Idhaya College for Women Kumbakonam

PG & Research Department of Commerce

III BCom

Financial Services – 16CCCCM15

Unit – I to V

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UNIT-I

MEANING OF FINANCIAL SERVICES

In general all types of activities which are of a financial nature could be brought under the term "financial services". In a broad sense it means "mobilizing and allocating savings". Thus it includes all activities involved in the transformation of saving in to investment.

It is also be called as financial intermediaries and it is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. The functioning of the financial system very much depends on the range of financial services provided by the providers, and their efficiency.

Two types of companies provide financial services. They are

- Asset management companies. It includes Mutual funds, merchant bankers, and portfolio managers.
- Liability management companies. It includes bills discounting houses, acceptance houses.

DEFINITION

The financial services are defined as "Facilities such as saving accounts, checking accounts, confirming, leasing and money transfer, provided generally by banks, credit unions and finance companies".

CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

- The financial intermediaries in India can be traditionally classified in to two.

Capital market intermediaries:

- They consist of term lending institutions and investing institutions which mainly provide long term funds.

Money market intermediaries:

- Money market consists of commercial banks, cooperative banks and other agencies who supply only short term funds.
- Hence, the term ‘Financial Services Industry’ includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

EVOLUTION OF FINANCIAL SERVICES IN INDIA

- The merchant banking services were introduced in 1960.
- The General insurance business was nationalized in the early 1970’s
- Leasing made its mark in the closing years of 1970’s
- Over the counter services, share transfers, factoring, discounting, venture capital, credit rating have found their origin from 1980.

FEATURES OF FINANCIAL SERVICES

Financial services are totally different other services. Their characteristics are as follows.

- It is a customer intensive industry. Customer is the king and he is the centre for all activities. Service industries must provide service according to the expectations of the customers to survive in the market. It will help the financial service firms to design the financial strategy, which gives due respect to costs, liquidity and maturity considerations.

- They are intangible in nature, these services are invisible and are not possible to touch, hear and taste but it can be feel by customer. The institutions providing the services should have a good image and confidence of the clients

- Financial services are belongs to perishable category. The services are to be consumed immediately after its production. The services should be created and to be delivered to target customer directly. Hence it is important to ensure the supply of services according to the demand and requirement.

- Financial services are inseparable in nature. Production and supply of financial services must be performed simultaneously.

- Demand and supply must be properly balanced.
- Marketing of financial service is people intensive.
- Financial services firms should always be proactive in visualizing in advance what the market wants, or reactive to the needs and wants of customers. They must always be changing to the tune of the market.

IMPORTANCE OF FINANCIAL SERVICES

The important uses of financial services in the modern economy are listed and discussed below.

1. **Economic Growth:**

   Financial services plays vital role in economic growth. Financial intermediation mobilizes the funds from savers and channelizes it into developing activities which enables more GDP as well as national income.

2. **Promotion of savings:**

   Service industries plays significant role in promoting savings from the public. Financial institutions fill enough confidence to public and create saving habit with the people. These savings will be utilized for developing activities.

3. **Capital formation:**

   Capital formation refers to process of adding additional capital to its current capital for a particular period of time. Financial intermediaries help in more capital formation. More and more capital formation ensures fast growth.

4. **Provision of liquidity:**

   Financial intermediaries ensure to maintain liquidity for companies as well as individuals. It facilitate various financial services for companies at the time of crisis by many ways like overdraft facilities, cash credit, mortgage loan etc. which enables company to maintain sufficient liquidity with them.

5. **Creation of employment opportunities:**

Financial services provide more number of employment opportunities directly as well as indirectly. Since financial services are labour intensive it requires more and more skilled human being to produce services, which facilitate direct employment to people. On the other hand it helps in capital creation of the country which leads to more production, to produce more goods and services more number of labour are required, which enables indirect employment opportunities to many fortunate employees.

FUNCTIONS OF FINANCIAL SERVICE INSTITUTIONS

The following are the some of the functions carried out by financial service institutions.

- They not only help to raise the required funds but also assure the efficient deployment of funds.
- They assist in deciding the financing mix.
- They extend their service up to the stage of servicing of lenders.
- They provide services like bills discounting, factoring of debtors, parking of short term funds in the money market, e-commerce, securitization debts.
- Financial services firms provide some specialized services like credit rating, venture capital financing,. Lease financing etc.

SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities. They can be broadly classified in to two namely. They can be broadly classified in to two namely

A. Traditional activities

Traditionally they are rendering services of both capital and money market activities. The can be grouped under two heads.

1. **Fund based activities.**

- → Underwriting of shares, debentures, bonds etc.
- → Dealing in secondary market activities.
- → Participating in money market instruments,

- Involving in leasing, hire purchase, venture capital etc.
- Dealing in foreign exchange market activities.

2. **Non fund based activities.**

This can also be called “Fee based” activities. Variety of services they are providing. They are

- Managing the capital issues.
- Making arrangements for the placement of capital and debt instruments.
- Arrangement of funds from financial institutions for the clients.
- Assisting in the process of getting all government and other clearances.

B. Modern activities

Some of the modern services provided by them are

- Rendering project advisory services.
- Planning for mergers and acquisitions.
- Guiding the corporate customers.
- Acting as trustees to the debenture holders,
- Recommending suitable changes in the in the management structure.
- Structuring the financial collaboration/ joint ventures.
- Rehabilitating and reconstructing sick companies
- Manage the port folio of large public sector corporations.
- Advisory the clients on the question of selecting the best source of funds.
- Guiding the clients in the minimization of the cost of the debt.

NEW FINANCIAL PRODUCTS AND SERVICES

As result of financial innovation new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. Some of them are briefly discussed below.

1. Merchant banking:

A merchant banker is a financial intermediary who helps to transfer capital from those who possess it to those who need it. In includes a wide range of activities such as portfolio management, underwriting of shares and debentures, loan syndication, handling interest and dividend warrants, public issue management, venture capital, lease financing, corporate counseling, project counseling, capital restructuring services etc.

2. Loan syndication:

This is more or less similar to ‘Consortium financing’. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government department and merchant banker acts as a lead manager. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies.

3. Leasing:

A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery on payment of a prescribed fee called rental charges. The lessee is not having any ownership but he can use it. There are different types of lease such as service lease, direct lease, sale and lease back, leveraged lease etc.

4. Mutual funds:

A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing the risks. It ensures low risks, steady returns, and high liquidity in the long run. Thus mutual fund is a concept of mutual help of subscribers for portfolio investment and management of these investment s by experts in the field.

5. Factoring:

It is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. A factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus Factoring is a financial package of credit, debt collection and sales ledger administration leading to regular cash flows to companies whose credit sales comprise a significant portion of the total sales. Main draw back is that it is highly expensive.

6. Forfaiting:

It is a technique by which a forfaitor discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

7. Venture capital:

A venture capitalist finances a project based on the potentialities of a new innovative project. Finance is being provided not only for ‘start up capital’ but also for ‘development capital’ by the financial intermediary. The role of venture capital institutions is very important to the economic growth of a nation. This is because due to their assistance new entrepreneurs spring up and contribute significantly to the total wealth of the nation.

8. Custodial services:

A financial intermediary mainly provides services to clients for a prescribed fee. They provide services like safe keeping of shares and debentures, collection of interest and dividend etc.

9. Corporate advisory services:

Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers.

10. Securitization:

It is a technique whereby a financial company converts its ill liquid, non negotiable and high value financial assets in to securities of small value which are made tradable and transferable.

11. Derivative security:

It is a security whose value depends upon the values of other basic variables backing the security. It is used as a risk management tool and it is resorted to cover the risks due to price fluctuations by the investments managers.

12. **New products in Forex market:**

The following are the important new products in Forex market.

a. **Forward contracts:**

It is one where the delivery of a foreign currency takes place at a specified future date for a specified price.

b. **Options:**

It is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a flat rate on a future date according to his option. Options may be of two types namely call option and put option.

c. **Futures:**

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

d. **Swaps:**

A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any between two countries.

13. **Lines of credit:**

It is an innovative funding mechanism for the import of goods and services on deferred payment terms. It is an arrangement of a financial institution of one country with another institution to support the export of goods and services so as to enable the importers to import on deferred payment terms.

MERCHANT BANKING

DEFINITION

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”.

It may be defined as

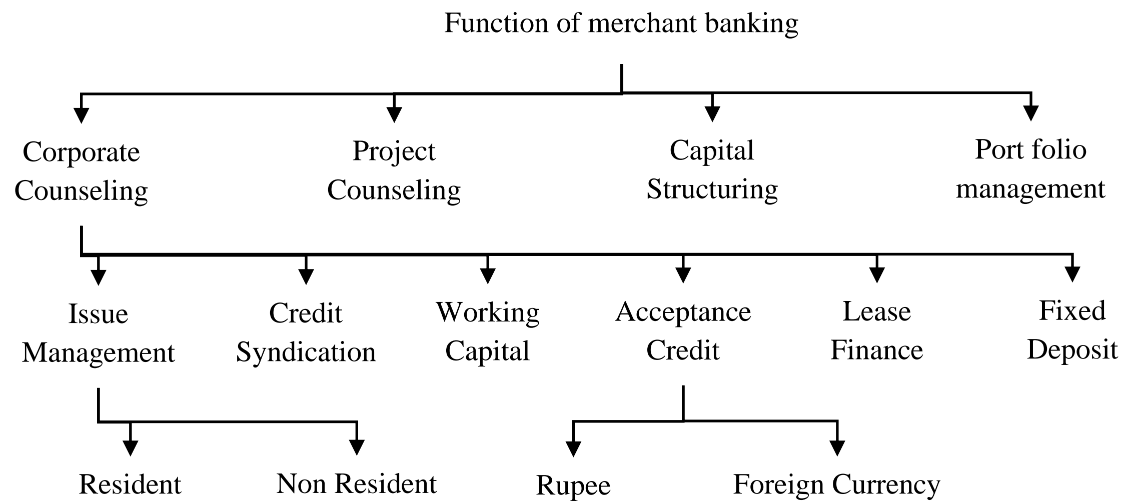
“A kind of financial institution that provide a variety of services including investment banking, management of customers securities portfolios, insurance, acceptance of bills etc”.

