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FINANCIAL SERVICES
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INTRODUCTION

The Indian financial services industry has undergone a metamorphosis since1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry. In fact, one of the world's largest industries today is the financial services industry. Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation.

MEANING OF FINANCIAL SERVICES

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilisation and allocation of savings. Thus, it includes all activities involved in the transformation of savings into investment. Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organisations that deal with the management of money.

These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises. Financial services may be defined as the products and services offered by financial institutions
for the facilitation of various financial transactions and other related activities.

FUNCTIONS OF FINANCIAL SERVICES

1. Facilitating transactions (exchange of goods and services) in the economy.
2. Mobilizing savings (for which the outlets would otherwise be much more limited).
3. Allocating capital funds (notably to finance productive investment).
4. Monitoring managers (so that the funds allocated will be spent as envisaged).
5. Transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

CHARACTERISTICS OR NATURE OF FINANCIAL SERVICES

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

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

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

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

4. Variability: In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers. The service institutions differentiate their services to develop their individual identity.

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

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

IMPORTANCE OF FINANCIAL SERVICES

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

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

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

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

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

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

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

TYPES OF FINANCIAL SERVICES

Financial service institutions render a wide variety of services to meet the requirements of individual users.

These services may be summarized as below:

1. Provision of funds:

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

2. Managing investible funds:

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

3. Risk financing:
(a) Project preparatory services
(b) Insurance
(c) Export credit guarantee

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

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

6. Research and development:
(a) Equity and market research
(b) Investor education
(c) Training of personnel
(d) Financial information services

SCOPE OF FINANCIAL SERVICES

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

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

Fund based Services

The fund based or asset based services include the following:

1. Underwriting
2. Dealing in secondary market activities
3. Participating in money market instruments like CPs, CDs etc.

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4. Equipment leasing or lease financing
5. Hire purchase
6. Venture capital
7. Bill discounting.
8. Insurance services
9. Factoring
10. Forfaiting
11. Housing finance
12. Mutual fund

Non-fund based Services

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

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

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

A. Asset/Fund Based Services

1. Equipment leasing/Lease financing: A lease is an agreement under which a firm acquires a right to make use of a capital asset like machinery etc. on payment of an agreed fee called lease rentals. The person (or the company) which acquires the right is known as lessee. He does not get the ownership of the asset. He acquires only the right to use the asset. The person (or the company) who gives the right is known as lessor.

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

3. Bill discounting: Discounting of bill is an attractive fund based financial service provided by the finance companies. In the case of time bill (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer's account. Thus, the bank

purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In short, discounting of bill means giving loans on the basis of the security of a bill of exchange.

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

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

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

According to Mc Gill, "Insurance is a process in which uncertainties are made certain". In the words of Jon Megi, "Insurance is a plan wherein persons collectively share the losses of risks". Thus, insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join themselves against such an event. The document which contains all the terms and conditions of insurance (i.e. the written contract) is called the 'insurance policy'. The amount for which the insurance policy is taken is called 'sum assured'. The consideration in return for which the insurer agrees to make good the loss is known as 'insurance premium'. This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

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

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

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

Non-Fund Based/Fee Based Financial Services

1. Merchant banking: Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

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

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

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

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

FINANCIAL SYSTEM

A **financial system** (within the scope of finance) is a system that allows the exchange of funds between lenders, investors, and borrowers. Financial systems operate at national, global, and firm-specific levels. They consist of complex, closely related services, markets, and institutions intended to provide an efficient and regular linkage between investors and depositors. Money, credit, and finance are used as media of exchange in financial systems. They serve as a medium of known value for which goods and services can be exchanged as an alternative to bartering.

A modern financial system may include banks (operated by the government or private sector), financial markets, financial instruments, and financial services. Financial systems allow funds to be allocated, invested, or moved between economic sectors. They enable individuals and companies to share the associated risks.

The formal financial system consists of four components:

1. Financial institutions,
2. Financial markets,
3. Financial instruments and
4. Financial services.

The financial system acts as a connecting link between savers of money and users of money and thereby promotes faster economic and industrial growth. Thus financial system may be defined as "a set of markets and institutions to facilitate the exchange of assets and risks." Efficient functioning of the financial system enables proper flow of funds from investors to productive activities which in turn facilitates investment.

various functions of financial system

1. Mechanism for mobilising savings
2. Mechanism for storing wealth
3. Liquidity
4. Credit mechanism
5. Payment system
6. Risk management
7. Policy implementation
8. Information provider

FINANCIAL INTERMEDIARIES

A financial intermediary is an institution which connects the deficit and the surplus. The best example of an intermediary can be a bank which transforms the bank deposits to bank loans. The role of financial intermediary is to channel funds from people who have extra inflow of money i.e., the savers to those who do not have enough money to fulfill the needs or to carry out the basic activities i.e. the borrowers.

FUNCTIONS OF FINANCIAL INTERMEDIARIES

Functions of Financial Intermediary are basically classified in three parts which are as follows:

Maturity transformation – Deals with the conversion of short-term liabilities to long term assets.

Risk transformation – Conversion of risky investments into relatively risk-free ones.

Convenience denomination – Way of making the unmatched matching which is matching small deposits with large loans and large deposits with small loans. Financial Intermediaries are classified into two types namely, Depository and Non- Depository Institutions.

FINANCIAL ASSETS

These assests are used for production or consumption or further creation of assests. The financial assests are the claims of money and perfoms some functions of money. They have high degree of liquidity but not as liquid as money has. The financial assest is different from physical assests. Financial assests are useful for further production of goods or for earning income. The physical assests are not useful for further production or for earning income.

