ANNAI WOMEN'S COLLEGE, KARUR
III.B.Com – FINANCIAL SERVICES
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Unit – I

FINANCIAL SERVICES

Introduction

The Indian financial services industry has undergone a transformation since1990. Beforeits emergence the commercial banks and other financial institutions dominated the field and theymet the financial needs of the Indian industry. It was only afterthe economic liberalisation that thefinancial service sector gained some prominence. Now this sector has developed into an industry.

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

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

Meaning of Financial Services

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

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

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

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

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

Functions of financialservices

- Facilitating transactions (exchange of goods and services) in the economy.
- Mobilizing savings (for which the outlets would otherwise be much more limited).
- Allocating capital funds (notably to finance productiveinvestment).
- Monitoring managers (so that the funds allocated will be spent as envisaged).

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- Transforming risk (reducing it through aggregation and enabling it to be carried by those morewilling to bear it).

CHARACTERISTICS OR NATURE OF FINANCIAL SERVICES

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

1. Intangibility

Financial services are intangible. Therefore, they cannot be standardized orreproduced in the same form. The institutions supplying the financial services should have a betterimage and confidence of the customers. Otherwise, they may not succeed. They have to focus onquality and innovation of their services. Then only they can build credibility and gain the trust ofthe customers.

2. Inseparability

Both production and supply of financial services have to be performedsimultaneously. Hence, there should be perfect understanding between the financial serviceinstitutions and its customers.

3. Perishability

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

4. Variability

In order to cater a variety of financial and related needs of different customers indifferent areas, financial service organisations have to offer a wide range of products and services.This means the financial services have to be tailormade to the requirements of customers. Theservice institutions differentiate their services to develop their individual identity.

5. Dominance of human element

Financial services are dominated by human element. Thus,financial services are labour intensive. It requires competent and skilled personnel to market thequality financial products.

6. Information based

Financial service industry is an information based industry. It involvescreation, dissemination and use of information. Information is an essential component in theproduction of financial services.

Importance of Financial Services

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

1. Economic growth

The financialservice industry mobilises the savings of the people, andchannels them into productive investments by providing various services to people in generaland corporate enterprises in particular. In short, the economic growth of any country dependsupon thesesavings and investments.

2. Promotion of savings

The financial service industry mobilises the savings of the people byproviding transformation services. It provides liability, asset and size transformation serviceby providing huge loan from small deposits collected from a large number of people. In thisway financial service industry promotes savings.

3. Capital formation

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Financial service industry facilitates capital formation by renderingvarious capital market intermediary services. Capital formation is the very basis for economicgrowth.

4. Creation of employment opportunities:

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

5.Contribution to GNP

Recently the contribution of financial services to GNP has beenincreasing year after year in almost countries.

6. Provision of liquidity

The financial service industry promotes liquidity in the financialsystem by allocating and reallocating savings and investment into various avenues ofeconomic activity. It facilitates easy conversion of financial assets into liquid cash.

Types of Financial Services

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

1. Provision of funds

(a)Venture capital
(b)Banking services
(c)Asset financing
(d)Trade financing
(e)Credit cards
(f)Factoring and forfaiting

2. Managing investible funds

(a)Portfolio management
(b)Merchant banking
(c)Mutual and pension funds

3. Risk financing

(a)Project preparatory services
(b)Insurance
(c)Export credit guarantee

4. Consultancy services

(a)Project preparatory services
(b)Project report preparation
(c)Project appraisal
(d)Rehabilitation ofprojects
(e)Business advisory services
(f)Valuation of investments
(g)Credit rating
(h)Merger, acquisition and reengineering

5. Market operations

(a)Stock market operations

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(b)Money market operations
(c)Asset management
(d)Registrar and share transfer agencies
(e)Trusteeship
(f)Retail market operation
(g)Futures, options and derivatives

6. Research and development

(a)Equity and market research
(b)Investor education
(c)Training of personnel
(d)Financial information services

SCOPE OF FINANCIAL SERVICES

The scope of financial services is very wide. This is because it covers a wide range ofservices. The financial services can be broadly classified into two:

(a) fund based services and
(b)Non-fund services (or fee-based services)

Fund basedServices

The fund based or asset based services include the following:

a. Underwriting
b. Dealing in secondary market activities
c. Participating in money market instruments like CPs, CDs etc.
d. Equipment leasing or lease financing
e. Hire purchase
f. Venture capital
g. Bill discounting
h. Insurance services
i. Factoring
j. Housing finance
k. Mutual fund

Non-fund based Services

Today, customers are not satisfied with mere provision of finance. Theyexpect more fromfinancial servicecompanies. Hence, the financial service companies or financial intermediariesprovide services on the basis of non- fund activities also. Such services are also known as fee basedservices. These include the following:

a. Securitisation
b. Merchant banking
c. Credit rating
d. Loan syndication
e. Business opportunity related services

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f. Project advisory services
g. Services to foreign companies and NRIs.
h. Portfolio management
i. Merger and acquisition
j. Capital restructuring
k. Debenture trusteeship
l. Custodian services
m. Stock broking

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

Asset/Fund Based Services

1. Equipment leasing/Lease financing

A lease is an agreement underwhich a firm acquires aright to make use of a capital asset like machinery etc. on payment of an agreed fee called leaserentals. The person (or the company) which acquires the right is known as lessee.He does not getthe ownership of the asset. He acquires only the right to use the asset. The person (or thecompany) who gives the right is known as lessor.

2. Hire purchase and consumer credit

Hire purchase is an alternative to leasing. Hirepurchase is atransaction where goods are purchased and sold on the condition that payment ismade in installments. The buyer gets only possession of goods. He does not get ownership. Hegets ownership only after the payment of the lastinstallments. If the buyer fails to pay anyinstallment, the seller can repossess the goods. Each installment includes interest also.

3. Bill discounting

Discounting of bill is an attractive fund based financial service provided bythe finance companies. In the case of time bill (payable after a specified period), the holder neednot wait till maturity or due date. If he is in need of money, he can discount the bill with hisbanker. After deducting a certain amount (discount), the banker credits the net amount in thecustomer’s account. Thus, the bank purchases the bill and credits the customer’s account with theamount of the bill less discount. On the due date, the drawee makes payment to the banker. If hefails to make payment, the banker will recover the amount from the customer who has discountedthe bill. In short, discounting of bill means giving loans on the basis of the security of a bill ofexchange.

4.Venture capital

Venture capital simply refers to capital which is available for financing thenew business ventures. It involves lending finance to the growingcompanies. It is the investmentin a highly risky project with the objective of earning a high rate of return. In short, venture capitalmeans long term risk capital in the form of equity finance.

5. Housing finance

Housing finance simply refers to providing finance for house building. Itemerged as a fund based financial service in India with the establishment of National Housing Bank (NHB) by the RBI in 1988. It is an apex housing finance institution in the country. Till now, anumber of specialized financial

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institutions/companies have entered in the field of housing finance.Some of the institutions are HDFC, LIC Housing Finance, Citi Home, Ind Bank Housing etc

6. Insurance services

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

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

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

7.Factoring

Factoring is an arrangement under which the factor purchases the accountreceivables (arising out of credit sale of goods/services) and makesimmediate cash payment to thesupplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client)are purchased by a financial institution or banker. Thus, the factor provides finance to the client(supplier) in respect of account receivables. The factor undertakes the responsibility of collectingthe account receivables.

The financial institution (factor) undertakes the risk. For this type ofservice as well as for the interest, the factor charges a fee for the intervening period. This fee orcharge is calledfactorage.

9. Mutual fund

Mutual funds are financial intermediaries which mobilise savings from thepeople and invest them in a mix of corporate and government securities. The mutual fund operatorsactively manage this portfolio of securities and earn income through dividend, interest and capitalgains. The incomes are eventually passed on to mutual fund shareholders.

Non-Fund Based/Fee Based Financial Services

1. Merchant banking:

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

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has defined a merchant bankeras, “any person who is engaged in the business of issue management either by makingarrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management”.

2. Credit rating

Credit rating means giving an expert opinion by a rating agency on the relativewillingness andability of the issuer of a debt instrument to meet the financial obligations in timeand in full. It measures the relative risk of an issuer’s ability and willingness to repay both interestand principal over the period of the rated instrument. It is a judgement about a firm’s financial andbusiness prospects. In short, credit rating means assessing the creditworthiness of a company by anindependent organisation.

3. Stock broking

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

4. Custodial services

In simple words, the services provided by a custodian are known ascustodial services (custodian services). Custodian is an institution or a person who is handed oversecurities bythe security owners for safe custody. Custodian is a caretaker of a public property orsecurities. Custodians are intermediaries between companies and clients (i.e. security holders) andinstitutions (financial institutions and mutual funds). There is anarrangement and agreementbetween custodian and real owners of securities or properties to act as custodians of those whohand over it. The duty of a custodian is to keep the securities or documents under safe custody. Thework of custodian is very risky and costly in nature. For rendering these services, he gets aremuneration called custodial charges. Thus custodial service is the service of keeping the securities safe for and on behalf of somebodyelse for a remuneration called custodial charges.

5. Loansyndication

Loan syndication is an arrangement where a group of banks participate toprovide funds for a single loan. In loan syndication, a group of banks comprising 10 to 30 banksparticipate to provide funds wherein one of the banks is the lead manager. This lead bank isdecided by the corporate enterprises, depending on confidence in the lead manager.A single bank cannot give a huge loan. Hence a number of banks join together and form asyndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortiumfinancing.

6. Securitisation (of debt)

Loans given to customers are assets for the bank. They are calledloan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assetsare not liquid. The problem is how to make the loan of a bank liquid. This problem can be solvedby transforming the loans into marketable securities. Now loans become liquid. They get thecharacteristic of marketability. This is done through the process ofsecuritization. Securitisation isa financial innovation. It is conversion of existing or future cash flows into marketable securitiesthat can be sold to investors. It is the process by which financial assets such as loan receivables,credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed intosecurities. Thus, any asset with predictable cash flows can be securitised.

Securitisation is defined as a process of transformation of illiquid asset into security whichmay be traded later in the opening market. In short, securitization is the transformation of illiquid,non-marketable

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assets into securities which are liquid and marketable assets. It is a process oftransformation of assets of a lending institution into negotiable instruments.

Securitisation is different from factoring. Factoring involves transfer of debts withouttransforming debts into marketable securities. But securitisation always involves transformation ofilliquid assets into liquid assets that can be sold to investors.

Challenges faced by the financial service sector

Financial service sector has to face lot of challenges in its way to fulfil the ever growingfinancial demand of the economy. Some of the important challenges are listed below:

- ❖ Lack of qualified personnel in the financial service sector.
- ❖ Lack of investor awareness about the various financial services.
- ❖ Lack of transparency in the disclosure requirements and accounting practices relating tofinancial services.
- ❖ Lack ofspecialisation in different financial services (specialisation only in one or twoservices).
- ❖ Lack of adequate data to take financial service related decisions.
- ❖ Lack of efficient risk management system in the financial service sector.

The above challenges are likely to increase in number with the growing requirements of thecustomers. However, the financial system in India at present is in a process of rapidtransformation, particularly after the introduction of new economic reforms.

MERCHANT BANKING

ORIGIN OF MERCHANT BANKING

- ✓ The concept of merchant banking originated in 13th century in Italy.
- ✓ The first-known firms to have been involved in merchant banking were Riccadi of Luca, Medici, and Fugger.
- ✓ In olden times, merchant banks were also called as “accepting and issuing houses” in the U.K and Investment Banks’ (IB) in the U.S.A.Until 1932, there was no distinction between the functions of merchant banking and commercial banks.
- ✓ Later, the Glass Steagall Act, 1933, distinguished the functions of merchant banking or investment banking from commercial banking.

