objective of this fund is capital appreciation.

(v) The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Hence , the fund manager can manage the investments efficiently and profitably without the necessity of maintaining any liquidity.

(vi) At the time of redemption, the entire investment pertaining to a close-ended scheme is liquidated and the proceeds are distributed among the unitholders.

(vii) From the investor's point of view, it may attract more tax since the entire capital appreciation is realized in at one stage itself.

(viii) If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

(xi) Generally, the prices of close-ended scheme units are quoted at a discount of up to 40 per cent below their Net Asset Value (NV)

(B) Open-ended funds

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not predetermined. The investors re fees to buy and sell any number of units at any point of time. For instance ,the Unit scheme (1964) of the Unit Trust of Indi is an open ended one, both in terms of period and target amount. Any time at his discretion.

The main features of the open-ended funds are:

(i) There is complete flexibility with regard to one's investment or disinvestment. In other words, there is free entry and exit of investors in n open-ended fund. There is no time limit. The investor can join in and come out from the fund as and when he desires.

(ii) These units are not publicly traded but, the fund is ready to repurchase them and resell them at any time.

(iii) The investors is offered instant liquidity in the sense that the units can be sold on any working dy. In fact, fund operates just like a bank account, wherein one can get cash across the counter for any number of units sold.

(iv) The main object of this fund is income generation. The investors get dividend, rights or bonuses s rewards for their investment.

(v) Since the units are not listed on the stock market, their prices are linked to the Net Asset Value (NAV) of the units. The NAV is determined by the fund and it varies from time-to-time.

(vi) Generally, the listed prices are very close to their Net Asset Value. The fund fixes a different prices for their purchase and sales.

(vii) The fund manager has to be very careful in managing the investments because he has to meet the redemption demands at any time made during the life of the scheme.

To put it in a nutshell, the pen ended funds have perpetual existence and their corpus is ever-changing depending upon the entry and exit of members.

- **On the basis of yield and investment pattern**

(A) Income funds

As the name suggests ,this fund aims at generating and distributing income to the members on periodical basis. it concentrates more on the distribution of regular income and it also sees that the average return is higher than that of the income from bank deposits.

The main features of the Income funds are:

(i) The investor is assured of regular income at periodic intervals say half-yearly or yearly and so on.

(ii) The main objective of this type of fund is to declare regular dividends and not capital appreciation.

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

(iv) This is best suited to the old and retired people who my not have any regular income.

(v) It concern itself with short-run gains only.

(B) Pure growth funds (growth-oriented funds)

Unlike the income funds ,concentrate mainly on long run gains , *i.e.,* capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described s 'Nest Eggs' investments.

The main features of the growth funds are:

(i) The growth-oriented fund aims at meeting the investors' need for capital appreciation.

(ii) The investment strategy, therefore, conforms to the fund objective by investing the funds predominantly on equities with high growth potential.

(iii) The fund tries to get capital appreciation by taking much risks and investing on risk-bearing equities and high growth equity shares.

(iv) The fund my declare dividend, but its principal objective is only capital appreciation.

(v) This is best suited to salaries and business people who have high risk-bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(c) Balanced funds

This is otherwise called "income-cum-growth" fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(D) Specialised funds

Besides the above, a large number of specialized funds are in existence abroad. They offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows, etc. There are also funds for investments in securities of specified areas. For instance, Japan fund, South Korea Fund, etc. In fact, these funds open the door for foreign investors to invest on the domestic securities of these countries.

Again, certain funds may be confined to one particular sector or industry like fertilizers, automobiles, petroleum, etc. These fund carry heavy risks since the entire investment is in one industry. But, there are high risk-taking investors who prefer this type of fund. Of course, in such cases, the rewards may commensurate with the risk taken. At times, it may be erratic. The best example of this type is the petroleum Industry funds in the USA.

(E) Money Market Mutual funds (MMMFs)

Those funds are basically open-ended mutual funds and as such they have all the features of the open-ended fund. But , they invest in highly liquid and safe securities like commercial paper, banker's acceptances, certificates of deposits, treasury bills, etc. these instruments re called money market instruments. They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest. These funds are called market. They pay money market rates of interest. These funds are called ' money funds' in USA and they have been functioning since 1972. Investors generally use it as a 'parking place' or 'stop-gap arrangement' for their cash resources till they finally decide about the proper avenue for their investment, *i.e,* long-term financial assets like bonds and stocks.

Since MMMFs are new concept in India, the RBI has laid down stringent regulations. For instance, the entry to MMMFs is restricted only to scheduled commercial banks and their subsidiaries. MMMFs can invest only in specified short-term money market instruments like certificate of Deposits, commercial paper and 182-day Treasury Bills. They cn also lend to call market. These funds go for safe and liquid investment. Frequent realization of interest and redemption of fund at short notice are the special features of this fund. The funds will not be subject to reserve requirements. The repurchase could be subject to a minimum lock-in period of 3 months.

Since the RBI has fixed the minimum amount of investment as Rs 1 lakh , it is out of the reach of many small investors. In the USA, the minimum amount is only $100. Recently, the private sector funds have been permitted to deal in money market mutual funds. Generally, it is best suited only to institutional investors like banks and other financial institutions.

(F) Taxation funds

A taxation fund is basically a growth –oriented fund. But , it offers tx rebates to the investors either in the domestic or foreign capital market. It is suitable to salaries people who want to enjoy tax rebates particularly during the month of February and march. In India , at present, the law relating to tax rebates is covered under sec.88 of the Income Tax Act, 1961. An investor is entitled to get 20 per cent rebates in Income Tax for investments made under this fund subject to a maximum investment of Rs 10,000 per annum. The Tax for investments made under this fund subject to a maximum investment of Rs 10,000 per annum. The Tax saving Magnum of SBI capital Market Limited is the best example for the domestic type. UTI's US $ 60 million India funds, based in the USA, is an example for the foreign type.

- **Other classification**

(G) Leveraged funds

These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increase, the earning capacity of the fund also increase. The gins are distributed to the unitholders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(H) Dual funds

This is a special kind of close –ended fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investments stocks, viz., income shares . and capital shares . these investors who seek current investment income cn purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(I) Index funds

Index funds refer to those funds where the portfolios re designed in such a way that they reflect the composition of some broad-based market index. This is done by holding securities in the same proportion as the index itself. The value of these index-linked funds will automatically go up whenever the market index goes up and *vice versa,* Since the construction of portfolio is entirely based upon maintaining proper proportions of the index being followed, it involves less administrative expenses, lower transaction costs, less number of portfolio manager, etc., it is so because only fewer purchases and sales of securities would take place.

(J) Bond funds

These funds have portfolios consisting mainly of fixed income securities like bonds. The main thrust of these funds is ‘capital gains’. They differ from Income funds in the sense income funds offer n average returns higher than that from bank deposits and also capital gains lesser than in equity shares

(K) Aggressive growth funds

These funds are just the opposite of bond funds. These funds are capital gains oriented and thus the trust area of these funds is ‘capital gains’. Hence , these funds re generally invested in speculative stocks. They may also use specialized investment techniques like short-term trading , option writing, etc. Naturally , these funds tend to be volatile in nature.

(L) Offshore mutual funds

Offshore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds abroad. So , they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repartriation . Offshore funds re preferred to direct foreign investment ,since, it does not allow foreign domination over host country’s corporate sector. However , these funds involve much currency and country risk and hence they generally yield higher return.

(M) Property fund

It is a real estate mutual fund. It is an investment vehicle which buys, develops, manages and sells real estate assets. Its investment also includes shares/bonds of companies involved in real estate and mortgage companies.

In India , these funds are subjects to the approval of the department of economic affairs, ministry of finance and the RBI monitors such funds by issuing directions then and there. In Indi, number of offshore funds exits. ‘India fund’ and ‘India growth fund’ were floated by the UTI in UK and USA respectively. The state Bank of India floated the India Magnum fund in Netherlands. ‘The Indo-Suez Himalayan Fund NV’ was launched by Can bank mutual fund in collaboration with Indo-Suez Asia Investment services Ltd. It also floated ‘Commonwealth Equity Fund’.

(N) Fund-of-funds

A fund-of-funds scheme is a mutual fund scheme that invests in other mutual fund schemes. The concept is widely prevalent abroad. Mutual funds in India are being allowed to launch fund-of-funds.

(O) Real Estate Mutual Fund (REMF)

The REMF scheme is a mutual fund scheme with the investment objective of direct or indirect investment in real estate property.

For instance, HDFC properly fund has been promoted as a joint venture of HDFC and SBI. This fund has floated two scheme, *viz.*, HDFC Real Estate Fund with a corpus of Rs 1,000 crore to invest in commercial, residential, hospitality and integrated projects all over India.

Another scheme HDFC IT corridor fund with a corpus of Rs 464 crore to focus on IT infrastructure Spread across major towns in India.

❖ **Gold Exchange Traded Fund (ETF)**

A gold exchange traded fund is nothing but exchange listed mutual fund representing some units of gold. Each unit represents one gram of gold generally and in the case of quantum gold ETF, it is 0.5 gram. This ETF can be traded on the floor of a stock exchange for which one must have a Demat and trading account. The demat for stock transaction can be used for dealing in ETF also. ETFs are listed both in NSE and BSE. Interested investors can buy units of gold ETF from the open market. One can enjoy the benefit of price appreciation in gold without any regard to its safety and storing charges. Moreover, physical investment on gold eats into price appreciation in the form of making charges and wastage charges. At present, there re 12 exchange listed gold ETFs in India, the largest and the most liquid being benchmark mutual funds GoldBEES. The intra-day volume in this ETF is round 1.5 and 2 lakh unit.

Recently ,some mutual funds have come forward to invest in gold ETF schemes under fund-of-funds option. Investors who do not intend to open a Demat account can choose this option. The demand for gold ETF is on the increase in recently years due to run-up in gold prices. There were 4.89 Gold ETF retail folios as on 31st March,2014 occupying the largest group of investors under this category.

7.5 IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country’s economy at large. The following are some of the important advantages of mutual funds:

(i) **Channelising savings for investment**: Mutual funds act as vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly. In the absence of MFs, these savings would have remained idle. Thus, the whole economy benefits due to the cost-efficient and optimum use and allocation of scare financial and real resources in the economy for its speedy development.

(ii) **Offering wide portfolio investment**: Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay .if they invest in a few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risk by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim ‘not to lay all eggs in one basket’. These funds have large amounts at their disposal ,and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus, MFs provide instantaneous portfolio diversification.

(iii) Providing better yields: The pooling of funds from a large number of customers enables the fund to have large funds t its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus , they are able to command better market rates and lower rates of brokerage. So they provide better yields to their customers. They also enjoy the economies of large-scale and can reduce the cost of capital market participation. The transaction costs of large in investments are definitely lower than that of small investments. In fact, all the profits of a mutual fund are passed on to the investors by way of dividends and capital appreciation. The expenses pertaining to a particular scheme alone are charged to the respective scheme. Most of the mutual funds so far floated have given a dividend at the rate ranging between 12 per cent p.a. it is fairly a good yield. It is an ideal vehicle for those who look for long-term capital appreciation.

(iv) Rendering expertise investment service at low cost: The management of the fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest. Due to the complex nature of the securities market, a single investor cannot do all these works by himself or he cannot go to a professional manager who manages individual portfolios. In such a case, he may charge hefty management fee. The intermediation fee is the lowest being 1 per cent in the case of a mutual fund.

(v) Providing research service: A mutual fund is able to command vast resources and hence it is possible for it to have an in-depth study and carry-out research on corporate securities. Each fund maintains a large research team which constantly analyses the companies and the industries and recommends the funds to buy or sell a particular share. Thus, investments are made purely on the basis of a thorough research. Since research involves a lot of time, efforts and expenditure, an individual investors cannot take up this work. By investing in a mutual fund, the investor gets the benefit of the research done by the fund.

(**vi) Offering tax benefits**: Certain funds offer tax benefits to its customers. Thus , apart from dividends, interest and capital appreciation, investors also stand to get the benefit of tax concession.

For instance, under section 80L of the Income Tax Act, a sum of Rs 10,000 received as dividend (Rs 13000 to UTI) from a MF is deductible from the gross total income. Under section 88, 20 per cent of the amount invested is allowed to be deducted from the Tax payable. Under the wealth Tax Act, investments in MF re exempted up to Rs 5 lakh.

The mutual funds themselves are totally exempt from tax on all income on their investments. But all other companies have to pay taxes and they can declare dividends only from the profits after tax. But mutual funds do not deduct tax at source from dividends. This is really a boon to investors.

(vii) Introducing flexible investment schedule : Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income units can be exchanged for growth units depending upon the performance of the funds. One cannot derive such a flexibility I any other investments.

(viii) Providing greater affordability and liquidity: Even very smll investors can afford to invest in mutual funds. They provide an attractive and cost- effective alternative to direct purchase of shares. In the absence of MFs , small investors cannot think of participating in number of investments with such a merge sum. Again there is greater liquidity. Units can be sold to the fund at any time at the net asset value and thus quick access to liquid cash is assured. Besides , branches of the sponsoring bank is always ready to provide loan facility against the unit certificates.

(ix) Simplified record keeping: An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is tedious and it consumes a lot of time. One may even forget to record the rights issue and may have to forfeit the same. Thus , record keeping is the biggest problem for small and medium investors. Now, a mutual fund offers a single investment source facility, *i.e.,* a single buy order of 100 units from a mutual fund is equivalent to investment in more than 100 companies. The investor has to keep a record of only one deal with the mutual fund. Even if he dose not keep a record, the MF sends statements very often to the investor. Thus, by investing in MFs, the record keeping work is also passed on to the fund.

(x) Supporting capital market: Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. Thus, funds serve as a conduit for disinter mediating bank deposits into stocks, shares and bonds. Mutual funds also provide a valuable liquidity to the capital market, and thus, the market is made very active and stable. When foreign investors and speculators exit and re-enter the market en masse, mutual funds keep the market stable and liquid. In the absence of mutual funds , the price of shares would be subject to wide price fluctuation due to the exit and re-entry of speculators into the capital market en masse, thus , it is rendering an excellent support to the capital market and helping in the process of institutionalization of the market.

(**xi) Promoting industrial development:** The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures. The mutual funds not only create a demand for these capital market instruments but also supply a large source of funds to the market, and thus, the industries are assured of their capital requirements. In fact, the entry of mutual funds has enhanced the demand for India's stock and bonds. Thus, mutual funds provide financial resources to the industries at market rates.

(**xii) Acting as substitute for Initial public Offerings (IPOs**): In most case, investors are not able to get allotment in IPOs of companies because they are often oversubscribed many time. Moreover, they have to apply for a minimum of 500 shares which is very difficult particularly for small investors. But , in mutual funds, allotment is more or less guaranteed. Mutual funds are also guaranteed a certain percentage of IPOs by companies. Thus, by participating in MFs , investors are a able to get the satisfaction of participating in hundreds of varieties of companies.

(xiii) Reducing the marketing cost of new issue: The mutual funds help to reduce the marketing cost of the new issues. The promoters used to allot a major share of the initial public offering to the mutual funds and thus they are saved from the marketing cost of such issues.

(xiv) Keeping the money market active: An individual investors cannot have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand, mutual funds keep the money market active by investing money on the money market instruments. In fact, the availability of more money market instruments itself is a good sign for a developed money market which is essential for the successful functioning of the central bank in country.

Thus, mutual funds provide stability to share prices , safety to investors and resources to prospective entrepreneurs.

Risks

Mutual funds are not free from risks. It is so because basically the mutual funds also invest their funds in the stock market on shares which re volatile in nature and are not risk-free. Hence , the following risks are inherent in their dealings:

(i) Market risks : In general , there are certain risks associated with every kind of investment on shares. They are called market risks. These market risks can be reduced, but cannot be completely eliminated even by a good investment management. The prices of shares are subject to wide price fluctuations depending upon market.

Economic growth cannot be accelerated without leasing industry. The government has indicated that it is open to suggestions for reviewing the existing policies . such conduciveness and the willingness to prevent bottlenecks in the area of taxation and other areas will go a long way in speeding up the growth of the industry.

7.6 ADVANTAGES AND DISADVANTAGES OF MUTUAL FUNDS

a. Liquidity

Unless you opt for close-ended mutual funds, it is relatively easier to buy and exit a mutual fund scheme. You can sell your units at any point (when the market is high). Do keep an eye on surprises like exit load or pre-exit penalty. Remember, mutual fund transactions happen only once a day after the fund house releases that day's NAV.

b. Diversification

Mutual funds have their share of risks as their performance is based on the market movement. Hence, the fund manager always invests in more than one asset class (equities, debts, money market instruments, etc.) to spread the risks. It is called diversification. This way, when one asset class doesn't perform, the other can compensate with higher returns to avoid the loss for investors.

c. Expert Management

A mutual fund is favoured because it doesn't require the investors to do the research and asset allocation. A fund manager takes care of it all and makes decisions on what to do with your investment. He/she decides whether to invest in equities or debt. He/she also decide on whether to hold them or not and for how long.