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Classification Of Financial Assets.

Financial assets can be classified in different ways.

Primary assets- those are the financial claim against real sector units created by themselves for raising funds to finance their deficient spending. They are the ultimate borrowers. Eg bills, bonds, equities etc are primary assets.

Secondary assets- these are financial claims issued by financial institution against themselves to raise funds from the public. These assests are the obligations of financial institution. Eg bank deposits, life insurance policies, UTI units etc are secondary assests.

Another classification is

Marketable assests-These are the financial assests which can be transferred from person to person without difficulty. It consist of shares, government securities, bonds, mutual funds units, UTI units, bearer debentures etc.

Non marketable assests- These are financial assests which cannot be transferred easily. It consists of bank deposits, provident funds, LIC schemes, company deposits ,Post office certificates.

Another classification is

Cash assests- Money assests consist of coins and currency notes and created money. reserve bank has the sole authority to issue currencies.

Debt asset- different type of organization issues debt assets for raising their debt capital. There is a fixed time schedule for payment of principal and interest. Debt capital is raised by way of issuing debentures or bonds, raising long term loans etc.

Stock asset- Corporate issue stocks for the purpose of raising their fixed capital. There are mainly two types of stocks such as preference and equity stock. Equity stock holders are the real owners of the organization. Preference shareholders have a preferential right to get a fixed percentage of dividends if there is a profit.

PRIMARY MARKET

The primary market is the part of the capital market that deals with the issuance ad sale of equity-backed securities to investors directly by the issuer. investors buy Securities that were never traded before. Primary markets create long term instruments through which corporate entities raise funds from the capital market it also known as the new issue market.

FEATURES OF NEW ISSUE MARKET

1. It is the market for new long term capital.
2. The securities are issued by company for the first time directly to the investors.
3. On receiving the money from new issues, the comany will issue the security certificates to the investors.
4. The amount obtained by the company after the new issues are utilized for expansion of the present business or for setting up new ventures.
5. External finance for long term such as loan from financial institutions is not included in new issue market. There is an option called “going public” in which the borrowers in new issue market raise capital for converting private capital into public capital.
6. The financial assests sold can be redeemed by the original holder of security.

FUNCTION OF NEW ISSUE MARKET

The main function of a new issue market can be divided into three service functions:

Origination: It refers to the work of investigation, analysis and processing of new project proposals. this function is done by merchant bankers who may be commercial banks, all India financial institutions or private firms.the success of the issue depends to a large extent on the efficiency of the market.

Underwriting: It is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. underwriting is a guarantee for marketability of shares. There are two types of underwriters in India- Institutional (LIC,UTI, IDBI,ICICI) and Non- institutional are brokers.

Distribution: It is the function of sale of securities to ultimate investors. This is performed by specialized agencies like brokers and agents who maintain a regular and direct contact with the ultimate investors.

ROLE OF NEW ISSUE/ PRIMARY MARKET

Capital Formation: It provides attractive issue to the potential investors and with this company can raise capital at lower costs.

Liquidity: As the securities issued in primary market can be immediately sold in secondary market. The rate of liquidity of securities is higher.

Diversification of Risk: Many financial intermediaries invest in primary market, as ther e is less risk of failure in investment as the company does not depend on a single investor.it reduces the overall risk.

Reduction in Cost: Prospectus containing all details about securities are given to the investors.

SEBI GUIDELINES FOR ISSUE OF SECURITIES

The guidelines were first issued on 11th June 1992 and were amended subsequently from time to time. SEBI has now issued consolidated guidelines as SEBI (Disclosure and investor protection) Guidelines, 2000 vide its circular No . 1 dated 19-01-2000. These guidelines shall be applicable to all public issues by listed and unlisted companies all offers for sale and rights issues by listed companies whose equity share Capitalist listed, except in case of rights issues where the aggregate value of securities offered does not exceed 50 lacs. Broadly there are three methods for issuing securities to the public.

1. Conventional mode of receiving applications through bankers.
2. Book building.
3. On line system of stock exchange.

ADVANTAGES OF NEW ISSUE/ PRIMARY MARKET

1. Mobilisation of savings.
2. Chanelizing savings for productive use.
3. Source of large supply of funds.
4. Rapid industrial growth.

DISADVANTAGES OF NEW ISSUE/ PRIMARY MARKET

1. Possibility of deceiving investors.
2. No fixed norms for project appraisal.

3. Ineffective role of merchant bankers.
4. Lack of confidence among investors.

SECONDARY MARKET OR STOCK MARKET

Stock market represents the secondary market where existing securities are traded. Stock exchanges are organised and regulated markets for various securities issued by corporate sector and other institutions.

DEFINITION OF SECONDARY MARKET

- As per Hartely withers, " a stock exchange is something like a vast warehouse where securities are taken away from the shelves and sold across the countries at a fixed price in a catalogue which is called the official list".
- Husband and Dockery-" securities or stock exchanges are privately organized markets which are used to facilitate trading in securities"

CHARACTERISTICS OF SECONDARY MARKET/ STOCK EXCHANGE

Salient features of stock exchange are:

- It is a place where securities are purchased and sold.
- A stock exchange is an association of persons whether incorporated or not.
- The trading in a stock exchange is strictly regulated.
- Both genuine investors and speculators buy and sell shares.
- The securities of corporations, trusts, governments, municipal corporations etc. are both allowed to be dealt at stock exchange.