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, Fugger and so on. Merchant banking originated through the entering of London merchants in financing foreign trade through acceptance of bill. Later the merchants assisted the Government of underdeveloped countries in raising long term funds through floatation of bonds in London money market. Over a period they extended their activities to domestic business of syndication of long term and short term finance. Underwriting of new issues, acting as registrars, and share transfer agents etc. The post war period witnessed the rapid growth of merchant banking through the innovative instrument like Euro Dollar and the growth of various financial institutions like Singapore, Hong Kong, Baharain, Dubai etc.

FUNCTIONS OF MERCHANT BANKING

The following are the various functions of merchant banking



OBJECTIVES OF MERCHANT BANKING

Following are the main objectives of merchant banking.

a. One of the main objectives of Merchant banking is to channelise the financial surplus of the general public into productive investment resources.

b. Their objective includes marketing of corporate securities such as equity shares, preference shares, debentures by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

c. They are coordinating the activities of various intermediaries to the share issue such as the registrar, bankers, advertising agency, printers, underwriters, brokers etc.

d. They offer services not only to the clients issuing the securities but also to the investors regarding investment decisions.

e. They provide counseling services to the companies.

f. They help their clients in various stages of the project.

g. They act as lead managers and co managers to the issue and their job is very responsive

h. Category I, II and III merchant bankers are permitted to underwrite an issue which enables the issuing company to sell securities quickly.

i. Merchant bankers provide port folio services to their clients.

SEBI REGULATIONS

I. REGISTRATION OF MERCHANT BANKERS

The relevant guidelines with regard to the registration of merchant bankers are as follows:

Application for grant of certificate

An application by a person for grant of a certificate shall be made to the Board in Form A. The application shall be made for any one of the following categories of the merchant banker namely

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

Category II - to act as adviser, consultant, co-manager, underwriter, portfolio manager;

Category III - to act as underwriter, adviser, consultant to an issue;

Category IV - to act only as adviser or consultant to an issue.

With effect from 9th December, 1997, an application can be made only for carrying on the activities mentioned in category I. An applicant can carry on the activity as underwriter only if he obtains separate certificate of registration under the provisions of Securities and Exchange Board of India (Underwriters) Regulations, 1993, and as portfolio manager only if he obtains separate certificate of registration under the provisions of Securities and Exchange Board of India (Portfolio Manager) Regulations, 1993.

Conformance to requirements

Subject to the provisions of the regulations, any application, which is not complete in all respects and does not conform to the instructions specified in the form, shall be rejected. However before rejecting any such application, the applicant shall be given an opportunity to remove within the time specified such objections as may be indicated by the Board.

Furnishing of information, clarification and personal representation

The Board may require the applicant to furnish further information or clarification regarding matters relevant to the activity of a merchant banker for the purpose of disposal of the application. The applicant or its principal officer shall, if so required, appear before the Board for personal representation.

Consideration of application

The Board shall take into account for considering the grant of a certificate, all matters, which are relevant to the activities relating to merchant banker and in particular the applicant complies with the following requirements that the

- ➔ applicant shall be **a body corporate** other than a non- banking financial company as defined under clause (f) of section 45-I of the Reserve Bank of India Act, 1934, (2 of 1934) as amended from time to time,
- ➔ merchant banker who has been granted registration by the Reserve Bank of India to act as a **Primary or Satellite dealer** may carry on such activity subject to the condition that it shall not accept or hold public deposit
- ➔ applicant has the **necessary infrastructure** like adequate office space, equipments, and manpower to effectively discharge his activities;
- ➔ applicant has in his **employment minimum of two persons** who have the experience to conduct the business of the merchant banker;
- ➔ a person directly or indirectly connected with the applicant has not been granted registration by the Board;
- ➔ applicant fulfils the **capital adequacy requirement** as specified in the relevant.

- ➔ applicant, his partner, director or principal officer is not involved in any **litigation connected** with the securities market which has an adverse bearing on the business of the applicant;
- ➔ applicant, his director, partner or principal officer has not at any time been **convicted** for any offence involving moral turpitude or has been found guilty of any economic offence;
- ➔ applicant has the **professional qualification** from an institution recognized by the Government in finance, law or business management;
- ➔ applicant is a **fit and proper** person,
- ➔ grant of certificate to the applicant is **in the interest of investors.**

Capital Adequacy Requirement

According to the regulations, the capital adequacy requirement shall not be less than the net worth of the person making the application for grant of registration. For this purpose, the net worth shall be as follows, namely: -

Category	Minimum Amount
Category I	Rs. 5, 00, 00, 000
Category II	Rs. 50, 00, 000
Category III	Rs. 20, 00, 000
Category IV	Nil

For the purpose of this regulation "net worth" means in the case of an applicant which is a partnership firm or a body corporate, the value of the capital contributed to the business of such firm or the paid up capital of such body corporate plus free reserves as the case may be at the time of making application.

1 Non-Banking Financial Company (NBFC): Meaning

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other

marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Definition of NBFCs:

According to Reserve Bank of India (Amendment Act) 1997, a non-banking finance company means –

a) a financial institution which is a company

b) a non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner;

c) Such other non-banking institution or class of such institutions as the bank may, with the previous approval of the Central Government specify.

Differences between Banks & NBFCs:

NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFC cannot accept demand deposits;
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
- Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

Different types/categories of NBFCs registered with RBI:

NBFCs are categorized

- In terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs,

- Non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and
- By the kind of activity they conduct.

Within this broad categorization the different types of NBFCs are as follows:

1.**Asset Finance Company (AFC) :** An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively.

2. Investment Company (IC) : IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,

3. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

4.Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

5. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities.

6. Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC) : IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

7. **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI):** NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

•. Loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs 1,00,000 or urban and semi-urban household income not exceeding Rs 1,60,000;

•Loan amount does not exceed Rs 50,000 in the first cycle and Rs 1,00,000 in subsequent cycles;

•Total indebtedness of the borrower does not exceed Rs 1,00,000;

•Tenure of the loan not to be less than 24 months for loan amount in excess of Rs 15,000 with prepayment without penalty;

•Loan to be extended without collateral;

•Aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

•Loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower

8. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

9. Mortgage Guarantee Companies (MGC) - MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is Rs 100 crore.

10. NBFC- Non-Operative Financial Holding Company (NOFHC) is financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

Action to be taken against persons/financial companies making false claim of being regulated by the Reserve Bank:

It is illegal for any financial entity or unincorporated body to make a false claim of being regulated by the Reserve Bank to mislead the public to collect deposits and is liable for penal action under the Indian Penal Code. Information in this regard may be forwarded to the nearest office of the Reserve Bank and the Police.

The list of registered NBFCs is available on the web site of Reserve Bank of India and can be viewed at www.rbi.org.in

Precautions to be taken by a depositor before placing deposit with an NBFC:

A depositor wanting to place deposit with an NBFC must take the following precautions before placing deposits:

1. That the NBFC is registered with RBI and specifically authorized by the RBI to accept deposits. A list of deposit taking NBFCs entitled to accept deposits is available at www.rbi.org.in. The depositor should check the list of NBFCs permitted to accept public deposits and also check that it is not appearing in the list of companies prohibited from accepting deposits.

2. NBFCs have to prominently display the Certificate of Registration (CoR) issued by the Reserve Bank on its site. This certificate should also reflect that the NBFC has been specifically authorized by RBI to accept deposits. Depositors must scrutinize the certificate to ensure that the NBFC is authorized to accept deposits.

3. The maximum interest rate that an NBFC can pay to a depositor should not exceed 12.5%. The Reserve Bank keeps altering the interest rates depending on the macro-economic environment. 4. The depositor must insist on a proper receipt for every amount of deposit placed with the company. The receipt should be duly signed by an officer authorized by the company and should state the date of the deposit, the name of the depositor, the amount in words and figures, rate of interest payable, maturity date and amount.

5. In the case of brokers/agents etc collecting public deposits on behalf of NBFCs, the depositors should satisfy themselves that the brokers/agents are duly authorized by the NBFC.

6. The depositor must bear in mind that public deposits are unsecured and Deposit Insurance facility is not available to depositors of NBFCs.

7. The Reserve Bank of India does not accept any responsibility or guarantee about the present position as to the financial soundness of the company or for the correctness of any of the statements or representations made or opinions expressed by the company and for repayment of deposits/discharge of the liabilities by the company.

UNIT-II

MEANING OF HIRE PURCHASE

Hire purchase is a method of selling goods. In a hire purchase transaction, the goods are let out on hire by a finance company (creditors) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditors and passes on to hirer on the payment of last installment.

FEATURES OF HIRE PURCHASE

Following are the features of hire purchase.

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
- Each installment is treated as hire charges.
- The ownership of the goods goes to buyer form seller on the payment of the last installment.
- In case, the buyer makes any default in the payment of any installment, the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charges.
- The hirer has the right to terminate the agreement any time before the property passes.