Your fund manager's reputation in fund management should be an essential criterion for you to choose a mutual fund for this reason. The expense ratio (which cannot be more than 1.05% of theAUM guidelines as per SEBI) includes the fee of the manager too.

d. Less cost for bulk transactions

You must have noticed how price drops with increased volume when you buy any product. For instance, if a 100g toothpaste costs Rs.10, you might get a 500g pack for, say, Rs.40. The same logic applies to mutual fund units as well.

If you buy multiple units at a time, the processing fees and other commission charges will be less compared to when you buy one unit.

e. Invest in smaller denominations

By investing in smaller denominations (SIP), you get exposure to the entire stock (or any other asset class). This reduces the average transactional expenses – you benefit from the market lows and highs. Regular (monthly or quarterly) investments, as opposed to lump sum investments, give you the benefit of rupee cost averaging.

f. Suit your financial goals

There are several types of mutual funds available in India catering to investors from all walks of life. No matter what your income is, you must make it a habit to set aside some amount (however small) towards investments. It is easy to find a mutual fund that matches your income, expenditures, investment goals and risk appetite.

g. Cost-efficiency

You have the option to pick zero-load mutual funds with fewer expense ratios. You can check the expense ratio of different mutual funds and choose the one that fits in your budget and financial goals. Expense ratio is the fee for managing your fund. It is a useful tool to assess a mutual fund’s performance.

h. Quick & painless process

You can start with one mutual fund and slowly diversify. These days it is easier to identify and handpicked fund(s) most suitable for you. Maintaining and regulating the funds too will take no extra effort from your side. The fund manager, with the help of his team, will decide when, where and how to invest. In short, their job is to beat the benchmark and deliver you maximum returns consistently.

i. Tax-efficiency

You can invest up to Rs.1.5 lakh in tax-saving mutual funds mentioned under 80C tax deductions. ELSS is an example of that. Though a 10% Long-Term Capital Gains (LTCG) is applicable for returns above Rs.1 lakh after one year, they have consistently delivered higher returns than other tax-saving instruments like FD in recent years.

j. Automated payments

It is common to forget or delay SIPs or prompt lumpsum investments due to any given reason. You can opt for paperless automation with your fund house or agent. Timely email and SMS notifications help to counter this kind of negligence.

k. Safety

There is a general notion that mutual funds are not as safe as bank products. This is a myth as fund houses are strictly under the purview of statutory government bodies like SEBI and AMFI. One can easily verify the credentials of the fund house and the asset manager from SEBI. They also have an impartial grievance redressal platform that works in the interest of investors.

l. Systematic or one-time investment

You can plan your mutual fund investment as per your budget and convenience. For instance, starting a SIP (Systematic Investment Plan) on a monthly or quarterly basis suits investors with less money. On the other hand, if you have surplus amount, go for a one-time lump sum investment.

Disadvantages

a. Costs to manage the mutual fund

The salary of the market analysts and fund manager comes from the investors. Total fund management charge is one of the first parameters to consider when choosing a mutual fund. Higher management fees do not guarantee better fund performance.

b. Lock-in periods

Many mutual funds have long-term lock-in periods, ranging from five to eight years. Exiting such funds before maturity can be an expensive affair. A specific portion of the fund is always kept in cash to pay out an investor who wants to exit the fund. This portion cannot earn interest for investors.

c. Dilution

While diversification averages your risks of loss, it can also dilute your profits. Hence, you should not invest in more than seven to nine mutual funds at a time.

As you have just read above, the benefits and potential of mutual funds can undoubtedly override the disadvantages, if you make informed choices. However, investors may not have the time, knowledge or patience to research and analyse different mutual funds. Investing with ClearTaxcould solve this as we have already done the homework for you by handpicking the top-rated funds from the best fund houses in the country.

7.7 LEGAL STRUCTURE OF MUTUAL FUND

A mutual fund is a trust made up of money collected from public or investors through the sale of units for investment in securities such as stocks, bonds, and money market instruments. Mutual Funds in India are governed by the Securities Exchange Board of India (Mutual Fund) Regulations 1996 with the exception of Unit Trust of India (UTI) as it was created by the UTI Act passed by the Parliament of India. All mutual funds must be registered with SEBI.

MUTUAL FUNDS

Structure of mutual fund in India

Mutual Funds in India primarily have a 3-tier structure i.e. Sponsor (1st tier), Public Trust (2ndtier) and Asset Management Company (3rd tier). Sponsor is any person who himself or in association with another corporate, establishes a mutual fund. The Sponsor seeks approval from the Securities & Exchange Board of India (SEBI). Once SEBI approves it, the sponsor creates the Public Trust as per the Indian Trusts Act, 1882. Since Trusts have no legal identity in India, the Trust itself cannot enter into contracts. Thus, Trustees are appointed who are authorized to act on behalf of the Trust. The instrument of trust must be in the form of a deed between the Sponsor and the trustees of the mutual fund registered under the provisions of the Indian Registration Act. The Trust is then registered with SEBI leading to formation of mutual fund. Henceforth, the Trust is known as mutual fund. Sponsor and the Trust are two separate entities.

The Trustee's role is only to act as internal regulators of mutual fund where they see, whether the money is being managed as per the objectives. Trustees appoint the Asset Management Company (AMC), to manage money collected through sale of mutual fund's units. The AMC's Board of Directors have at least 50% of independent directors. The AMC is also approved by SEBI. The AMC functions under the supervision of its Board of Directors, the direction of the Trustees and SEBI. AMC in the name of the Trust floats new schemes and manage these schemes by buying and selling securities. In order to do this, the AMC needs to follow all rules and regulations prescribed by SEBI and as per the Investment Management Agreement it signs with the Trustees.

7.8 REGULATION OF MUTUAL FUNDS

Mutual funds are regulated primarily by Securities and Exchange Board of India (SEBI). In 1996, SEBI formulated the Mutual Fund Regulation. SEBI is also the apex regulator of capital markets and its intermediaries. Issuance and trading of capital market instruments also comes under the purview of SEBI. Along with SEBI, mutual funds are regulated by RBI, Companies Act, Stock exchange, Indian Trust Act and Ministry of Finance. RBI acts as a regulator of

Sponsors of bank-sponsored mutual funds, especially in case of funds offering guaranteed returns. In order to provide a guaranteed returns scheme, mutual fund needs to take approval from RBI. The Ministry of Finance acts as supervisor of RBI and SEBI and appellate authority under SEBI regulations. Mutual funds can appeal to Ministry of finance on the SEBI rulings.

7.9 SOME SEBI REGULATIONS FOR MUTUAL FUNDS

Mutual funds must set up AMC with 50% independent directors, a separate board of trustee companies with minimum 50% of independent trustees and independent custodians to ensure an arm's length relationship between trustees, fund managers, and custodians. As the funds are managed by AMCs and the custody of assets are with trustees, a counter balancing of risks exists as both can keep tabs on each other.

SEBI takes care of the track record of a Sponsor, integrity in business transactions and financial soundness while granting permission. The particulars of schemes are required to be vetted by SEBI. Mutual funds must adhere to a code of advertisement.

As per the current SEBI guidelines, mutual funds must have a minimum of Rs. 50 crore for an open-ended scheme, and Rs. 20 crore corpus for the closed-ended scheme. Within nine months, mutual funds must invest money raised from the saving schemes. This protects the mutual funds from the disadvantage of investing funds in the bullish market and suffering from poor NAV after that. Mutual funds can invest a maximum of 25% in money market instruments in the first six months after closing the funds and a maximum of 15% of the corpus after six months to meet short-term liquidity requirements.

SEBI inspects mutual funds every year to ensure compliance with the regulations.

7.10 TERMINOLOGIES

1) Mutual funds 2) Schemes 3) Investing 4) Structure 5)Regulation

7.11 MODEL QUESTIONS

1. What are the Importance of Mutual Funds?
2. Explain the Advantages and Disadvantages of Mutual Funds?
3. Bringout the Legal Structure of Mutual Fund?
4. Explain the Regulation of Mutual Fund?
5.Explain the SEBI Regulations for Mutual Fund?

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UNIT- VIII LEASE

Structure

8.1 Introduction
8.2 Steps involved in leasing transaction
8.3 Types of Lease
8.4 Distinction between a financial lease and Operating lease
8.5 Leasing as a source of finance
8.6 Installment Buying, Hire purchase and leasing
8.7 Advantages of lease
8.8 Disadvantages of lease
8.9 Terminologies
8.10 Model Questions
8.11 Reference Books

8.1 INTRODUCTION

Traditionally **,** firms acquire productive assets and use them as owners. The sources of finance to firm for procuring assets may be internal or external. Over the years, there has been a declining trend in the internally generated resources of Indian companies due to low profitability. The financial institutions experience paucity of funds at their disposal to meet the increasing needs of borrowers. Further, modern business environment is becoming more and more complex . to succeed in the situation, the firms aim at growth with stability. To accomplish this objective, firms are required to go for massive expansion, diversification and modernization Essentially, such projects involve a huge amount of investment. High rte of inflation, severe cost escalation, heavy taxation and meager internal resources forced many companies to look for alternative means of financing the projects. Leasing has emerged as a new source of financing capital assets.

CONCEPT OF LESING

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an greed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing , the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent per cent tax deductible.

A Lease is defined as follows:

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

- Dictionary of business and management

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

-James c. van Horne

' A contract between lessor and lessee for the hire of specific asset selected from a manufactured or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period'.

-Equipment leasing association of UK

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

8.2 STEPS INVOLVED IN LEASING TRANSACTION

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

1. First, the lessee has to decide the asset required and select the supplier. He has to decide about the design specifications, the price, warranties, terms of delivery, servicing, etc.

2. The lessee, then enters into a lease agreement with the lessor. The lease agreement contains the terms and conditions of the lease such as ,

(a) The basic lease period during which the lease is irrecoverable.

(b) The timing and amount of periodical rental payments during the lease period.

(c) Details of any option to renew the lease or to purchase the asset at the end of the period.

(d) Details regarding payment of cost of maintenance and repairs, taxes insurance and other expenses.

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

8.3 TYPES OF LEASE

The lease agreement can be classified broadly into four categories.

1. Financial lease

A financial lease is also known as capital lease, long-term lease, net lease and close lease. In a financial lease, the lessee selects the equipment, settles the price and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable and non- cancellable contractual agreement with the leasing company. The lessee uses the equipment exclusively, maintains it, insures and avails of the after-sales service and warranty backing it. He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.

The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain non-cancellable clause which means that the lessor transfers the title to the lessee t the end of the lease period.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available. The leasing company may also charges to cover legal and other costs. The leasing company may also insist on collaterals or bank’s guarantee in individual cases. In a large number of cases, the financial leases are used as financing-cum-tax planning tool.

The financial lease is very popular in India as in other countries like USA, UK and japan. On an all India basis, at present, approximately a lease worth Rs. 75 crore to Rs. 100 crore is transacted as a tax planning device. The high cost of equipment such as office equipment, diesel generators, machine tools, textile machinery, containers, locomotives, etc., are leased under financial lease.

2. Operating lease

An operating lease is also known as service lease, short-term lease or true lease. In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment. This means that the lease is for a limited period, may be a month, six months a year or few years. The lease is terminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. The risk of obsolescence is enforced on the lessor who will also bear the cost maintenance and other relevant expenditure. The lessor also does the services like handling warranty claims, paying taxes, scheduling and performing maintenance and keeping complete records lease suitable for,

(i) Computers, copy machines and other office equipments, vehicles, material handling equipments, etc., which are sensitive to obsolescence and

(ii) where the lessee is interested in tiding over temporary problem

3. Leverage lease

A leverage lease is used for financing those assets which require huge capital outly. The outlay for purchase cost of the asset generally varies from Rs. 50 lakh to Rs.2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties- the lessee, the lessor and the lender. The lessor acquires the assets per the terms of the lease agreement but finances only a part of the total investment, say 20 per cent to 50 per cent. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as railroad, rolling stock, coal mining, electricity generating plants, pipelines, ships, etc. are acquired.

Under a leverage lease, there are some attractive investment features in the form of after tax consequences for the owner of the equipment. By investing 20 per cent or 25 per cent of the cost of an asset, the lessor is entitled to 100 per cent allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

4. Sale and lease

Under this type of lease, a firm which has an asset sells it to leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and get the right to use the asset during the lease period. The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on net-basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase the property at the termination of lease.

The sale and lease back agreement is beneficial to both lessor and lessee. The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

5. Cross-border lease

Cross- border lease is international leasing and is known as transnational leasing. It relates to a lease transaction between a lessor and lessee domiciled in different countries and includes exports leasing. In other words, the lessor and lessee domiciled in different countries and includes another country. To illustrate, if a leasing company in USA makes available an air bus on lease to air India, there would be a cross-border lease.

Indian leasing industry is unlikely to deal in export border lease for big ticket items such as aircraft but it is well placed to contribute to india's export earnings by offering the lease option. First leasing company hs initiated discussions with Bulgaria to export bull dozers and shovels in significant number of an export lease to that country.

6. Wet lease and dry lease

A wet lease is one where the lessor is responsible for full control and maintenance of leased asset. For instance, the Jet Airways has entered into wet lease agreement with Oman Airways for two air buses for 6 months from May 2009.

On the other hand, a dry lease involves the payment of insurance and maintenance costs by the lessee.

7. Vendor leasing

A vendor lease is one where the retail vendors tie-up with the lease finance companies which give financing option to the customers of the vendors to purchase a product. This type of lease is popular in auto finance.

8.4 DISTINCTION BETWEEN A FINANCIAL LEASE AND OPERATING LEASE

Financial lease	*Operating lease*
1. A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over specified period of time. The lessee commits to series of	1. An operating lease is rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period.

payment which in total exceed the cost of the equipment.	
2. It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2. Operating lease provides for maintenance expenses and taxes of the lessor.
3. The risk of obsolescence is assumed by the lessee.	3. Leasing company assumes risk of obsolescence.
4. Contract are usually non-cancellable.	4. Contract period ranges from intermediate to short-term.
5. Contracts period ranges from medium to long term.	5. Contract are usually cancellable either by the lessor or by the lessee.
6. Aircrafts, land and building, heavy machinery re leassed.	6. Computers, office equipments, automobiles, truck, etc.,
7. The lease involves a financial commitment similar to a leasing company. It places the lessee in a position of borrow.	7. The financial commitment is restricted to regular rental payment. The rentals find place in the P&L A/c of the lessee.
8. The lessor fulfils financial function.	8. The lessor fulfils service function.

8.5 LEASING AS A SOURCE OF FINANCE

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

1. Modernization of business.
2. Balancing equipment.
3. cars, scooters and other vehicles' and durables.
4. Items entitled to 100 per cent depreciation.
5. Assets which are not being financed by banks/institutions.

8.6 INSTALLMENT BUYING.HIRE PURCHASE AND LEASING

In installment buying, the property passes on to the buyer immediately as soon as the first installment, the buyer has no right to return the goods. In case of default, the seller has the right to file a suit in the court of law to recover his dues.

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

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

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

In leasing, rental charges are debited to profit and loss account and the leased asset is not shown in the Balance Sheet of the lessee. As against this, hire purchaser capitalises the asset brought under hire purchaser contract. The liability for future hire purchase installments not yet due is shown separately in the balance sheet.

8.7 ADVANTAGES OF LEASING

The following are the advantages of leasing:

1. Permit alternative use of funds: A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

2. Faster and cheaper credit: Depending on tax structure of the lessee, it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going through formal scrutiny procedure. Hence, acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

3. Flexibility: Leasing arrangements may be tailored to the lessee’s needs more easily than ordinary financing. Lease rentals can be structured to match the lessee’s cash flows. It can be skipped during the months when the cash flows are expected to be low.

4. Facilitates additional borrowings: Leasing my increase long-term ability to acquire funds. The lessee can utilize more funds for working capital needs. Moreover acquisition of assets under the lease agreement does not alter debt-equity ratio. Hence, the lessee can go for additional borrowings in case need arises.

5. Protection against obsolescence: A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

6. No restrictive covenants: The restrictive covenants such s debt-equity ratio, declaration of dividend, etc., which are usually imposed under debenture or loan agreement are absolutely absent in lease agreement.

8.8 DISADVANTAGES OF LEASING

(i) In leasing the cost of interest is very high.

(ii) The asset reverts back to the owner on the termination of the lease period and the lesser loses his claim on the residual value.

(iii) Leasing is not useful in setting up new projects as the rentals become payable soon after the acquisition of assets.

(iv) The lessor generally leases out assets which are purchased by him with the help of bank credit. In the event of a default made by the lessor in making the payment to the bank, the asset would be seized by the bank much to the disadvantage of the lessee.

8.9 TERMINOLOGIES

1) Lease 2) Benefits 3) Types 4)Protection 5)Permit

8.10 MODEL QUESTIONS

1. Explain the Types of Lease ?
2. Distinction between a financial lease and Operating lease?
3. Explain the Leasing as a source of finance?
4. Explain the Installment Buying, Hire purchase and leasing?
5. What are the Advantages of lease?