FUNCTIONS OF SECONDARY MARKET / STOCK EXCHANGE

The functions of secondary market are:

1. Ensure liquidity of capital.
2. Regular market for securities.
3. Evaluation of securities.
4. Mobilising surplus savings.
5. Helpful in raising new capital.
6. Safety in dealing.
7. Listing of securities.
8. Platform for public dept.
9. Clearing house of business information.
10. Smoothens the price movements.
11. Investors protection.

Financial Markets

- ❖ Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services.
- ❖ It caters the credit needs of the individuals, firms and institutions.It deals with the financial assets of different types such as currency deposits, cheques, bills, bonds etc. it is defined as a transmission mechanism between investors and the borrowers through which transfer of funds is facilitated.

- It consists of individual investors, financial institutions and other intermediaries who are linked by a formal trading rules and communication network for trading the various financial assets and credit instruments.

Nature Of Financial Market

Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services. Financial markets are critical for producing an efficient allocation of capital, allowing funds to move from people who lack productive investments opportunities to people who have them. It caters the credit needs of the individuals, firms and institutions. Financial market deals with the financial assets or instrunents of different types such as currency deposits, cheques, bills, bonds etc. the main participants in the financial markets are financial institutions, agents, brokers, dealers, borrowers, savers,lenders and others who are interconnected by law, contract and communication networks. The important role performed by a financial market is described below.

- They generate and apportion credits.
- They serve as intermediaries in the process of mobilization of savings.
- They provides convenience and benefits to the lender and borrowers.

They promote the economic development through a balanced regional and sectoral allocation of investible funds.

FUNCTION OF FINANCIAL MARKETS

Financial markets serve six basic functions. They are briefly listed below.

1. Borrowing and Lending : Financial markets permit the transfer of funds from one agent to another for either investment or consumption purposes.

2. Price Determination: It provides means by which prices are set both for newly issued financial assets and for the existing stock of financial assets.

3. Information Aggregation and Coordination: It acts as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.

4. Risk Sharing: It allow a transfer of risk from those who undertake investments to those who provide funds for those investments.

5. Liquidity: It provides the holders of financial assets with a chance to resell or liquidate these assets.

6. Efficiency: It reduce transaction costs and information costs.

TYPES OF FINANCIAL MARKETS

1. Money Market: it is a market for short-term funds normally up to one year. It refers to the institutional arrangement which deals with the short term borrowing and lending of funds. It is a short-term credit market.

2. Capital Markets: it is a market for issue and trading of long-term securities. The term to maturity should be longer than 3 years. The securities traded in capital market are informally classified into short-term, medium-term, and long-term securities depending on their term to maturity. It is market for long term borrowing and lending of funds.

3. Financial Mortgages Market: It is a market through which mortgage loans are granted to individual customers. Mortgage loans are granted against immovable property like real estate. Mortgage is the transfer of an interest in the specific immovable property for the purpose of securing loans. The

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transferor is called mortgager and transferee is called mortgagee. The common type of mortgage loan, which are seen in India is residential mortgages, housing Development Corporation, National Housing Bank, Housing Finance Companies and Life Insurance Corporation are prominent players in financing residential projects.

4. Financial Guarantees Market: The financial guarantee market is an independent market. It is a financial service market. It is the centre where finance is provided against the guarantee of a reputed person in the financial circle.There are many types of guarantees.The common forms are

- **Performance guarantee**: It covers the payment of earnest money, retention money, advance payments etc. these quarantees are given by the banks to government or public bodies on behalf of on tractors undertaking to pay the penalty in the event of the non-fulfillment o the contract.
- **Financial guarantees:** It covers only financial contracts. The main sources of guarantee in India are.
  - a) Personal guarantee.
  - b) Government guarantee.
  - c) Institutional guarantee.

5. Foreign Exchange Market: Foreign exchange refers to the process of conversion of home currencies into foreign currencies and vice versa. According to Kindle Berger: Foreign exchange market is a place where foreign moneys are bought and sold. This market deals with exchange of foreign currency, notes , coins and bank deposits denominated in foreign currency units and liquid claims like drafts, traveler's cheques, letters of credit and bills of exchange expressed in Indian rupee but payable in foreign currency.In india foreign exchange market is the privilege of the Reserve Bank of India.Foreign Exchange Regulation Act (FERA) was passed by the Government of India in 1947, which was later modified in 1973 to regulate foreign exchange market.

MERCHANT BANKING

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

MEANING AND DEFINITION OF MERCHANT BANKING

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services. The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking. We can define merchant banking as a process of transferring capital from those who own it to those who use it.

According to Random House Dictionary, "merchant bank is an organization that underwriters securities for corporations, advices such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks".

According to SEBI (Merchant Bankers) Rules 1992, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering corporate advisory services in relation to such issue management". In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

DIFFERENCE BETWEEN MERCHANT BANK AND COMMERCIAL BANK

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

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

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

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

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

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

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

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

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

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

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

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

(f) Monitoring of rehabilitation schemes.

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

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

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

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

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

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

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

(f) Identification of potential investment avenues.

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

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

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

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

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

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

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

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

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

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

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

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

d) Selecting institutions and banks for participation in financing.

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

(f) Arranging bridge finance.

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

(h) Assessing working capital requirements.

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

(a) Public issue through prospectus.

(b) Marketing and underwriting.

(c) Pricing of issues.

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

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

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

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

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

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

(a) Undertaking investment in securities.

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

(c) Providing advice on selection of investments.

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

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

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

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

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

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

'Foreign Currency Finance'. The provision of foreign currency finance takes the form of export import trade finance, euro currency loans, Indian joint ventures abroad and foreign collaborations. The main areas that are covered in this type of merchant activity are as follows:

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

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

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

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

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

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

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

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

(a) Assessment of working capital requirements.