PROCESS OF HIRE PURCHASE:

The Hire Purchase Act, 1972 defines a hire purchase agreement 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 agreement under which:

- ✓ Payment is to be made in installments over a specified period
- ✓ The possession is delivered to the purchaser at the time of entering into a contract
- ✓ The property in the goods passes to the purchaser on payment of the last installment
- ✓ Each installment is treated as hire charge so that if default is made in payment of any one installment, the seller is entitled to take away the goods
- ✓ The hirer/purchaser is free to return the goods without being required to pay any further installments falling due after the return

Hire purchase involves a certain procedure, that is to say, modus operandi to be followed. For this, an agreement called hire purchase agreement is made in written between the parties involved in the hire purchase transaction.

HIRE PURCHASE AGREEMENT

The agreement contains the following:

(i) The hire purchase price of the goods to which the agreement relates;

(ii) The cash price of the goods, that is to say, the price at which the good is purchased for cash;

(iii) The date of the commencement of the agreement;

(iv) The number and time interval of installments by which the hire purchase price is to be paid;

(v) The name of goods, with its sufficient identity, to which the hire purchase agreement relates to;

(vi) The amount to be paid, if any, at the time of signing the agreement;

(vii) The signatures of the parties involved in transaction.

If the hire purchase transaction is financed by the manufacturer or dealer, then two parties, called, hire vendor and hire purchaser, are involved in the agreement. The hire purchase transaction is financed by some financial institution, and then there are three parties involved in the transaction.

These are:

(i) Hire Vendor,

(ii) Hire Purchaser, and

(iii) Financial Institution.

In such case, the vendor, firstly, receives the bills of exchange for hire purchase price of the goods from the hirer. The vendor, then, discounts the bills with the financial institution and, thus, gets payment for the goods sold under hire purchase system. The financial institution collects the payments of the bills from the hirer, as and when the installments fall due.

HIRE PURCHASE AND LEASE

Leasing is a contractual agreement under which the owner of an asset called lessor agrees to allow the use of the asset by another party called lessee for a periodic payment as lease rent.

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company to the hire purchase customer. The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with the creditor and passes on to hirer on the payment of last installment.

HIRE PURCHASE AND LEASING SIMILARITIES:

- Economic substance of both of them is same.
- Both are instances of bailment with hire purchase having an additional element of sale.
- Financial remains owner in both cases.
- Repossession rights are similar in both cases.
- In case of motor vehicles in both cases user is recognized as owner.
- Documentation largely same in both cases.
- Requirements of bailment are applicable to both with equal force.

DEFINITION

‘Lease is a contract whereby the owner of an asset (Lessor) grants to another party (Lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent’ **- James C Van Horne**

‘Leasing is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent’.

VARIOUS TERMS USED IN LEASE AGREEMENT

- **Lessor:** The party who is the owner of the equipment and who gives it for lease to the other party for payment of a periodical amount.
- **Lessee:** The party who obtains the equipment for use for which he pays periodical rentals.
- **Lease property**: The subject of the lease, the asset, article or equipment that is on lease.
- **Term of lease:** This refers to the lease period for which the agreement will be in operation.
- **Lease rentals:** This refers to the consideration for lease. This may be connected with
  - Interest on lessor investment.
  - In case of any maintenance of the equipment by the lessor that will also be included.
  - Depreciation of the asset.
  - Servicing charges or packaging charges for providing the above services.

TYPES OF LEASE

Following are the various types of lease.

1. Financial lease or capital lease or long term lease or net lease or close lease

Definition: A lease is defined as a financial lease if it transfers a substantial part of the risks and rewards associated with ownership from the lessor to the lessee.

It is contract involving payment over a longer period. It is a long term lease and the lessee will be paying much more than the cost of the property or equipment to the lessor in the form of

lease charges. It is irrevocable and in this type of leasing the lessee has to bear all costs and the lessor does not render any service.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, period of lease, periodicity of rent payment and the rate of depreciation and other tax benefits available. The leasing can also charges nominal service charges to cover legal and other costs. In a large number of cases the financial leases are used as financing cum tax planning tool

The financial lease could also be purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price.

***2.* Operating lease or service lease or short term lease or true lease**

The lessee uses the asset for a specified period. The lessor bears the risk of obsolescence and incidental risks. There is an option to either party to terminate the lease after giving notice. In these type of leasing

- → Lessor bears all expenses.
- → Lessor will not be able to realize the full cost of the asset.
- → Specialized services are provided by the lessor.

This kind of lease is preferred where the equipment is likely to suffer obsolescene and this kind of leasing is suitable for computers, copy machines, office equipments, vehicles, material handling equipments etc

***3.* Leveraged lease**

The value of the asset leased may be of a large amount which may not be possible for the lessor to finance. So the lessor involves one more financier who will have charge over the leased asset. In leveraged lease the lessee contracts to make periodic payments in the lease period and in return he is entitled to the use of the asset over that period of time.

***4.* Conveyance type lease:**

Here the lease will be for a long period with a clear intention of conveying the ownership of title on the lessee.

***5.* Sale and lease back**

Here a company owing the asset sells it to the lessor. The lessor pays immediately for the asset but leases the asset to the seller. Thus the seller of the asset becomes the lessee. The asset remains with the seller who is a lessee but the ownership is with the lessor who is the buyer. This arrangement is done so that the selling company obtains finance for running the business along with the asset.

***6.* Direct leasing**

It is one wherein the owner of the equipment and the lessor are two different parties. Direct lease is of two types.

- → **Bipartite agreement:** Here there are two agreements one between the owner of the equipment and the other between the lessor and the lessee.
- → **Tripartite agreement:** Here there will be three agreements first the agreement between the owner and lessor, then between the lessor and the lessee and finally between the lessee and the owner.

***7.* Full and non payout leasing**

A full payout lease is one in which the lessor recovers the full value of the leased asset by way of leasing

In non payout lease, the lessor leases out the same asset over and over again.

***8.* Specialised service lease:**

The lessor or the owner of the asset is a specialist of the asset which he is leasing out. He not only leases out but also gives specialized personal service to the lessee.

***9.* Net and non net lease**

In non net lease the lessor is in charge of maintenance, insurance and other incidental expenses. In a net lease, the lessor is not concerned with the above maintenance expenditure. The lessor confines only to financial service.

***10.* Sales aid lease**

In case, the lessor enters in to any tie up arrangement with manufacturer for the marketing it is called sales aid lease.

11. **Tax oriented lease:**

Where the lease is not a loan on security but qualifies at a lease, it will come under this category.

12. **Cross border lease:**

Lease across national frontiers are called cross border lease. Shipping, air service will come under this category

DIFFERENCE BETWEEN HIRE PURCHASE AND LEASING

S.No	Leasing	Hire purchase
1	Ownership is with financier forever	Ownership passed at the option of the hirer at end
2	No option to buy	It contains option to buy
3	Legal ownership is with the lessor.	Legal ownership with the financier
4	Income tax recognizes lessor as owner	Income tax recognizes hirer as owner
5	Depreciation allowed to lessor	Depreciation allowed to hirer.
6	Lease rental taxed as lessor's income and allowed as lessee's expenses.	Only the interest point of installments taxed as financier income and allowed as hirer's expenses.
7	Accounted as a lessors asset	Accounted as hirer's asset
8	Sales tax laws treat as special sale	Sales tax laws treat as nominal sale
9	Leasing finance business assets	Hire purchase financing both business assets and consumer articles
10	Lessee does not enjoy the salvage value of the asset	Hirer being owner of the asset, enjoy the salvage value of the asset
11	No deposit in leasing	20% deposit is required in hire purchase.

UNIT-III

MEANING

Mutual funds represent pooled savings of numerous investors invested by professional fund managers as diversified portfolio to obtain optimum return on investments with least risk to the investors. Thus every investor whether big or small, will have a stake in the fund and can enjoy the wide portfolio of the investment held by the fund. Hence mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emerged as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk.

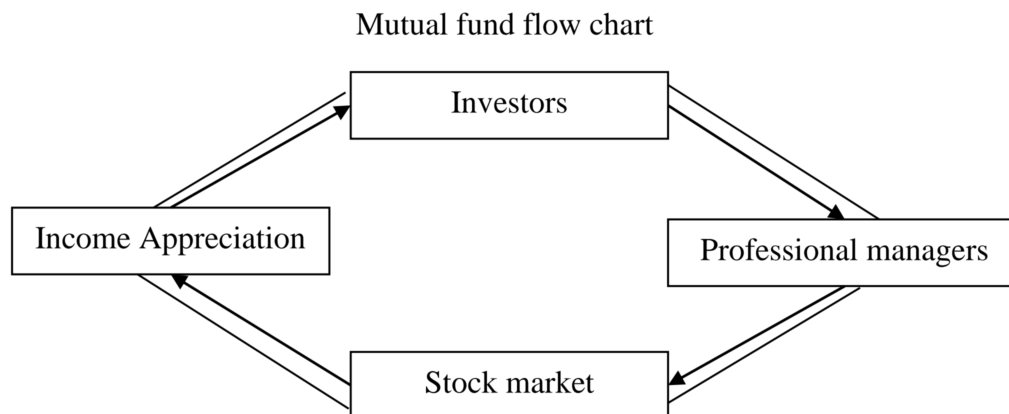
DEFINITION

The securities and exchange board of India (MFs) regulations, 1993 defines a mutual fund as "a fund established in the form of a trust by a sponsor, to raise moneys by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with those regulations".