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BLOCK - III HIRE PURCHASE, MERGER AND ACQUISITIONS PROTFOLIO MANAGEMENT

UNIT – IX HIRE PURCHASE

Structure

9.1 Introduction
9.2 Characteristics of Hire Purchase
9.3 Advantages of Hire Purchase System
9.4 Disadvantages of Hire Purchase System
9.5 Types of Financial Innovation
9.6 Difference between lease and Hire purchase
9.7 Features of Hire Purchase
9.8 A summary of Tabular presentation of Difference between lease and Hire purchase
9.9 Terminologies
9.10 Model Questions
9.11 Reference Books

9.1 INTRODUCTION

Hire purchase is type of the legal contract, in which a buyer agrees to pay for goods in parts or a percentage over a number of months. Hire purchase is used to buy luxurious products which a person cannot afford to pay out right such as a car. A down payment is generally paid and the balance is paid over several months as a monthly installments (Steve Carter, 1997).

In countries like Canada and the United States, a hire purchase is termed an installment plan although these may vary marginally as in a hire purchase agreement, the ownership of the goods remains with the merchant until the last payment is done. Other similar practices are described as closed-end leasing or rent to own. The hire purchase agreement was established in the United Kingdom in the 19th century to permit customers with a cash shortage to make a luxurious purchase. It was done because companies did not want to lose customers or delay the buying process.

According to hire purchase act of 1972, an agreement under which goods are let on hire under which the hirer has an option to purchase them in accordance with the terms of agreement and include an agreement under which Possession of goods is delivered by the owner thereof to a person on the condition that such person pays the amount in periodic payments. The property of the goods is to pass to such a person on the payment of the last installment. Such a person has a right to dismiss the agreement any time before the property so passes.

Abundant of management studies have explained concept of hire purchase system. Many theorists defined that “Hire Purchase System is a system under which money is paid for goods by means of periodical installments with the view of ultimate purchase. All money being paid in the meantime is regarded as payment of hire and the goods become the property of the buyers only when all the installments have been paid. J. Stephenson stated that “The hire-purchase is a form of trade in which credit is granted to the customer on the security of a lien on the goods."

From the above descriptions it is established that the buyer takes the delivery of the article on the payment of first installment and becomes the owner only after paying the final installment. Hire purchase type of business is generally carried in the case of durable consumer articles such as sewing machines, televisions, desert coolers and refrigerators.

9.2CHARACTERISTICS OF HIRE PURCHASE:

1. Possession
2. Ownership upon the full payment
3. Installment buying
4. Social innovation
5. Expands economy
6. Additional income

Hire purchase involves a definite procedure to be followed. For this, an agreement called hire purchase agreement is made in written between the parties involved in the hire purchase transaction.
The agreement comprises of the following elements:

1. The hire purchase price of the goods to which the agreement relates.
2. The cash price of the goods, that is to say, the price at which the good is purchased for cash.
3. The date of the beginning of the agreement.
4. The number and time interval of installments by which the hire purchase price is to be paid.
5. The name of goods, with its sufficient identity, to which the hire purchase agreement relates to.
6. The amount to be paid, if any, at the time of signing the agreement.
7. The signatures of the parties involved in transaction.

When the hire purchase deal is funded by the manufacturer or dealer, then two parties, called, hire vendor and hire purchaser, are involved in the agreement. The hire purchase transaction is financed by some financial institution, and then there are three parties involved in the transaction. These are Hire Vendor, Hire Purchaser, and Financial Institution. In such case, the vendor, initially receives the bills of exchange for hire purchase price of the goods from the hirer. The vendor, then, discounts the bills with the financial institution and gets payment for the goods sold under hire purchase system. The financial institution collects the payments of the bills from the hirer, as and when the installments fall due.

Three parties involved in hire purchase:

9.3 ADVANTAGES OF HIRE PURCHASE SYSTEM:

1. Convenience in Payment: The buyer gets advantage as he has to make the payment in installments. This system is greatly beneficial to the people having limited income.
2. Increased Volume of Sales: This system fascinates more customers as the payment is to be made in easy installments. This leads to increased volume of sales.
3. Increased Profits: Large volume of sales guarantees increased profits to the seller.
4. Encourages Savings: It boosts thrift among the buyers who are forced to save some portion of their income for the payment of the installments. This inculcates the habit to save among the people.
5. Helpful for Small Traders: This system is highly beneficial for the small manufacturers and traders. They can purchase machinery and other equipment on installment basis and in turn sell goods to the buyer charging full price.
6. Earning of Interest: The seller gets the installment which includes original price and interest. The interest is calculated in advance and added in total installments to be paid by the buyer.
7. Lesser Risk: From seller's viewpoint, this system is greatly beneficial as he knows that if the buyer fails to pay one installment, he can get the article back.

9.4 DISADVANTAGES OF HIRE PURCHASE SYSTEM:

1. Higher Price: A purchaser has to pay higher price for the article purchased which includes cost plus interest. The rate of interest is normally quite high.
2. Artificial Demand: Hire purchase system creates false demand for the product. The buyer is desirous to purchase the products, even if he does not need or afford to buy the product.
3. Heavy Risk: The seller runs a heavy risk under such system, though he has the right to take back the articles from the defaulting customers. The second hand goods make little price.
4. Problems to recover installments: It has been perceived that the sellers do not get the installments from the buyers on time. They may choose immoral buyers which may put them in trouble. They have to waste time and incur extra expenditure to recollect the installments. This sometimes leads to serious fights between the buyers and the sellers.

5. Break Up of Families: The system puts heavy financial load on the families which cannot afford to buy costly and luxurious items. In many studies, it has been shown that many happy homes and families have been broken by hire purchase buying's.

It is said that hire purchase in similar to leasing with the exception that ownership of the goods passes to hire purchase customer on payment of the final payment installment, whereas a lessee never becomes the owner of the goods (Steve Carter, 1997).

9.5 TYPES OF FINANCIAL INNOVATION

Financial innovation enhances sustainability of institutions and their outreach to the poor. A
useful distinction between different types of financial innovations include:

a. **Financial system/institutional innovations.**

   Such innovations can effect the financial sector as a whole, relate to changes in business structures, to the establishment of new types of financial intermediaries, or to changes in the legal and supervisory framework. Important examples include the use of the group mechanism to retail financial services, formalizing informal finance sysems, reducing the access barriers for women, or setting up a completely new service structure.

b. **Process innovations**

   Such innovations cover the introduction of new business processes leading to increased efficiency, market expansion, etc. Examples include office automation and use of computers with accounting and client data management software.

c. **Product innovations**

   Such innovations include the introduction of new credit, deposit, insurance, leasing, hire purchase, and other financial products. Product innovations are introduced to respond better to changes in market demand or to improve the efficiency of

9.6 DIFFERENCE BETWEEN LEASE AND HIRE PURCHASE:

LEASE

In simple words, a Lease is a financial contract between the business customer (user/lessee) and the equipment supplier (normally owner/lessor) for using a particular asset/equipment over a period of time against the periodic payments called "Lease rentals".

The lease generally involves two parties i.e. the lessor (owner) and the lessee (user). Under this arrangement, the lessor transfers the right to use to the lessee in return of the lease rentals agreed upon. A lease agreement can be made flexible enough to meet the financial requirements of both the parties. A lease also acts as an alternative to financing business assets. There are many options for a finance manager to choose from. He can opt for equity finance, debt finance, term loan, hire-purchase or many others. All the means of financing differ from each other due to their different characteristics. There are some advantages and disadvantages of leasing.

HIRE PURCHASE

Hire Purchase is a kind of installment purchase where the businessman (hirer) agrees to pay the cost of the equipment in different installments over a period of time. This installment covers the principal amount and the interest cost towards the purchase of an asset for the period the asset is utilized. The hirer gets the possession of the asset as soon as the hire purchase agreement is signed. He becomes the owner of the equipment after the last payment is made. The hirer has the right to terminate the agreement anytime before taking the title or the ownership of the asset.

1. **Ownership of the Asset**: In lease, ownership lies with the lessor. The lessee has the right to use the equipment and does not have an option to purchase. However in hire purchase, the hirer has the choice to purchase. The hirer becomes the owner of the asset/equipment immediately after the last installment is paid.
2. **Depreciation:** In lease funding, the depreciation is demanded as an expense in the books of lessor. Instead, the depreciation claim is allowed to the hirer in case of hire purchase deal.
3. **Rental Payments**: The lease rentals cover the cost of using an asset. Usually, it is derived with the cost of an asset over the asset life. But in the process of hire purchase, installment is inclusive of the principal amount and the interest for the time period the asset is used.
4. **Duration**: Normally lease agreements are done for longer duration and for big assets such as land, property. But hire Purchase agreements are done generally for shorter duration and cheaper assets such as hiring a car or machinery.

5. **Tax Impact**: In lease agreement, the total lease rentals are revealed as expenditure by the lessee. In hire purchase, the hirer claims the depreciation of asset as an expense.
6. **Repairs and Maintenance**: Repairs and maintenance of the asset in financial lease is the responsibility of the lessee but in operating lease, it is the responsibility of the lessor. In hire purchase, hirer is responsible for maintenance.
7. **Extent of Finance**: Lease financing can be called the complete financing choice in which no down payments are required but in hire purchase, the normally 20 to 25 % margin money is required to be paid upfront by the hirer.

9.7 FEATURES OF HIRE PURCHASE:

The main features of hire purchase finance are:

1. The hire purchaser becomes the owner of the asset after paying the last installment.

2. Every installment is treated as hire charge for using the asset.

3. Hire purchaser can use the asset right after making the agreement with the hire vendor.

4. The hire vendor has the right to repossess the asset in case of difficulties in obtaining the payment of installment.

9.8 A SUMMARY OF TABULAR PRESENTATION OF DIFFERENCES BETWEEN LEASE AND HIRE PURCHASE

Points of Distinction	**Leasing**	**Hire Purchase**
Ownership	Lessor is the owner until the end of the agreement	Hirer has the option of purchasing the asset at the end of the agreement
Duration	Done for longer	Done for a shorter

	duration	duration
Depreciation	Lessor claims the depreciation	Hirer claims the depreciation
Payments	Rental payments are the cost of using the asset	Payments include the principal amount and the effective interest for the duration of the agreement
Tax Impact	Lease rentals categorized as expenditure by the lessee	Only interest component is categorized as expenditure by the hirer
The Extent of Financing	Complete financing	Partial financing
Repairs and Maintenance	Responsibility of the lessee in the financial lease, and of the lessor in operating lease	Responsibility of the hirer

9.10 TERMINOLOGIES

1) Hire Purchase 2) Financial 3) Innovations 4) Lease 5) Payments

9.11 MODEL QUESTIONS

1. What are the Advantages of Hire Purchase System?
2. What are the Disadvantages of Hire Purchase System?
3. Explain the Types of Financial Innovation?
4. Difference between lease and Hire purchase?
5. Explain the Features of Hire Purchase?

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UNIT- X MERGERS AND ACQUISITIONS

Structure

10.1 Introduction
10.2 Reasons for mergers and Acquisitions

10.3 Stages involved in Any M & A

10.4 Benefits of Mergers and Acquisitions

10.5 Ten Steps in M & A Deal process includes

10.6 Legal Aspect of Mergers and Acquisitions

10.7 Takeover in India – M & A for firms- A Boon or BANE

10.8 Advantages of Mergers and Takeovers

10.9 Effects of M & A

10.10 Reasons for the failure of M & A

10.11 Terminologies

10.12 Model Questions

10.13 Reference Books

10.1 INTRODUCTION

Merger and acquisition proves useful when either of the company wants to get into new market. There is a long but required process that both companies need to undergo before getting into the merging process.Company, in terms of new production or increase in market share are not the only which it looks for, but also for employees benefits.There can other schemes and financial benefits for employees after the merger, which depends on the condition of both companies. With having multiple benefits, many companies are now getting into this process for further business growth.

Meaning of Mergers & Acquisitions

Mergers and acquisitions (M&A) are defined as consolidation of companies. Differentiating the two terms, ***Mergers*** is the combination of two companies to form one, while ***Acquisitions*** is one company taken over by the other. M&A is one of the major aspects of corporate finance world. The reasoning behind M&A generally given is that two separate companies together create more value compared to being on an individual stand. With the objective of wealth maximization, companies keep evaluating different opportunities through the route of merger or acquisition.

Mergers & Acquisitions can take place

- by purchasing assets
- by purchasing common shares
- by exchange of shares for assets
- by exchanging shares for shares

10.2 REASONS FOR MERGERS AND ACQUISITIONS:

- Financial synergy for lower cost of capital
- Improving company's performance and accelerate growth
- Economies of scale
- Diversification for higher growth products or markets
- To increase market share and positioning giving broader market access
- Strategic realignment and technological change
- Tax considerations
- Under valued target
- Diversification of risk

10.3 STAGES INVOLVED IN ANY M&A:

Phase 1: Pre-acquisition review: this would include self assessment of the acquiring company with regards to the need for M&A, ascertain the valuation (undervalued is the key) and chalk out the growth plan through the target.
Phase 2: **Search and screen targets:** This would include searching for the possible apt takeover candidates. This process is mainly to scan for a good strategic fit for the acquiring company.

Phase 3: **Investigate and valuation of the target:** Once the appropriate company is shortlisted through primary screening, detailed analysis of the target company has to be done. This is also referred to as due diligence.

Phase 4: Acquire the target through negotiations: Once the target company is selected, the next step is to start negotiations to come to consensus for a negotiated merger or a bear hug. This brings both the companies to agree mutually to the deal for the long term working of the M&A.

Phase 5:Post merger integration*:* If all the above steps fall in place, there is a formal announcement of the agreement of merger by both the participating companies.

10.4 BENEFITS OF MERGERS AND ACQUISITIONS:

Greater value of generation

Generally it is seen with the M&A, company's value generation increases. Moreover, the value of shareholder increases compared to the value in parent company.

Benefit in tax gains

One of the benefits of the merger is the tax gains and revenue enhancement through market share. Joint companies generally expect more value from separate firms after merger.

Good option to overcome the current situation

If a company suffering from various financial or business issues, the best thing to do M&A. An acquiring company needs to have a good strong hold in the market, which deals in buying weak firm under cost effective deal. This is beneficial for both loss making and acquiring company and get into new strategy.

Cost efficiency

This is the major benefit a company can have under M&A. It helps in creating economies of scale which in turn generates good cost efficiency result. When two companies merge, the production takes place in large scale which in turn increases the output production and cost of per product production is reduced. There are also other benefits with M&A:

- A firm looking to enter into new market
- When the firm wants to introduce new products
- To bring down the cost of operation
- To gain higher competitiveness
- To gain financial leveraging

10.5 TEN STEPS IN M&A DEAL PROCESS INCLUDES:

1. **Develop an acquisition strategy** – Developing a good acquisition strategy revolves around the acquirer having a clear idea of what they expect to gain from making the acquisition – what their business purpose is for acquiring the target company (e.g., expand product lines or gain access to new markets)
2. **Set the M&A search criteria** – Determining the key criteria for identifying potential target companies (e.g., profit margins, geographic location, or customer base)
3. **Search for potential acquisition targets** – The acquirer uses their identified search criteria to look for and then evaluate potential target companies
4. **Begin acquisition planning** – The acquirer makes contact with one or more companies that meet its search criteria and appear to offer good value; the purpose of initial conversations is to get more information and to see how amenable to a merger or acquisition the target company is
5. **Perform valuation analysis** – Assuming initial contact and conversations go well, the acquirer asks the target company to provide substantial information (current financials, etc.) that will enable the acquirer to further evaluate the target, both as a business on its own and as a suitable acquisition target

6. **Negotiations** – After producing several valuation models of the target company, the acquirer should have sufficient information to enable it to construct a reasonable offer; Once the initial offer has been presented, the two companies can negotiate terms in more detail
7. **M&A due diligence** – Due diligence is an exhaustive process that begins when the offer has been accepted; due diligence aims to confirm or correct the acquirer's assessment of the value of the target company by conducting a detailed examination and analysis of every aspect of the target company's operations – its financial metrics, assets and liabilities, customers, human resources, etc.
8. **Purchase and sale contract** – Assuming due diligence is completed with no major problems or concerns arising, the next step forward is executing a final contract for sale; the parties make a final decision on the type of purchase agreement, whether it is to be an asset purchase or share purchase
9. **Financing strategy for the acquisition** – The acquirer will, of course, have explored financing options for the deal earlier, but the details of financing typically come together after the purchase and sale agreement has been signed
10. **Closing and integration of the acquisition** – The acquisition deal closes, and management teams of the target and acquirer work together on the process of merging the two firms

10.6 LEGAL ASPECTS OF MERGERS AND ACQUISITIONS

Different legal issues can arise at different stages of the acquisition process and require separate and sequential treatment.

Carrying out due diligence

Due diligence is the process of uncovering all liabilities associated with the purchase. It is also the process of verifying that claims made by the vendors are correct. Directors of companies are answerable to their shareholders for ensuring that this process is properly carried out.