ORIGIN OF MERCHANT BANKING IN INDIA

1. In 1967, the National Grind lays Bank in India initiated merchant banking services.
2. In 1970, the Citibank followed the merchant banking services.
3. In 1973, the SBI was the first Indian commercial bank to set up a separate merchant banking division.
4. In 1974, ICICI followed it.
5. During 1974-75, these Indian merchant bankers emerged as leaders in merchant banking having done significant business in comparison to foreign banks.
6. A number of commercial banks, financial institutions and other organizations are now engaged in providing merchant banking services.

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The word ‘merchant banking’ was originated among the Dutch and Scottish traders. Later on itwas developed and professionalised in the UK and the USA. Now this has become popularthroughout the world.

MEANING AND DEFINITION OF MERCHANT BANKING

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

The term merchant banking is used differently in different countries.So there is no universaldefinition for merchant banking. We can define merchant banking as a process of transferringcapital from those who own it to those who use it.

According to Random House Dictionary,“merchant bank is an organization that underwriters securities for corporations, advices such clientson mergers and is involved in the ownership of commercial ventures. These organizations aresometimes banks which are not merchants and sometimes merchants who are not bankers andsometimes houses whichneither merchants nor banks”.

According to SEBI (Merchant Bankers)Rules 1992, “A merchant banker has been defined as any person who is engaged in the business ofissue management either by making arrangements regarding selling, buying or subscribing tosecurities or acting as manager, consultant advisor or rendering corporate advisory services inrelation to such issue management”.

In short, “merchant bank refers to an organization thatunderwrites securities and advises such clients on issues like corporate mergers, involving in theownership of commercial ventures”.

Thus merchant banking involves a wide range of activities such as management of customerservices, portfolio management, credit syndication, acceptance credit, counseling, insurance,preparation of feasibility reports etc. It is not necessary for a merchant banker to carry out all theabove mentioned activities. A merchant banker may specialise in one activity, and take up otheractivities, which may be complementary or supportive to the specialized activity.In short, merchant banking involves servicing any financial need of the client.

As per the Securities Exchange Board Of India (Merchant Bankers) rules 1992, “Merchant banker” means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management”.

Merchant Bank may be defined as “a kind of financial institution that provide a variety of services, including investment banking, management of customers securities, portfolios, insurance, acceptance of bills, etc”

FUNCTIONS (SERVICES) OF MERCHANT BANKERS (SCOPE OF MERCHANT BANKING)

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

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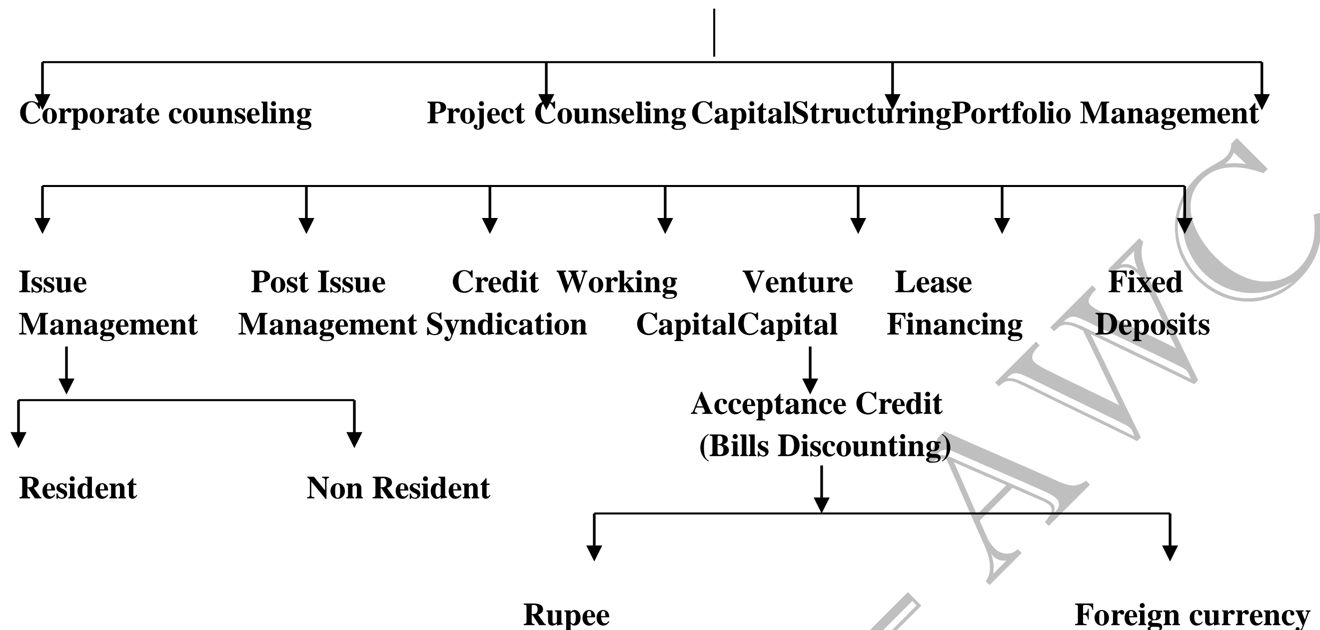
FUNCTIONS OF MERCHANT BANKING



1. Corporate Counseling: Merchant bankers provide counseling services to companies with regard to their timing of issue of shares, capital structure and other promotional aspects with regard to the company. The scope of this function limited to giving suggestions and opinions to the client and helps in taking decisions to solve their problems.

2. Project Counseling: Here, the new entrepreneurs is helped in the conception of idea identification of various projects, preparation of projects, feasibility reports, location of factory, obtaining funds, sanctions and approval from state and central government departments.

3. Capital Structure: Here, the amount of capital required, rising of the capital, debt-equity ratio, issue of shares and debentures, working capital, fixed capital requirements etc are worked out.

4. Portfolio Management: In portfolio, management, the merchant banker helps the investor in matters pertaining to investment decisions. Taxation and inflation are taken into account. While advising on investment in different securities. The merchant banker also undertakes the function of buying and selling of securities on behalf of their client companies.

5. Issue Management: Obtaining clearances, drafting of prospectus, underwriting, leasing with brokers and bankers and keeping constant communication with investors.

6. Credit Syndication: When more funds are required different financial institutions are approached for capital requirements. The financial institutions joining together for providing finance to a needy company is known as Credit syndication. This is also called 'Consortium finance'.

7. Working Capital: Companies are given working capital finance, depending upon their earning capacities in relation to the interest rate prevailing in the market.

8. Venture Capital: Venture capital is a kind of finance where in a new venture proposed by an entrepreneur is financial. Venture capital carries more risks and hence very few financial institutions come forward to finance.

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9. Lease Finance: The leasing companies are providing finance for procurement of different assets that are required by different companies. It is a form of finance employed to acquire the use of assets.

10. Fixed Deposit: Merchant bankers enable companies to raise finance by way of fixed deposits from the public. However, such companies should fulfill credit rating requirements. The merchant banker helps the borrowing company to accept depositors from the public.

11. Other functions: In addition to the above functions, the merchant banker undertakes the following functions also.

(i) Treasury Management: Management of cash and short term funds required by client companies.

(ii) Stock Broking: Access to the stock market, providing odd lot counters and helping upcountry investors through a network of service units.

(iii) Servicing of Issues: Merchant bankers maintain registers of shareholders and debentures holders of their client companies and distribute dividends and debenture interest. They also have safe custody of securities belonging to their clients.

(iv) Small Scale Industry Counseling: SSI entrepreneurs are given necessary counseling on marketing and finance by merchant bankers.

(v) Equity research and investment counseling: Generally a common investor is not in a position to take appropriate investment decision. In order to help such investors, many finance companies are providing equity research and investment counseling.

(vi) Assistance to NRI Investors: Here the various investors' opportunities in the country are brought to the notice of NRI investors by the merchant banker.

(vii) Foreign Collaboration: Foreign collaboration agreements (technical and financial) are also arranged by merchant bankers.

(viii) Off-Shore Banking: Merchant bankers are now allowed to get loans from other countries and invest it in safe and profitable ventures. Here, the MB receives loans from a foreign country which can be invested in the home country, but the same cannot be done vice versa.

(ix) SWAP: SWAP is yet another trading instrument. In fact, it is a combination of forwards by two counter parties. It is arranged to reap the benefits arising from the fluctuations in the market, either a currency market or interest rate market or any other market for that matter.

The functions of merchant banker can be summarized as follows:

(a)Issue management.
(b)Underwriting of issues.
(c)Project appraisal.
(d)Handling stock exchange business on behalf of clients.
(e)Dealing in foreign exchange.
(f)Floatation of commercialpaper.
(g)Acting as trustees.
(h)Share registration.
(i)Helping in financial engineering activities of the firm.
(j)Undertaking cost audit.
(k)Providing venture capital.
(l)Arranging bridge finance.

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(m)Advising business customers (i.e. mergers and takeovers).
(n)Undertaking management of NRI investments.
(o)Large scale term lending to corporate borrowers.
(p)Providing corporate counseling and advisory services.
(q)Managing investments on behalf of clients.
(r)Acting as a stock broker.

OBJECTIVES OF MERCHANT BANKING

The objectives of merchant banking are as follows:

- ✓ To provide non financial services such as arranging for funds rather than providing them with the help of financial institutions, banks, stock exchanges and money market.
- ✓ To co-ordinate the activities of various intermediaries to the share issue such as the registrar, banker, advertising agency, printers, underwriters, brokers etc.
- ✓ To promote industrial enterprises in India.
- ✓ To promote customized solutions to their client's financial problems.
- ✓ To help companies in obtaining venture capital financing for financing their new and innovative strategies and also arranges for the tie up loans for their clients
- ✓ To provide portfolio management services to their clients
- ✓ To provide investment advisory services to attract NRI investments
- ✓ To provide leasing finance facilities to their clients
- ✓ They offer services not only to the clients issuing the securities but also to the investors regarding investment decisions.
- ✓ They provide counseling services to the companies.

ROLE OF MERCHANT BANKERS IN MANAGING PUBLIC ISSUE

In issue management, the main role of merchant bankers is to help the company issuingsecurities in raising funds for the purpose of financing new projects, expansion/ modernization/diversification of existing units and augmenting long term resources for working capitalrequirements.The most important aspect of merchant banking business is to function as lead managers to theissue management. The role of the merchant banker as an issue manager can be studied from thefollowing points:

1. Easy fund raising:

An issue manager acts as an indispensable pilot facilitating a public/ rightsissue. This is made possible with the help of special skills possessed by him to execute themanagement ofissues.

2. Financial consultant:

An issue manager essentially acts as a financial architect, by providingadvice relating to capital structuring, capital gearing and financial planning for the company.

3.Underwriting:

An issue manager allows for underwriting the issues of securities made bycorporate enterprises. This ensures due subscription of the issue.

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4. Due diligence:

The issue manager has to comply with SEBI guidelines. The merchant bankerwill carry out activities with due diligence and furnish a Due Diligence Certificate to SEBI.The detailed diligence guidelines that are prescribed by the Association of Merchant Bankersof India (AMBI) have to be strictly observed. SEBI has also prescribed a code of conduct formerchant bankers.

5. Co-ordination:

The issue manger is required to co-ordinate with a large number of institutionsand agencies while managing an issue in order to make it successful.

6. Association with SEBI:

The issue manager, as a part of merchant banking activities, shouldregister with SEBI. While managing issues, constant interaction with the SEBI is required byway of filing of offer documents, etc. In addition, they should file a number of reports relatingto the issues being managed.

REGULATIONS OF MERCHANT BANKING BY SEBI

1. Objectives of merchant banking regulation:

- ✓ It provides for the merchant bankers a dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency.
- ✓ It ensures a fair, efficient and flexible primary market to all involved in the process of primary issue.
- ✓ It regulates the raising of funds in primary market.
- ✓ It assures the issuer a market for raising resources at low cost, effectively and easily.
- ✓ It ensures a high degree of protection to the interest of the investors.