MECHANISM OF MUTUAL FUND OPERATION

The following flowchart will show the mechanism of mutual fund operation.

Mutual fund flow chart



The professional manager of a fund invests the collected money in different types of securities for and on behalf of the investors. The investment is based on the objectives for which the money is collected. These could range from shares to debentures to money market instruments. The income earned through the investments and the capital appreciation realized by

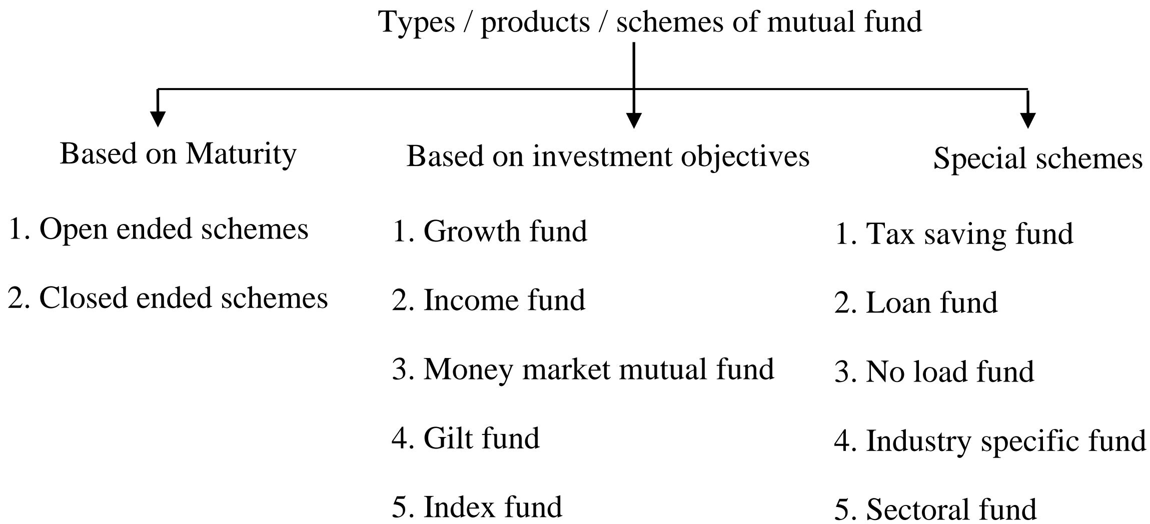
the scheme is shared by its unit holders in proportion to the number of units owned by them. The received income is invested on funds by investors. Thus a mutual fund is the most suitable investment for the common person as it offers an opportunity to invest in a diversified, professionally, managed portfolio at a relatively low cost. Each mutual fund scheme has a defined investment objective and strategy.

Reward for investment:

Mutual fund earns income by way of interest or dividend or both from the securities it holds. It deducts fees, operating expenses and management income and then passes the remainder to wealth holders through dividends on the mutual fund share. The dividend fluctuates with the income on mutual funds investments.

DIFFERENT TYPES OF MUTUAL FUNDS.

The following are the different types / products / schemes of mutual funds.



Open ended fund or scheme:

Under this scheme the size of the fund and / or the period of the fund are not pre determined. The investors are free to buy and sell any number of units at any point of time. It is available for subscription and repurchase on a continuous basis. Repurchases are generally allowed at specified rates. They do not have a fixed maturity.

Features of this fund:

- → There is free entry and exit of investors.
- → These units are publicly traded.
- → The units can be sold on any working day.
- → The main objective of this fund is income generation.
- → Since they are not listed ion the stock market, their prices are linked to the NAV of the units.

Closed ended funds:

The corpus of the funs and the number of units are determined in advance. Once the subscription reaches that level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus the fund ceases to be a fund, after the final distribution. So schemes that have a stipulated maturity period are called close ended funds.

Features:

- → The period and / or the target amount of the fund are definite and fixed beforehand.
- → They cannot purchase any more units over the target fixed.
- → Units are publicly traded out.
- → Main object is capital appreciation.
- → There will not be any redemption demand before its maturity
- → Generally prices of closed end scheme units are quoted as a discount of up to 40% below their NAV.

Based on investment objectives

Growth oriented mutual fund

The aim is to provide capital appreciation over the medium to long run. The investment is made in equity stock, and these funds have high risk. These schemes provide different opinions to the investors like dividend option, capital appreciation and investors may choose an option

depending on their preferences and they must give their preference in the appreciation form. This scheme is ideal for

- Investors in their prime earning years.
- Investors seek growth over the long run.

Income fund: This fund aims at generating and distributing regular income to the members on periodical basis. It concentrates more on the distribution of regular income and it also sees that the average return is more than that of the income from bank deposits.

Features:

- Investor is assured of regular income at periodical intervals.
- The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc
- It is best suited to the old and retired people who may not have any regular income.
- It concerns itself with short run gains only.

Balanced fund:

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

Money market or liquid fund:

The main aim is to provide easy liquidity, preservation of capital and moderate income. These funds are also income funds. These schemes invest exclusively in safer short term instruments like treasury bills, certificate of deposits. Returns are less fluctuate when compared to other funds. These funds are suitable for corporate and individual investors as a means to part their surplus funds for short periods. Investors generally use it as a "Parking place" or "stop gap agreement" for their cash resources till they finally decide about the proper avenue for their investment i.e long term financial assets like bonds and stocks.

Gilt bond:

Those funds invest exclusively in government securities which have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as in the case with income or debt oriented schemes.

Index funds:

These funds simply follow the pattern of the portfolio of a particular index such as the BSE sensitive index etc. These schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index. The construction of portfolio is entirely based upon maintaining proper proportion of the index being followed, it involves less administrative and transaction cost and less numbers of portfolio managers.

Special schemes:

This category includes index schemes as already seen that attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50, or industry specific schemes. Keep in mind that any one scheme may not meet all your requirements for all time. You need to place your money judicially in different schemes to be able to get the combination of growth, income and stability that is right for you. A few frequently used terms are explained below.

Taxation schemes:

It is basically a growth oriented fund and it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. The tax saving magnum of SBI capital market Ltd is the best example for the domestic type.

Load funds:

It is one that charges a commission for entry or exit. That is each time you buy or sell units in the fund, a commission will be payable. Typically entry and exit loads range from 1% to 2%

No load funds:

A no load fund is one that does not charge a commission for entry and exit. That is no commission is payable on purchase or sale of units in the fund.

Industry specific schemes:

These schemes invest only in the industries specified in the offer document. The investment of these funds is limited to specific industries like InfoTech, FMCG, etc.

Sectoral schemes:

These are funds, which invest in the securities of only those sectors or industries as specified in the offer documents. The returns are depending on the performance of the respective sectors. These funds give higher returns and more risky. Investors need to keep a watch on the performance of those sectors or industries and must exit at an appropriate time.

Other classifications

Leveraged funds:

They are also called borrowed funds. They are used to increase the size of the value for portfolio of the mutual fund. When the value increases earning capacity of a fund also increases. The gains are distributed to the Unit holders.

Dual funds:

It is a special type of closed end fund. It provides a single investment opportunity for two different types of investors. It sells two types of investment stocks viz, income shares and capital shares. Those investors who seek current investment income can purchase income shares and they are guaranteed for guaranteed minimum dividend. The holders of capital shares receive all types of capital gains earned on those shares and they are not entitled to get any dividend.

Bond funds:

These funds have portfolios consisting mainly of fixed income securities like bonds. Main aim is mostly on income rather than capital gains.

Off shore mutual funds:

These are those funds which are meant for non residential investors. In other words, the sources of investment for these funds are from abroad and they are regulated by the provisions of the foreign countries where those funds are registered. These funds involve much currency and country risk and hence they generally yield higher return.

Stock fund:

These are mutual funds which primarily invest in common stock, ranging from Blue ship companies to newly promoted companies.

Real estate funds:

The mutual funds invest in real estate institution such as commercial property company, residential builders and mortgage bankers.

Junk bond funds:

These funds are rated low and carry high risks. However the reward comes in the form of higher yields. They are not found in India and they are popular in U.K.

Specialized funds:

These are funds set up for some specialized purposes. They are

a. International funds: They consist of foreign securities.

b. Global funds: Here the stocks are traded in markets throughout the world with the exception of the country which launches the fund.

c. Regional or country funds: These may be confined to continents in India they are called off shore funds.

d. Sector funds: They are specializing in the particular industry and are regarded as aggressive funds.

PROBLEMS OF MUTUAL FUNDS

Mutual funds are not free form risks. It is so because basically the mutual funds also invest their funds in the stock market on shares which are violate in nature and are not risk free.

Hence the following risks are inherent in their dealings. Risk is the measure of the possibility that the investor will not receive an expected return on investment.

- **Market risk:**

  These are certain risks associated with every kind of investment on shares. These are called market risks and these risks can be reduced but can not be completely eliminated even by a good investment management. More ever every economy has to pass through a cycle – Boom, Recession, Slump and recovery. The phase of the business cycle affects the market conditions to a larger extent.

- **Scheme risk:**

  There are certain risks involved in the scheme itself. It all depends upon the nature of the scheme. For example in a pure growth income risks are greater. It is obvious because if one expects more returns as in the case of a growth scheme, one has to take more risks.

- **Investment risk:**

  Whether mutual funds makes money in shares or losses, depends up on the investment expertise of the AMC If the investment advice goes wrong, the fund has to suffer a lot. Investment expertise of various funds is different and it is reflected on the returns which they offer to investors.