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

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

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

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

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

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

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

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

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

The functions of merchant banker can be summarized as follows:

(a) Issue management.

(b) Underwriting of issues.

(c) Project appraisal.

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

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(e) Dealing in foreign exchange.
(f) Floatation of commercial paper.
(g) Acting as trustees.
(h) Share registration.
(i) Helping in financial engineering activities of the firm.
(j) Undertaking cost audit.
(k) Providing venture capital.
(l) Arranging bridge finance.
(m) Advising business customers (i.e. mergers and takeovers).
(n) Undertaking management of NRI investments.
(o) Large scale term lending to corporate borrowers.
(p) Providing corporate counseling and advisory services.
(q) Managing investments on behalf of clients.
(r) Acting as a stock broker.

OBJECTIVES OF MERCHANT BANKING

The objectives of merchant banking are as follows:

1. To help for capital formation.
2. To create a secondary market in order to boost the industrial activities in the country.
3. To assist and promote economic endeavour.
4. To prepare project reports, conduct market research and pre-investment surveys.
5. To provide financial assistance to venture capital.
6. To build a data bank as human resources.
7. To provide housing finance.
8. To provide seed capital to new enterprises.
9. To involve in issue management.
10. To act as underwriters.
11. To identify new projects and render services for getting clearance from government.
12. To provide financial clearance.
13. To help in mobilizing funds from public.
14. To divert the savings of the country towards productive channel.
15. To conduct investors conferences.
16. To obtain consent of stock exchange for listing.
17. To obtain the daily report of application money collected at various branches of banks.
18. To appoint bankers, brokers, underwrites etc.
19. To supervise the process on behalf of NRIs for their ventures.
20. To provide service on fund based activities.
21. To assist in arrangement of loan syndication.
22. To act as an acceptance house.
23. To assist in and arrange mergers and acquisitions.

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ROLE OF MERCHANT BANKERS IN MANAGING PUBLIC ISSUE

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

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

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

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

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

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

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

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

MERCHANT BANKING IN INDIA

- Prior to the enactment of Indian Companies Act, 1956, managing agents acted as merchant bankers. They acted as issue houses for securities, evaluated project reports, provided venture capital for new firms etc. Few share broking firms also functioned as merchant bankers. With the rapid growth in the number and size of the issues made in the primary market, the need for specialized merchant banking service was felt.
- Grindlays Bank (foreign bank) opened its merchant banking division in 1967, followed by Citibank in 1970.
- SBI started its merchant banking division in 1972 and it followed up by setting up a fully owned subsidiary in 1980, namely SBI Capital Markets Ltd.
- The other nationalized banks and financial institutions, like IDBI, IFCI, ICICI, Securities and Finance Company Ltd., Canara Bank (Can Bank Financial Services Ltd.), Bank of India (BOI Finance Ltd.) and private sector financial companies, like JM Financial and Investment Consultancy Services Ltd., DSP Financial Consultancy Ltd. have also set up their merchant banking divisions. With over 1,100 merchant bankers operating in the country, the primary market activity is picking up.
- Merchant banking services have assumed greater importance in the present capital market scenario. With the investor becoming more cautious and discerning, the role of merchant banker has gained more prominence.
- In India, apart from the overall control by the RBI, merchant bankers' operations are closely supervised by the SEBI for their proper functioning and investor protection.

PARCAS

SETTING UP AND MANAGEMENT OF MERCHANT BANKS IN INDIA

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

a) Institutional Base:-

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

b) Banker Base:-

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

c) Broker Base:-

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

d) Private Base:-

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

CATEGORIES OF MERCHANT BANKS

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

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

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

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

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

WEAKNESS OF MERCHANT BANKS / PROBLEMS OF MERCHANT BANKS

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

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

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

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

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

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

LEASE FINANCING

MEANING OF LEASING

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

Lease can be defined as the following ways:

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.
2. The document in which this contract is written.
3. A great way companies can conserve capital.
4. An easy way vendors can increase sales.

IMPORTANCE OF LEASE FINANCING

Lease financing is based on the observation made by Donald B. Grant: “Why own a cow when the milk is so cheap? All you really need is milk and not the cow.”

Leasing industry plays an important role in the economic development of a country by providing money incentives to lessee.

The lessee does not have to pay the cost of asset at the time of signing the contract of leases. Leasing contracts are more flexible so lessees can structure the leasing contracts according to their needs for finance.

The lessee can also pass on the risk of obsolescence to the lessor by acquiring those appliances, which have high technological obsolescence.

Today, most of us are familiar with leases of houses, apartments, offices, etc.

THE ADVANTAGES OF LEASING INCLUDE:

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

b. Leasing enables businesses to preserve precious cash reserves.

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

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

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

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

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

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

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

j. 'ease instalments are exclusively material costs.

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

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

LIMITATION OF LEASING

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

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

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

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

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

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

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

TYPES OF LEASE

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

1) Financial lease

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of

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the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease‘. In India, f’nancial leases are very popular with high-cost and high technology equipment.

2) Operational lease

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

3) Sale and lease back

It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement.

4) Leveraged leasing

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

5) Direct leasing

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

Other types of leasing:

1) First Amendment Lease:

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

2) Full Payout Lease:

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

3) Guideline Lease:

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

4) Net Lease:

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

5) Open-end Lease:

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

6) Sales-type Lease:

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

7) Synthetic Lease:

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

8) Tax Lease:

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

9) True Lease:

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

DIFFERENCES BETWEEN FINANCIAL LEASE AND OPERATING LEASE

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

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

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

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

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

REGULATORY FRAME WORK FOR LEASING IN INDIA

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

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

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

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

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

CONTENTS OF A LEASE AGREEMENT:

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

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

PROBLEMS OF LEASING IN INDIA

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

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

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

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

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

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

HIRE PURCHASE

CONCEPT AND MEANING OF HIRE PURCHASE

Hire purchase is a type of installment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as "An agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

1) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic installments.