2. Authorized activities:

- ✓ Authorized activities are
- ✓ Issue management.
- ✓ Corporate advice.
- ✓ Managing, consultation and advising.
- ✓ Port folio management services.

3. Prospectus: The registrar of companies is advised that the merchant banker who is authorized by the SEBI only can file the prospectus, for which each merchant banker is assigned a code number by SEBI. If prospectus is in contravention of any law, SEBI can instruct the register not to register such prospects.

4. Four categories of merchant bankers:

1. **Category I:** They will carry on any activity of the issue management and they will act as adviser, Consultant, manager underwriter and port folio manager. They are responsible for preparation of products, determining financial structure, making final allotment and refund of subscription amount.
2. **Category II:** They act as adviser, consultant, co-managers, and portfolio manager
3. **Category III:** They act as underwriter, adviser, and consultant to an issue.
4. **Category IV:** They act only as advisor or consultant to an issue.

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5. Registration fee to be merchant banker:

- ✓ **For category I:** Rs.2.5 Crores per annum for the first 2 years and Rs.1 lakh for the third year has to be paid to SEBI towards registration fee.
- ✓ **For category II:** Rs.1.5 lakhs for the first 2 years per annum and Rs.50, 000 for the third year.
- ✓ **For category III:** Rs.1 lakh per annum for first 2 years and Rs.25, 000 for the third year.
- ✓ **For category IV:** Rs.5000 per annum for first years and Rs.1, 000 for the third year.

6. Code of conduct:

- ✓ To become a merchant banker one has to register himself with SEBI.
- ✓ He shall observe high standards of integrity and fairness in all his dealings with his clients and other
- ✓ Merchant's bankers.
- ✓ He shall render at all times high standards of service, ensure proper care and exercise independent
- ✓ Professional judgments.
- ✓ He shall not make any statement or do any act which is likely to be harmful to the interest of the
- ✓ Other merchant bankers.
- ✓ He shall not make any exaggerated statements to the client.
- ✓ He shall endeavor to render best possible advice to their client.
- ✓ He shall not divulge any confidential information about his client to other clients.

7. Obligations and responsibilities of merchant banker:

- ✓ He should maintain and keep
  - ➢ A copy of the balance sheet.
  - ➢ A copy of the auditor's report.
  - ➢ Statement of financial position.
- ✓ He should furnish final statement and such other documents to SEBI.
- ✓ He should submit half yearly working results to SEBI.

8. Responsibilities of lead manager:

- ✓ The lead merchant banker should submit the following documents,
- ✓ Particular of issue and draft prospectus
- ✓ Any other literature intended to be circulated to the investor including the shareholders and
- ✓ Such other documents relating to prospectus or letter of offer as the case may be these documents should be furnished at least two weeks before filing the draft prospectus with registrar of companies.

9. Acquisition of shares: Merchant banker submits particulars of any transaction for acquisition of shares of a company whose issue is managed by them within 15 days from the date of entering such transaction.

10. Enquiry: An enquiry officer is appointed by SEBI to inquire in to the defaults of a merchant banker. He issues notice to the merchant banker and later may furnish a reply with evidences sought by the board within 30 days and the merchant banker will be given reasonable opportunity to the banker to explain.

11. Action by SEBI: On receipt of report from enquiry officer, board initiates an action.

- ✓ It issues a show cause notice and merchant banker has to respond to the notice within 21 days.
- ✓ Merchant banker ceases to carry on business on and from the date of suspension.

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- ✓ Order of suspension shall be published in at least two daily newspapers by the board.
- ✓ Aggrieved person may apply to the central government against the order.

PROCEDURE FOR AUTHORIZATION OF A MERCHANT BANK

If any person or body is interested in the business of merchant banking either to start it as a new business or to add its existing business, would need authorization from SEBI and it must be done in prescribed format. SEBI's authorization criteria would taken in to consideration mainly the following

1. Professional competence: Whether a person or a body requiring authorization has the necessary professional know how and the competence to run the business successfully.

2. Capital: They must have adequate capital and ready financial resource.

3. Track record: The person or firm must possess a clear record and their performance in past is considered. Their experiences, reputation and failure in all their transactions also scrutinized.

4. Infrastructure: Quality of their personnel and the basic foundation and infrastructure like adequate office space, equipment are also considered by SEBI.

5. Net worth: SEBI lays down that all merchant bankers must be worth at least Rs. One Crore. However net worth level varies according to the category that an applicant opts for.

LATEST DEVELOPMENTS IN MERCHANT BANKING

1. Stock Option Scheme: This scheme invites the employees to invest in new issues so that all the employees will put in their best.

2. Stock Holding Corporation: The Stock Holding Corporation of India has been set up for handling shares of public sector companies and issuing them equally.

3. Employees stock option scheme: In the recent years it has become the order of the day to include the employees as part owners of the corporation. Any company whose securities are listed in any stock exchange it may offer its securities to its employees through this scheme and they have to follow the following conditions.

- ✓ The issue is such shares should not exceed 5% of the paid up capital of the company.
- ✓ It should submit a certificate to the concerned stock exchange as to whether the securities have been issued as per the scheme to permanent regular employees.
- ✓ Promoters and part tine debtors will not be entitled to receive these benefits unless the debtor is only an employee and not as promoter of a company.

4. Transparency in Takeover Bids: SEBI has laid down that take-over should be done openly and no surprise takes-over would be allowed. So, that a company tries to take over the shares of another company, it has to come into the stock exchange market and has to announce publicly.

5. Foreign investments: Foreign financial institutions are now allowed to enter the Indian stock exchange market and buy and sell shares of certain companies.

6. Credit Rating Agencies: Developing credit rating agencies like CRISIL, to go into a company's financial structure when such companies issue debentures to the public. Such organization makes sure that such companies will be able to pay back the investors and creditors when dissolving the company.

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7. Trading in future: Under this a person is allowed to enter in to a contact to buy or sell shares at a future date.

PROBLEMS OF MERCHANT BANKERS

SEBI does not authorize merchant banker to undertake portfolio management and these guidelines have made merchant banker to restrict activities.

- ✓ Small but professional and specialized merchant banker who does have a net worth of Rs.1 Crore may have to close down their business.
- ✓ They have to seek the cooperation of the issuing company to shoulder the responsibility.
- ✓ Some of the merchant banker lack entrepreneurial ability.
- ✓ There is lack of professionalized people.
- ✓ Indulging speculation in the selling or in the new issue of shares.
- ✓ Unhealthy practices in inter corporate leading market.

CONCEPT OF MERCHANT BANKING IN INDIA

- ✓ Merchant banker' service first started by foreign banks and the banking commission in this report 1972 recommended the setting up of merchant banking institutions by commercial banks and financial institutions.
- ✓ Following banks are having merchant banking divisions, SBI, ICICI, 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.
- ✓ The number of merchant banks increased to 115 by the end of 1992-94 and 501 by the end of august 1994.
- ✓ All merchant bankers registered with SEBI under four different categories.
- ✓ Thus by the end of 1980's there were 33 merchant bankers belonging to 3 major segment viz, Commercial banks, Financial institutions, and Private Firms.

SCOPE OF MERCHANT BANKING IN INDIA

In a present day capital market scenario, merchant bankers play the role of an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market because of following reasons.

1. Growth of New Issues Market: The growth of new issue market is unprecedented since 1990-91. The number of capital issues has also increased from 363 in 1990-91 to 900 in 1993-94. The trend is expected to continue in future.

2. Entry of Foreign Investors: An outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly tap foreign capital through euro issues.

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3. Changing Policy of Financial Institutions: The policy of decentralization and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by Merchant bankers.

4. Development of Debt Market: The concept of debt market has to set to work through National Stock Exchange and the Cover of Counter Exchange of India. Experts feel that of the estimated capital issues of Rs.40, 000 Crores in 1994-95, a good portion may be raised through debt instruments. The development of debt market will offer tremendous opportunity to Merchant Bankers.

5. Innovations of Financial Instruments: The Indian capital market has witnessed innovations in the introduction of financial instruments. This has further extended the role of Merchant Bankers as market makers for these instruments.

6. Corporate Restructuring: As a result of liberation and globalization the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning. This offers good opportunity to Merchant Bankers to extend the area of their operations.

7. Disinvestment: The government raised Rs.2000 crores through disinvestment of equity shares of selected public sector undertakings in 1993-94. The government proposes to shift the present method of periodic sale of public sector shares to round the year off loading of shares directly on the stock exchange from the year 1995-96. The government will sell the shares of identified public sector at any time during the year when they get a good price above minimum stipulated level. This is likely to provide good business to Merchant Bankers in future.

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DIFFERENCE BETWEEN MERCHANT BANKING AND COMMERCIAL BANKS

Basis	**Merchant Banking**	**Commercial Banking**
Type of Finance	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.	Commercial banks basically deal in 'debt and debt related finance' and their activities are appropriately arrayed around credit proposals, credit appraisals and loan sanctions.
Orientation	The merchant bankers are management oriented. They are willing to accept risks of business.	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 risk.
Activities	The activities of merchant bankers include project counseling, corporate counseling, amalgamation, mergers, takeover, issue management activities, advisors on portfolio management in stock exchange, discounting & re-discounting of short term	Commercial banks are merely financiers.

	papers in money market. Merchant banking activities have impact on growth and liquidity of money market.	

QUALITIES REQUIRED FOR A MERCHANT BANKER

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

2. Knowledge: 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: 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: Innovative approach in developing capital market instruments to satisfy the ever changing needs of investing public.

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

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Unit II
HIRE PURCHASE

Concept and Meaning of Hire Purchase

Hire purchase is a type of installment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid.

The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as "An agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

1. The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic installments.
2. The property in the goods is to pass to such person on the payment of the last of such installments, and
3. Such person has a right to terminate the agreement at any time before the property so passes".

Legal framework of Hire purchase transactions

The hire purchase system is regulated by the Hire Purchase Act 1972. In a hire – purchase transaction, assets are let on hire, the price is to be paid in installments and hirer is allowed an option to purchase the goods by paying all the installments. A Hire Purchase agreement usually requires the customer to pay an initial deposit, with the remainder of the balance, plus interest, paid over an agreed period of time.

Under hire purchase agreement, you:

1. Purchase goods through installment payments
2. Use the goods while paying for them
3. Do not own the goods until you have paid the final installment Rights of the hirer

The hirer usually has the following rights:

i. To buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate
ii. To return the goods to the owner -this is subject to the payment of a penalty.
iii. With the consent of the owner, to assign both the benefit and the burden of the contract to a third person.

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iv. Where the owner wrongfully repossesses the goods, either to recover the goods plus damages for loss of quiet possession or to damages representing the value of the goods lost.

Additional rights-

i. Rights of protection
ii. Rights of notice
iii. Rights of repossession
iv. Rights of Statement
v. Rights of excess amount

Obligations of hirer

The hirer usually has following obligations:

1. To pay hire installments,
2. To take reasonable care of the goods
3. To inform the owner where goods will be kept.

Owner's rights

The owner usually has the right to terminate agreement where hirer defaults in paying the installments or breaches any of the other terms in agreement.

This entitles the owner:

- To forfeit the deposit.
- To retain the installments already paid and recover the balance due.
- To repossess the goods (which may have to be by application to a Court depending on the nature of the goods and the percentage of the total price paid.
- To claim damages for any loss suffered.

Features of Hire Purchase

1. Immediate possession

Under HP, the buyer takes immediate possession of goods by paying only a portion of its price.

2. Hire Charges

Under HP, each installment is treated as hire charges.

3. Property in goods

Ownership is – passed to the hirer only after paying last or specified number of installments

4. Down payment

Hirer has to pay 20 to 25% of asset price to the vendor as down payment.

5. **Repossession**

Hire vendor, if default in payment of installment made by hirer, can reposes the goods and he can resell the goods.

6. **Return of goods**

Hirer is free to return the goods without being required to pay further installment falling due after the return.