- **Business risk:**

  The corpus of a mutual fund might have been invested in a company’s shares. If the business of that company suffers any set back, it can’t declare any dividend. It may even go to the extent of winding up. Though the mutual fund can withstand such a risk, its income paying capacity is affected.

- **Political risk:**

  Successive governments bring with them fancy new economic ideologies and policies. Changes in the government bring in the risk of uncertainty which every player in the financial service industry has to face.

- **Interest rate risk:**

  The value of a fixed income security will drop as interest rates rise. It is called interest rate risk and this risk can not be avoided.

- **Inflation risk:**

The return on investments will not increase with rising consumer prices. It is called inflation risks. Thought this risk can not be avoided, one can manage it by investing a small portion in equity mutual funds.

- **Credit risk:**

As issuer will default on a fixed income security by failing to pay interest, principal when due this risk can be limited by investing in mutual funds having a high exposure to quality paper.

- **Liquidity risk:**

Mutual funds underlying securities i.e low profile securities can not be sold at a fair price when the need arises. It affects the liquidity of a security.

- **Timing risk**

Buying or selling a security at the wrong time is leading to this risk. The best way to counter market timing is to invest systematically

FUNCTIONS OF MUTUAL FUNDS

The important functions of mutual funds are

- To mobilize funds by selling their own shares known as units.
- To act as an investment intermediary to acquire individual investments and pass on the returns to small fund investors.
- To provide an ideal avenue for investment for persons of small means, and enables them to earn a reasonable return with the advantages of relatively better liquidity.
- Investors are relieved of the emotional stress involved in buying or selling securities since mutual funds take care of this function.
- To provide high degree of liquidity for the fund holders.
- To provide the advantage of an active secondary market.
- To provide investors with flexible investment opportunities, whereby it is possible to switch from one scheme to another.
- To provide tax shelter to the investors.

- To enhance the quantum of distributable income available for investors.
- To make contributions to the development of a country's economy.
- To provide automatic reinvestment of dividends and capital gains.
- To provide investors stress free investment opportunities.
- To render expertised investment service at low cost.
- To support the development of capital markets.

WORKING MECHANISM OF AMC

The working of an AMC revolves around the investment functions. The AMC carries out the specialized investment function by designing strategies. The working mechanism of the AMC is described below:

Creating Fund Manager

A fund manager is responsible for managing the funds of an AMC. The fund manager should desirably be an independent agency, as is the practice in the USA. But, according to the practices in India, a single fund manager handles many schemes simultaneously. The basic function of a fund manager is to decide the rate, time, kind and quantum of securities to be bought or sold. It is the fund manager who ensures the success the fund schemes.

In the case of bank-sponsored funds, committees created for that purpose handle the investment exercise. For instance the 'Investment Committee', which is a broad based committee having even nominees of the sponsor decides the primary market investments. The 'Market Operation Committee' handles the assignment of disinvestments and interactions with the secondary market.

Research and planning

The research and Planning cell of the AMC undertakes research activities relating to securities as well as prospective investors. The results of the study are analyzed to draft future policy governing investment management. It is also possible that the research work is assigned to an independent outside agency.

Creating Dealers

Dealers having a deep understanding of stock market operations may be created by the AMC in order to execute the sale and purchase transactions in the capital or money market. It is possible that this job is assigned to a separate marketing division of AMC. Dealers should comply with all the formalities of sale and purchase through brokers, the brokers being appointed by the Board of Directors of AMC. The Board lays down the sidelines for allocation of business to different brokers.

PORTFOLIO MANAGEMENT PROCESS IN MUTUAL FUNDS:

The Portfolio management process of a mutual fund involves the following four basic steps:

1. Setting investment goal

2. Identification of specific securities

3. Portfolio designing

4. Portfolio revision

Setting Investment Goal

The first and foremost task of managing the portfolio of a mutual fund is to identify and set the goal for the proposed scheme. The goal is set keeping in mind considerations such as the protection of investors, nature of the scheme, risk and return, market conditions, regulatory norms, size of issue, etc.

Identifying Specific Securities

When once the goal to be accomplished by the proposed scheme has been identified, efforts are made to analyze and identify the right security where funds are required to be invested. For this purpose, security analysis carried out from the viewpoint of the company, industry and the economy. For each security, risk and return characteristics are evaluated in a broader perspective. For the purpose of analysis, the fund manager considers the strengths and weaknesses of some of the sample securities.

Portfolio Designing

Portfolio designing involves making an ideal mix of debt and equity securities of corporates, government, etc. It is concerned with decisions regarding the type of securities to be bought, the quantum and the timing of issue. Portfolio designing is carried out on the basis of research and analysis of stock market. Based on their results, the long-term and short-term investment strategies are worked out.

The fund manager makes efforts at building the portfolio that consists of a well-diversified portfolio of securities so as to reduce significantly the unsystematic risk. For this purpose, the expected returns on individual security and portfolio as a whole, is associated with the market or systematic risk. The design will consider the ways and means by which liquid resources in the scheme could be invested in money market instruments like government securities, commercial papers, certificates of deposits, treasury bills, etc.

While designing the portfolio, regulations are to be followed. For instance, as per SEBI, mutual funds

1. Are prohibited from making investments in unlisted securities

2. Cannot own more than 10 percent of any company's paid up capital carrying voting rights

3. Can make investments in other schemes of the same mutual fund upto 5 percent of the NAV 4. Can make investment only in transferable securities in the money or capital market

Portfolio Revision

The build-up of portfolio needs to be periodically reviewed keeping in mind the risk-return characteristics of all securities under the changing circumstances. The revision of the portfolio has to be undertaken in the context of the dynamic investment world. Further, the exercise is to be taken up to cash on the renewed market opportunities in order to maximize the portfolio returns.

GROWTH OF MUTUAL FUND IN INDIA.

In India, the mutual fund industry has been monopolized by the UTI ever since 1963. Now the commercial banks like SBI, Canara bank, Indian bank, Bank of India and The Punjab National Bank, LIC and private sectors and other financial institutions have entered in to field.

On the whole as on 30-09-95 there were nearly 25 Mutual Funds offering 80 different schemes and serving nearly 60 million investors.

With the amendment of banking regulations act, commercial banks were allowed to start mutual funds from the public. It was SBI which first started its mutual fund called SBI Magnum Fund. This was followed by other banks such as Canara Bank, Bank of India, Punjab National Bank, Central Bank of India etc. By 1990 some of the public sector units were allowed to enter mutual funds.

Entry of Private sector in Mutual Funds

With the emergence of SEBI, the functioning of mutual fund was regulated. At this stage more private sector institutions also entered mutual funds. We have a number of private sector mutual funds starting from Kothari Pioneer Mutual Fund, Twentieth Century Mutual Fund, ICICI Mutual Fund, Morgan Stanley Mutual Fund, Tarus Mutual Fund etc. In south India, Sundaram finance has become the leading mutual fund, Birla group also entered along with TATA's in mobilizing funds for mutual funds. Private sector entered mutual fund industry only in 1993 with Kothari Pioneer getting the license in July 1993 to operate in India. Since then, the industry has grown by leaps and bounds.

With only one AMC in 1963, the industry has grown sharply. In 1993, there were only nine AMCs. Within three years, number of AMCs rose to 26. At present, the private mutual fund industry have 43 AMCs.

Number of schemes have risen from 59 in 1993 to almost 2,000 mutual fund schemes in 2018. The schemes include all open-ended, close-ended and interval schemes.

Of late mutual funds find their going very tough. Most of the funds are not able to collect the targeted amount from small investors. The mutual fund industry has to face many problems also. Some of them are explained below.

PROBLEMS OF MUTUAL FUNDS IN INDIA

- ✓ **Disparity between NAV and listed price:**
  - Though the NAV seems to be good, the listed price are awfully poor of course the NAV is used as a parameter to rate the performance of the

mutual funds. However almost all the mutual fund schemes are deeply discounted to their NAV by as much as 30 To 40%. Thus the real dilemma for the investor is this disparity between the NAV and the listed price.

- ✓ **No uniformity in the calculation of NAV:**
  - There is no standard formula for the calculation of NAV. Different companies applies different formula and hence any fruitful comparison of one fund with another is not at all possible.

- ✓ **Lack of transparency:**

Mutual funds in India are not providing adequate information and materials to the investors. It was expected that they would provide a detailed investment pattern of their various schemes. For the success of mutual funds it is very essential that they should create a good rapport with the investors by declaring their entire holdings to them.

- ✓ **Poor investor servicing:**
  - Mutual funds have failed to build up investor confidence by rendering poor services. Due to the recurring transfer problems and non receipt of dividend in time, people are hesitant to touch the mutual fund script.

- ✓ **Too much dependence on outside agencies:**
  - Most of the funds depend upon outside agencies to collect data and to do research. They thought that research involves a lot of money but in fact they have to pay more for borrowed research.

- ✓ **Investors psychology:**
  - Investors often compare with that of shares and expect a high listing price. They don't realize that unit is a low risk long term instrument. Instead mutual funds are only for those who have the patience to wait for a longer period say 3 to 5 years.

- ✓ **Absence of qualified sales service:**
  - Efficient management of a fund requires expertise knowledge in portfolio management and skill in execution. Without professional agents and

intermediaries, it cannot be managed efficiently. Unfortunately professional people are rare.

- ✓ **Other reasons:**
    - Few funds which have not performed well have actually demoralized in investing public. There is a lack of investor education in the country. Most of the investors are not aware of the mutual fund industry and the various products offered by it.

FUTURE OF MUTUAL FUND INDUSTRY IN INDIA

In spite of the above bottlenecks, the mutual fund industry is having a good prospect in our country. It is likely to show a good progress in the coming years due to a variety of factors.