2) The property in the goods is to pass to such person on the payment of the last of such installments, and

3) Such person has a right to terminate the agreement at any time before the property so passes".

LEGAL FRAMEWORK OF HIRE PURCHASE TRANSACTIONS

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

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

RIGHTS OF THE HIRER

The hirer usually has the following rights:

1. To buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate

2. To return the goods to the owner —this is subject to the payment of a penalty.

3. with the consent of the owner, to assign both the benefit and the burden of the contract to a third person.

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

Additional rights-

1. Rights of protection
2. Rights of notice

3. Rights of repossession
4. Rights of Statement
5. Rights of excess amount

Obligations of hirer

The hirer usually has following obligations:

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

Owner's rights

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

This entitles the owner:

1.To forfeit the deposit.

2. To retain the installments already paid and recover the balance due.

3. To repossess the goods (which may have to be by application to a Court depending on the nature of the goods and the percentage of the total price paid.

4. To claim damages for any loss suffered.

FEATURES OF HIRE PURCHASE

1. **Immediate possession-**under HP, the buyer takes immediate possession of goods by paying only a portion of its price.

2. Hire Charges- under HP, each instalment is treated as hire charges.

3. Property in goods - ownership is–passed to the hirer only after paying last or specified number of instalments

4. Down payment- hirer has to pay 20 to 25% of asset price to the vendor as down payment.

5. Repossession- Hire vendor, if default in payment of instalment made by hirer, can reposes the goods and he can resell the goods.

6. Return of goods- hirer is free to return the goods without being required to pay further instalment falling due after the return.

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

DIFFERENCES BETWEEN LEASE AND HIRE PURCHASE

1. Ownership- in lease, ownership rests with the lessor throughout and the hirer of the goods not becomes owner till the payment of specified instalments.

2. Method of financing- leasing is a method of financing business assets whereas HP is financing both business and non-business assets.

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

4. Tax benefits- the entire lease rental is tax deductible expense. Only the interest component of the HP instalment is tax deductible.

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

6. Deposit- lessee is not required to make any deposit whereas 20% deposit is required in HP.

7. Nature of deal - with lease w– rent and with HP we buy the goods.

8. **Extent of Finance**- in lease financing is 100 % financing since it is required down payment, whereas HP requires 20 to 25% down payment.

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

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

RBI GUIDELINES FOR HIRE PURCHASE BUSINESS

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

1. Banks shall not themselves undertake directly (departmentally) the business of hire purchases.

2. Banks desirous of undertaking HP business through an existing companies or new subsidiaries will require prior approval of RBI.

3. Banks investments in the shares of subsidiaries engaging in leasing and HP business shall not exceed 10% of the paid up share capital and reserves of the banks.

4. Without prior approval of RBI, banks shall not act as promoters of other hire purchase companies.

5. Prior clearance of RBI is required for the purpose of any application to the Controller of Capital issue in case of IPO of new subsidiary and FPO of existing subsidiaries of Banks.

6. Bank shall furnish necessary information regarding its HP or equipment leasing subsidiaries, as and when RBI demands.

ADVANTAGES OF HIRE PURCHASE:

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

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

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

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

5. Debt solutions -Consumers tha– buy on credit can pursue a debt solution, such as debt engagement plan, should they experience money problems further down the line.

PROBLEMS OF HIRE PURCHASE BUSINESS IN INDIA

Hire purchase transactions are very uncommon transactions in India. Meaning there by the awareness of this concept is very lesser in India. All segment of India's population treat the hirepurchase transaction as a hypothecation loan but there is a slight differentiation among all processes related to hire purchases. Almost for the population of India the hire purchase transaction is very similar to the loans & hypothecation. Person who wants to purchase any asset then the best option & way for him or her would be loan or hypothecation. Because the public is not aware with transaction named hire purchases. Hire purchase transaction is of two types the cash credit & asset hire purchases. People do not go for hire purchases in India because in India business people are very less so they can not hire the assets for a longer period of

time. Finally, we would like to end up over here that, lack of awareness leads to occurrence of problem in dealing with hire purchase. Other problems of HP are as follows:

1. Personal debt - A hire purch–se agreement is yet another form of personal debt it is monthly repayment commitment that needs to be paid each month;

2. Final payment - A consumer d–esn't have legitimate title to the goods until the final monthly repayment has been made;

3. Bad credit - All hire pur–hase agreements will involve a credit check. Consumers that have a bad credit rating will either be turned down or will be asked to pay a high interest rate;

4. Creditor harassment - Opting to bu– on credit can create money problems should a family experience a change of personal circumstances;

5. **Repossession rights** - seller is en–itled to 'snatch back' any goods when less than a third of the amount has been paid back.

MUTUAL FUNDS

MEANING OF MUTUAL FUNDS

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

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

DEFINITION OF MUTUAL FUNDS

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

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

FEATURES OF MUTUAL FUNDS

Mutual fund possesses the following features:

1. Mutual fund mobilizes funds from small as well as large investors by selling units.
2. Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.
3. Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.
4. Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.
5. Mutual fund provides switching facilities to investors who can switch from one scheme to another.

6. Various schemes offered by mutual funds provide tax benefits to the investors.
7. In India mutual funds are regulated by agencies like SEBI.
8. The cost of purchase and sale of mutual fund units is low.
9. Mutual funds contribute to the economic development of a country.