7. **Depreciation**

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Depreciation and investment allowances can be claimed by the hirer even though he is not an exact owner.

Hire purchase should be distinguished from installment sale wherein property passes to the purchaser with the payment of the first installment. But in case of HP (ownership remains with the seller until the last installment is paid) buyer gets ownership after paying the last installment. HP also differs from leasing

Differences between lease and Hire purchase

1. Ownership

In lease, ownership rests with the lessor throughout and the hirer of the goods not becomes owner till the payment of specified installments.

2. Method of financing

Leasing is a method of financing business assets whereas HP is financing both business and non - business assets.

3. Depreciation

In leasing, depreciation and investment allowances cannot be claimed by the lessee, in HP, depreciation and IA can be claimed by the hirer.

4. Tax benefits

The entire lease rental is tax deductible expense. Only the interest component of the HP installment is tax deductible.

5. Salvage value

The lessee, not being the owner of the asset, doesn't enjoy the salvage value of the asset. The hirer, in HP, being the owner of the asset, enjoys salvage value of the asset.

6. Deposit

Lessee is not required to make any deposit whereas 20% deposit is required in HP.

7. Nature of deal

With lease rent and with HP we buy the goods.

8. Extent of Finance

In lease financing is 100 % financing since it is required down payment, whereas HP requires 20 to 25% down payment.

9. Maintenance

Cost of maintenance hired assets is borne by hirer and the leased asset (other than financial lease) is borne by the lessor.

10. Reporting

HP assets is a balance sheet item in the books of hirer where as leased assets are shown as off - balance sheet item (shown as Foot note to BS).

RBI GUIDELINES FOR HP BUSINESS

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Under section 6(I) (0) of Banking Regulation Act - 1949, the Govt. Of India has permitted banks to engage in HP business. Following are some of the important guidelines of RBI for HB business of banks;

1. Banks shall not themselves undertake directly (departmentally) the business of hire purchases.
2. Banks desirous of undertaking HP business through an existing companies or new subsidiaries will require prior approval of RBI.
3. Banks investments in the shares of subsidiaries engaging in leasing and HP business shall not exceed 10% of the paid up share capital and reserves of the banks.
4. Without prior approval of RBI, banks shall not act as promoters of other hire purchase companies.
5. Prior clearance of RBI is required for the purpose of any application to the Controller of Capital issue in case of IPO of new subsidiary and FPO of existing subsidiaries of Banks.
6. Bank shall furnish necessary information regarding its HP or equipment leasing subsidiaries, as and when RBI demands.

ADVANTAGES OF HP

1. Spread the cost of finance

Whilst choosing to pay in cash is preferable,. A hire purchase agreement allows a consumer to make monthly repayments over a pre - specified period of time;

2. Interest-free credit

Some merchants offer customers the opportunity to pay for goods and services on interest free credit.

3. Higher acceptance rates

The rate of acceptance on hire purchase agreements is higher than other forms of unsecured borrowing because the lenders have collateral.

4. Sales

A hire purchase agreement allows a consumer to purchase sale items when they aren't in a position to pay in cash.

5. Debt solutions

Consumer's buy on credit can pursue a debt solution, such as debt engagement plan, should they experience money problems further down the line.

PROBLEMS OF HP BUSINESS IN INDIA

Hire purchase transactions are very uncommon transactions in India. Meaning there by the awareness of this concept is very lesser in India. All segment of India's population treat the hire purchase transaction as a hypothecation loan but there is a slight differentiation among all processes related to hire purchases. Almost for the population of India the hire purchase transaction is very similar to the loans & hypothecation.

Person who wants to purchase any asset then the best option & way for him or her would be loan or hypothecation. Because the public is not aware with transaction named hire purchases. Hire purchase transaction is of two types the cash credit & asset hire purchases. People do not go for hire purchases in India because in India business people are very less so they can not hire the assets for a longer period of

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time. Finally, we would like to end up over here that, lack of awareness leads to occurrence of problem in dealing with hire purchase.

Other problems of HP are as follows:

1. Personal debt

A hire purchase agreement is yet another form of personal debt it is monthly repayment commitment that needs to be paid each month;

2. Final payment

A consumer doesn't have legitimate title to the goods until the final monthly repayment has been made;

3. Bad credit

All hire purchase agreements will involve a credit check. Consumers that have a bad credit rating will either be turned down or will be asked to pay a high interest rate;

4. Creditor harassment

Opting to buy on credit can create money problems should a family experience a change of personal circumstances;

5. Repossession rights

Seller is entitled to 'snatch back' any goods when less than a third of the amount has been paid back.

LEASE FINANCING

Meaning of leasing

Leasing as a financing concept is an arrangement between two parties, the leasing company or lessor and the user or lessee, where by the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. In other words, Firms can acquire the use of assets.

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

DEFINITION

According to the Equipment Leasing Association of UK."Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive party to use the asset usually for an agreed period of time in return for the payment of rent".

Lease can be defined as the following ways

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.
2. The document in which this contract is written.

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3. A great way companies can conserve capital.

4. An easy way vendors can increase sales.

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

Terms used in the lease agreement

1. **Lessor** – The party who is the owner of the equipment and who gives it for lease
2. **Lessee-** The party who obtains the equipment for use for which he pays periodical rentals
3. **Lease property** – The subject of the lease, the asset, article or equipment that is on lease
4. **Term of lease** – This refers to the period for which the agreement will be in operation
5. **Lease rentals** – This refers to the consideration for lease

Importance of Lease Financing

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

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

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

The advantages of leasing include

- Leasing helps to possess and use a new piece of machinery or equipment without huge investment.
- Leasing enables businesses to preserve precious cash reserves.
- The smaller, regular payments required by a lease agreement enable businesses with limited capital to manage their cash flow more effectively and adapt quickly to changing economic conditions.
- Leasing also allows businesses to upgrade assets more frequently ensuring they have the latest equipment without having to make further capital outlays.
- It offers the flexibility of the repayment period being matched to the useful life of the equipment.
- It gives businesses certainty because asset finance agreements cannot be cancelled by the lenders and repayments are generally fixed.
- However, they can also be structured to include additional benefits such as servicing of equipment or variable monthly payments depending on a business's needs.
- It is easy to access because it is secured – largely or entirely – on the asset being financed, rather than on other personal or business assets.
- The rental, which sometimes exceeds the purchase price of the asset, can be paid from revenue generated by its use, directly impacting the lessee's liquidity.

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- Ease installments are exclusively material costs.
- Using the purchase option, the lessee can acquire the leased asset at a lower price, as they pay the residual or non - depreciated value of the asset.
- For the national economy, this way of financing allows access to state – of – the - art technology otherwise unavailable, due to high prices, and often impossible to acquire by loan arrangements.

Limitation of leasing

- It is not a suitable mode of project financing because rental is payable soon after entering into lease agreement while new project generate cash only after long gestation period.
- Certain tax benefits/ incentives/subsidies etc. may not be available to leased equipments.
- The value of real assets (land and building) may increase during lease period. In this case lessee may lose potential capital gain.
- The cost of financing is generally higher than that of debt financing.
- A manufacturer(lessee) who want to discontinue business need to pay huge penalty to lessor for pre - closing lease agreement
- There is no exclusive law for regulating leasing transaction.

TYPES OF LEASE

(a) Financial lease
(b) Operating lease.
(c) Sale and lease back
(d) Leveraged leasing and
(e) Direct leasing.

1) Financial lease

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

2) Operational lease

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

3) Sale and lease back

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

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

4) Leveraged leasing

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

5) Direct leasing

Under direct leasing, a firm acquires the right to use an asset from the manufacture directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

Other types of leasing:

1) First Amendment Lease

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

2) Full Payout Lease

A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

3) Guideline Lease

A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

4) Net Lease

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

5) Open-end Lease

A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

6) Sales-type Lease

A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

7) Synthetic Lease

A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-

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balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

8) Tax Lease

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

9) True Lease

A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

Differences between financial lease and operating lease

i. While financial lease is a long term arrangement between the lessee (user of the asset) and the owner of the asset, whereas operating lease is a relatively short term arrangement between the lessee and the owner of asset.
ii. Under financial lease all expenses such as taxes, insurance are paid by the lessee while under operating lease all expenses are paid by the owner of the asset.
iii. The lease term under financial lease covers the entire economic life of the asset which is not the case under operating lease.
iv. Under financial lease the lessee cannot terminate or end the lease unless otherwise provided in the contract which is not the case with operating lease where lessee can end the lease anytime before expiration date of lease.
v. While the rent which is paid by the lessee under financial lease is enough to fully amortize the asset, which is not the case under operating lease.

Regulatory frame work for Leasing in India

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

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

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

i. The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement
ii. The lessor has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

Contents of a lease agreement:

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The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following:

- Description of the lessor, the lessee, and the equipment.
- Amount, time and place of lease rentals payments.
- Time and place of equipment delivery.
- Lessee's responsibility for taking delivery and possession of the leased equipment.
- Lessee's responsibility for maintenance, repairs, registration, etc. and the lessor's right in case of default by the lessee.
- Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.
- Insurance to be taken by the lessee on behalf of the lessor.
- Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.
- Options of lease renewal for the lessee.
- Return of equipment on expiry of the lease period.
- Arbitration procedure in the event of dispute.

PROBLEMS OF LEASING IN INDIA

Leasing has great potential in India. However, leasing in India faces serious handicaps which may bar its growth in future. The following are the some of the problems.

1. Un healthy competition

There is over supply of lessor in India. The stiff competition between these lessors are force them to reduce their profit margin to bare minimum level. More over subsidiaries of banks and financial institution have competitive edge over private sector lessor due their cheap source of finance.

2. Lack of qualified personnel

Leasing requires qualified and experienced personnel at the helm of its affairs. In India, leasing is of recent one and hence it is difficult to get right man to deal with leasing business.

3. Tax Consideration -

In reality, the lessee's tax shelter is lessors' burden.The lease becomes economically viable if lessor's effective tax rate is low. More over taxes like sales tax, wealth tax, additional tax, surcharge etc. , add to the cost of leasing. It makes leasing relatively more expensive.

4. Stamp Duty-

States treats the leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as pure lease transactions. Accordingly heavy stamp duty imposed on lease document.

5. Delayed payment and bad debts-

The problem of delayed payment of rents and bad debts add to the cost of lease. This problem would disturb prospects of leasing business.

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Unit III
MUTUAL FUNDS

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

MEANING

- A mutual fund pools the savings of investors who share a common financial goal and he acts as a special type of institution that acts as an investment agent.
- It invests thereafter careful research and analysis in various types of securities.
- It offers the individual saver, the advantages of reasonable dividend and capital appreciation coupled with safety and liquidity.
- Corporation, which receives funds from investors and deploy (invest) the same in equities, long term bonds and money market instruments etc., is called mutual funds.

DEFINITION

The Securities Exchange Board of India (SEBI Mutual Funds) Regulations, 1993 defines Mutual Funds as "A fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations".

According to Frank Reilly defines Mutual Funds as "Financial intermediaries which bring a wide variety of securities within the reach of most modest of investors".

MECHANISM OF MUTUAL FUND

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1. The professional manager of a fund invests the collected money in different types of securities for and on behalf of the investors.
2. The investment is based on the objectives for which the money is collected. These could range from shares to debentures to money market instruments.
3. The income earned through these investments and the capital appreciation realized by the scheme is shared by its unit holders in proportion to the number of units owned by them (pro rata).
4. The received income again in invested on funds by investors. Thus a mutual fund is the most suitable investment for the common person as it offers an opportunity to invest in a diversified, professionally managed portfolio at a relatively low cost.
5. Anybody with an investible surplus of as little as a few thousand rupees can invest in mutual funds.