- ❖ The SEBI is lending full support for the promotion of the mutual fund industry directly as well as indirectly.
- ❖ Disbanding of the controller of capital issues office, many companies have entered in to the market with a petty premium on their shares.
- ❖ In recent times the interest rates on bank deposits have been declining. The returns on the mutual fund schemes compare favorably with the returns on bank deposits.
- ❖ The trend of rising PE ratio, entry of large domestic institutional investors, the opening of the market to the foreign investors etc, would make stock market inaccessible to the small investors. Hence they have to necessarily go to the mutual fund industry.
- ❖ Mutual funds provide a wider range of products to meet the diverse needs of the investing public.
- ❖ Mutual funds have been permitted to underwrite shares also.
- ❖ The Union budget 1999-2000 contains many measures to encourage the mutual fund industry.
- ❖ A three year dividend tax exemption from UTI and equity dominated open ended mutual funds.

- ❖ A full income tax exemption for all income from the UTI and other mutual funds in the hands of the investors.

All these factors would go a long way in making mutual funds an increasingly popular, lucrative and cost efficient vehicle for investment. If mutual funds ensure good returns, quick liquidit and safety and create a good rapport with the investors, their future will be very bright.

FACTORS TO BE CONSIDERED IN SELECTION OF A MUTUAL FUND.

The investor has to be very careful in selecting a fund. He must take in to account the following factors for evaluating the performance of any fund and then finally decide the one has to choose.

- **Objective of the fund:**

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.

- **Consistency of performance:**

It is a good indicator of its investment expertise. So investors should measure the performance of a fund over a period of at least 3 years.

- **Historical background:**

The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. Investor takes in to account all these factors.

- **Cost of operation:**

Hence the prospective investor should scrutinize the expense ratio of the fund and compare it with others. Higher the ratio will be the actual returns to the investor.

- **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.

- **Investor servicing:**

Most important factor is prompt and efficient servicing. Quick response to investor enquiries, prompt despatch of certificates, quick transfer of funds, and immediate encashment of units will go a long way in creating a lasting impression in the minds of investors.

UNIT-IV

MEANING

It refers to the commitment of capital as shareholding, for the formulation and setting up of small firms especially in new ideas or new technologies. Venture capital is long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity shareholdings at high premium.

DEFINITION

It is defined as 'a financing institution which joins an entrepreneurs as a co promoter in a project and shares the risks and rewards of the enterprise'.

FEATURES OF VENTURE CAPITAL

Features of venture capital are

- It is usually in the form of an equity participation, convertible debt or long term loan.
- Investment is made not only in high risk but also in high growth potential projects.
- It is available only for commercialization of new ideas and not for enterprises which are engaged in trading, booking, financial services agency, liason work or research and development.

- → Venture capitalist joins the entrepreneurs as a co- promoter in projects and share the risk and rewards of the enterprise.
- → There is continuous involvement in business after making an investment by the investor.
- → Once the venture has reached the full potential the venture capitalist, disinvests his holdings either to the promoters or in the market.
- → Basic objective is not profit but capital appreciation at the time of disinvestment.
- → It is not just injection of money but also an input needed to set up the firm, design its marketing strategy and organize and manage it.
- → Investment is usually made in small and medium scale enterprises.

ADVANTAGES OF VENTURE CAPITAL

Venture capital is of great potential value to every corporate enterprise

Advantages to investing public

- ✓ The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business with their enterprise in the field and continuous involvement in the business they would be able to stop malpractices by management.
- ✓ Investors have no means to vouch for the reasonableness of the business. The venture funds equipped wit necessary skills will be able to analyse the prospects of the business.
- ✓ The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the board of directors of the company overcomes it.

Advantages to promoters:

- ✓ The entrepreneurs for the success of public issue are required to convince tens of underwriters, brokers and thousands of investors. But to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

- ✓ Public issue of equity shares has to be preceded by a lot of efforts. Venture fund assistance would eliminate those efforts by leasing entrepreneur to concentrate upon bread and butter activities of business.
- ✓ Costs of public issues of eqity shares often range between 10% to 15% of nominal value of issue of moderate size, which are often even higher for small values. These items of expenses can be ill afforded by the business when it is new, assistance from venture fund does not require such expenditure.

General advantages

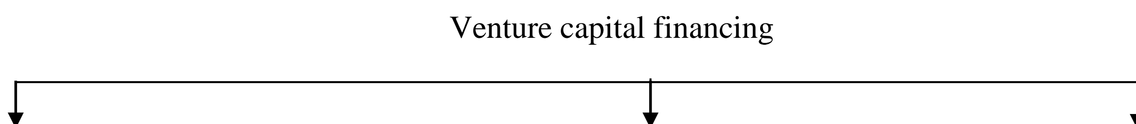
- ✓ A developed venture capital institutional set up reduces the time lag between a technologoval innovation and its commercial exploitation.
- ✓ It helps in developing new processes / products in conductive atmosphere, free from the dead weight of corporate bureaucracy which helps in exploiting full potential.
- ✓ It acts as a cushion to support business borrowings as bankers and investors will not lend money with inadequate margin of equity capital.
- ✓ Once venture capital funds starts earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. There fore the investors would be able to invest in new business through venture funds and at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism helps to channelise investment in new high tech business or the existing sick business.
- ✓ It induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.
- ✓ It servers as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.
- ✓ It also paves the way for private sector to share the responsibility with public sector.
- ✓ New products with modern technology become commercially feasible mainly due to the financial assistance of venture capital institutions.

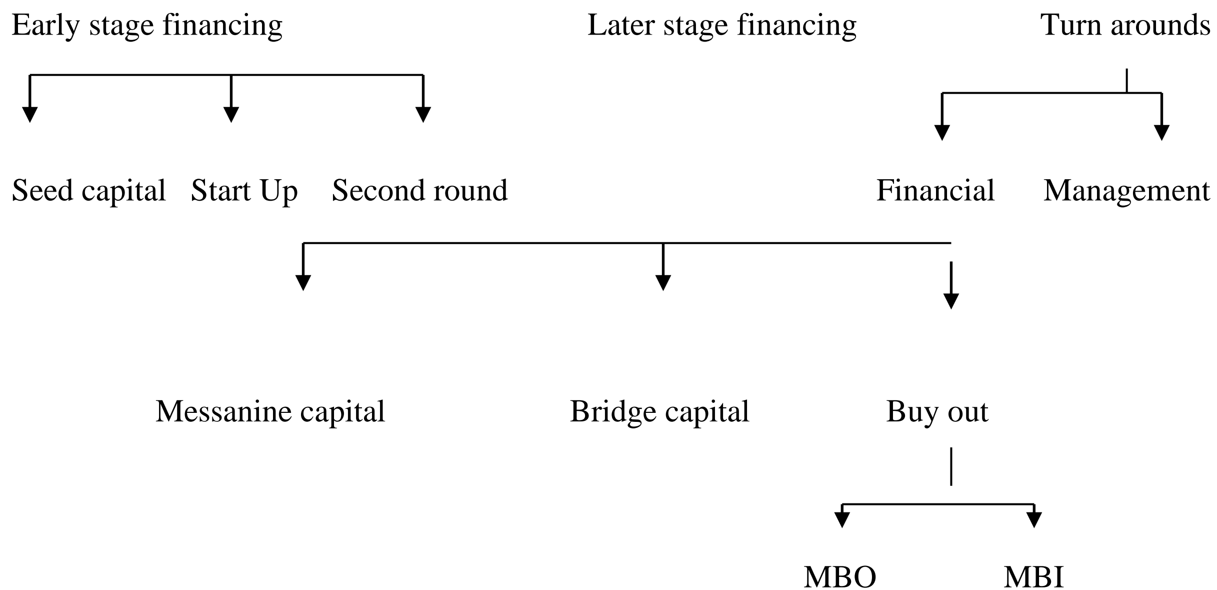
- ✓ Financial institutions provide venture capital to their customers not as a mere financial assistance but more as a package deal which includes assistance in management, marketing, technical and others.
- ✓ Venture capital institutions give more thrust to potential talent of the borrowers which helps in the growth of the borrowing concern.
- ✓ It encourages export oriented units because of which there is more foreign exchange earnings of the country.
- ✓ It acts more as catalyst in improving the financial and managerial talents of the borrowing concern.
- ✓ By promoting entrepreneurship, venture capital institutions are encouraging self employment and this will motivate more educated unemployed to take up new venture.
- ✓ They strengthen the capital market also.
- ✓ Modern technology will be put to use in the country, when fiancial institutions encourage business ventures with new technology.
- ✓ Many sick companies are able to turn around after getting proper nursing from the venture capital institutions.
- ✓ Venture capital institutions are responsible for development of backward regions and human resources.
- ✓ It leads to economic growth of the country.

SCOPE OF VENTURE CAPITAL

- ✓ Before going in for venture capital finance, the venture capital institution will have to assess the potentiality of the borrowing concern by a proper appraisal.
- ✓ There are three stages involved in the venture capital finance.

Venture capital financing





VENTURE CAPITAL SCHEMES OFFERED BY THE VENTURE CAPITAL INSTITUTIONS

- ✓ A venture capital institution may go in for different schemes for investment. It can be on the basis of equity and debt instruments.

Investment in equity:

- ✓ Investment on the basis of equity is of three types. They are as follows.

Unquoted venture investments:

- ✓ Here the companies in which investments are undertaken are companies which are not quoted.
- ✓ But the value of these investments is made through a reliable source and is also based on operating performance of the company.