TYPES OF MUTUAL FUNDS

These may be briefly described as follows:

A. On the basis of Operation

1. Close ended funds:

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

Features of Close ended Funds

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

2. Open-ended funds:

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

Features of Open-ended Funds

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

Difference between Open-ended and Close-ended Schemes

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

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

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

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

B. On the basis of return/ income

1. Income fund:

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

Features of Income Funds

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

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

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

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

(e) It focuses on short run gains only.

2. Growth fund:

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

Features of Growth Funds

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

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

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

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

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

3. Conservative fund:

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

C. On the basis of Investment

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

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

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

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

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

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

from the borrowed funds are more than the cost of the borrowed funds. The gains are distributed to unit holders.

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

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

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

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

OBJECTIVES OF MUTUAL FUNDS

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

ADVANTAGES (IMPORTANCE) OF MUTUAL FUNDS

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

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

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

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

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

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

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

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

8. Offer tax benefits: Mutual funds offer tax benefits to investors. For instance, under section 80 L of the Income Tax Act, a sum of Rs. 10,000 received as dividend from a mutual fund (in case of UTI, it is Rs. 13,000) is deductible from the gross total income.

9. Support capital market: The savings of the people are directed towards investments in capital markets through mutual funds. They also provide a valuable liquidity to the capital market. In this way, the mutual funds make the capital market active and stable.

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

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

MUTUAL FUND RISKS

In spite of the advantages offered by mutual funds, there are some risks also. This is so because mutual funds invest their funds in the stock market on shares. These shares are subject to risks. Hence, the following risks are inherent in the dealings of mutual funds:

1. Market risks: These risks are unavoidable. These arise due to fluctuations in share prices.

2. Investment risks: Generally mutual funds make investments on the advice sought from Asset Management Company. If the advice goes wrong, the fund has to suffer a loss.

3. Business risk: Mutual funds invest mostly in equity shares of companies. If the business of the companies suffers any set back, they cannot declare dividend. Ultimately, such companies may be wound up. As a result, mutual funds will suffer.

4. Political risk: Change in government policies brings uncertainty in the economy. Every player including mutual funds has to face this risk and uncertainty.

5. Scheme risks: There are certain risks in the schemes themselves. Risks are greater in certain schemes, e.g., growth schemes.

OPERATION OF MUTUAL FUNDS

- A mutual fund invites the prospective investors to participate in the fund by offering various schemes. It offers different schemes to suit the varied requirements of the investors. The small and medium resources from the investors are pooled together.
- Then the pool of fund is divided into a large number of equal shares called units. These are issued to investors. The amount so collected is invested in capital market instruments like

shares, debentures, government bonds etc. Investment is also made in money market instruments like treasury bills, commercial papers etc.

- Usually the money is invested in diversified securities so as to minimize the risk and maximize return. The income earned on these securities (after meeting the fund expenses) is distributed to unit holders (investors) in the form of interest as well as capital appreciation. The return on the units depends upon the nature of the mutual fund schemes.

MUTUAL FUNDS IN INDIA

- In India the first mutual fund was UTI. It was set up in 1964 under an Act of parliament. During the year 1987-1992, seven new mutual funds were established in the public sector.
- In 1993, the government changed its policy to allow the entry of private corporates and foreign institutional investors into the mutual fund segment.
- Now the commercial banks like the SBI, Canara Bank, Indian bank, Bank of India, Punjab National Bank etc. have entered into the field.
- LIC and GIC have also entered into the market. By the end of March 2000, there was 36 mutual funds, 9 in the public sector and 27 in the private sector.
- However UTI dominated the mutual fund sector. In India mutual funds are being regulated by agencies like SEBI. Mutual funds play an important role in promoting saving and investment within the country.

REASONS FOR SLOW GROWTH OF MUTUAL FUNDS IN INDIA

1. There is no standard formula for calculating Net Asset Value. Different companies apply different formulae. Thus there is no uniformity in the calculation of NAV.

2. Mutual funds in India are not providing adequate information and materials to the investors. There is not good rapport between mutual funds and investors. In short, there is no transparency in the dealings of mutual funds.

3. Mutual funds are rendering poor services to investors. Hence mutual funds fail to build up investor confidence.

4. In India, most of the funds depend upon outside agencies for collecting data and conducting research.

5. In India, professional experts in security analysis and portfolio management are rare.

6. Investors do not know that units are low-risk long term investment. They do not have the patience to wait for long time to get good returns. They always want return in the short run.

PROBLEMS OF MUTUAL FUNDS IN INDIA

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

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

9. Poor risk management.

SEBI GUIDELINES ON MUTUAL FUNDS

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

1. The sponsoring company, called Sponsor: SEBI(mutual funds) Regulations define Sponsor as any person who acting alone or in combination with another body corporate, establishes a mutual fund. SBI Mutual fund is sponsored by State Bank of india, LICMF is sponsored by Life Insurance Corporation (LIC) of India. Sponsors have to comply with the following regulations laid down by SEBI.

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

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

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

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

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

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

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

c. Grant of certificate of registration.

d. Annual fee.

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

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

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

i. Maintains accounts of securities of a client.

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

iii. Maintains and reconciles the records of securities.

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

v. Prevents any manipulation of records and documents.

The following are the SEBI regulations with regard to custodian. Appointment of custodian (SEBI Regulation 26)

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

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

VENTURE CAPITAL

There are some businesses that involve higher risks. In the case of newly started business, the risk is more. The new businesses may be promoted by qualified entrepreneurs. They lack necessary experience and funds to give shape to their ideas. Such high risk, high return ventures are unable to raise funds from regular channels like banks and capital markets.