Features of Mutual Funds

Mutual fund possesses the following features:

- Mutual fund mobilizes funds from small as well as large investors by selling units.
- Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.
- Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.
- Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.
- Mutual fund provides switching facilities to investors who can switch from one scheme to another.
- Various schemes offered by mutual funds provide tax benefits to the investors.
- In India mutual funds are regulated by agencies like SEBI.
- The cost of purchase and sale of mutual fund units is low.
- Mutual funds contribute to the economic development of a country.

Types of Mutual Funds (Classification of Mutual Funds)

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

MutualFunds

A. **On the basis of Operation**
B. **On the basis of Return**
C. **On the basis of Investment**

These may be brieflydescribed as follows:

A. On the basis of Operation

1.Close ended funds:

Under this type of fund, the size of the fund and its duration are fixed inadvance. Once the subscription reaches the predetermined level, the entry of investors will beclosed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds aredistributed to the unit holders in proportion to their holding.

Features of Close ended Funds

- The period and the target amount of the fund is fixed beforehand.

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- Once the period is over and/ or the target is reached, the subscription will be closed (i.e.investors cannot purchase any more units).
- The main objective is capital appreciation.
- At the time of redemption, the entire investment is liquidated and the proceeds are liquidatedand the proceeds are distributed among the unit holders.
- Units are listed and traded in stock exchanges.
- Generally the prices of units are quoted at a discount of upto 40% below their net asset value.

2. Open-ended funds:

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

Features of Open-ended Funds

- The investors are free to buy and sell units. There is no time limit.
- These are not trade in stock exchanges.
- Units can be sold at any time.
- The main motive income generation (dividend etc.)
- The prices are linked to the net asset valuebecause units are not listed on the stock exchange.

Difference between Open-ended and Close-ended Schemes

1. The close-ended schemes are open to the public for a limited period, but the open –endedschemes are always open to be subscribed all the time.
2. Close-ended schemes will have a definite period of life. But he open-ended schemes aretransacted in the company.
3. Close-ended schemes are transacted at stock exchanges, where as open-ended schemes aretransacted (bought and sold) in the company.
4. Close-ended schemes are terminated at the end of the specified period. Open-ended schemescan be terminated only if the total number of units outstanding after repurchase fall below 50%of the original number of units.

B. On the basis of return/ income

1. Income fund:

This scheme aims at generating regular and periodical income to the members.
Such funds are offered in two forms. The first scheme earns a target constant income at relativelylow risk. The second scheme offers the maximum possible income.

Features of Income Funds

- The investors get a regular income at periodic intervals.
- The main objective is to declare dividend and not capital appreciation.
- The pattern of investment is oriented towards high and fixed income yielding securities likebonds, debentures etc.
- It is best suited to the old and retired people.
- It focuses on short run gains only.

2. Growth fund:

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Growth fund offers the advantage of capital appreciation. It means growth fundconcentrates mainly on long run gains. It does not offers regular income. In short, growth funds aimat capital appreciation in the long run. Hence they have been described as "Nest Eggs" investmentsor long haul investments.

Features of Growth Funds

- It meets the investors' need for capital appreciation.
- Funds are invested in equities with high growth potentials in order to get capital appreciation.
- It tries to get capital appreciation by taking much risk.
- It may declare dividend. But the main objective is capital appreciation.
- This is best suited to salaried and business people.

3. Conservative fund:

This aims at providing a reasonable rate of return, protecting the value ofthe investment and getting capital appreciation. Hence the investment is made in growth orientedsecurities that are capable of appreciating in the long run.

C. On the basis of Investment

1. Equity fund:

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

2. Bondfund:

It mainly consists of fixed income securities like bonds, debentures etc. Itconcentrates mostly on income rather than capital gains. It carries lower risk. It offers secureand steady income. But there is no chance of capital appreciation.

3.Balanced fund:

It has a mix of debt and equity in the portfolio of investments. It aims atdistributing regular income as well as capital appreciation. This is achieved by balancing theinvestments between the high growth equity shares and also the fixed incomeearningsecurities.

4. Fund of fund scheme:

In this case funds of one mutual fund are invested in the units of othermutual funds.

5. Taxation fund:

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

6. Leverage fund:

In this case the funds are invested from the amounts mobilized from smallinvestors as well as money borrowed from capital market. Thus it gives the benefit of leverageto the mutual fund investors. The main aim is to increase the size of the value of portfolio. Thisoccurs when the gains from the borrowed funds are more than the cost of the borrowed funds.

7. Index bonds:

These are linked to a specific index of share prices. This meansthat the fundsmobilized under such schemes are invested principally in the securities of companies whosesecurities are included in the index concerned and in the same proportion. The value of theseindex linked funds will automatically go up whenever themarket index goes up and vice versa.

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8. Money market mutual funds:

These funds are basically open ended mutual funds. They haveall the features of open ended mutual funds. But the investment is made is highly liquid andsafe securities like commercial paper, certificates of deposits, treasury bills etc. These aremoney market instruments.

9. Off shore mutual funds:

The sources of investments for these funds are from abroad.

10. Guilt funds:

This is a type of mutual fund in which the funds are invested inguilt edgedsecurities like government securities. It means funds are not invested in corporate securitieslike shares, bonds etc.

OBJECTIVES OF MUTUAL FUNDS

1. Tomobilise savings of people.
2. To offer a convenient way for the small investors to enter the capital and the money market.
3. To tap domestic savings and channelize them for profitable investment.
4. To enable the investors to share the prosperity of the capital market.
5. To act as agents for growth and stability of the capital market.
6. To attract investments from the risk aversers.
7. To facilitate the orderly development of the capital market.

FUNCTIONS OF MUTUAL FUNDS

1. To mobilize the funds by selling their own shares known as units.
2. To provide high degree of liquidity for the fund holders.
3. To provide advantages of an active secondary market.
4. To provide an ideal avenue for investors.
5. To act as an investment intermediaries to acquire individual investments.
6. To provide investors with flexible investment opportunities whereby it is possible to switch from one scheme to another.
7. To relieve the investors from emotional stress in selling and buying securities.
8. To provide tax shelter to the investors
9. To make contributions to the development of a country.
10. To render expertise investment service at low cost.

RISKS OF MUTUAL FUNDS

Higher the risk greater the return/ loss and lower the risk lesser the returns/loss. Hence it is upto the investor to decide how much risk he is willing to take. In order to do this we must first be aware of the different types of risks involved with the investment decision and they are given as follows:

1. Investment risk: Whether the mutual fund makes money in shares or losses depends upon the investment expertise of the Assets Management Companies (AMC).

2. Business risk: A company issuing a security may not be financially sound due to factors like poor management, low product demand or huge operating expenses. It is known as business risk.

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3. Market risk: In general, there are certain risks associated with every kind of investment on shares. They are called market risks. One could minimize the market risk by diversifying among a variety of instruments rather than investing his money in one or two stocks.
4. Liquidity risk: A mutual fund underlying securities, i.e., low profile securities cannot be sold at a fair price when the need arises. It affects the liquidity of a security. It is known as liquidity risk.
5. Timing risk: Buying or selling a security at the wrong time is leading to the risk. For example, there is the chance that a few days after an investor sells a fund, it will go up in value or there is decline in value of a fund after he buys it.
6. Inflation risk: The return on investments will not increase with rising consumer prices. It is called inflation risk.
7. Interest rate risk: The value of a fixed income security will drop as interest rates rise. It is called interest rate risk.
8. Scheme risk: There are certain risks inherent in the scheme itself. It all depends upon the nature of the scheme. For instance, in a pure growth scheme, risks are greater.
9. Credit risk: An issue will default on a fixed income security by failing to pay interest or principal when due. It is the credit risk.
10. Political risk: Political events may unfavorably influence the value of a security. It is known as political risk. Other political risks could include was change in government etc.

ADVANTAGES/ BENEFITS OF MUTUAL FUNDS

1. Professional management: One of the most important benefits is availability of low cost, highly professional management services. Mutual funds are managed by highly skilled managers who have a sound knowledge of the market and wide experience in investment.
2. Low cost high value Diversification: Mutual funds invest in a number of companies across a broad cross section of industries and sectors. The diversification reduces the risk.
3. Switching: Many mutual funds allow investors to switch from one fund to another. Investors can switch from growth funds to income funds and vice versa.
4. Investment protection: Investors in mutual funds receive adequate protection from state agencies. Mutual funds operate under strict regulatory norms set out by agencies such as SEBI in India and the Securities Exchange Commission (SEC) in the U.S.
5. Low initial investment: The amount a person has to invest in a mutual fund is usually very low. In India one can invest a minimum of Rs. 1,000 and buy units many schemes, at least at the beginning of new schemes.
6. Easy liquidity: Investment in mutual funds offers sufficient liquidity i.e. immediate cash.
7. 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.
8. Reduced risk: Mutual fund provides small investors access to reduced investment rise resulting from diversification, economies of scale in transaction cost and professional finance management.
9. Convenience and flexibility: The investors in the mutual fund can transfer their investment from one scheme to the other on the basis of up dated market information.

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10. Diversified investment: Small investors participate in large basket of securities and share the benefits of efficiency managed portfolio by experts and are free from keeping record of share certificate etc of various companies, tax rules etc

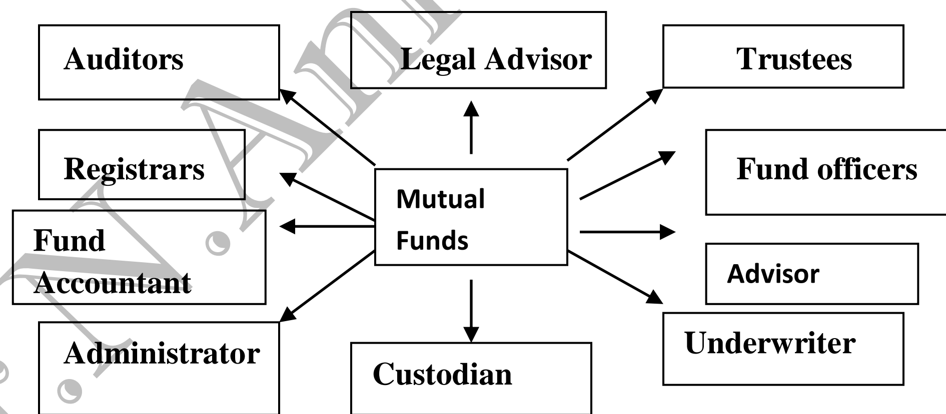
11. Keeping the money market active: Mutual funds keep the money market active by investing money on the money market instruments. In fact, the availability of more money market instruments itself is a good sign for a developed money market.

12. 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.

OPERATIONS OF THE FUND

- A mutual fund invites the prospective investors to join the fund by offering various schemes so as to suit to the requirements of different categories of investors.
- The resources of individual investors are pooled together and the investors are issued units/shares for the money invested.
- The amount so collected is invested in capital market instruments like shares and debentures and money market instruments like treasury bills, commercial bills, commercial papers, etc.

STRUCTURE / INSTITUTIONS INVOLVED IN INDIAN MUTUAL FUNDS



Mutual fund organization

MUTUAL FUND ORGANIZATION:

1. Auditors: An auditor is required to be appointed by the AMC and must undertake independent inspection and verification of its accounting activities.

2. Registrars and Transfer Agents: The registrars and transfer agents who are appointed by the AMC carry out the following functions.

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- ❖ Receiving and processing the application form of investors.
- ❖ Issuing unit certificates
- ❖ Sending refund orders
- ❖ Giving approval for all transfers of units and maintaining all such records.
- ❖ Repurchasing the units and redemption of units.
- ❖ Issuing dividends or income warrants
- ❖ These intermediaries are paid compensation for their services by the AMCs. In India, almost all AMCs engage such agent.

3. Fund Accountants:

- ❖ Fund accountants are appointed by the AMC.
- ❖ They are in charge of maintaining proper books of accounts relating to fund transactions and management.
- ❖ The functions performed by these agencies

4. Sponsor / Settler / Sponsoring Institution:

- ❖ The Company which sets up the mutual fund is called the sponsor.
- ❖ The SEBI has laid down certain criteria to be met by the sponsor.
- ❖ These criteria mainly deal with adequate experience, good past track record, net worth etc.