Unquoted development instruments:

- ✓ Here the venture capital is invested in companies which are earning profits and where the venture capital could be withdrawn within a reasonable period and these securities do not enjoy a market value.

Quoted investments:

- ✓ Here the borrowing companies in which venture capital are invested would have reaches a stage of maturity and hence venture capital could be withdrawn. In such cases the value of the shares can be easily assessed from the market.

Investment in debt instruments

Convertible debt instruments:

- ✓ These debt instruments are convertible in to equity shares at a particular time and price.
- ✓ The value of these instruments can be made either under market value method or under fair value method.

Non convertible debt instruments:

- ✓ Here the debt instruments can not be converted in to equities but they will have fixed interest or zero interest bonds.

Leveraged debt instruments:

- ✓ Here adequate facility is given to venture capital companies so that they can convert a part of their debt instruments into equity and a part of it as debentures.
- ✓ It will depend upon market conditions, earnings of the company and tax structure.

INSTITUTIONS INVOLVED IN THE PROCESS OF VENTURE CAPITAL FINANCE

Different types of venture capital institutions in India

- → Venture capital companies promoted by development banks
- → State level venture capital companies.
- → Commercial banks promoted venture capital companies.
- → Private sector venture capital companies.
- → Foreign venture capital funds.

I. Venture capital institutions promoted by development banks

a. IDBI –VFC (Venture Fund Company)

IDBI promoted venture Fund Company in the year 1986. It is promoted by the technology development wing of IDBI.

b. TDICI- Technology development and information company of India Ltd.

This was started in Jan 1988 with the support of ICICI and UTI. This is the country's first venture fund.

c. RCTC- Risk Capital And technology Finance Corporation Ltd.

It is a subsidiary of IFCI, started in Jan 1988. Its resource base has contributions from UTI, IFCI, and world banks.

II. State level venture capital companies:

a. **Gujarat venture finance Ltd:**

Gujarat industries investment corporation Ltd along with Gujarat lease finance corporation Ltd, Gujarat Alkalis & Chemicals Ltd and Gujarat state fertilizers Ltd promoted Gujarat venture finance Ltd.

b. **Andhra Pradesh Venture capital Ltd (AVCI)**

This was promoted by Andhra Pradesh industrial development corporation, IDBI, Andhra bank and IOB.

III. Venture capital companies promoted by commercial banks:

- Canara bank venture capital fund(CVCF)
- Grindlays bank has promoted India investment fund and second India investment fund.
- SBI capital venture capital fund

IV. Private sector venture capital companies

a. Larazd credit capital venture fund.

b. Indus venture management fund (IVML)

V. Foreign venture capital funds

These funds are promoted by

a. Hong Kong Bank.

b. Alliance capital of USA.

REASONS FOR SLOW GROWTH OF VCC IN INDIA

- **Lack of understanding of venture capital:** The VCC should also provide managerial assistance. But they are quite content with providing financial assistance. They are totally forgetting to provide the other forms of assistance such as managerial, technical etc. to the borrowing concerns.

- **The companies act is not in favour of VCF:** Sections 370 and 372 of the Indian companies act deal with inter company investments and inter company borrowings. These restrictions prevent VCC from investing in new companies.

- **Exit policy:** There is no proper exit policy in Indian VCC while freeing from the borrowing company, the value of equity in which investment is made must be properly assessed.

- **Training of employees:** Employees must be given proper training to assess the net worth of the borrowing company and also find out the quantum of financial assistance required by the company.

- **Unfavorable tax:** The present income taxes are not in favour of VCC. There is double taxation and capital gains tax for the VCC.

- **Foreign venture capital:** The foreign VCC are not given absolute freedom in investing with Indian companies because they have to get clearance from foreign investment promotion board and from RBI.

- **Lack of clarity in the valuation of equity**: Both at the initial stage and at the middle stage, the equity value of borrowing companies has to be assessed and there is confusion in the valuation of equity.

- **Revival of sick companies:** Sick companies can be revived with proper financial, technical and managerial support. The existing VCC lack competence in reviving such sick companies.

UNIT-V

Factoring is a specialized activity whereby a firm converts its receivables in to cash by selling them to a factoring organization. The factor assumes the risk of collection and in the event of non payment by the customer debtors bears the risk of bad debts losses

Thus factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. Factoring is a continuous arrangement between a financial institution and a company which sells goods and services to trade customers on credit. To put in a Layman's language a factor is an agent who collects the dues of his client for a certain fee.

DEFINITION

"An arrangement which includes at least two of the services, namely of finance, maintenance of accounts, collection of debts and protection against credit risk"

"Factoring is a service of financial nature involving the conversion of credit bills into cash".

- V.A Avathari.

"Factoring is an asset based of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amount from the customers to whom the company has supplied goods".

FACTORING MECHANISM

Step I: The customer places an order with the seller (the client).

Step II: The factor and the seller enter into a factoring agreement about the various terms of factoring.

Step III: Sale contract is entered into which the buyer and the goods are delivered.

Step IV: The copy of invoice covering the above sale is to the factor, who maintains the sales ledger.

Step V: The factor prepays 80% of the invoice value.

Step VI & VII: Monthly statements are sent by the factor to the buyer. If there are any unpaid invoices follow up action is initiated.

Step VIII: The buyer settles the invoices on expiry of credit period allowed.

Step IX: The balance 20% less the cost of factoring is paid by the factor to the client.

FUNCTIONS OF FACTORING

Factoring involves the following functions

❖ **Purchase and collection of book debts:**

Under factoring, the factor purchases the entire book debts and thus he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

The factor undertakes to do the collection of debts and thus relieves the client and this reduces the time, effort and money spent thereon. Client will give concentration on improving purchases, production, marketing and other aspects of the business.

❖ **Sales ledger management:**

Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger, following are the functions of factor for the execution of sales ledger.

- → Crediting customers account as soon as payment is received.
- → Sending monthly statements to the customers.
- → Maintaining liason with the client and the customer to resolve all possible disputes.

- → Informing the client about the balances in the account, the over due period the financial sending of the customers.

- ❖ **Credit investigation and undertaking of credit risk.**

The factor has to monitor the financial position of the customer carefully, because he assumes the risk of default in payment by customers due to their financial inability to pay. Before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world. For this factor undertakes credit investigation work.

- ❖ **Provision of finance:**

After the finalization of the agreement and sale of goods by the clients, the factor provides 80% of the credit sales as prepayment to the client. So client can go ahead with his business plans or production schedule without any interruption.

- ❖ **Rendering consultancy services:**

Factor informs about the additional business opportunities available, the changing business and financial profits of the customers, the likelihood of coming recession etc.

TYPES OF FACTORING

1. **Full service factoring:**

Here all the functions of factoring are done by the factor and the factor undertakes the credit risk.

2. **With recourse factoring:**

Credit risk is taken by the seller or the client and when the customer fails to pay on the due date, the factor will take action on the seller.

3. **Without recourse factoring:**

Here the factor takes the risk and the client need not bear the credit risk in case of non payment funds by the 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 60% to 75% 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. The arrangement between the seller and the factor is kept highly secret. 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 wholesaler 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. Thus, the international factoring consists of export and import factor. In export factor, the exporter is provided the finance and in the import factor, the factor undertakes to collect the money from the buyer.

10. Bulk factoring:

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

a. The client has to look after the sales ledger administration.

b. 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 receivables to the factor after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter all the documents are handed over to the factor.

IMPORTANCE OF FACTORING

Factoring can play an important role in any developing economy. In India factoring can play an important role in development of small scale industries and thus help in employment generation, as SSI are labour intensive industries. The importance of factoring can be summarized under below given headings.

→ **In small scale industries:** Most of these units face cash flow problems because of their inability to recover the receivables and inadequate working capital often caused by delayed collection of accounts receivable and therefore need factoring services.

→ **Export traders:** Export traders go for factoring services on account of the availability of additional services and it may be extremely useful to small scale exporters and new entrants.

→ **Prevention of industrial sickness:** The incidence of industrial sickness in India has been on the rise during the last decade. Any of the medium and small units may not have been in red if they had been able to recover their dues in time. Most of these units face cash

flow problems because of mounting overdue accounts and therefore need factoring services.

- → For the timely collection of receivables to meet the working capital problems forced by the seller.

CONCEPT OF FACTORING IN INDIA

In India the idea of providing factoring services was first thought of by the Vaghul working group. It had recommended that banks and private non banking financial companies should be encouraged to provide factoring services with a view to helping the industrialists and traders to tide over their financial crunch arising out of delays in the realization of their book debts. Kalyanasundaram study group was set up in Jan 1988 under the chairmanship of Mr C.S Kalyanasundaram , former MD of the SBI, by RBI to examine the feasibility of starting banking services. On the recommendations 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.

On the initiation of the RBI four of five zonal organizations are set up as subsidiaries of the SBI and other nationalized banks factoring has been introduced only for domestic trade and the private sector has been kept out so far. Much more has to be done in their sphere. There is a good prospect for factoring in India.

In the public interest and in the interest of banking policy, the RBI is of the view that

a. The banks should not directly undertake the business of factoring.

b. The banks may set up separate subsidiaries or invest in factoring companies jointly with other banks.

c. Joint venture factoring company may undertake the factoring business but should not finance other factoring companies.

d. The banks can invest in the in the shares of factoring companies not exceeding 10% of the paid up capital and reserve of the bank concerned.

But recently in Feb 1994, the RBI has permitted all banks to enter in to the factoring business departmentally and it has further stipulated that

1. Factoring should be treated on par with loans and advances and should accordingly be given risk weight of 100% for calculation of capital to risk asset ratio.