For legal purposes, make sure you:

- obtain proof that the target business owns key assets such as property, equipment, intellectual property, copyright and patents
- obtain details of past, current or pending legal cases
- look at the detail in the business' current and possible future contractual obligations with its employees (including pension obligations), customers and suppliers
- consider the impact of a change in the business' ownership on existing contracts

Always use a lawyer to conduct legal due diligence.

Completing the deal for a merger or acquisition

When you are considering general terms of a potential deal you will probably seek certain confirmations and commitments from the seller of the target business. These will provide a level of assurance and comfort about the deal and are indications of the seller's own confidence in their business.

- **Warranty** - a written statement from the seller that confirms a key fact about the business. You may require warranties on the business' assets, the order book, debtors and creditors, employees, legal claims and the business' audited accounts.
- **Indemnity** - a commitment from the seller to reimburse you in full in certain situations. You might seek indemnities for unreported tax liabilities, for example.

Your professional adviser can assist in reviewing the content and adequacy of warranties and indemnities.

Cross-border mergers

The Companies (Cross-Border Mergers) Regulations 2007 outline the requirements for **mergers between UK and overseas companies**.

Every UK company involved in a cross-border merger must file the following documents with Companies House:

- a copy of the draft terms of merger
- a copy of any court order summoning a meeting of members or creditors
- a completed cross-border mergers **form CB01**

These documents must be delivered to the Registrar at least two months before the first meeting of the members. See **filing company information using Companies House WebFiling**.

If the company resulting from the merger is a UK company, an order is made from the High Court or Court of Sessions approving the completion of the merger. Every UK company involved must deliver a copy of this order to Companies House within seven days.

Upon receipt of this order, Companies House will:

- send notification of the order to the register of each company involved from another European Economic Area (EEA) state
- dissolve any UK company that is transferring to another EEA state and place a note in the register stating that as from the date on which the merger took effect the assets and liabilities of the UK company were transferred to the transferee company in the relevant EEA state

If you are contemplating a cross-border merger, make sure you take appropriate professional advice from the start. Read more about **cross border mergers**.

For more information about the legal aspects of partnership agreements, see **joint ventures and business partnerships**.

10.7 TAKEOVERS IN INDIA-MERGERS AND ACQUISITIONS FOR FIRMS – A BOON OR BANE

Mergers and acquisitions in its basic terminology means that merger is a combination of two companies to form a new company, while an acquisition (or takeover) is the purchase of one company by another in which no new company is formed. Although the terms Mergers and Acquisitions may be used synonymously, but they differ in sense that a merger take place when two firms agree to go forward as a single new company and in acquisition the right over other company is acquired. Acquisition (or takeover) is an attempt to acquire the Target Company.

Mergers and acquisitions is one of the best processes of corporate restructuring that has gained substantial prominence in the present day corporate world. Restructuring usually means major changes and modifications in the corporate strategies and beliefs.

Types of Mergers:
Based on the offerors' objectives profile, combinations could be vertical, horizontal, circular and conglomeratic as precisely described below with reference to the purpose in view of the offeror company.

(A) Vertical combination:
A company would like to takeover another company or seek its merger with that company to expand espousing backward integration to assimilate the resources of supply and forward integration towards market outlets. The acquiring company through merger of another unit attempts on reduction of inventories of raw material and finished goods, implements its production plans as per the objectives and economizes on working capital investments.

In other words, in vertical combinations, the merging undertaking would be either a supplier or a buyer using its product as intermediary material for final production.

The following main benefits accrue from the vertical combination to the acquirer company:
(1) It gains a strong position because of imperfect market of the intermediary products, scarcity of resources and purchased products;
(2) Has control over products specifications.

(B) Horizontal combination:
It is a merger of two competing firms which are at the same stage of industrial process. The acquiring firm belongs to the same industry as the target

company. The mail purpose of such mergers is to obtain economies of scale in production by eliminating duplication of facilities and the operations and broadening the product line, reduction in investment in working capital, elimination in competition concentration in product, reduction in advertising costs, increase in market segments and exercise better control on market.

(C) Circular combination:
Companies producing distinct products seek amalgamation to share common distribution and research facilities to obtain economies by elimination of cost on duplication and promoting market enlargement. The acquiring company obtains benefits in the form of economies of resource sharing and diversification.

(D) Conglomerate combination:
It is amalgamation of two companies engaged in unrelated industries like DCM and Modi Industries. The basic purpose of such amalgamations remains utilization of financial resources and enlarges debt capacity through re-organizing their financial structure so as to service the shareholders by increased leveraging and EPS, lowering average cost of capital and thereby raising present worth of the outstanding shares. Merger enhances the overall stability of the acquirer company and creates balance in the company's total portfolio of diverse products and production processes.

Reasons –
One of the most reason for mergers and acquisitions is the belief that "synergies" exist, allowing the two companies to work more efficiently together than either would separately. Such synergies may result from the firms' combined ability to exploit economies of scale, eliminate duplicated functions, share managerial expertise, and raise larger amounts of capital. Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. Usually mergers occur in a consensual (occurring by mutual consent) setting. The dictionary meaning of Mergers is "to combine commercial or industrial firms" or "to lose identity by being absorbed in something else".

The basic purpose of merger or business combination is to achieve faster growth of the corporate business. Faster growth may be had through product improvement and competitive position.

1) Procurement of supplies: To safeguard the source of supplies of raw materials or intermediary product

2) Revamping production facilities: To achieve economies of scale by amalgamating production facilities through more intensive utilization of plant and resources;

3) Market expansion and strategy: To eliminate competition and protect existing market;

4) Financial strength: To improve liquidity and have direct access to cash resource;

5) Strategic purpose: The Acquirer Company view the merger to achieve strategic objectives through alternative type of combinations which may be horizontal, vertical, product expansion, market extensional or other specified unrelated objectives depending upon the corporate strategies

6) Desired level of integration: Mergers and acquisition are pursued to obtain the desired level of integration between the two combining business houses. Such integration could be operational or financial.

10.8 ADVANTAGES OF MERGERS AND TAKEOVERS

Mergers and acquisitions are caused with the support of shareholders, managers and promoters of the combining companies.

From the standpoint of shareholders
Investment made by shareholders in the companies subject to merger should enhance in value. The sale of shares from one company's shareholders to another and holding investment in shares should give rise to greater values i.e. the opportunity gains in alternative investments. Shareholders may gain from merger in different ways viz. from the gains and achievements of the company i.e. through

(a) realization of monopoly profits;
(b) economies of scales;
(c) diversification of product line;
(d) acquisition of human assets and other resources not available otherwise;
(e) better investment opportunity in combinations.

From the standpoint of managers
Managers are concerned with improving operations of the company, managing the affairs of the company effectively for all round gains and growth of the company which will provide them better deals in raising their status, perks and

fringe benefits. Mergers where all these things are the guaranteed outcome get support from the managers. At the same time, where managers have fear of displacement at the hands of new management in amalgamated company and also resultant depreciation from the merger then support from them becomes difficult.

Promoter’s gains:
Mergers do offer to company promoters the advantage of increasing the size of their company and the financial structure and strength. They can convert a closely held and private limited company into a public company without contributing much wealth and without losing control.

Benefits to general public:
Impact of mergers on general public could be viewed as aspect of benefits and costs to:
(a) Consumer of the product or services;
(b) Workers of the companies under combination;
(c) General public affected in general having not been user or consumer or the worker in the companies under merger plan.

Mergers are pursued under the Companies Act, 1956 vide sections 391/394 thereof or may be envisaged under the provisions of Income-tax Act, 1961 or arranged through BIFR under the Sick Industrial Companies Act, 1985

10.9 EFFECTS OF MERGERS AND ACQUISITIONS:

Effects Of Mergers And Acquisitions on workers or employees:
Aftermath of mergers and acquisitions impact the employees or the workers the most. It is a well known fact that whenever there is a merger or an acquisition, there are bound to be lay offs.

In the event when a new resulting company is efficient business wise, it would require less number of people to perform the same task. Under such circumstances, the company would attempt to downsize the labor force. If the employees who have been laid off possess sufficient skills, they may in fact benefit from the lay off and move on for greener pastures. But it is usually seen that the employees those who are laid off would not have played a significant role under the new organizational set up. This accounts for their removal from the new organization set up. These workers in turn would look for re employment and may have to be satisfied with a much lesser pay package than the previous one. Even though this may not lead to drastic unemployment levels, nevertheless, the workers will have to compromise for the same. If not drastically, the mild undulations created in the local economy cannot be ignored fully.

Effect on Management:
Effect of mergers and acquisitions on top level management:
It may actually involve a "clash of the egos". There might be variations in the cultures of the two organizations. Under the new set up the manager may be asked to implement such policies or strategies, which may not be quite approved by him. When such a situation arises, the main focus of the organization gets diverted and executives become busy either settling matters among themselves or moving on. If however, the manager is well equipped with a degree or has sufficient qualification, the migration to another company may not be troublesome at all.

Effects of Mergers and Acquisitions on Shareholders:
We can further categorize the shareholders into two parts:
The Shareholders of the acquiring firm
The shareholders of the target firm.

Shareholders of the acquired firm:
The shareholders of the acquired company benefit the most. The reason being, it is seen in majority of the cases that the acquiring company usually pays a little excess than it what should. Unless a man lives in a house he has recently bought, he will not be able to know its drawbacks. So that the shareholders forgo their shares, the company has to offer an amount more then the actual price, which is prevailing in the market. Buying a company at a higher price can actually prove to be beneficial for the local economy.

Shareholders of the acquiring firm:
They are most affected. If we measure the benefits enjoyed by the shareholders of the acquired company in degrees, the degree to which they were benefited, by the same degree, these shareholders are harmed. This can be attributed to debt load, which accompanies an acquisition.

10.10 REASONS FOR THE FAILURE OF M&A

Poor strategic fit: Wide difference in objectives and strategies of the company
Poorly managed Integration: Integration is often poorly managed without planning and design. This leads to failure of implementation

Incomplete due diligence: Inadequate due diligence can lead to failure of M&A as it is the crux of the entire strategy

Overly optimistic: Too optimistic projections about the target company leads to bad decisions and failure of the M&A

Example: Breakdown in merger discussions between IBM and Sun Microsystems happened due to disagreement over price and other terms.

10.11 TERMINOLOGIES

1) Mergers 2) Acquisitions 3) Procedure4) Governing 5) takeover

10.12 MODEL QUESTIONS

1. What are the Benefits of Mergers and Acquisitions?
2. Explain the Ten Steps in M & A Deal process includes?
3. Explain the Legal Aspect of Mergers and Acquisitions?
4. Discuss the Takeover in India – M & A for firms- A Boon or BANE?
5. What are the Advantages of Mergers and Takeovers?

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UNIT-XI PORTFOLIO MANAGEMENT

Structure

11.1 Introduction

11.2 Elements of Portfolio management

11.3 Portfolio Performance Evaluation methods

11.4 Portfolio Return and Risk

11.5 Portfolio Risk and Expected Return

11.6 Terminologies

11.7 Model Questions

11.8 Reference Books

11.1 INTRODUCTION

Although it is common to use the terms "portfolio management" and "financial planning" as synonyms, these staples of the financial services industry are not the same. Portfolio management is the act of creating and maintaining an investment account, while financial planning is the process of developing financial goals and creating a plan of action to achieve them. Professional licensed portfolio managers are responsible for portfolio management on behalf of others, while individuals may choose to self-direct their own investments and build their own portfolio. Portfolio management's ultimate goal is to maximize the investments' expected return given an appropriate level of risk exposure.

Portfolio management, in general, can by either passive or active in nature.. Passive management is a set-it-and-forget-it long-term strategy that often involves simply tracking a broad market index (or group of indexes), commonly referred to as indexing or index investing.

Active management instead involves a single manager, co-managers or a team of managers who attempt to beat the market return by actively managing a fund's portfolio through investment decisions based on research and decisions on individual holdings. Closed-end funds are generally actively managed.

Meaning of Portfolio Management

Portfolio management is the art and science of making decisions about investment mix and policy, matching investments to objectives, asset allocation for individuals and institutions, and balancing risk against performance. Portfolio management is all about determining strengths, weaknesses, opportunities and threats in the choice of debt vs. equity, domestic vs. international, growth vs. safety, and many other trade-offs encountered in the attempt to maximize return at a given appetite for risk.

11.2 ELEMENTS OF PORTFOLIO MANAGEMENT

Asset Allocation: The key to effective portfolio management is the long-term mix of assets. Asset allocation is based on the understanding that different types of assets do not move in concert, and some are more volatile than others. Asset allocation seeks to optimize the risk/return profile of an investor by investing in a mix of assets that have low correlation to each other. Investors with a more aggressive profile can weight their portfolio toward more volatile investments. Investors with a more conservative profile can weight their portfolio toward more stable investments. Indexed portfolios may employ modern portfolio theory (MPT) to aid in building an optimized portfolio, while active managers may use any number of quantitative and/or qualitative models.

Diversification: The only certainty in investing is it is impossible to consistently predict the winners and losers, so the prudent approach is to create a basket of investments that provide broad exposure within an asset class.Diversification is the spreading of risk and reward within an asset class. Because it is difficult to know which particular subset of an asset class or sector is likely to outperform another, diversification seeks to capture the returns of all of the sectors over time but with less volatility at any one time. Proper diversification takes place across different classes of securities, sectors of the economy and geographical regions.

Rebalancing is a method used to return a portfolio to its original target allocation at annual intervals. It is important for retaining the asset mix that best reflects an investor’s risk/return profile. Otherwise, the movements of the markets could expose the portfolio to greater risk or reduced return opportunities. For example, a portfolio that starts out with a 70% equity and 30% fixed-income allocation could, through an extended market rally, shift to an 80/20 allocation that exposes the portfolio to more risk than the investor can tolerate. Rebalancing almost always entails the sale of high-priced/low-value securities and the redeployment of the proceeds into low-priced/high-value or out-of-favor securities. The annual iteration of rebalancing enables investors to capture gains and expand the opportunity for growth in high potential sectors while keeping the portfolio aligned with the investor's risk/return profile.

Active Portfolio Management

Investors who implement an active management approach use fund managers or brokers to buy and sell stocks in an attempt to outperform a specific index, such as the Standard & Poor's 500 Index or the Russell 1000 Index.

An actively managed investment fund has an individual portfolio manager, co-managers, or a team of managers actively making investment decisions for the fund. The success of an actively managed fund depends on combining in-depth research, market forecasting, and the experience and expertise of the portfolio manager or management team.

Portfolio managers engaged in active investing pay close attention to market trends, shifts in the economy, changes to the political landscape, and factors that may affect specific companies. This data is used to time the purchase or sale of investments in an effort to take advantage of irregularities. Active managers claim that these processes will boost the potential for returns higher than those achieved by simply mimicking the stocks or other securities listed on a particular index.

Since the objective of a portfolio manager in an actively managed fund is to beat the market, he or she must take on additional market risk to obtain the returns necessary to achieve this end. Indexing eliminates this, as there is no risk of human error in terms of stock selection. Index funds are also traded less frequently, which means that they incur lower expense ratios and are more tax-efficient than actively managed funds.

Active management traditionally charges high fees, and recent research has cast doubts on managers' ability to consistently outperform the market.

Passive Portfolio Management

Passive management, also referred to as index fund management, involves the creation of a portfolio intended to track the returns of a particular market index or benchmark as closely as possible. Managers select stocks and other securities listed on an index and apply the same weighting. The purpose of passive portfolio management is to generate a return that is the same as the chosen index instead of outperforming it.

A passive strategy does not have a management team making investment decisions and can be structured as an exchange-traded fund (ETF), a mutual fund, or a unit investment trust. Index funds are branded as passively managed because each has a portfolio manager replicating the index, rather than trading securities based on his or her knowledge of the risk and reward characteristics of various securities. Because this investment strategy is not proactive, the management fees assessed on passive portfolios or funds are often far lower than active management strategies.

Index mutual funds are easy to understand and offer a relatively safe approach to investing in broad segments of the market.

11.3 PORTFOLIO PERFORMANCE EVALUATION METHODS

The objective of modern portfolio theory is maximization of return or minimization of risk. In this context the research studies have tried to evolve a composite index to measure risk based return. The credit for evaluating the systematic, unsystematic and residual risk goes to Sharpe, Treynor and Jensen. The portfolio performance evaluation can be made based on the following methods:

Sharpe’s Measure

Treynor’s Measure

Jensen’s Measure

1. Sharpe’s Measure

Sharpe’s Index measure total risk by calculating standard deviation. The method adopted by Sharpe is to rank all portfolios on the basis of evaluation measure. Reward is in the numerator as risk premium. Total risk is in the denominator as standard deviation of its return. We will get a measure of portfolio’s total risk and variability of return in relation to the risk premium. The measure of a portfolio can be done by the following formula:

SI =(Rt – Rf)/σf

Where,

SI = Sharpe’s Index

Rt = Average return on portfolio

Rf = Risk free return

σf = Standard deviation of the portfolio return.