5. Legal advisors:

- ❖ Legal advisors are appointed to offer legal guidance about planning and execution of different schemes.
- ❖ A group of advocates and solicitors may be appointed as legal advisors.
- ❖ Their fees is in no way associated with the net assets of the fund, but is paid to them as decided.

6. Custodians: A person carrying on the activity of safe keeping of the securities by participating in clearing system on behalf of the clients to effect deliveries of the securities are known as "Custodians".

The jobs to be performed by custodians are:

1. Settlements: Payments, receipts and deliveries.
2. Safer custody of securities
3. Registration of documents
4. Collection of dividend, interest, bonus, right and other benefits (Corporate action)
5. Accounting scheme-wise, both for money handled and scraps held.
6. Comprehensive insurance coverage – minimizing the risks involved in operations.
7. Reporting about physical holding, bad delivers, pending purchases, pending sales

7. Trustees:

- ❖ Trustees are people with long experience and good integrity in their respective fields.
- ❖ They carry the crucial responsibility of safeguarding the interest of investors.
- ❖ For this purpose, they monitor the operations of the different schemes.
- ❖ These have wide ranging powers and they can even dismiss asset management companies with the approval of the SEBI.

8. Investment advisors:

1. Carrying out the market and security analysis.
2. Advising the AMC to design its investment strategies on a continuous basis.

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9. Underwriters:

In recent times, mutual funds also undertake the activities of underwriting issues; such activities generate an additional source of income for mutual funds. Prior approval from SEBI is necessary for underwriting the activity.

10. Lead Managers: Lead managers carry out the following functions:

1. Selecting and coordinating the activities of intermediaries such as advertising agency, printers, collection centre's and marketing the services.
2. Carrying out extensive campaigns about the scheme and acting as marketing associated to attract investors.
3. Assisting the AMC to approach potential investors through meetings, exhibitions, contacts, advertising, publicity and sales promotion.

GROWTH OF MUTUAL FUNDS IN INDIA

- Recently, the SEBI has flagged off the entry mutual funds from the ICICI 20th Century financial service, Tata Sons, Credit Capital Financial services many others.
- Among all these the Unit Trust of India enjoys a very special status being more than all other mutual funds put together.

The following are the various growths of mutual fund schemes in India:

1. Unit Trust of India 1964:

- The UTI was set up by the Government of India under the Unit Trust of India Act 1963.
- The objective was "to encourage savings and investments and participation in the income, profit and gains accruing from the acquisition, holding management and disposal of securities".
- As of April, 1993 the UTI has launched 50 Schemes of these 42 are close ended, 6 are open ended and 2 are off shore mutual funds.
- Thirty four of these schemes are income funds, 3 are income/ growths funds are 3 are tax saving funds.

2. State Bank of India Mutual Funds 1987:

- The State Bank of India entered the field in the year 1987.
- By the end of 1992: it has launched 13 schemes out of these 13 schemes, 11 are close ended and 2 are off shore funds.
- Initially the SBI Mutual Funds were mainly of Income and Tax saving type.

3. Canara Bank Mutual Funds:

- The first Canara Bank Mutual Fund was established in the year 1987.
- Can Bank Mutual Funds played an aggressive role in the mutual fund market until the securities scan of 1992. However they Can Bank Mutual Funds were innovative and aimed at the various segments of investors.

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4. Ind Bank Mutual Fund:

- It is a comparatively late entrant to the industry but has remained a fore runner in the mutual fund market.
- It has 13 schemes and all are close ended.
- There of these is IndRatna, IndSagar and IndMoti is growth schemes.

5. Bank of India Mutual Fund:

- It is also a comparatively new comer.
- The initial success was marred by the 1992 scam. Seven schemes are offered by BOI Mutual Fund.
- All are close ended.

6. Punjab National Bank Mutual Fund:

- All the schemes are closed ended.
- The PNB RIPS in income oriented scheme and PNB premium plus is an income and growth oriented scheme.

7. Life Insurance Corporation Mutual Fund:

- The LIC Mutual Fund provides comprehensive packages to its investors.
- It has a total corpus of nearly Rs. 1,000 Crores with investors numbering over five lakhs.

8. General Insurance Corporation Mutual Fund:

The GIC Mutual Fund was set up in 1990 by the GIC and its four subsidiaries National Insurance Company Ltd, the New India Assurance Company Ltd, Oriental Insurance Company and the United India Insurance Company.

SEBI GUIDELINES FOR THE OPERATION OF MUTUAL FUNDS

- Every offer letter must contain the caution that mutual funds are subject to market risks.
- The risk factors should be clearly spelt out in bold letters.
- The relevant information regarding pre-operative expenses on forms, advertisement and commission to agents should be indicated in the offer letter.
- The dates of allotment of units and the issue of certificates must be spelt out.
- The periodic disclosure of NAV shall be brought out.
- The mutual fund company must be a registered company.
- Before commencing mutual fund, prior permission of SEBI must be obtained.
- Not more than 10% of the issued shares of the company can be purchased by mutual fund companies.
- Every mutual fund company must give their Net Asset Value periodically (preferably weekly) in the leading newspapers of the country.
- A mutual fund company cannot invest more than 10% of its investable funds in single company.
- Issuing of dividends, bonus shares, right shares etc requires prior permission of SEBI.

FACTORS SHOULD BE CONSIDEREDBEFORE SELECTING A MUTUAL FUND BY THE INVESTORS

SELECTION FACTORS

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1. Objective of the Fund: First of all, he must see the objective of the fund, whether income oriented or growth oriented. The investor should compare the particular scheme of one fund with the same scheme of another fund and make a comparative analysis. His objective should also coincide with the objective of the scheme which he proposes to choose.

2. 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 over a period of at least three years. Consistency in performance is a good indicator of its investment expertise.

3. Historical Background: The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. A good historical record could be a better horse to bet on than new funds. It is in accordance with the maxim" A known devil is better than an unknown angel".

4. Cost of Operation: Mutual funds seek to do a better job of the investible funds at a lower cost than the individuals could do for themselves.

5. Capacity for Innovation: An innovator will be always a successful man. It is quite natural that an investor will look for funds which are capable of introducing innovations in the financial market.

6. Investor Servicing: The most important factor to be considered is prompt and efficient servicing. Servicing like quick response to investor queries, prompt dispatch of unit certificates, quick transfer of units, immediate encashment of units etc., will go a long way in creating a lasting impression in the minds of investors.

7. Market Trends: A prudent investor must keep his eyes on the stock market index, interest rate and the inflation rate in the market.

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FACILITIES AVAILABLE TO INVESTORS

1. Repurchase facilities:

- Close ended schemes units must be compulsorily listed in recognized stock exchanges.
- Such units can be sold or bought at market prices.
- But, units of open ended schemes are not at all listed and hence they have to be bought only from the fund. So the fund receives the right to buy back the units from its members.
- This process of buying back the units from investors by the fund is repurchasing facility.

2. Reissue facilities:

- In this case of open ended schemes, units can be bought only from the fund and not in the open market.
- The units bought from the investors are again reissued to those who are interested in purchasing them.
- The price fixed for this purpose is called re-issue price.

3. Roll over facilities:

- At the time of redemption, the investor is given an option to reinvest his entire investment once again for another term.

- An investor can overcome an adverse market condition prevailing at the time of redemption by resorting to this roll over facility. This is applicable in the case of close ended funds.

4. Lateral shifting facilities:

- Some mutual funds permit the investors to shift from one scheme to another on the basis of the Net Asset Values with a view to providing total flexibility in their operation.
- This is done without any discount on the fund and without any additional charges.
- This is a great privilege given to the investors.
- This shifting is called "lateral shifting".

RIGHTS OF INVESTORS

The SEBI (MF) Regulations, 1993 contains certain rights for the investors. They are as follows,

1. 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 within a period of 6 weeks from the date of closure of the initial offer in the case of a open ended scheme

2. Transfer of units: An investor has the right to transfer the unit certificate.

3. Refund of application money: If a mutual fund is not able to collect the statutory minimum amount (close ended funds) – Rs. 20 crores, open ended funds – Rs. 50 crores or 60% of the targeted amounts whichever is higher) it has to return the application money as refund within a period of 6 weeks from the date of closure of subscription lists.

4. Audited annual report: Every investor has the right to receive information about the Net Assets Value (NAV) at intervals not exceeding 3 months 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.

NEED/ROLE FOR COMMERCIAL BANK

There has been an urgent need for the banks to enter into the field of mutual fund due to the following reasons.

- Banks are not able to provide better yields to the investing public with their savings and fixed deposit interest rates.
- Hence there is a necessity to enter in to the field of mutual fund.
- Mutual fund backed by a bank will be in a better position to tap the savings effectively and vigorously for the capital market.
- Indian investor's particularly small and medium ones may hesitate to invest in a direct way through private financial intermediaries.
- Thus banks have the advantage of public confidence which is very essential for the success of mutual; funds.
- Earlier banks were not permitted to tap the capital market for funds or to invest their funds in the market.
- Now a green signal has been given to them to enter into this market and reap the maximum benefits.

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- Banks can provide a wider range of products in mutual funds by introducing innovative schemes and extend the professionalism in the mutual funds industry.
- Banks as merchant banks have wide experience in the capital market and hence managing a mutual fund may not be a big problem for them.
- The entry of banks would provide much needed competition in the mutual fund industry and his competition will improve customer service and widen customer choice also.
- Investor servicing can be effectively done by banks through their network branches spread throughout the country.
- Hence the commercial banks have entered into the mutual fund market without any hesitancy

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UNIT - IV

VENTURE CAPITAL

There are some businesses that involve higher risks. In the case of newly started business, the risk is more. The new businesses may be promoted by qualified entrepreneurs. They lack necessary experience and funds to give shape to their ideas. Such high risk, high return ventures are unable to raise funds from regular channels like banks and capital markets. Generally, people would not like to invest in new high-risk companies. Some people invest money in such new high-risk companies. Even though the risk is high, there is a potential of getting a return of ten times more in less than five years. The investors making such investments are called venture capitalists. The money investd in new, high risk and high return firms is called venture capital. Venture capitalists not only provide money but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. They get good return on their investment. The percentage of the profits the venture capitalists get is called the carry.

Origin/History of Venture Capital

In the 1920's and 1930's, the wealthy families of individual investors provided the start-up money for companies that would later become famous. Eastern Airlines and Xerox are the more famous ventures they financed. Among the early VC fund set-ups was the one by the Rockfeller family which started a special fund called Venrock in 1950, to finance new technology companies. General Georges Doriot (the father of venture capital), a professor at Harvard Business School, in 1946 set up the American Research and Development Corporation (ARD). ARD's approach was a classic VC in the sense that it used only equity, invested for long term. ARD's investment in Digital Equipment Corporation (DEC) in 1957 was a watershed in the history of VC financing. While in its early years VC may have been associated with high technology, over the years, the concept has undergone a change and, as it stands today, it implies pooled investment to unlisted companies.

Meaning of Venture Capital

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

A young hi-tech company that is in the early stage of financing and is not yet ready to make a public issue may seek venture capital. Such a high-risk capital is provided by venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Venture capital is the money and resources made available to startup firms and small business with exceptional growth potential (e.g., IT, infrastructure, real estate etc.). It is fundamentally a long-term risk capital in the form of equity finance for the small new ventures which involve risk. But at the same time, it a the strong potential for the growth. It thrives on the concept of high riskhigh return. It is a means of equity financing for rapidly growing private companies.

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

When venture capitalists invest in a business, they typically require a seat on the company's board of directors. But professional venture capitalists act as mentors and provide support and advice on a number of issues relating to management, sales, technology etc. They assist the company to develop its full potential. They help the enterprise in the early stage until it reaches the stage of profitability. When the

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business starts making considerable profits and the market value of the shares go up to considerable extent, venture capitalists sell their equity holdings at a high value and thereby make capital gains.