Generally people would not like to invest in new high risk companies. Some people invest money in such new high risk companies. Even though the risk is high, there is a potential of getting a return of ten times more in less than five years. The investors making such investments are called venture capitalists. The money invested in new, high risk and high return firms is called venture capital.

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

MEANING OF VENTURE CAPITAL

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

CHARACTERISTICS OF VENTURE CAPITAL

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

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

TYPES OF VENTURE CAPITALISTS

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

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

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

3. Private capital firms/funds: The primary source of venture capital is a venture capital firm. It takes high risks by investing in an early stage company with high growth potential.

METHODS OR MODES OF VENTURE FINANCING (FUNDING PATTERN)/DIMENSIONS OF VENTURE CAPITAL

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

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

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

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

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

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

STAGES OF VENTURE CAPITAL FINANCING

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

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

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

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

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

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

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

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

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

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

ADVANTAGES OF VENTURE CAPITAL

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

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

VENTURE CAPITAL IN INDIA

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

For a long time, funds raised from public were used as a source of venture capital. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from the public. In India, the need for venture capital was recognised in the 7th five-year plan and long term fiscal policy of the Government of India. In 1973, a committee on development of small and medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) – promoted by ICICI and UTI.

The first private VC fund was sponsored by Credit Capital Finance Corporation (CEF) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation, namely, Credit Capital Venture Fund. At the same time, Gujarat Venture Finance Ltd. and AFIDC Venture Capital

Ltd. were started by state-level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net worth individuals.

LEGAL ASPECTS OF VENTURE CAPITAL

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

Regulatory Structure: The SEBI regulates venture capital industry in India. It announced the regulations for the venture capital funds in 1996, with the primary objective of protecting the interest of investors and providing enough flexibility to the fund managers to make suitable investment decisions. Venture capital funds appoint an asset management company to manage the portfolio of the fund. Any company proposing to undertake venture capital investments is required to obtain certificate of registration from SEBI. Venture capital fund can invest up to 40% of the paid up capital of the invested company or up to 20% of the corpus of the fund in one undertaking.

At least 80% of funds raised by VCF shall be invested in equity shares or equity related securities issued by company whose shares are not listed on recognised stock exchange. Venture capital investments are required to be restricted to domestic companies engaged in business of software, information technology, biotechnology, agriculture, and allied sectors.

GUIDELINES FOR THE VENTURE CAPITAL COMPANIES

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

1. The financial institutions, State Bank of India, scheduled banks, and foreign banks are eligible to establish venture capital companies or funds subject to the approval as may be required from the Reserve Bank of India.
2. The venture capital funds have a minimum size of Rs. 10 crores and a debt equity ratio of 1:1.5. If they desire to raise funds from the public, promoters will be required to contribute minimum of 40% of the capital.
3. The guidelines also provide for NRI investment upto 74% on a non-repatriable basis.
4. The venture capital funds should be independent of the parent organisation.
5. The venture capital funds will be managed by professionals and can be set up as joint ventures even with non-institutional promoters.
6. The venture capital funds will not be allowed to undertake activities such as trading, broking, and money market operations but they will be allowed to invest in leasing to the extent of 15% of the total funds deployed. The investment or revival of sick units will be treated as a part of venture capital activity.
7. A person holding a position of being a full time chairman, chief executive or managing director of a company will not be allowed to hold the same position simultaneously in the venture capital fund/company.
8. The venture capital assistance should be extended to the promoters who are now, and are professionally or technically qualified with inadequate resources.

SEBI (Venture Capital Funds) (Amendment) REGULATIONS, 2000 AND SEBI (Foreign Venture Capital Investors) REGULATIONS, 2000

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

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

(a) has a dedicated pool of capital;

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

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

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

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

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

3. Minimum contribution and fund size: The minimum investment in a Venture Capital Fund from any investor will not be less than Rs. 5 lakhs and the minimum corpus of the fund before the fund can start activities shall be at least Rs. 5 crores.

4. Investment criteria: The earlier investment criteria have been substituted by a new investment criteria which has the following requirements:

(a) Disclosure of investment strategy;

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

(c) Investment in the associated companies not permitted;

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

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

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

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

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

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

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

7. Relaxation in takeover code: The acquisition of shares by the company or any of the promoters from the Venture Capital Fund under the terms of agreement shall be treated on the same footing as that of

acquisition of shares by promoters/companies from the state level financial institutions and shall be exempt from making an open offer to other shareholders.

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

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

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

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

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

c. Investment criteria:

(i) Disclosure of investment strategy;

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

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

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

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

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

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

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

FACTORING

MEANING AND DEFINITION OF FACTORING

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

According to this agreement the factor undertakes the receivables, the credit, the collection task, and the risk of bad debt. The firm selling its receivables (client) receives the value of the receivables minus a commission charge as compensation for the risks the factor assumes. Thereafter, customers make direct payments to the factor. In some cases receivables are sold to factor at a discount. In this case factor does not get commission.

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

OBJECTIVES OF FACTORING

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

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

TYPES OF FACTORING

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

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

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

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

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

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

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

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

a) Exporter,
b) Export Factor,
c) Import Factor, and
d) Importer.

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

PROCESS OF FACTORING (FACTORING MECHANISM)

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

FEATURES (NATURE) OF FACTORING

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

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.