2. Treynor’s Measure

The Treynor’s measure related a portfolio’s excess return to non-diversifiable or systematic risk. The Treynor’s measure employs beta. The Treynor based his formula on the concept of characteristic line. It is the risk measure of standard deviation, namely the total risk of the portfolio is replaced by beta. The equation can be presented as follow:

Tn =(Rn – Rf)/βm

Where,

Tn = Treynor’s measure of performance

Rn = Return on the portfolio

Rf = Risk free rate of return

βm = Beta of the portfolio (A measure of systematic risk)

3. Jensen's Measure

Jensen attempts to construct a measure of absolute performance on a risk adjusted basis. This measure is based on Capital Asset Pricing Model (CAPM) model. It measures the portfolio manager's predictive ability to achieve higher return than expected for the accepted riskiness. The ability to earn returns through successful prediction of security prices on a standard measurement. The Jensen measure of the performance of portfolio can be calculated by applying the following formula:

Rp = Rf + (RMI – Rf) x β

Where,

Rp = Return on portfolio

RMI = Return on market index

Rf = Risk free rate of return

11.4 PORTFOLIO RETURN & RISK

Investing in a portfolio involves both returns and risks. In order to evaluate the performance, we should consider both the aspects. Evaluating a portfolio's performance involves comparing it to an appropriate benchmark.
Let's assume you have invested in a portfolio that gave a return of 20% over a year, whereas the market index has given returns of 15% over the same year. You might think that your portfolio has generated better returns, but how do you confirm this? In order to have a proper comparison against the benchmark, you should have methods to evaluate both returns and risk. We will now understand how to measure the returns and risks of a portfolio.

The return of a portfolio is derived from the **weighted average** returns of the assets in the portfolio. For a portfolio with *n* number of assets, the portfolio returns are:

$$r_P = w_1 r_1 + w_2 r_2 + \ldots + w_n r_n$$

Total risk of the portfolio can be determined by its **volatility**, which is the standard deviation of its returns over a period of time. For *n*period returns of a portfolio, volatility is:

$$\sigma_P = \sqrt{\frac{1}{n}\sum_{i=1}^{n}(r_i - r_{mean})^2}$$

The **total risk** has two components:

1. **Systematic risk** of a portfolio is the inherent risk in the portfolio that cannot be diversified. It's measured as **beta**, relative to the market as a whole.

2. **Unsystematic risk:** the component of risk that can be diversified away

Let's assume that over the year, your portfolio had a standard deviation of 12% and that of the market index was 7%. So now you can see that your portfolio had more risk than the benchmark

11.5 PORTFOLIO RISK AND EXPECTED RETURN

MPT makes the assumption that investors are risk-averse, meaning they prefer a less risky portfolio to a riskier one for a given level of return. This implies that an investor will take on more risk only if he or she is expecting more reward.

The expected return of the portfolio is calculated as a weighted sum of the individual assets' returns. If a portfolio contained four equally-weighted assets with expected returns of 4, 6, 10, and 14%, the portfolio's expected return would be:

(4% x 25%) + (6% x 25%) + (10% x 25%) + (14% x 25%) = 8.5%

The portfolio's risk is a complicated function of the variances of each asset and the correlations of each pair of assets. To calculate the risk of a four-asset portfolio, an investor needs each of the four assets' variances and six correlation values, since there are six possible two-asset combinations with four assets. Because of the asset correlations, the total portfolio risk, or standard deviation, is lower than what would be calculated by a weighted sum.

11.6 TERMINOLOGIES

1) Portfolio 2) Management 3) Measures 4) Techniques 5) Evaluation

11.7 MODEL QUESTIONS

1. Explain the Elements of Portfolio management?
2. Explain the Portfolio Performance Evaluation methods?
3. Discuss the Portfolio Return and Risk?
4. Explain the Portfolio Risk and Expected Return?
5. Explain the Importance of Portfolio management?

11.8 REFERENCE BOOKS

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UNIT – XII SECURITISATION OF DEBT

Structure

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12.2 Sturctured Securities vs. Conventional Securities
12.3 Securitisation Vs. Factoring
12.4 Modus Operandi
12.5 Structure for Securitisation (Types)
12.6 Benefits of Securitisation
12.7 Securitisation and Banks
12.8 Conditions for Successful Securitisation
12.9 Securitisation in Indian Context
12.10 New guidelines of Securitization
12.11 Terminologies
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12.1 INTRODUCTION

The financial system all over the word is in the process of rapid transformation. As a result, the capital market, money market and the debt market are getting widened and deepened. It is interesting to note that new instruments and new products are emerging in the debt market . In fact, the development of a debt market increases the efficiency of a capital market to a greater extent. Again, along with the equity market, there is bound to be a natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary markets. In this context, debt or asset securitisation assumes a significant role and it is one of the most innovative techniques introduced in the debt market to achieve the above objective. Moreover, it is the debt market which has provided more impetus for capital formation than the equity market in the economically advanced countries.

Meaning of Securitisation

Securitisation of debt or asset refers to the process of liquidating the illiquid and long- term assets like loans and receivables of financial institutions like banks by issuing marketable securities against them. In other words, it is a technique by which a long-term, non-negotiable and high-valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Thus, it is nothing but a process of removing long-term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long-term assets, creates securities against them, gets them rated and sells them to investors .It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into assets and assets into securities and so on.

Generally, extension of credit by banks and other financial institutions in the form of bills purchase or discounting or hire purchase financing appears as an asset on their balance sheets. Some of these assets are long-term in nature and it implies that funds are locked up unnecessarily for an undue long period. So, to carry on their lending operations without much interruptions, they have to rely upon various other sources of finance which are not only costly but also not available easily. Again, they have to bear the risk of the credit out standings. Now, securitisation is a ready-made solution for them. Securitisation helps them to recycle funds at a reasonable cost and with less credit risk. In other words, securitisation helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments.

Again from another angle also, securitisation is a boon to financial institutions. From the risk management point of view, the lending financial institutions have to absorb the entire credit risk by holding the credit out standings in their own portfolio. Securitisation offers a good scope for risk diversification. It is worthwhile to note that the entire transaction relating to securitisation is carried out on the asset side of the balance sheet. That is one asset (illiquid) is converted into another asset
(cash).

Definition

As stated earlier, securitisation helps to liquidly assets mainly of medium and long-term loans and receivables of financial institutions. The concept of securitisation can be defined as follows:

'A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities'.

Yet another simple definition is as follows:

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

According to Hendersen, J. and Scott, J.P., 'Securitisation is the process which takes when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead, by investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse, to the original lender'. .

Thus, financial assets can be made liquid through securitisation, i.e., through packaging loans and selling them in the market. It is very clear from the above definitions that securitisation is nothing but the packaging of a pool of financial assets into marketable securities. In brief, illiquid assets are converted into tradable securities.

12.2 STRUCTURED SECURITIES VS. CONVENTIONAL SECURITIES

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

1. Source of repayment: In the case of conventional securities, the primary source of repayment is the earning power and cash flow of the issuing company. But, under 356 securitisation, the issuing company is completely free from this botheration since the burden of repayment is shifted to a pool of assets or to a third party.

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

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

12.3 SECURITISATION VS. FACTORING

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

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

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

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

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

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

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

12.4 MODUS OPERANDI

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

(i) The originator.

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

(iii) A merchant or investment banker.

(iv) A credit rating agency.

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

(vi) The original borrowers or obligors.

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

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

1. Identification stage/process.
2. Transfer stage/process.
3. Issue stage/process.
4. Redemption stage/process.
5. Credit rating stage/process.

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

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

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

4. Redemption process: The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator or a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer. Thus, under securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either with recourse to the originator or 'without recourse'. The usual practice is to make it without recourse'. Hence, the holder of a pass through certificate has to look to the SPV for payment of the principal and interest on the certificates held by him. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment of interest and principal to the investors.

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

Pass through certificates, like debentures, directly reflect the ownership rights in the assets

securitised, their repayment schedule, interest rate, etc. These certificates, before maturity,
are tradable in a secondary market to ensure liquidity for the investors. They are negotiable
securities and hence they can be easily tradable in the market.

- **Role of merchant bankers**

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

- **Role of other parties**

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

12.5 STRUCTURE FOR SECURITISATION (TYPES)

Securitisation is a structured transaction, whereby the originator transfers or sells some of its assets to a SPV which breaks these assets into tradable securities of smaller values which could be sold to the investing public. The appropriate structure for securitisation depends on a variety of factors like quality of assets securitised, default experience of original borrowers, amount of amortisation at maturity, financial reputation and soundness of the originator, etc.

The general principle is that the securities must be structured in such a way that the maturity of these securities may coincide with the maturity of the securitised loans. However, there are three important types of securities as listed below:

(i) Pass through and pay through certificates,

(ii) Preferred stock certificates, and

(ii) Asset-based commercial papers.

Pass through and pay through certificates

In the case of pass through certificates, payments to investors depend upon the cash flow from the assets backing such certificates. In other words, as and when cash principal and interest) is received from the original borrower by the SPV, it is passed on to the holders of certificates at regular intervals and the entire principal is returned with the retirement of the assets packed in the pool. Thus, pass through certificates have a single maturity structure and the tenure of these certificates is matched with the life of the securitised assets.

On the other hand, pay through certificates have a multiple maturity structure depending upon the maturity pattern of underlying assets. Thus, two or three types of securities with different maturity patterns like short-term, medium, term and long-term may be issued. The greatest advantage is that they can be issued depending upon the investor's demand for varying maturity patterns. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves, i.e., they are offered at a discount to face value as in the case of deep discount bonds.

• Preferred stock certificates

Preferred stocks are instruments issued by a subsidiary company against the trade debts and consumer receivables of its parent company. In other words, subsidiary companies buy the trade debts and receivables of parent companies, convert them into short-term securities, and help the parent companies to enjoy liquidity. Thus, trade debts can also be securitised through the issue of preferred stocks. Generally, these stocks are backed by guarantees given by highly rated merchant banks and hence they are also attractive from the investor's point of view. These instruments are mostly short-term in nature.

*** Asset-based commercial papers**

This type of structure is mostly prevalent in mortgage-backed securities. Under this type, the SPV purchases portfolio of mortgages from different sources (various lending institutions) and they are combined into a single group on the basis of interest rates, maturity dates and underlying collaterals. They are, then, transferred to a trust which in turn, issues mortgage backed certificates to the investors. These certificates are issued against the combined are value of the mortgages and they are also short-term instruments. Each certificate entitled to participate in the cash flow from underlying mortgages to the extent of his investments in the certificates.

• Other types

Apart form the above, there are also other types of certificates namely:

(i) Interest only certificates, and

(ii) Principal only certificates.

In the case of interest only certificates, payments are made to investors only from the interest incomes earned from the assets securitised. As the very name suggests, payments are made to investors only from the repayment of principal by the original borrowers, in the case of principal only certificates. These certificates enable speculative dealings since the speculators know well that the interest rate movements would affect the bond values immediately. For instance, the principal only certificates would increase in value when interest rates go down. It is so because, it becomes advantageous to repay the existing debts and resort to fresh borrowings at lower cost. This early redemption of securities would benefit the investors to a greater extent. Similarly, when the interest rates go up, interest only certificate holders stand to gain since more interest would be available from the underlying assets. One cannot exactly predict the future movements of interest, and hence, these certificates give much scope for speculators to play their game.

Thus, securitisation offers much scope for the introduction of newer and newer instruments
so as to meet the varying requirements of investors. Debt securitisation offers a variety of
investment instruments to the investing public at large as well as to the financial intermediaries
like mutual funds, insurance companies, etc.

SECURITISABLE ASSETS

As stated earlier, all assets are not suitable for securitisation. For instance, trade debts and receivables are not generally suitable for securitisation, whereas they are readily acceptable to a factor. Only in rare cases, they are securitised. Example: Preferred Stock Certificates.

The following assets are generally securitised by financial institutions:

(i) Term loans to financially reputed companies.

(ii) Receivables from Government Departments and Companies.

(iii) Credit card receivables.

(iv) Hire purchase loans like vehicle loans.

(v) Lease finance.

(vi) Mortgage loans, etc.

12.6 BENEFITS OF SECURITISATION

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

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

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

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

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

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

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

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

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

(ix) Better than traditional instruments: Certificates are issued to investors against

the backing of assets securitised. The underlying assets are used not only as a collateral

to the certificates but also to generate the income to pay the principal and interest to the investors. It does not entail any servicing needs and hence does not require much costs. It is better that even mutual fund units because it is issued against the backing of collateral securities, whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset-backed securities, afford a greater protection to investors.

Again, there is much transparency from the investor's point of view. They can very

well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element

(x) Other benefits: Securitisation, if carried out in true spirit, leads to greater economy

in the use of capital with efficiency and cost-effectiveness in both funding and lending.

This is a great boon to the regulating authorities as well since their primary objective

is to prevent the accumulation of capital where it is not needed.

In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrowers, There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.

12.7 SECURITISATION AND BANKS

There is a vast scope for commercial banks to go in for securitisation due to the following
factors:

(i) Innovative and low cost source of fund: Traditionally, deposit has been the only dependable source of funds for banks over the years. But, in recent times, banks have to face severe competition from other non-banking institutions in deposit mobilisation Now, securitisation offers an excellent source of funds at cheaper rates. Unlike deposits, it will not entail any servicing needs and the consequent increase in costs.

(ii) Better capital adequacy norms: Securitisation has the effect of improving the capital adequacy norms of banks. Generally, commercial firms utilise the cash flow from securitisation for repayment of their borrowings, and thus, they can achieve good debt-equity ratio. But, in the case of banks, borrowings are limited. So, they can better utilise the cash flow to create lower risk-weighted assets. Hence, high risk- weighted assets can be easily converted into lower risk-weighted assets. Thus, banks to achieve better capital adequacy norms.

(iii) Creation of more credit: In India, banks are subject to high statutory pre-emptions for which more liquid cash is essential now and then. This has necessarily impaired the capacity of banks to create credit. In fact, securitisation is not at all affected by these factors. The cash flow from securitisation could be very well used for further expansion of credit without any statutory restrictions.

(iv) Increased profitability: The profitability of banks has been very much affected to a greater extent in these days due to many factors. In this context, securitisation has a salutary impact on the profitability of banks. It provides for more liquidity, quicker recycling of funds and greater economy in the use of capital. This has the effect on improving the profitability of banks. Besides, they can also earn income in the form of service fee by acting as receiving and paying agent.

(v) Tool for asset-liability management and risk management: Securitisation can be better used as a tool to avoid mismatch in the asset-liability management. It would reduce the overdependence of banks on the market for money at call and short notice as well as the refinancing agencies for recycling of funds. Again, it can be used as a risk management tool also. It completely eliminates the interest risks and thus it provides a hedge to banks against interest risks which are inherent in the free interest rate market.

12.8 CONDITIONS FOR SUCCESSFUL SECURITISATION

If securitisation of debt has to be successful, the following conditions must have been fulfilled.

(i) Ultimately, the success of securitisation depends upon the ability of the original borrower to repay his loan. Therefore, selection of assets to be securitised requires utmost care. The assets should be ranked and selected on the basis of least losses and to provide for maximum protection to the investor.

(ii) The credit rating is an integral part of securitisation. Hence, credit rating must be done by credit rating agencies on a scientific basis and the ratings should be unquestionable. Then only, the prospective investor's confidence can be built. The credit rating agencies should take into account the various types of risks such as credit risk, interest risk, liquidity risk, etc., along with other usual factors.

(ii) The SPV should be a separate organisation from that of the originator. It should be completely insulated from the parent corporate entity so that SPV could be protected from the danger of bankruptcy.

(iv) The pass through certificates or any other similar instruments arising out securitisation must be listed in stock exchanges so that they may be readily acceptable to investors. It would provide instant liquidity and moreover, its price could also easily ascertained.

(v) Alternatively, it is also advisable to provide two-way quotations for facilitating the buying and selling of the pass through certificates in the market as in the case of mutual fund units.

(vi) There must be standardised loan documentation for similar loans so that there maybe uniformity between different financial institutions. It must carry a right to assign debts to third parties, so that, it could be sold or transferred to the SPV.

(vii) There should be a proper accounting treatment for the various transactions involved in asset securitisation. Suitable accounting norms for the recognition of the trust created for securitised debt should be evolved. The accounting system should provide for the removal of the securitised assets from the balance sheet of the originator Only then, the real benefit will go to the originator.

(viii) Above all, there should be proper and adequate guidelines given by the regulatory authorities dealing with the various aspects of the process of securitisation.

12.9 SECURITISATION IN INDIAN CONTEXT

Generally, securitisation of auto loans has been popular in India. Now, the securitisation market has spread into several asset classes, viz., housing loans, corporate loans, commercial mortgage receivables, project receivables, toll revenues, gold loans, and recently microfinance loans too. The Asset-Backed Securitisation (ABS) is very popular in India due to the growing retail loan portfolio of banks, short-term maturity of these loans and above all the investors familiarity with the underlying assets.

The Mortgage-Backed Securitisation (MBS) has been rather slow in India due to the long maturity periods, lack of secondary market liquidity and the risk arising from prepayments/repricing of the underlying loan.