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

Characteristics of Venture Capital

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

1. It is basically equity finance.
2. It is a long-term investment in growth-oriented small or medium firms.
3. Investment is made only in high risk projects with the objective of earning a high rate of return. 4. In addition to providing capital, venture capital funds take an active interest in the management of the assisted firm. It is rightly said that, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".
5. The venture capital funds have a continuous involvement in business after making the investment.
6. Once the venture has reached the full potential, the venture capitalist sells his holdings at a high premium. Thus, his main objective of investment is not to earn profit but capital gain.

Types of Venture Capitalists

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

1. **Venture capital funds set up by angel investors (angels)**: They are individuals who invest their personal capital in startup companies. They are about 50 years old. They have high income and wealth. They are well educated. They have succeeded as entrepreneurs. They are interested in the startup process.
2. **Venture capital subsidiaries of Corporations**: These are established by major corporations, commercial banks, holding companies and other financial institutions.
3. **Private capital firms/funds**: The primary source of venture capital is a venture capital firm. It takes high risks by investing in an early stage company with high growth potential.

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

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

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

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Conditional loan: It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 and 15 per cent; actual rate depends on the other factors of the venture, such as gestation period, cost-flow patterns and riskiness.

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

Conventional loan: Under this form of assistance, the enterprise is assisted by way of loans. On the loans, a lower fixed rate of interest is charged, till the unit becomes commercially operational. When the company starts earning profits, normal or higher rate of interest will be charged on the loan. The loan has to be repaid as per the terms of loan agreement.

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

Stages of Venture Capital Financing

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

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

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

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

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

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

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

(b) *Turnarounds*: This refers to finance to enable a company to resolve its financial difficulties. Venture capital is provided to a company at a time of severe financial problem for the purpose of turning the company around.

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(c) *Fourth stage financing/bridge financing*: This stage is the last stage of the venture capital financing process. The main goal of this stage is to achieve an exit vehicle for the investors and for the venture to go public. At this stage the venture achieves a certain amount of market share.

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

Advantages of Venture Capital

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

1. It is long term equity finance. Hence, it provides a solid capital base for future growth.
2. The venture capitalist is a business partner. He shares the risks and returns.
3. The venture capitalist is able to provide strategic operational and financial advice to the company.
4. The venture capitalist has a network of contacts that can add value to the company. He can help the company in recruiting key personnel, providing contracts in international markets etc.
5. Venture capital fund helps in the industrialization of the country.
6. It helps in the technological development of the country.
7. It generates employment.
8. It helps in developing entrepreneurial skills.
9. It promotes entrepreneurship and entrepreneurism in the country.

Venture Capital in India

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

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

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

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

Legal Aspects of Venture Capital

The legal aspects relating to venture capital in India may be briefly explained as follows:

Regulatory Structure: The SEBI regulates venture capital industry in India. It announced the regulations for the venture capital funds in 1996, with the primary objective of protecting the interest of investors and providing enough flexibility to the fund managers to make suitable investment decisions. Venture capital funds appoint an asset management company to manage the portfolio of the fund. Any company proposing to undertake venture capital investments is required to obtain certificate of registration from SEBI. Venture capital fund can invest up to 40% of the paid up capital of the invested company or up to 20% of the corpus of the fund in one undertaking. At least 80% of funds raised by VCF shall be invested in equity shares or equity related securities issued by company whose shares are not listed on recognised stock exchange. Venture capital investments are required to be restricted to domestic companies engaged in business of software, information technology, biotechnology, agriculture, and allied sectors.

Guidelines for the Venture Capital Companies

The Government of India has issued the following guidelines for various venture capital funds operating in the country.

1. The financial institutions, State Bank of India, scheduled banks, and foreign banks are eligible to establish venture capital companies or funds subject to the approval as may be required from the Reserve Bank of India.
2. The venture capital funds have a minimum size of Rs. 10 crores and a debt equity ratio of 1:1.5. If they desire to raise funds from the public, promoters will be required to contribute minimum of 40% of the capital.
3. The guidelines also provide for NRI investment upto 74% on a non-repatriable basis.
4. The venture capital funds should be independent of the parent organisation.
5. The venture capital funds will be managed by professionals and can be set up as joint ventures even with non-institutional promoters.

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6. The venture capital funds will not be allowed to undertake activities such as trading, broking, and money market operations but they will be allowed to invest in leasing to the extent of 15% of the total funds deployed. The investment or revival of sick units will be treated as a part of venture capital activity.
7. A person holding a position of being a full time chairman, chief executive or managing director of a company will not be allowed to hold the same position simultaneously in the venture capital fund/company.
8. The venture capital assistance should be extended to the promoters who are now, and are professionally or technically qualified with inadequate resources.

SEBI (Venture Capital Funds) (Amendment) Regulations, 2000 and SEBI (Foreign Venture Capital Investors) Regulations, 2000

A. Following are the salient features of the SEBI (Venture Capital Funds) (Amendment) Regulations, 2000:

1. **Definition of venture capital fund**: The venture capital fund is now defined as a fund established in the form of a Trust, a company including a body corporate and registered with SEBI which:

(a) has a dedicated pool of capital;

(b) raised in the manner specified under the Regulations; and

(c) to invest in venture capital undertakings in accordance with the Regulations.

2**. Definition of venture capital undertaking:** Venture capital undertaking means a domestic company:

(a) Whose shares are not listed on a recognised stock exchanges in India

(b) Which is engaged in business including providing services, production or manufacture of articles or things, or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf. The **negative list** includes real estate, non-banking financial services, gold financing, activities not permitted under the Industrial Policy of the Government of India.

3. **Minimum contribution and fund size:** The minimum investment in a Venture Capital Fund from any investor will not be less than Rs. 5 lakhs and the minimum corpus of the fund before the fund can start activities shall be at least Rs. 5 crores.
4. **Investment criteria:** The earlier investment criteria have been substituted by a new investment criteria which has the following requirements:

(a) Disclosure of investment strategy;

(b) Maximum investment in single venture capital undertaking not to exceed 25% of the corpus of the fund;

(c) Investment in the associated companies not permitted;

(d) At least 75% of the investible funds to be invested in unlisted equity shares or equity linked instruments.

(e) Not more than 25% of the investible funds may be invested by way of;

(i)subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year.

(ii) Debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

It has also been provided that venture capital fund seeking to avail benefit under the relevant provisions of the Income Tax Act will be required to divest from the investment within a period of one year from the listing of the venture capital undertaking.

5. **Disclosure and information to investors:** In order to simplify and expedite the process of fund raising, the requirement of filing the placement memorandum with SEBI is dispensed with and instead the fund will be required to submit a copy of Placement Memorandum/copy of contribution agreement entered with the investors along with the details of the fund raised for information to SEBI. Further, the contents of the Placement Memorandum are strengthened to provide adequate disclosure and information to investors. SEBI will also prescribe suitable reporting requirement from the fund on their investment activity.

6. **QIB status for venture capital funds:** The venture capital funds will be eligible to participate in the IPO through book building route as Qualified Institutional Buyer subject to compliance with SEBI (Venture Capital Fund) Regulations.

7. **Relaxation in takeover code**: The acquisition of shares by the company or any of the promoters from the Venture Capital Fund under the terms of agreement shall be treated on the same footing as that of acquisition of shares by promoters/companies from the state level financial institutions and shall be exempt from making an open offer to other shareholders.

8. **Investments by mutual funds in venture capital funds:** In order to increase the resources for domestic venture capital funds, mutual funds are permitted to invest upto 5% of its corpus in the case of open-ended schemes and upto 10% of its corpus in the case of close-ended schemes. Apart from raising the resources for venture capital funds this would provide an opportunity to small investors to participate in venture capital activities through mutual funds.

9. **Government of India guidelines:** The government of India (MOF) guidelines for overseas venture capital investment in India dated September 20, 1995 will be repealed by the MOF on notification of SEBI Venture Capital Fund Regulations.

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10. The following will be the salient features of SEBI (Foreign Venture Capital Investors) Regulations, 2000.

a. Definition of foreign venture capital investor: Any entity incorporated and established outside India and proposes to make investment in venture capital fund or venture capital undertaking and registered with SEBI.

b. Eligibility criteria: Entity incorporated and established outside India in the form of investment company, trust partnership, pension fund, mutual fund, university fund, endowment fund, asset management company, investment manager, investment management company or other investment vehicle incorporated outside India would be eligible for seeking registration from SEBI. SEBI for the purpose of registration shall consider whether the applicant is regulated by an appropriate foreign regulatory authority; or is an income tax payer; or submits a certificate from its banker of its or its promoters' track record where the applicant is neither a regulated entity not an income tax payer.

C. Investment criteria:

(a) Disclosure of investment strategy;

(b) Maximum investment in single venture capital undertaking not to exceed 25% of the funds committed for investment to India. However, it can invest its total fund committed in one venture capital fund.

(c) At least 75% of the investible funds to be invested in unlisted equity shares or equity linked instruments.

(d) Not more than 25% of the investible funds may be invested by way of;

(1) Subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year;

(2) Debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

11. Hassle free entry and exit: The foreign venture capital investors proposing to make venture capital investment under the Regulations would be granted registration by SEBI. SEBI registered foreign venture capital investors shall be permitted to make investment on an automatic route within the overall sectoral ceiling of foreign investment under Annexure III of Statement of Industrial Policy without any approval from FIPB. Further, SEBI registered FVCIs shall be granted a general permission from the exchange control angle for inflow and outflow of funds and no prior approval of RBI would be required for pricing, however, there would be ex-post reporting requirement for the amount transacted.

12. Trading in unlisted equity: The Board also approved the proposal to permit OTCEI to develop a trading window for unlisted securities where Qualified Institutional Buyers (QIB) would be permitted to participate.

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Unit - V
FACTORING

When a firmsells goods on credit, cash is not received immediately. This means there is atime gap between sale of goods/services and receipt of cash out of such sale. The outstandingamounts get blocked for a period. This period depends upon the credit period allowed to buyers.The outstanding amounts are called ‘Debtors’ or ‘Accounts Receivables’. If the debts are notcollected in time, the firm will be handicapped due to lack of sufficient working capital. The otherside is that if the debts were collected speedily the amount could be used productively. Further, it isvery difficult to collect debts. Moreover, there is the problem of defaults (i.e. bad debts). In short, debtors or accounts receivables involve risks. So,

business enterprises are always looking forselling the debtors for cash, even at a discount. This is possible through a financial service. Such afinancial service is known as factoring.

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

Meaning of Factoring

- ✓ The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or do or to get things done'.
- ✓ Factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution were established to assist firms in meeting their working capital requirements by purchasing their receivables.

DEFINITION

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; Finance, Maintenance of debts, Collection of debts, Protection against credit risk"

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

OBJECTIVES OF FACTORING

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

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and othermajor areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

STEPS (OR) STAGES INVOLVED IN FACTORING

1. Order received by the seller from the buyer.
2. Seller obtains details of buyer's credit worthiness with the factor
3. Seller executes the order
4. Seller raising the invoice with the factor
5. Factor paying 80% of invoice value of seller

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6. Factor sending statement of account to buyer for payment on due date
7. Buyer settling transaction with the factor
8. Factor paying the balance amount to seller and obtaining commission.
9. The balance 20% less the cost of factoring is paid by the factor to the credit.

FUNCTIONS / SERVICES OF FACTORING

The factor purchases the book debts of the client. As such he performs certain basic services as well as auxiliary services.

1. Provision of collection facilities:

- ✓ Undertaking to collect the receivables on behalf of the client, thus relieving the client of the problems involved in collection in the areas of business.
- ✓ Helping in cost reduction on matters connected with collection through savings in manpower, time and efforts.
- ✓ Making timely demands on debtors and urging them to make prompt payment.
- ✓ Initiating legal action, as may be necessary, on customers to secure payments.