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

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

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

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

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

FUNCTIONS OF A FACTOR

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

1. **Provision of finance:** Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally a factor gives about 80% of the value of receivables as advance to the client. Thus the nonproductive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.
2. **Administration of sales ledger:** The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables and the amount received from customers. Thus the factor undertakes the responsibility of entire sales administration of the client.
3. **Collection of receivables:** The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.
4. **Protection against risk:** If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.
5. **Credit management:** The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc. In this way the factor advocates the best credit and collection policies suitable for the firm (client). In short, it helps the client in efficient credit management.
6. **Advisory services:** These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide experience in the field of finance. It is a

specialised institution for managing account receivables. It possesses extensive credit information about customer's creditworthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

ADVANTAGES OF FACTORING

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

1. Improves efficiency: Factoring is an important tool for efficient receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.

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

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

4. Additional source: Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

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

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

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

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

LIMITATIONS OF FACTORING

The main limitations of factoring are outlined as below:

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

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

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

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

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

FORFAITING

Generally there is a delay in getting payment by the exporter from the importer. This makes it difficult for the exporter to expand his export business. However, for getting immediate payment, the concept of forfeiting shall come to the help of exporters. The concept of forfaiting was originally developed to help finance German exports to Eastern block countries. In fact, it evolved in Switzerland in mid 1960s.

MEANING OF FORFAITING

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

CHARACTERISTICS OF FORFAITING

The main characteristics of forfaiting are:

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

ADVANTAGES OF FORFAITING

The following are the benefits of forfaiting:

1. The exporter gets the full export value from the forfaitor.
2. It improves the liquidity of the exporter. It converts a credit transaction into a cash transaction.
3. It is simple and flexible. It can be used to finance any export transaction. The structure of finance can be determined according to the needs of the exporter, importer, and the forfaitor.
4. The exporter is free from many export credit risks such as interest rate risk, exchange rate risk, political risk, commercial risk etc.
5. The exporter need not carry the receivables into his balance sheet.
6. It enhances the competitive advantage of the exporter. He can provide more credit. This increases the volume of business.
7. There is no need for export credit insurance. Exporter saves insurance costs. He is relieved from the complicated procedures also.
8. It is beneficial to forfaitor also. He gets immediate income in the form of discount. He can also sell the receivables in the secondary market or to any investor for cash.

DIFFERENCE BETWEEN FACTORING AND FORFAITING:

Forfaiting and factoring have similarities. Both have similar features of advance payment and non-recourse dealing. But there are some differences between them. The differences are as follows:

Factoring	Forfaiting
Used for short term financing.	Used for medium term financing.
May be with or without recourse.	Always without recourse.
Applicable to both domestic and export receivables.	Applicable to export receivables only.
Normally 70 to 85% of the invoice value is provided as advance.	100% finance is provided to the exporter.
The contractor is between the factor and the seller.	The contract is between the forfaitor and the exporter.
Other than financing, several other things like sales ledger administration, debt collection etc. is provided by the factor.	It is a financing arrangement only.
A bulk finance is provided against a number of unpaid invoices.	It is based on a single export bill resulting from only a single transaction.
No minimum size of transaction is specified.	There is a minimum specified value per transaction.

BILLS DISCOUNTING

- When goods are sold on credit, the receivables or book debts are created. The supplier or seller of goods draws a bill of exchange on the buyer or debtor for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months. Sometimes it is drawn for 9 months. After drawing the bill, the seller hands over the bill to the buyer. The buyer accepts the same.
- This means he binds himself liable to pay the amount on the maturity of the bill. After accepting the bill, the buyer (drawee) gives the same to the seller (drawer). Now the bill is with the drawer. He has three alternatives. One is to retain the bill till the due date and present the bill to the drawee and receive the amount of the bill.
- This will affect the working capital position of the creditor. This is because he does not get immediate payment. The second alternative is to endorse the bill to any creditors to settle the business obligation. The third or last alternative is to discount the bill with his banker.
- This means he need not wait till the due date. If he is in need of money, he can discount the bill with his banker. The banker deducts certain amount as discount charges from the amount of the bill and balance is credited in the customer's (drawer's or holders) account. Thus the bank provides immediate cash by discounting trade bills.
- In other words, the banker advances money on the security of bill of exchange. On the due date, the banker presents the bill to the drawee and receives payment. If the drawee does not make payment, the drawer has to make payment to the banker. Here the bank is the financier. It renders financial service. In short, discounting is a financial service.

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ADVANTAGES OF BILL DISCOUNTING/BILL FINANCING

1. It offers high liquidity. The seller gets immediate cash.
2. The banker gets income immediately in the form of discount.
3. Bills are not subject to any fluctuations in their values.
4. Procedures are simple.
5. Even if the bill is dishonoured, there is a simple legal remedy. The banker has to simply note and protest the bill and debit in the customer's account.
6. The bills are useful as a base for the maintenance of reserve requirements like CRR and SLR.

DIFFERENCE BETWEEN BILL DISCOUNTING AND FACTORING

Bills Discounting	Factoring
Finance alone is provided	In addition to the provision of finance, several other services like maintenance of sales ledger, advisory services etc. are provided.
Advances are made against bills	Receivables are purchased by assignment
Drawer or holder is the collector of receivables.	Factor is the collector of receivables.
It is individual transaction-oriented.	Bulk finance is provided (i.e., based on whole turnover).
It is not an off-balance sheet method of finance.	It is off-balance sheet method finance.
Stamp duty is charged on bills.	No stamp duty is charged on invoices.
The grace period for payment is usually3 days.	The grace period is higher.
Does not involve assignment of debts	It involves assignment of debts.
Bills discounted may be rediscounted several times before the due date.	Debts purchased cannot be rediscounted; they can only be refinanced.
It is always with recourse.	It may be with or without recourse.