Very recently, Single Loan Sell-off (LSO) of corporate loans of banks and other financial institutions is gaining momentum in the Indian Securitisation market. On the other side of the coin, direct assignment of single loan or retail loan pools, as against securitisation, has also been gaining importance in India. It does not require any issuance of instruments like PTCs.

12.10 NEW GUIDELINES ON SECURITISATION

Recently, the RBI has issued guidelines allowing commercial banks to finance Special Purpose Vehicles (SPVS) which have been formed to transfer securitised assets separated from them. Some of the important guidelines are:

(i) All banks, term lending institutions and NBFCs have to securities only standard assets.

(ii) Banks can finance SPVs which are engaged in transferring securitised assets.

(iii) While financing SPVs, an independent third party, other than the originator’s (banks)group entities, should provide at least 25 per cent of the liquidity facility. It means that every bank should locate a third party for financing SPVs.

(iv) The liquidity facility provided by banks should not be available for:

(a) Meeting recurring lapses of securitisation,

(b) Funding acquisition of additional assets by SP VS,

(c) Funding the financial scheduled repayment of investors, and

(d) Funding breach of warranties.

Legal framework for Securitisation

The Securities Contracts (Regulation) Act, 1956 has been amended in 2007 with a view to providing a legal framework for trading in securitised debt. The important amendments are:

(i) The term 'securities' as mentioned in the Act includes securitisation instruments.

(ii) The SEBI's permission is necessary to issue securitisation instruments.

(iii) A legal framework has been provided for trading in securitised debt, mortgage-backed debt, etc.

12.11 TERMINOLOGIES

1)Debts 2) Features 3) Process 4) Securitization 5) Legal

12.12 MODEL QUESTIONS

1.Difference between the Securitisation Vs. Factoring?

2. Explain the Modus Operandi?

3. Explain the Structure for Securitisation?

4. What are the Benefits of Securitisation?

5. Explain the Securitisation and Banks?

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UNIT- XIII VENTURE CAPITAL FUNDS

Structure

13.1 Introduction
13.2 Features of Venture Capital
13.3 Scope of Venture Capital
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13.1 INTRODUCTION

Venture capital is growing business of recent origin in the area of industrial financing in India. The various financial institutions set up in India to promote industries have done commendable work. However, these institutions do not come up to the benefit of risky ventures when they are undertaken by new or relatively unknown entrepreneurs. They contend to give dept finance, mostly in the form of term loans to the promoters and their functioning has been more akin to that of commercial banks. The financial institutions have devised schemes such as seed capital scheme, risk capital fund, etc., to help new entrepreneurs. However , to evaluate the projects and extend financial assistance, they follow the criteria such as safety, security, liquidity and profitability and not potentiality. the capital market with its conventional financial liquidity and profitability. The capital market with its conventional financial instruments/ schemes dose not come much to the benefit or risky venture. New institutions such as mutual funds, leasing and hire purchase companies have been established as another source of finance to industries. These institutions also do not mitigate the problems of new breed of entrepreneurs with required professional temperament and technical know-how. To make the innovative technology of the entrepreneurs a successful business venture, support in all respects and more particularly in the form of financial assistance is all the more essential. This has necessitated the setting up of venture capital financing division/companies during the later part of eighties.

ORIGIN

Venture capital as a new phenomenon originated in the US and developed spectacularly worldwide since the second half of the seventies. American Research and Development corporation, founder by Gen. Doriot soon after the second world war, is believed to have heralded the institutionalisation of venture capital in the USA. Since then, the industry has developed in many other countries in Europe, North America and Asia. The real development of VC took place in 1958 when the business Administration Act was passed by the US Congress In the US alone, there are 800 venture capital firms managing around $ 40 billion of capital with annual accretions of between $ 5 billion. It is reported that some of the present-day giants like Apple, Microsoft, Xerox, etc., are the beneficiaries of venture capital.

Uk occupies a seconds place after US in term of investment in VC. The concept became popular in late sixties in UK. The Government's Business Expansion Scheme which permitted individuals to claim tax reliefs for investment in companies not listed in stock exchange led to the success of VC in UK. The CHARTER House development Limited is the oldest venture capital company established in 1934 in UK. The Bank of England established its venture capital company in late 40s. The UK witnessed massive growth of industry during 70s and 80s. During 1988, there were over 1,000 venture capital companies in UK which provided Rs. 3,700 crore to over 1,500 firms.

The success of venture capital in these countries prompted other countries to design and implement measures to promote venture capital and their total commitment have been rising.

Concept of venture capital

The term 'venture capital' is understood in many ways. In a narrow sense, it refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

❖ **Meaning of venture capital**

Venture capital is long-term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalists pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at a high premium.

❖ **Definition of a venture capital company**

A venture capital company is defined as 'a financing institution which joins an entrepreneur as a copromoter in a project and shares the risks and rewards of the enterprise'.

13.2 FEATURES OF VENTURE CAPITAL

Some of the features of venture capital financing are as under:

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible dept or long-term loan.

2. Investment is made only in high risk but high growth potential projects.

3. Venture capital is available only for commercialization of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

4. Venture capitalist joins the entrepreneur as a copromoter in projects and share the investor.

5. There is continuous involvement in business after making an investment by the investor.

6. Once the venture has reached the full potential, the venture capitalist disinvests his holding either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.

7. Venture capital is not just injection of money but also an input needed to set up the firm, design its marketing strategy and organize and manage it.

8. Investment is usually made in small and medium-scale enterprises.

❖ **Disinvestment mechanism**

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

(i) Promoter's buyback
(ii) public issue.
(iii) sale to other venture capital funds.
(iv) sale in OTC market.

(v) Management buyouts.

In India, the most popular investment route is promoter's buyback. This permits the ownership and control of the promoter in tact.

The Risk capital and technology finance corporation, CAN-VCF, etc., 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 cost 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.It is hoped that OTCEI would provide disinvestment opportunities to venture capital firms.

The other investment options such as management buyout or sale to other venture capital fund are not considered appropriate in India.

❖ **Activities of VC funds**

- Provide seed capital for industries and support a concept or idea.
- Provide additional capital to new business at various stages of growth.
- Bridge finance/project financing.
- Equity financing to management groups for taking over other companies.
- Capital to mature enterprises for expansion, diversification and restructuring.
- Research and development financing for production and marketing.
- Start-up capital for initial production and marketing.
- Development financing for facilitating public issues.
- Acquisition or buyout financing for acquiring another firm.
- Turnaround financing for turning around a sick unit.

13.3 SCOPE OF VENTURE CAPITAL

Venture capital may take various forms at different stages of the project. There are successive stage of development of a project, *viz.,* development of project idea, implementation of the idea, commercial production and marketing and finally large-scale investment to exploit the economies of scale and achieve stability. Financial investment and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) Development of an idea-seed finance: In the initial stage, venture capitalists provide seed capital for translating an idea into business proposition. T this stage, investigation is made in depth which normally takes a year or more.

(2) Implementation stage-start –up finance: When the firm is set up to manufacture a product or provide a service, start-up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

(3) Fledging stage- additional finance: In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

(4) Establishment stage- establishment finance: At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point he venture capitalist disinvests their shareholdings through available exit routes.

13.4 IMPORTANCE OF VENTURE CAPITAL

Venture capital is of great practical value to every corporate enterprise in modern times.

I. Advantages to investing public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business, they would be able to stop malpractices by management.

2. Investors have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyse the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

II. Advantages to promoters

1. The entrepreneur for the success of public issue is required to convince the underwriters, brokers and thousands of investors. But to obtain venture capital; assistance, he will be required to sell his idea to justify the officials of the venture fund. Venture capital provides a solid capital base for future growth by injecting long-term equity financing.

2. Public issue of equity shares has to be preceded by a lot of effort, *viz.*, necessary statutory sanctions, underwriting and broker, s arrangement, publicity of issue, etc. The new entrepreneurs find it very difficult to make underwriting arrangements which require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issue of equity share often range between 10 per cent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs for maintenance.

of share registry cell, stock exchange listing fee ,expenditure on printing and posting

of annual reports ,etc. These items of expenditure can be ill-afforded by the business

when it is new. Assistance from venture fund dose not require such expenditure.

Business partner: The venture capitalists act as business partners who share the rewards as well as the risks.

Mentoring: Venture capitalists provide strategic, operational, tactical and financial advice based on past experience with other companies in similar situations.

Alliances: The venture capitalists help in recruitment of key personnel, improving relationship with international markets, coinvestment with other VC firms and in decision making.

III. General

1. A developed venture capital institution set-up reduces the time-lag between a technological innovation and its commercial exploitation.

2. I t helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

3. Venture capital act as a cushion to support business borrowings, as bankers and investors will not lend money with inadequate margin of equity cpital.

4. Once venture Capital funds start ,earning profits, it will be very esy for them to raise resources from primary capital market in the form of equity and debts. Therefore , the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund dispose its own holding. This mechanism will help to channelize investment in new hi-tech business or the existing sick business. These business will take-off with help of finance from venture funds and this would help in increasing productivity, better capacity utilization, etc.

5. The economy with well-developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilising industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.

6. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start-ups.

7. It also paves the way for private sector to share the responsibility with public sector.

13.5 INVESTOR’S RIGHTS

The SEBI (MF) regulations, 1993 contain specific provisions with regord to investor servicing. Certain rights have been guaranteed to the investors s per the above regulations They are as follow:

(i) Unit certificates: An investor has a right to receive his unit certificates on allotment within a period of 10 weeks from the date of closure of subscription lists in the case of a close-ended scheme and 6 weeks from the date of n open-ended scheme.

(ii) Transfer of units: An investor is entitled to get the unit certificates transferred within a period of 30 days from the date of lodgement of the certificates long with the relevant transfer forms.

(iii) Return of application money: If a mutual fund is not able to collect the statutory minimum amount (close-ended funds- Rs.20 crore, open –

ended funds- Rs. 50 crore or 60 per cent of the targeted amounts whichever is higher), it has to return the application money s refund within a period of 6 weeks from the date of closure to get the refund with interest at the rate of 15 per cent p.a. for the period of delay.

(iv) Audited annual report: Every mutual fund is under an obligation to its investors to publish the audited annual report and unaudited half-yealy report through prominent newspapers in respect of each of its schemes within 6 months and 3 months respectively of the date of closure of accounts.

(v) Net asset value: Again, every investors has the right to receive information about the NAV at intervals not exceeding 3 month in the case of open-ended scheme and one month in the case of close- ended funds. It must also be published at least in two daily newspapers.

13.6 MUTUAL FUNDS IN INDIA

In India, the mutual fund industry has been monopolized by the Unit Trust of India ever since 1963. Now, the commercial banks like the State Bank of Indi, Canara Bank, Indian Bank, Bank of India and Punjap National Bank have entered into the field. To add to the list are the LIC of India and the private sector bankds and other financial institutions. These institutions have successfully launched a variety of schemes to meet the diverse needs of millions of small investors. The Unit Trust of India has introduced huge portfolio of schemes like unit 64, Master gain, Master share, etc. it is the country’s largest mutual fund company with over 25 million investors and a corpus exceeding Rs. 55,000 crore, accounting for nearly 10 per cent of the country’s stock market capitalization. The total corpus of the 13 other mutual funds in the country is less than Rs.15000 crore. The SBI fund has a corpus of Rs. 2,925 crore deployed in its 16 schemes servicing over 2.5 million shareholders.

There are also mutual funds with investments sourced abroad called ‘Offshore funds’. They have been established for attracting NRI investments to the capital market in india. The India fund U nit scheme 1986 traded in the London Stock Exchange and the India Fund Unit Scheme 1988 traded in the New York Stock Exchange were floated by the Unit Trust of India and ‘The India Magnum fund’ was floated by the State Bank of India. At present, there are 16 different offshore Indian funds which have brought about $ 2.7 billion to the Indian market.

Besides the above , the LIC and the GIC have also entered into the market, Again , many private organizations have entered into the field. Most of the schemes have declared a dividend ranging between 13.5 per cent and 17 per cent . in most of the cases, it is around 14 per cent only.

The recent trend in the mutual fund industry is to go for the –up arrangements with foreign collaborators. We find Tatas tying up with Kleinworth Benson; GIC with George Soros; credit capital with Lazard Brothers; Kothari with pioneer; ICICI with JP Morgan; 20th century with Morgan and so on. Of course, these tie-up would bring in new perspective, systems and technology and this very foreign tag may add credit to the institution.

The private sector which entered the arena in 1993 is concentrating on the primary market. It is so because , investments in new shares fetch appreciation between 30 and 1500 per cent in a very short period. Promoters too give preferential treatment to mutual funds because it reduces their marketing cost. Gin , they go for fund participation in a venture even before it goes public. They see potential for immense appreciation in unlisted securities which intend to go to public with a short period of one year.

Today , mutual funds have started playing a positive role in the country's saving revolution.

The funds mobilized by mutual funds under various schemes as on march 29,2016 are displayed in the following Table.

13.7 GENERAL GUIDELINES

For proper functioning of mutual funds and for ensuring investor protection, the following important guidelines have been framed by the Government of India :

(A) General

(i) Money market mutual funds would be regulated by the RBI while other mutual funds would be regulated by the securities and Exchange Board of India (SEBI).

(ii) Mutual fund shall be established in the form of trusts under the Indian Trust Act and be authorized for business by the SEBI.

(iii) Mutual funds shall be operated only by separately established Asset management companies (AMCs).

(iv) At least 50 per cent of the Board of AMC must be independent directors who have no connections with the sponsoring organisation. The directors must have professional experience of at least 10 years in the relevant fields such as portfolio management, financial administration, etc.

(v) The AMC should have a minimum net worth of Rs. 5 crore at all times.

(vi) The SEBI is given the power to withdraw the authorisation given to any AMC if it is found to be not serving the best interest of investors as well as the capital market. It is not applicable to bank-sponsored AMCs

(B) Business activities

(i) Both AMCs and trustees should be treated as two separate legal entities.

(ii) AMCs should not be permitted to undertake any other business activity except mutual funds.

(iii) One AMC cannot act as the AMC for another mutual funds.

(C) schemes

(i) Each scheme of a mutual fund must be compulsorily registered with the SEBI before it is floated in the market.

(ii) The minimum size of the fund should be Rs. 20 crore in the case of each close-ended scheme and it is Rs. 50 crore for each open-ended scheme.

(iii) Close-ended schemes should not be kept opened for subscription for more than 45 days. For open-ended schemes, the first 45 days should be considered for determining the target figure or the minimum size.

(iv) If the minimum mount or 60 per cent of the targeted amount, whichever is higher, is not raised, then the entire subscription has to be refunded to the investors.

(v) To provide continuous liquidity, close-ended schemes should be listed on stock exchanges. In the case of open-ended schemes, mutual funds shall sell and repurchase units at predetermined prices based on the Net Asset Value and such prices should be published at least once in a week.

(vi) For each scheme, there should be a separate and responsible fund manager.

(D) Investment norms

(i) Mutual funds should invest only in transferable securities either in the capital market or money market or securitized debt. It cannot exceed 10 per cent in the case of growth funds and 40 per cent in the case of income funds.

(ii) The mutual fund should not invest more than 5 per cent of its corpus of any scheme in any one company's shares.

(iii) This list of 5 per cent can be extended to 10 per cent if all the schemes of a mutual fund are taken together.

(iv) No scheme should invest in any other scheme under the same AMC.

(v) No mutual fund under all its schemes taken together can invest more than 15 per cent of the funds in the shares and debentures of any specific industry, except in the case of those schemes which re specifically floated for investment in one or more specified industries.

(E) Expenses

(i) The AMC may charge the mutual fund with investment management and advisory fees. Such fees should have been disclosed in the prospectus.

(ii) The initial issue expenses should not exceed 6 per cent of the funds raised under each scheme.

(iii) Excepting the initial issue expenses, all other expenses to be charged to the fund should not exceed 3 per cent of the weekly average net assets outstanding during the current year. It must be disclosed through advertisements, account, etc.

(F) Income distribution

All mutual funds must distribute a minimum of their profits in any given year.

(G) Disclosure and reporting

(i) The SEBI is given wide powers to call for any information regarding the operation of mutual funds and any of its schemes from the mutual fund or any person associated with it like the AMC, Trustee, sponsor, etc.

(ii) Every mutual fund is required to send its copies of duty audited annual statements of accounts, six-monthly unaudited accounts, quarterly statements of movements in net assets for each of its schemes to the SEBI.

(iii) The SEBI can lay down the accounting policies, the format and contents of financial statements and other reports.

(iv) The SEBI shall also lay down a common advertising code for all mutual funds to comply with.

(H) Accounting norms

(i) All mutual funds should segregate their earnings as current income, short-term capital gains and long- term capital gains.

(ii) Accounting for all the schemes must be done for the same year ending.

(I) Winding up

(i) Each close-ended scheme should be wound up or extended with the permission of the SEBI as soon s the predetermined period is over.

(ii) An open-ended scheme shall be wound up, if the total number of units outstanding after repurchases at a point of time falls below 50 per cent of the originally issued number of units.