2. Administration of sales ledger:

- ✓ Maintain of the clients sales ledgers.
- ✓ Sending periodical reports to the client on the current status of receivables, receipts of payments from customers and other useful information.
- ✓ Maintenance of payment schedule, whereby details of payments spread over a certain period of time shown, besides the changes that take place in the payment pattern.

3. Credit control and production:

- ✓ Fixing credit limits for approved customers in consultation with the client.
- ✓ Undertaking to buy all trade debts of the customer within the approved limits.
- ✓ Assuming the risk of default in payments.
- ✓ Determining the extent of the limit of credit.

4. Financing the trade debts:

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- ✓ Purchasing the book debts of the client at a price and getting the same assigned in the factor's favor.
- ✓ Making advanced payments on the strength of book debts to the extent of 80 percent of the assigned debts

5. Rendering Advisory Services:

- ✓ Providing information about the customer's perception of the client's products, changes in marketing strategies, emerging trends etc.,
- ✓ Evaluating the procedures followed for invoicing, delivering and dealing with sales returns.
- ✓ Operating the credit department for banks and other institutions which are engaged in leasing, hire-purchase, merchant banking.

TYPES (OR) KINDS OF FACTORING

1. Full service factoring: Here all the functions of factoring are done by the factor and undertake the credit risk.

2. With recourse factoring: Credit risk is taken by the seller or the cline and when the customer fails to pay on the due date, the factor will take action on the seller.

3. Maturity factoring: Here the factor takes the risk and the client need not bear the credit risk in case of non-payment of funds by ht customer.

4. Maturity factoring: The factor makes payment only on the maturity of the bill or at the end of the collection period to the supplier.

5. Advance factoring: The factor provides advance against uncollected debts at an interest to the seller. Normally this may be 70% to 80% of the debt amount.

6. Bank finance factoring: Here the bank, finances that portion which the factor has held in reserve i.e 15% to 20% of the amount of debt.

7. Confidential factoring: Here the arrangement is not disclosed to outsiders. On the supplier receiving money from the customer, he will repay the advance to the factor.

8. Suppliers guarantee factoring: Factor guarantees the supplier against invoice raised by supplier upon the suppliers to wholesalers and retailers.

9. International factoring: In export factor, factor takes the bills belonging to the buyer and arranges to make payment to the exporter. Under import factor, the factor in the importing country undertakes to control and collect funds due from the importers.

10. Bulk factoring:

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- ✓ Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned.
- ✓ This type is resorted to when the factor is not fully satisfied with the financial condition of the client.

11. Agency factoring: Under this type, the factor and the client share the work between themselves as follows

- ✓ The client has to look after the sales ledger administration.
- ✓ The factor has to provide finance and assume the credit risk.

12. Limited factoring: Factor discounts only selected invoices on merit basis and converts credit bills in to cash in respect of those bills only.

13. Buyer based factoring: The buyer approaches a factor to discount his bills. Thus the initiative for factoring comes from the buyer's end.

14. Seller based factoring:

- ✓ The seller instead of discounting his bills sells all his accounts receivable to the factor after invoicing the customers.
- ✓ The seller's job is over as soon as he prepares the invoices.
- ✓ Thereafter all the documents are handed over to the factor.

ADVANTAGES OF FACTORING

1. Prompt payment and reduction in debt: Capital locked up in the form of outstanding sundry debtors is available to use within the business as all sales become cash sales.

2. Improves current ratio: This advantage is an indication of improved liquidity, enables better working capital management. This will enable the unit to offer better credit terms to its customers and increases orders.

3. Increase in turnover of stock: Turnover of stock into cash is speeded up and this results in larger turnover on the same investments.

4. Improved credit standing: It improves the credit rating of an individual unit.

5. Lesser risk: Present risk in bills financing can be reduced to maximum.

6. Specialized service: Since the factor collects the debts on behalf of the client, specialized service is obtained at a minimum cost services concerning the commercial viability of a project are provided by the factor. Factor provides information regarding product mix, price, market conditions, and economic prospects to its clients.

7. No need for collection department: The industrial units especially in the tiny small sector need not have any administrative setup for the credit realization.

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8. Financial service: Clients will be able to convert their trade debts in to cash up to 80% immediately as soon as the credit sales are over. Factoring assures immediate cash flow. So that client is able to make his purchases on cash basis and they can avail of cash discount facilities. There is no constrains by way of fixed limits.

9. Collection service: Collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. The cost of collection is also out down as a result of the professional expertise of a factor.

10. Credit risk service: The factor assumes the risk of default in payment by customers and thus the client is assured of complete realization of his bad debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client.

11. Provision of expertise sales ledged managed service: Because of expertise sales ledger management service, factoring offers an excellent credit control for the client

12. Consultancy service: They collect information regarding, Credit worthiness of the customers of their clients; Ascertain their track record, Quality of portfolio turnover, Average service inventory.

DISADVANTAGES OF FACTORING

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

2. Unsuitability: All companies may not be suitable for entering into factoring contracts. Some of the limiting factors may be

- It is uneconomical for small companies with less turnovers.
- It is not suitable for companies selling large number of small products to various types of people or companies having large number of debtors for small amounts.
- It is not suitable for; (i) Companies with speculative business, (ii) Companies which have inefficient management, (iii) Companies which have high bad debt past experience.

3. Expensive: Factoring is an expensive form of financing and also as finance of the last resort. This tends to have a negative effect on the creditworthiness of the company in the market. Also it is very difficult in financial evaluation of clients.

KEY ELEMENTS OF FACTORING

1. Selection of accounts: The factor selects accounts of a supplier to be bought on a continuous basis based on customer's age, time of credit, quantum of amount etc. Normally, the factor and the seller or supplier agrees

- On the credit limit for their customer,
- The collection period, Rebate to be charged.

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2. Collection of accounts: The supplier or seller informs each customer that the factor has purchased the debt and the customer should pay only to the factor. If the customer fails to pay on the due date, the factor may or may not recover the amount from the supplier, which depends upon the terms of agreement in factoring.

3. Granting advances against receivables: The factor generally advances a portion of the value of assigned debts. The balance amount is paid on maturity. By providing funds to the supplier, the factor enables him to resume production.

FEATURES (NATURE) OF FACTORING

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

- Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.
- The factor purchases the credit/receivables and collects them on the due date. Thus the risks associated with credit are assumed by the factor.
- A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).
- A factor specialises in handling and collecting receivables in an efficient manner.
- Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.
- Factoring is a technique of receivables management. It is used to release funds tied up in receivables (credit given to customers) and to solve the problems relating to collection, delays and defaults of the receivables.

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DIFFERENCE BETWEEN FACTORING AND LEASING

Basis	Factoring	Leasing
1. Nature	It is the process of selling trade debts of a company to a financial institution.	It is an arrangement to buy capital equipment for use for an agreed period of time in return for the payment of rent.
2. Financing	Factoring provides off-balance sheet financing.	Leasing does not provide off-balance sheet financing

3. Agreement	Factoring agreement is entered between the client (which sells goods and services to trade customers on credit) and the factor, which is the financing organization.	Lease agreement is entered between lessor and lessee.
4. Extent of financing	The factor makes an immediate payment upto 80% of the assigned invoices and the balance 20% will be paid on realization of the debt.	Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So 100% financing is assured to the lessee.
5. Depreciation	No depreciation charges are involved in factoring.	Depreciation is claimed by the lessor
6.Maturity period	For transactions with short term maturity period.	For transactions with medium term maturity period.
7.Other services	Besides financing, a factor also provides other services such as ledger administrations etc.	It is a pure financing agreement.
8. Cost	The cost of factoring comprises of two aspects namely finance charges (interest) and service charges.	Lease rentals constitute the consideration payable by the lessee as specified in the lease transaction.
9. Risk	Risk can be transferred to seller.	All risks are assumed by the lessor.

PROCESS OF FACTORING (FACTORING MECHANISM)

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

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

FORFEITING

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- 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 Forfaiting a scheme, the exporter gives up his right to receive payments in future under an export bill for immediate cash payments by the forfaitor.
- This right to receive payment on the due date passes on to the forfaitor, since; the exporter has already surrendered his right to the forfaitor.
- Thus, the forfaiting 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.

MEANING &DEFINITION OF FORFEITING

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

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

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

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

Forfeiting 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.**”**

CHARACTERISTICS OF FORFAITING

The main characteristics of forfaiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer’s obligation is normally supported by a local bank guarantee (i.e., ‘aval’).
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

ADVANTAGES OF FORFAITING

The following are the benefits of forfaiting:

1. The exporter gets the full export value from the forfaitor.
2. It improves the liquidity of the exporter. It converts a credit transaction into a cash transaction.
3. It is simple and flexible. It can be used to finance any export transaction. The structure of finance can be determined according to the needs of the exporter, importer, and the forfaitor.

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4. The exporter is free from many export credit risks such as interest rate risk, exchange rate risk, political risk, commercial risk etc.
5. The exporter need not carry the receivables into his balance sheet.
6. It enhances the competitive advantage of the exporter. He can provide more credit. This increases the volume of business.
7. There is no need for export credit insurance. Exporter saves insurance costs. He is relieved from the complicated procedures also.
8. It is beneficial to forfaitor also. He gets immediate income in the form of discount. He can also sell the receivables in the secondary market or to any investor for cash.

ROLE OF INDIAN BANKS IN FACTORING

- The idea of providing factoring services in India was first thought of by the Vaghul working Group.
- 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
- On the recommendation of the committee, the Banking Regulations Act was amended in July 1990 with a view to enabling commercial banks to take up factoring services by forming separate subsidiaries.

DISTINGUISH BETWEEN FACTORING AND FORFEITING

Basis	Factoring	Forfeiting
1. Suitability	For transactions with short-term maturity period.	For transactions with medium-term maturity period.
2. Recourse	Can be either with or without recourse.	Can be without recourse only.
3. Risk	Risk can be transferred to seller.	All risks are assumed by the forfeiter.
4. Cost	Cost of factoring is usually borne by the seller.	Cost of forfeiting is borne by the overseas buyer (importer).
5. Coverage	Covers a whole set of jobs at a predetermined price.	Structuring and costing is done on a case –to-case basis.
6. Extent of financing	Only a certain percent of receivables factored is advanced.	100% finance is available.
7. Basis of	Financing depends on the credit	Financing depends on the financial

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financing	standing of the exporter.	standing on the available bank.
8. Services	Besides financing, a factor also provides other services such as ledger administration etc.,	It is a pure financing arrangement.
9. Exchange fluctuations	No security against exchange rate fluctuations.	A forfeiter guards against exchange rate fluctuations for a premium charge.
10. Contract	Between seller and factor.	Between exporter and forfeiter.

RBI GUIDELINES FOR FACTORING:

As a central monetary authority, RBI issued the following guidelines aimed at regulating the factoring provided by banks on the basis of the recommendations of various working groups

1. Prior approval: No business of factoring is to be undertaken by banks directly. However, indirect participation of banks in factoring services with the Reserve Bank's prior approval will be allowed, whereby banks could invest in shares of other factoring companies within the limits specified.

2. Subsidiaries: Banks are permitted to set up separate subsidiaries for undertaking the factoring business, either individually or jointly with other banks, with prior approval of RBI.

3. Exclusive business: Factoring is to be undertaken by a factoring subsidiary or a joint venture factoring company, and such Factors should not engage in financing other companies who are also engaged in the business of factoring.

4. Investment limit: The investment limit of a bank in the shares of factoring companies, inclusive of its subsidiary in the factoring business, shall not exceed in aggregate 10 percent of the paid up capital and reserves of the bank.

5. RBI clearance: Prior clearance of the RBI is to be obtained for making application to the Controller of Capital Issues in connection with the setting up of subsidiaries of the joint venture factoring companies.

6. Reporting: Factor-banker shall submit periodical reports to the RBI regarding the factoring business undertaken by it.

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