2. A banks exposure shall not exceed 25% of the banks capital funds to an individual borrower and 50% to a group of borrowers.

3. Factoring services should be provided only in respect of those invoices which represent genuine trade transactions.

Forfeiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium-term deferred basis.

FORFAITING-MEANING

Forfaiting in French means to give up one's right. Thus, in forfaiting the exporter hands over the entire export bill with the forfaiter and obtains payments. The exporter has given up his right on the importer which is now taken by the forfaiter. By doing so, the exporter is benefited as he gets immediate finance for his exports. The risk of his exports is now borne by the forfaiter. In case if the importer fails to pay, recourse cannot be made on the exporter.

Definition:

Forfaiting 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'.

Forfaiting Overview

Forfaiting is an excellent tool for raising trade financing very quickly and with little fuss. a common method of financing international trade that provides cash to exporters in return for selling their medium and long-term foreign accounts receivable. The accounts are sold to a forfaiter, a specialized financier or bank that performs non-recourse export financing through the purchase of medium and long-term trade receivables, at a discount without recourse.

Forfaiting Key Points

- Forfaiting eliminates virtually all risk to the exporter, with 100 percent financing of contract value
- Exporters can offer medium and long-term financing in markets where the credit risk would otherwise be too high
- Suitable for exports of capital goods, commodities and large projects on medium and long-term credit
- Forfaiting generally works with bills of exchange, promissory notes, or a letter of credit
- Financing can be arranged on a one-shot basis in any of the major currencies, usually at a fixed interest rate
- Forfaiting can be used in conjunction with officially supported credits backed by export credit agencies
- In most cases, foreign buyers must provide a bank guarantee in the form of a letter of guarantee or letter of credit

Description of Forfaiting

Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount on a "without recourse" basis. A forfaiter is a specialized finance firm or a department in a bank that performs non-recourse export financing through the purchase of medium and long-term trade receivables. "Without recourse" or "non-recourse" means that the forfaiter assumes and accepts the risk of non-payment. Similar to factoring, forfaiting virtually eliminates the risk of non-payment, once the goods have been delivered to the foreign buyer in accordance with the terms of sale. However, unlike factors, forfaiters typically work with exporters who sell capital goods and commodities, or engage in large projects and therefore need to offer extended credit periods from 180 days to seven years or more. In forfaiting, receivables are normally guaranteed by the importer's bank, which allows the exporter to take the transaction off the balance sheet to enhance key financial ratios. The current minimum transaction size for forfaiting is $10 million. In the United States, most users of forfaiting are large established corporations, but small and medium-size companies are slowly embracing forfaiting as they become more aggressive in seeking financing solutions for exports to countries considered high risk.

Cost of Forfaiting

The cost of forfaiting to the exporter is determined by the rate of discount based on the aggregate of the LIBOR (London inter bank offered rate) rates for the tenor of the receivables and a margin reflecting the risk being sold. In addition, there are certain costs that are borne by the importer that the exporter should also take into consideration. The degree of risk varies based on the importing country, the length of the loan, the currency of the transaction, and the repayment structure–the higher the risk, the higher the margin and therefore the discount rate. However, forfaiting can be more cost-effective than traditional trade finance tools because of the many attractive benefits it offers to the exporter.

How Forfaiting Works

The exporter approaches a forfaiter before finalizing the transaction's structure. Once the forfaiter commits to the deal and sets the discount rate, the exporter can incorporate the discount into the selling price. The exporter then accepts a commitment issued by the forfaiter, signs the contract with the importer, and obtains, if required, a guarantee from the importer's bank that provides the documents required to complete the forfaiting. The exporter delivers the goods to the importer and delivers the documents to the forfaiter who verifies them and pays for them as agreed in the commitment. Since this payment is without recourse, the exporter has no further interest in the financial aspects of the transaction and it is the forfaiter who must collect the future payments due from the importer.

FORFAITING PROCESS OR PARTIES INVOLVED IN FORFAITING

1. Before resorting to forfaiting, the exporter approaches the forfaiting company with the details of his export and the details of the importer and the importing country.

2. On approval by the forfaiter, along with the terms and conditions, a sale contract is entered into between the exporter and importer.

3. On execution of the export, the exporter submits the bill to the forfaiter and obtains payment. In this way, the three parties involved in the forfaiting process are the exporter, the importer and the forfaiter.

4. If the exports are done against Document Acceptance Bill, it has to be signed by the importer and since the importer's bank has guaranteed through the L/C, it will be easy for the forfaiter to collect payment.

5. All the trade documents, connected with exports, are handed over by the exporter to his bank which in turn hands over the documents to the importer's bank.

6. The proof of all these documents will be submitted by the exporter to the forfaiter who will make payment for the export.

7. The cost of forfaiting is included in the bill. The exporter may not lose much as the interest will be included in the invoice and recovered from the importer. However, the forfaiter is exposed to the risk of fluctuations in the exchange rate, interest rate and commercial risk, and to cover these risks, he charges suitably.

ADVANTAGES OF FORFAITING

Forfaiting is one of the most suitable forms for financial trade financing. Forfaiting does not limit the effect only in solving liquidity problems, but this kind of instrument influences the management of all risks faced by the exporting companies during the late payment collection. Forfaiting can be an alternative to export credit or insurance cover, particularly for those transactions in which export credit agency is not open to a certain place and / or bank.

- It converts deferred payment exports into a cash transaction, improving liquidity and cash flow.
- Forfaiting simplifies the transaction by transforming a credit-based sale into a cash transaction. This credit-to-cash process gives immediate cash flow for the seller and eliminates collection costs.
- Forfaiting is flexible. A forfaiter can tailor its offering to suit an exporter's needs and adapt it to a variety of international transactions.
- It absolves exporter from cross-border political or commercial risk associated with export receivable.
- It finances upto 100% of the export value as compared to 80-85% financing available under conventional export credit.

- It acts as an additional source of funding and hence does not have any impact on the exporter's borrowing limits. It does not reflect as debt in exporter's balance sheet.
- It provides fixed rate finance and hence automatically hedges against interest and exchange rate fluctuation arising from deferred export credit.
- Exporters can use forfaiting in place of credit or insurance coverage for a sale. Forfaiting is helpful in situations where a country or a specific bank within the country does not have access to an export credit agency (ECA).

DISADVANTAGES OF FORFAITING

Forfaiting mitigates risks for exporters, but it is generally more expensive than commercial lender financing leading to higher export costs. These higher costs are generally pushed onto the importer as part of the standard pricing.

Some discrimination exists where underdeveloped countries are concerned compared to Western countries. For example, only selected currencies are taken for forfaiting because they have international liquidity. Lastly, there is no International Credit Agency that can provide guarantees for forfaiting companies. This lack of guarantee affects long-term forfaiting.

DIFFERENCES BETWEEN FACTORING AND FORFAITING

Though financial transactions involved in 'factoring' and 'forfaiting' appears alike, these two terms are different in their nature, perception and scope.

From the below table, let us find out the key difference between factoring and forfaiting;

FACTORING	**FORFAITING**
Factoring is a financial arrangement whereby a supplier of goods sells its **trade receivables** to the factor at discounted price for immediate cash payment.	Forfaiting is **relinquishing the right** (selling the **claim)** on trade receivables by an exporter to a forfeiter at discounted price for immediate cash payment.
Factoring can be with or without recourse	Forfaiting is always without recourse

Factoring refers to discounting of trade receivables of short maturities.	Although discounted receivables often have maturities over medium terms of 1 to 3 years they can be as short as 1 month or as long as 10 years.
Factoring involves trade receivable on ordinary goods.	Forfaiting usually takes place on trade receivable on capital goods, but it can be applied to a wide range of trade related and even purely financial receivables and payment instruments.
Factoring transaction does not set up in Negotiable Instrument.	Forfaiting establishes on negotiable instrument.
Factoring does not deal in secondary market.	Forfaiting may involve dealing in secondary market
Factor disburses payment of the invoices immediately to the customer, which will be usually up to 80% of their value,	The exporter gets 100 percent financing , and also escapes from various types of risks involved in export business viz. interest rate risk, currency risks, credit risk and political risk etc. involved in deferred payments.

FORFAITING IN INDIA

For a long time, Forfaiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of Export-Import Banks, since 1994 forfaiting is available on liberalized basis.

The EXIM bank undertakes forfaiting for a minimum value of Rs. 5 lakhs. For this purpose, the exporter has to execute a special Pronote in favor of the EXIM bank. The exporter will first enter into an agreement with the importer as per the quotation given to him by the EXIM bank. The EXIM bank on its part, gets quotation from the forfaiting agency abroad. Thus, the entire forfaiting process is completed by exporter agreeing to the terms of the EXIM bank and signing the Pronote.

Forfaiting business in India will pick up only when there is trading of foreign bills in international currencies in India for which the value of domestic currency has to be strengthened.

This would be possible only with increasing exports. At present, India's share stands at 1.7 percent in the world exports. Perhaps, this will bring a push to the forfaiting market.

However, in order to encourage forfeiting finance business, it is necessary to designate export contracts in leading international currencies. In the wake of economic liberalization and opening of our economy to the global market, there are good prospects for forfeiting business in India. To promote forfeiting business, it is essential that we should denominate our trade contracts in foreign currencies rather than in Indian rupees. Now, since the rupee has gained strength, it is time for us to denominate our trade obligations in foreign currencies so that the pace of forfeiting business may be accelerated mainly to boost our export trade.

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