(J) Violation of guidelines

The SEBI Can, after due investigation, impose penalties on mutual funds for violating the guidelines as may be necessary.

His objective should also coincide with the objective of the scheme which he proposes to choose.

(ii**) Consistency of performance:** A mutual fund is always intended to give steady long-term returns, and hence, the investor should measure the performance of a fund

13.8 CREDIT RATING MEANING

Credit Rating is the evaluation of the credit worthiness of an instrument of a company based on perceived overall risk of a company’s business and financial profile as well as structural consideration. Credit rating establishes a link between risk and return. An investor or any other interested person uses the rating to assess the risk level and compares the offered rate of return with his expected rate of return. It facilitates the investors in taking a decision whether to go for an investment or not. The agency, which performs the credit rating is called the Credit Rating Agency.

Following Points May be Noted in Respect of Credit Rating

1. Credit rating is an assessment of a borrower's willingness and ability to repay the rated obligation in accordance with its terms and conditions.

2. It is only an opinion but not a recommendation to purchase, sell, or hold a borrower's security.

1. The agencies change ratings only for significant and permanent changes in a company's financial and operating performances

2. Credit rating agencies rate securities and not issuers. Generally, the rating of highest rated debt is taken as the rating of the company.

13.9 CREDIT RATING AGENCIES

The Credit Rating Agencies (CRA) is one of the capital market intermediaries. It is a body corporate, which is engaged in the business of rating of securities offered by way of public issue or right issue.

Rating means an opinion regarding securities, expressed in the form of standard symbols (numeric, alphanumeric and alphabets) or any other standardized manner assigned by a CRA and used by the issuer of such securities. For instance, public issues of convertible / redeemable debentures/bonds having a maturity period of more than 18 months requires credit rating. Similarly, issue of commercial paper in India also requires a specified credit rating.

13.10 CREDIT RATING AGENCIES IN INDIA

Following are the important CRA in India:

I.Credit Analysis and Research Limited (CARE)

II. Investment Information and Credit Rating Agency of India Limited (ICRA)

III. Credit Rating and Information Services (India) Limited (CRISIL)

IV. FITCH Credit Ratings India Private Limited

V. Standard and Poor's Corporation.

Registration of CRA

It may be noted that as per Section 12 of the SEBI Act, 1992, a person has to get itself registered with SEBI under SEBI (Credit Rating Agencies) Regulations, 1999 in order to carry on the activities of Credit Rating.

Every CRA shall abide by the code of conduct contained in the Third Schedule to SEBI (Credit Rating Agencies) Regulations, 1999.

It may be noted that SEBI (Credit Rating Agencies) Regulations, 1999 cover rating of securities only and not rating of fixed deposits, foreign exchange, country ratings, real estates, etc.

13.11 USES OF CREDIT RATING

Credit rating is useful to the following:

Investors: In absence of credit rating, an investor has to make investment based on general available information about the company and its promoters and properly analyzed opinions of a credit rating agency minimizes the risk.

Issuers: Market places faith in the opinion of credit rating agencies. This enables the issuers of high rated instruments to access the market even during adverse conditions.

Intermediaries: Credit Rating also helps intermediaries like merchant bankers, brokers, etc. Credit Rating helps merchant bankers in pricing of the issues whereas it helps the brokers in monitoring their risk exposure.

Regulators: In India, the main regulator related to securities market is SEBI and one of the important functions of SEBI is to protect the interest of investors in securities market. SEBI ensures this by specifying requirement of a certain credit rating for a particular instrument.

promoters of a cra

A CRA can be promoted only by any of the following:

- A public financial institution ;
- Scheduled commercial bank;
- A foreign bank;
- A foreign credit rating agency having minimum 5 years of experience;
- A body corporate having net worth of □100 crores in each of the immediately preceding 5 years.

13.12 PROCEDURE FOR CREDIT RATING

Generally, CRA follows the following procedure/process for credit rating:

a. Seek information required for the rating from the company

b. On receipt of required information, have discussion with the company's management and visit the company's operating locations, if required.

c. Prepare an analytical assessment report.

d. Present the analysis to a committee comprising senior executives of the concerned CRA

e. The aforesaid committee would discuss all relevant issues and assign a rating

f. Communicate the rating to the company along with an assessment report outlining the rationale for the rating assigned.

13.13 TERMINOLOGIES

1) Venture Capital 2) Funds 3) Emergence 4) Credit Rating 5)Agencies

13.14 MODEL QUESTIONS

1. Explain the Investor's Rights?
2. Explain the Mutual funds in India?
3. Discuss the General Guidelines?
4. Explain the Credit Rating Meaning?
5. Explain the Credit Rating Agencies?

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UNIT-XIV FACTORING

Structure

14.1 Introduction
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14.1 INTRODUTION

In India, the financial services sector is developing at a faster rate so as to meet the emerging needs of the economy. Many innovative schemes have been introduced by this sector and one such area wherein it has been introduced is book debt financing. Financial institutions try to extend their financial assistance to a larger cross-section of the trading community through book debt financing. A kind of book debt financing is already practiced in India by the commercial banks. It is nothing but bill financing. This type of financing is done either by way of direct purchase of bills of customers or discounting them.

Discounting

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price the of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case , the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where the commercial banks enter into as a financier.

The commercial banks provide immediate cash by discounting genuine trade bills. They deduct certain charge as discount charge from the amount of the bill and the balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills. Of course, this discount charge include interest for the unexpired period of the bill plus some service charges. Bill financing is the most liquid one from the banker's point of view since, in time of emergencies, they can take these bills to the Reserve Bank of India for rediscounting purposes. In fact, it was viewed primarily as a scheme of accommodation for banks. Now, the situation is completely changed. Today, its viewed as a kind of loan backed by the security of bills.

Bill financing is superior to the conventional and traditional system of cash credit in many ways.

(i) First of all, it offers high liquidity, in the sense, fund could be recycled promptly and quickly through rediscounting.

(ii) It offers quick and high yield. The bankers gets income in the form of discounting charges and rediscount.

(iii) Again, there is every opportunity to earn the spread between the rates of discount and rediscount.

(iv) Moreover, bills drawn by business people would never be dishonored and they are not subject to any fluctuations in their values.

(v) Cumbersome procedures to create the security and the positive obligations to maintain it are comparatively very fewer.

(vi) Even if the bill is dishonoured, there is a simple legal remedy. The banker has to simply note and protest the bill and debit the customer's account. Bills are always drawn with recourse and hence, all the parties on the instrument are liable till the bill is finally discharged.

(vii) Above all, these bills would be very much useful as a base for the maintenance of reserve requirements like CRR and SLR.

It is for these reasons, the Reserve Bank of India hs been trying its best to develop a good bill market in India. The Reserve Bank of India introduced a bill market scheme as early as 1952 itself and thereafter, with some modifications. It has lowered the effective rate of interest on bill finance by 1 per cent below the cash credit rate. Despite many efforts of the Reserve Bank of India to promote and develop a good bill market, bill financing forms barely 5 per cent of the total credit extended by banks. The latest step of the Reserve Bank India to promote the bill market is the launching of the factoring service organizations.

Factoring

As stated earlier, a lot of working capital is tied up in the form of trade debts. Collection of debts, especially for the small-scale and medium-scale companies is the biggest problem. The average collection period has been on the increase. Delays in collection process, in turn lead to liquidity problems and consequently to delay in production and supplies. The peculiar situation in India is that a number of small-scale units are catering to the requirements of a single large buyer. This large buyer is always known for his procrastination in paying his small suppliers. The crux the problem is not so much the failure to pay altogether as the failure to pay on time. As a result, the interest cost of financing book debts is quite heavy. This increase in cost of capital reduces profit and competitiveness of a company particularly the small ones in the market. Ultimately, the small unit may become even sick. To overcome this situation, the factoring service has been conceived.

meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done' . 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. As the dictionary rightly points out, factoring is nothing but financing through purchase of accounts receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the client) which sells goods and services to customers on credit. As per this arrangement, the factor purchase the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

DEFINITION

Robert W. Johnson in his book ' Financial Management' states, 'factoring is a service involving the purchase by a financial organization, called a factor, of receivables owed to manufactures and distributors by their customers, with the factor assuming full credit and collection responsibilities'.

According to V.A.A vadhani, 'factoring is a service of financial nature involving the conversion of credit bills into cash'.

In the words of Kohok. ' factoring is an asset-based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods'.

Prof. S.P.Singh, a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that 'factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance'.

14.2 MODUS OPERANDI

A factor provides finance to his client up to a certain percentage of the unpaid invoices which represent the sale of goods or services to approved customers. The modus operandi of the factoring scheme is as follows:

(i) There should be a factoring arrangement (invoice purchasing arrangement) between the client (which sells goods and services to trade customers on credit) and the factor, which is the financing organization.

(ii) Whenever the client sells goods to trade customers on credit, he prepares invoices in the usual way.

(iii) The goods are sent to the buyers without raising a bill of exchange but accompanied.

(vi) The debt due by the purchaser to the client is assigned to the factor by advising the trade customers, to pay the amount due to the client, to the fctor.

(v) The client hands over the invoices to the factor under cover of a schedule of offer along with the balance 20 per cent will be paid on realistion of the dept.

14.3 TERMS AND CONDITIONS

The existence of an agreement between the factor and the client is central to the function factoring. The main terms and conditions generally included in a factoring agreement are the following:

(i) Assignment of debt in favour of the factor,

(ii) Selling limits for the client,

(iii) Conditions within which the factor will have recourse to the client in case of non- payment by the trade customer.

(iv) Circumstances under which the factor will have recourse in case of non-payment,

(v) Details regarding the payment to the factor for his services, say for instance, as a certain percentage on turnover,

(vi) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier , and

(vii) Limit of any overdraft facility and the rate of interest to bre charged by the factor.

14.4 FUNCTIONS OF FACTORING

As stated earlier, the term ‘factoring’ simply refers to the process of selling trade debts of a company to a financial institution. But, in practice, it is more than that. Factoring involves the following functions:

(i) Purchase and collection of debts,

(ii) Sales ledger management,

(iii) Credit investigation and undertaking of credit risk,

(iv) Provision of finance against debts, and

(v) Rendering consultancy services.

(i) Purchase and collection of debts: Factoring envisages the sale of trade debts to the factor by the company, *i.e.*, the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client.

He does so as an agent of the client. But, under factoring, the factor purchases the entire tradedebts and thus, he becomes a holder for value and not an agent. Once the debts are purchasedby the factor, collection of those debts becomes his duty automatically.

(ii) Sales ledger management: Sales ledger management function is an important one in factoring. Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus, the factor takes up the work of monthly sales analysis overdue invoice analysis and credit analysis.

(iii) Credit investigation and undertaking of credit risk: The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of the most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world, etc. For this purpose, the factor also undertakes credit investigation work.

(iv)Provision of finance: After the finalisation of the agreement and sale of goods by he client, the factor provides 80 per cent of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

(v) Rendering consultancy services: Apart from the above, the factor also provides management services to the client. Hence, the client about the additional business opportunities available, the changing business and financial profiles of the customers, the likelihood of coming recession, etc.

14.5 TYPES OF FACTORING

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows:

(i) Full service factoring or without recourse factoring

(ii) With recourse factoring.

(iii) Maturity Factoring.

(iv)Bulk factoring.

(v) Invoice factoring.

(vi)Agency factoring.

(vii) International factoring.

(viii) Suppliers' guarantee factoring.

(ix) Limited factoring

(x) Buyer based factoring.

(xi) Seller based factoring,

(i) Full service factoring or without recourse factoring: Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since he assumes the credit risk also. He cannot pass on this responsibility to his client and, hence, this type of factoring is also called 'Without Recourse' factoring.

(ii) With recourse factoring: As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges.

(iii) Maturity factoring: Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount collected less factoring fees is paid to the client immediately. Hence, it is also called Collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk factoring: Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring 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, collection work, etc, has to be done by the client him self. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as 'Disclosed Factoring' or 'Notified Factoring'.

(v) Invoice factoring: Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues, etc., have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called 'Confidential Invoice Discounting' or 'Undisclosed Factoring'.

(vi)Agency factoring: The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows:

(a) The client has to look after the sales ledger administration and collection work, and.

(b) The factor has to provide finance and assume the credit risk.

(vii) International factoring: Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80 per cent of the export invoice under international factoring. International Facwr11is facilitated with the help of export factors and import factors.

(viii) Suppliers' guarantee factoring: This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix) Limited factoring: Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer based factoring: In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed creditworthy buyers and hence itis also called 'Selected Buyer Based Factoring’.

xi) Seller based factoring: Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is Over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and creditworthy sellers and hence it is also called 'Selected Seller Based Factoring’

14.6 FACTORING VS. DISCOUNTING

Factoring differs from discounting in many respects. They are:

(i) Factoring is a broader term covering the entire trade debts of a client where as discounting covers only those trade debts which are backed by accounts receivables

(ii) Under factoring, the factor purchases the trade debt and thus becomes a holder for value. But, under discounting the financier acts simply as an agent of his customer and he does not become the owner. In other words, discounting is a kind of advance against bills, whereas factoring an outright purchase of trade debts.

(iii) The factors may extend credit without any recourse to the client in the event of non-payment by customers. But, discounting is always made with recourse to the client.

(iv)Accounts receivables under discount are subject to rediscounting, whereas it is not possible under factoring.

(v) Factoring involves purchase and collection of debts, management of sales ledger assumption of credit risk, provision of finance and rendering of consultancy services. But, discounting involves simply the provision of finance alone.

(vi) Bill discounting finance is a specific one in the sense that it 1s based on an individual bill arising out of an individual transaction only. On the other hand, factoring is based on the whole turnover, i.e., a bulk finance is provided against a number of unpaid invoices.

(vii) Under discounting, the drawee is always aware of the banks charge on receivable But, under undisclosed factoring, everything is kept highly confidential.

(viii) Bill financing through discounting requires registration of charges with the Registrar or Companies. In fact, factoring does not require such registration.

(ix) Discounting is always a kind of in-balance sheet financing. That is, both the amount of receivables and bank credit are shown in the balance sheet itself due to its with recourse' nature. But, factoring is always 'off-balance sheet financing'.

14.7 COST OF FACTORING

The cost of factoring comprises of two aspects namely finance charges and service fees. Since the factor provides 80 per cent of the invoice as credit, he levies finance charges. This charge 18normally the same interest rates which are in vogue in the banking system. Factoring is a cheap source because the interest is charged only on the amount actually provided to the client as repayment of his supplies. Apart from this financial charge, a service charge is also levied. This service fees is charged in proportion to the gross value of the invoice factored based on sales volume, number of invoices, work involved in collections, etc. Generally, the factor charges a service fee on the total turnover of the bills. It is around 1 per cent. If the bills get paid earlier, service charges could be reduced depending upon the volume of work involved.

Pricing of factoring services

while pricing factoring services, the following components should be taken into account:

(i) Factoring fees or administrative charges.

(ii) Discount charges.

Factoring fees

This is charged mainly as administrative expenses for providing various services to the

clients namely:

(i) Sales ledger administration.

(ii) Credit control administration.

(iii) Bad debts administration.

This fees is normally computed with reference to the projected sales turnover of the client during the next twelve months. It is always quoted as a per cent of projected sales turn over. Generally, this charge varies between 1 per cent and 2.5 per cent of the projected turnover In fact, the quantum of levy actually depends on several factors as given below:

(a) Reputation of the client as well as the debtors

(b) Nature of the industry to which the client belongs.

(c) Volume of sales per annum.

(d) Terms of sales.

(e) Average invoice value.

(f) Security available to the factor.

(g) Type of factoring service offered.

(h) Profit margin.

Usually, a minimum handling/administrative charge is stipulated to which a certain percent of the projected turnover is added.

Discount charges

For providing instant credit to the client by way of prepayment, some charges have to be levied and they are called discount charges. This charge is normally linked with the base rate.

benefits

Factoring offers a number of benefits to the clients. Some of the important benefits are:

(i) Financial service: Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small-scale and medium-scale manufacturers because they have to wait for 3 months to 9 months to realise their debts. In the meantime, the business may suffer due to want of funds. In fact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash up to 80 per cent immediately as soon as the credit sales are over. They need not wait for months together to get cash for recycling. Another major advantage is that there are no constraints by way of fixed limits as in the cash of cash credit or O.D. As sales grow, the financial assistance also grows and both are directly proportional to each other.

The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus, he can avail of cash discount facilities also.

(ii) Collection service: Collection of debts is another problematic area for many concerns. It is found that over 60 per cent of the total sales of the SSI sector and over 50 per cent of total sales of the medium-scale and large-scale sector are made on "On Account Terms of Payment", i.e., credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organisation, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) Credit risk service: In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realisation of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

(iv) Provision of expertised 'Sales Ledger Management service: Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. In fact, the success of any organisation depends upon the efficiency with which the sales ledger is managed. It requires a specialised knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the
factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy service: Factors are professionals in offering management services like consultancy. They collect information regarding the creditworthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory, etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally, no time is available to the client for investigating his customer's credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in servicing: Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80 per cent of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(vii) off–balance sheet financing: Factoring is an off-balance sheet means of financing. When the factor purchases the book debt of the client, these debt no longer exist on the current asset side of the balance sheet. It leads to reduction in debts and less collection problems. The client can utilise the money so received to reduce his current Liabilities. It means an improved current ratio.

This can be batter understood by means of an illustration.

Given below is the Balance Sheet of X Co. Ltd.

Balance Sheet before Factoring Arrangement

Liabilities	**Rs.**	**Assets**	**Rs.**
Current Liabilities		Current Assets	
Bank icon-against	5,00,000	Stock	8,00,000
stock	4,00,000	Receivables	6,00,000
Bank loan-against bills	2,00,000	Others	2,00,000
Others	5,00,000	-	-
Net working capital	16,00,000	-	16,00,000

Now, the current ratio comes to 16,00,000: 11,00,000 = 1.45:1

Now, receivables of Rs 6,00,000 are purchased by the factoring agent. The factor pays 80 per

Cent cash immediately. So the company gets Rs 4.80,000 whish is used for paying some liabilities like bank loan and others. The amount due from the factors comes to Rs 1,20,000 being 20 per cent of the balance of receivables.

The New Balance Sheet after Factoring Arrangement

Liabilities	**Rs.**	**Assets**	**Rs.**
Current Liabilities		Current Assets	
Bank icon-against	5,00,000	Stock	8,00,000
stock	1,20,000	Receivables (Due from factor)	1,20,000
Others	5,00,000	Others	2,00,000
		-	-
Net working capital	11,20,000	-	16,00,000

New the current ratio comes to 11,20,000 : 6,20,000 = 1.8:1

Note: Bank loan against bills is paid out of Rs 4,80,000 received from the factor. The balance Rs 80,000 is paid to other liability. Hence, other liabilities. Hence, other liabilities appear as Rs 1,20,000 in the new balance sheet.

(viii)Trade benefits: Availability of ready cash against bills enable the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, Factoring enables the supplier to concentrate on production and materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customer and thus to attract more business. Thus, many trade benefits are available under factorings.

(ix) Miscellaneous service: Generally, factors are able to computerise their operations fully. So, they are able to render prompt service at reasonable rates. They spend more on MIS analysis. They also build bigger credit library of debtors by means of collecting information about new debtors. Thus, improved cash flow through realisation of trade debts by factoring, efficient follow- up of collections, computerised sales ledger maintenance and the competitive rates are the main benefits of factoring.

14.8 FACTORING IN INDIA

In India, the idea of providing factoring services was first thought of by the Vaghul Working Group. It had recommended that banks and private non-banking financial companies should be encouraged to provide factoring services with a view to helping the industrialists and traders to tide over their financial crunch arising out of delays in the realisation of their book debts. The RBI subsequently constituted a study group in January 1988 under the chairmanship of Mr. C.S. Kalyanasundaram, former Managing Director of the SBI, to examine the feasibility of starting factoring services. On the recommendation of the committee, the Banking Regulations Act was amended in July 1990 with a view of enabling commercial banks to take up factoring services by forming separate subsidiaries.

In the public interest and in the interest of banking policy, the RBI is of the view that:

(i)The banks should not directly undertake the business of factoring.

(ii) The banks may set up separate subsidiaries or invest in factoring companies jointly with other banks.

(iii) A factoring subsidiary or a joint venture factoring company may undertake the factoring business. But, they should not finance other factoring companies.

(iv) The banks can invest in the shares of factoring companies not exceeding 10 per cent of the paid-up capital and reserves of the bank concerned.

But, recently in February 1994, the RBI has permitted all banks to enter into factoring business departmentally. Perhaps, this step would have been taken with a view of giving further impetus to the factoring system. Since factoring requires special skills and infrastructure, the RBI has further stipulated that:

(i) Factoring activities should be treated on par with loans and advances and should accordingly be given risk weight of 100 per cent for calculation of capital to risk asset ratio.

(ii) A bank's exposure shall not exceed 25 per cent of the bank's capital funds to an individual borrower and 50 per cent to a group of borrowers. Factoring would also be covered within the above exposure ceiling along with equipment leasing and hire purchase finance.

(iii) Factoring services should be provided only in respect of those invoices which represent genuine trade transactions.

In India, the factoring service was first started by the State Bank of India in association with the Small Industries Development Bank of India, Union Bank of India, State Bank of Saurashtra and State Bank of Indore. The pioneering factoring company founded by the SBI is called 'SBI Factors and Commercial Services PVT. Ltd., (SBI-FACS)'. It was started in July 1991 with a subscribed capital of 25 crore. It has been allotted the Western Zone composing of Maharashtra, Gujarat, Goa, Madhya Pradesh, The Union Territories of Dadra and Nagar HAVELI. Daman and Diu. Similarly, the RBI has allotted the Southern Region to the Canara Bank, the Northern Region to the Punjab National Bank and the Eastern Region to the Allahabad Bank for providing necessary factoring services to the clients of those regions. This zonal restriction has been removed by the RBI in 1993. In South, Canara Bank has already established Can Factors Ltd. Now, these two factoring companies can operate in the centres outside their given zones. Besides the above, some non-banking companies also have made a bid for entering into factoring services. Thus, factoring service has got a very bright future in India due to its superiority over other forms of financing.

14.9 Regulation of Factors (Assignment of Receivables) Bili 2011

The Government is in the process of enacting the above bill which seeks to provide for and regulate the assignment of receivables by making provisions for registration and rights and obligations of parties. The bill empowers the RBI to issue directions, call for information from the factors and prohibit financial institutions from undertaking business if the factor fails to comply with the directions given by the RBI. The bill also provides for the establishments of a central registry which would maintain details regarding all transactions carried out by factors.
It makes registration of all factor transactions mandatory. Besides, factors would be entitled to take legal resource for recovering assigned debt and receivables from buyers of goods and services.

International factoring

Generally, factoring services are very popular for domestic business. They are gradually entering into export business also.

Just as domestic suppliers, the exporters also find that there is a considerable delay in receiving payments from the importers. As a result, they are hard pressed for money to ensure their profitability as well as to maintain and expand their export business. In this situation, international factoring comes really handy to them to find the required resources.

Definition

The International Institute for the Unification of Private Law in 1988 has defined international factoring as follows:

Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor: (i) Finance, (ü) Maintenance of accounts, (iii) Collection of Debts and (iv) Protection against credit risks'.

As the definition points out, the services of a factor in a domestic business are simply extended to international trade. However, the functioning of this scheme is different depending upon the type of export factoring and the arrangement made by the exporter and the factor.

Types of export factoring

Generally, in the absence of factoring, all export finance transactions are backed by Letters of Credit. But, factoring relates purely to 'Open Account Transactions with no promissory notes and collaterals. Factoring is done entirely on the basis of the invoice prepared by the exporter and so it is purely an 'invoice-based export finance' technique.

In an international factoring transaction, there are four parties namely:

(i) The exporter who is taking the place of a client in a domestic transaction.
(ii) The importer who is taking the role of a customer in a domestic transaction.
(iii) Export Factor (EF).
(iv) Import Factor (IF). The exporter (client) and the factor enter into an agreement for export factoring which may take any one of the following types:

(i) Two factor system.
(ii) Single factor system.
(iii) Direct export factor system.
(iv) Direct import factor system.

Two factor system

There are two factors under this system - one in the export's country and the other in the importer's country. When the exporter wants to do business with some importer or importers, he approaches the factor in his country and informs him of his business proposal, the likely size of the business, the number of invoices likely to be raised, the value of the consignment and the currency involved.

This export factor in turn informs the same to his counterpart, i.e., import factor in the importing country. The import factor makes enquiries regarding the financial position of the importer and his dealings and, if satisfied, he conveys the message to the export factor. He also indicates the limit for factoring and his commission for undertaking this work. Then, the export factor contacts the exporter and conveys the positive findings and his readiness to cover the credit risk through factoring. If the rates are acceptable to the exporter, he signs an agreement with the export factor.

Once this factoring relationship is established, the exporter sends the goods to the importer along with the invoice with a condition that the payments should be made to the import factor. Two copies of the invoices are sent to the export factor along with a notification that the debts have been assigned to the import factor. At this stage, the export factor makes payment immediately to the extent of 80 per cent of the invoice amount to the exporter.

Thereafter, the export factor informs the import factor about the financial deal by sending a copy of the invoice. Now, it becomes the responsibility of the import factor to monitor and maintain the account and take all possible efforts to collect the amount at the due date. When the amount is collected, it is sent to the export factor. In case of any default, the import factor has to pay the amount to the export factor from his own sources.

14.10 FORFEITING

Forfeiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium-term deferred basis.

The term 'a forfait’ is a French word denoting to give something or 'give up one's rights' or relinquish rights to something'. In fact, under forfeiting scheme, the exporter gives up his right to receive payments in future under an export bill for immediate cash payments by the forfeitor. This right to receive payment on the due date passes on to the forfeitor, since, the exporter has already surrendered his right to the forfeitor. Thus, the exporter is able to get 100 per cent of the amount of the bill minus discount charges immediately and get the benefits of cash sale. Thus, it is a unique medium which can convert a credit sale into a cash sale for an exporter. The entire responsibility of recovering the amount from the importer rests with the forfeitor. Forfeiting is done without any recourse to the exporter, i.e., in case the importer makes a default, the forfeitor cannot go back to the exporter for the recovery of the money.

• Definition

For faiting has been defined as 'the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services'.

14.11 Factoring vs. Forfeiting

Both factoring and forfeiting are used as tools of financing. But there are some differences:

(i) Factoring is always used as a tool for short-term financing, whereas forfeiting is for medium-term financing at a fixed rate of interest.

(ii) Factoring is generally employed to finance both the domestic and export business. But, forfeiting is invariably employed in export business only.

(iii) The central theme of factoring is the purchase of the invoice of the client, whereas it is only the purchase of the export bill under forfeiting.
(iv) Factoring is much broader in the sense. It includes the administration of the sales ledger, assumption of credit risk, recovery of debts and rendering of consultancy services. On the other hand, forfeiting mainly concentrates on financing aspects onlyand that too in respect of a particular export bill.
(v) Under factoring, the client is able to get only 80 per cent of the total invoice as 'credit facility', whereas the 100 per cent of the value of the export bill (of course deducting service charges) is given as credit under forfeiting.
(vi) Forfeiting is done without recourse to the client, whereas it may or may not be so under factoring
(vii) The bills under forfeiting may be held by the forfeitor 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.
(viii) Forfeiting is a specific one 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., a bulk finance is provided against a number of unpaid invoices.

Working of Forfeiting

In a forfeiting transaction, the exporter is the client and the financial institution is called 'the forfeitor' and the importer is the debtor'. When an exporter intends to export goods and services, he approaches a forfeitor and gives him the full details of his likely export dealing such as the name of the importer, the country to which he belongs, the currency in which the export of goods would be invoiced, the price of the goods and services, etc. He discusses with him the terms and conditions of finance. If it is acceptable, a sale contract is signed between the exporter and the importer on condition that the payment should be made by the importer to the forfeitor.

As usual, bills or promissory notes are signed by the importer. Such notes are guaranteed by
the importer's bank and forwarded to the exporter's bank. Generally, such notes would be released to the exporter only against shipping documents. When goods are exported, the shipping documents are handed over to the exporter's bank. The exporter's bank, then forwards the shipping documents to the importer's bank after releasing the notes/bills to the exporter. These documents finally reach the hands of the importer through his bank.

Thereafter, the exporter takes these notes to the forfeitor who purchases them and gives ready cash after deducting discount charges.

Cost of Forfeiting

The cost of forfeiting finance is always at a fixed rate of interest which is usually included in the face value of the bills or notes. Of course, it varies depending upon the arrangements duration, creditworthiness of the party, the country where the importer is staying, the denomination of the currency in which the export deal is to be done and the overall political, economic and monetary conditions prevailing in the importer's country. Since the forfeitor has to assume currency fluctuation risk, interest rate fluctuation risk and the country's risk, he charges a fee and obviously it varies according to the risk factor involved in the deal.

14.12 BENEFITS OF FORFEITING

(i) Profitable and liquid: From the forfeitor's point of view, it is advantageous because he not only gets immediate income in the form of discount charges, but also, can sell them in the secondary market or to any investor for cash.

(ii) Simple and flexible: It is also beneficial to the exporter. All the benefits that are available to a client under factoring are automatically available under forfeiting also. However, the greatest advantage is its simplicity and flexibility. It can be adopted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and the forfeitor.

(iii).Avoids export credit risks: The exporter is completely free from many export credit risks that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations or any political upheaval that may affect the collection of bills. Forfeiting acts as an insurance against all these risks.

(iv)Avoids export credit insurance: In the absence of forfeiting, the exporter has to go for export credit insurance. It is very costly and at the same time it involves very cumbersome procedures. Hence, if an exporter goes for forfeiting, he need not purchase any export credit insurance.

(v) Confidential and speedy: International trade transactions can be carried out very quickly through a forfeitor. It does not involve much documentary procedures. Above all, it is confidential. The speed and confidentiality with which deals are made beneficial for both the parties namely the exporter and the importer. No banking relationship with the forfeitor is necessary, since, it is a one-time transaction only.

(vi) Suitable to all kinds of export deal: It is suitable to any kind of goods – whether capital goods exports or commodity exports. Any export deal can be subject to forfeiting.

(vii) Cent per cent finance: The exporter is able to convert his deferred transaction into

cash transaction through a forfeitor. He is able to get 100 per cent finance against export receivables.

(viii) Fixed rate finance: Forfeiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

Drawbacks

(i) Non-availability for short and long periods: Forfeiting is highly suitable to only medium-term deferred payments. Forfeitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short-term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short-term and long-term credit have to seek some other alternative source.

(ii) Non-availability for financially weak countries: Similarly, forfeitors generally do not come forward to undertake any forfeit financing deal involving an importer from a financially weak country. Generally, the forfeitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be under taken at a higher price.

(iii) Dominance of western currencies: In International forfeiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutshe Mark and French and Swiss Francs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in procuring international bank's guarantee: Forfeitors do not normally finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfeitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

14.13 FORFEITING IN INDIA

Forfeiting, as a source of finance, has gained substantial momentum abroad. Though it had its origin in Zurich', it has been well established in all the financial centres of the world. Some of the important forfeiting centres are

London, Zurich, Hong Kong, Singapore and Frankfurt. It has become a popular source of finance among Europeans.

In India, forfeiting is slowly emerging as a new product in the liberalised financial market. It was approved by the Union Government only in January, 1994. The existing scheme available for exporters like concessional finance by commercial banks, insurance cover against export credit risks by ECGC, etc., are available mainly to large and well established exporters. In this context, forfeiting may be a real boon to the small, as well as, new exporters.

In India, forfeiting is done by the EXIM Bank. The minimum value of a forfeiting transaction
is 5,00,000. A special form of promote/bill has to be used for forfeiting transactions. An Indian exporter who wants to avail of this service has to approach the EXIM bank through his bank. The
EXIM Bank would obtain the forfeiting quotation from the forfeiting agency abroad. Based on this, the exporter would workout his price to be quoted to the importer. If the importer accepts the price and the payment terms, the contract would be finalised and executed. The exporter would then get cash through forfeiting arrangements for which he has to enter into a separate contract with the forfeitor through the EXIM Bank.

14.14 TERMINOLOGIES

1)Process 2) Factoring 3) Contracts 4) Discounting 5) forfeiting

14.15MODEL QUESTIONS

1. Explain the Functions of Factoring?
2. What are the Types of Factoring?
3. Explain the Factoring Vs. Discounting?
4. Discuss the Cost of Factoring?
5.Bring out the Factoring in India?

14.16 REFERENCE BOOKS

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Model Questions

Part – A.(10x2=20)

Answer All the Questions

1.Define financial services.

2. What do you understand from dematerialisaton?

3. Explain the term public issue.

4. How a project financed?

What is cross border factoring?

6. What is E-Share

7. What is meant by financial innovation?

8. Define certificate of deposit.

9. What are the features of commercial papers?

10.What is insider trading?

Part – B(5x5=25)

Answer All the Questions

11. (a) Explain in detail the various components of financial system.

(or)

b)Discuss the problems financial services firm in India, Suggest suitable measure to overcome the problem.

12. A) What are the characteristic feature of venture capital?

(or)

b) Mention the guidelines of SEBI on Merchant banker.

13. (a) Distinguish between money market and capital market.

(or)

b) Sketch the characteristic features of a Money market.

14. A) Distinguish between factoring and discounting.

(or)

B) Explain the securitization process with example.

15. A) Explain the importance of money market in India.

(or)

b) Explain the importance of mutual funds.

Part – C(3x10=30)

Answer Any THREE Questions

16. Discuss the functions of modern financial services firm in India.

17. Critically examine the present status of securitization in India.

18. Explain the functions of stock exchange.

19. Give an account of various types of mutual funds available in the Indian capital market.

20. What is the contribution of money market in Indian prospective?