Financial services

Sixth semester BBA

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BACHELOR OF BUSINESS ADMINISTRATION (BBA6B15)

FINANCIAL SERVICES Lecture hours per week: 5 Credits: 4 Internal: 20, External: 80

Course Objective: the students with an understanding of the various financial services and investment opportunities available in the country Learning Outcomes: On completion of the course students will be able to aware of various financial services available in Indian financial system

Module I : Financial Services: Meaning and importance of financial services- classification of financial services- fund based and fee based services- capital market services – stock broking and depository services – regulation of capital market services in India. 10 Hours

Module II : Fund Investments: Mutual funds-meaning and importance-organisation of mutual funds-types of schemes- fund units and valuation- merits and demerits of mutual funds- mutual fund regulations in India. Pension funds; Exchange Traded Funds (ETFs)-ETF vs Mutual Funds investment implications of ETF. 20 Hours

Module III : Investment Banking and Merchant Banking: Meaning, nature and functions of merchant banking – pre and post issue management services – loan syndication- Merchant banking services in India –SEBI merchant bank regulations. 20 Hours

Module IV : Lease Finance and Venture Capital Finance: Lease finance- meaning and definition types of lease- merits and demerits of lease financing. Venture capital finance: meaning and importance – risk capital – angel investing, crowd funding and private equity (PE). 15 Hours Module V : Credit Rating and Factoring Services: Credit rating – meaning, importance and advantages – rating methodology- credit rating agencies in India. Factoring services – meaning, scope and functions – types of factoring services – forfaiting and international factoring. 15 Hours

Module I

FINANCIAL SERVICES

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 liberalization 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.

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

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 forfeiting

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 service

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.
4. Equipment leasing or lease financing
5. Hire purchase
6. Venture capital
7. Bill discounting.
8. Insurance services
9. Factoring
10. Forfeiting
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. Securitization
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 lesser.

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 by-laws.

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 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.

A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

6. **Securitisation (of debt):** Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of *securitization*. Securitisation is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitised.

Securitisation is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non- marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments.

Securitisation is different from factoring. Factoring involves transfer of debts without transforming debts into marketable securities. But securitisation always involves transformation of illiquid assets into liquid assets that can be sold to investors.

Challenges faced by the financial service sector.

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

1. Lack of qualified personnel in the financial service sector.
2. Lack of investor awareness about the various financial services.
3. Lack of transparency in the disclosure requirements and accounting practices relating to financial services.
4. Lack of specialisation in different financial services (specialisation only in one or two services).
5. Lack of adequate data to take financial service related decisions.
6. Lack of efficient risk management system in the financial service sector.

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

MODULE – 2

MUTUAL FUNDS

Today, housing finance is no longer a risky advance. It has become a very lucrative businessfor bankers. The RBI has deregulated the interest rates giving greater freedom to banks to price their housing financial products according to their discretion.

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

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.

Mutual fund works on the principle of "small drops of water make a big ocean". It is a form of collective investment. To get the surplus funds from investors, it adopts a simple technique. Each fund is divided into a small share called 'units' of equal value. Each investor is allocated units in promotion to the size of his investment.

Mutual fund is a trust that pools the savings of investors. The money collected is then invested in financial market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. Thus mutual fund invests in a variety of securities (called diversification). This reduces risk. Diversification reduces the risk because all stock and/ or debt instruments may not move in the same direction.

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.

In short, a mutual fund collects the savings from small investors, invests them in government and other corporate securities and earns income through interest and dividends, besides capital gains.

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 (Classification of Mutual Funds)

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

Mutual Funds

On the basis of Operation	on the basis of Return	On the basis of Investment
Open ended	Income fund	Equity fund
Close ended	Growth fund	Bond fund
	Conservative fund	Balanced fund
		Money market mutual fund
		Taxation fund
		Leveraged fund
		Index bond fu

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.

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

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

(c) It focuses on short run gains only.

1. 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.

2. **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.

B. 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.

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. **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.

8. **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.

9. **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.

10. **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. There are around 196 mutual fund schemes, and the amount of assets under their management was Rs. 47,000 crores in 1993, Rs. 80,590 crores in 2003 and it went up to Rs. 2, 17,707crores by 31.3.2006. Thus mutual funds are growing in India. However, their growth rate is very slow.

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.

Module -3

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 clientson 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 andsometimes 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 inrelation 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 theownership of commercial ventures".

Thus merchant banking involves a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, preparation of feasibility reports etc. It is not necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialise in one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

In short, merchant banking involves servicing any financial need of the client.

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 etc..

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 counselling: One of the important functions of a merchant banker is corporate counselling. Corporate counselling 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 counselling:

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

These may be briefly discussed as follows:

(a) Public issue through prospectus: To being out a public issue, merchant bankers have to co-ordinate the activities relating to issue with different government and public bodies, professionals and private agencies. First the prospectus should be drafter. The copies of consent of experts, legal advisor, attorney, solicitor, bankers, and bankers to the issue, brokers and underwriters are to be obtained from the company making the issue. These copies are to be filed along with the prospectus

To the Registrar Companies. After the prospectus is ready, it has to be sent to the SEBI for clearance. It is only after clearance by SEBI, the prospectus can be filed with the Registrar. The brokers to the issue, principal agent and bankers to issue are appointed by merchant bankers.

(b) Marketing and underwriting: After sending prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaigns and fixing date of board meeting to approve and pass the necessary resolutions. The role of merchant banker in publicity campaigns to help selecting the media, determining the size and publications in which the advertisement should appear. The merchant bank shall decide the number of copies to be printed, check accuracy of statements made and ensure that the size of the application form and prospectus are as per stock exchange regulations. The merchant banker has to ensure that he material is delivered to the stock exchange at least 21 days before the issue opens and to the brokers to the issue, and underwriters in time.

(c) Pricing of issues: Pricing of issues is done by companies themselves in consultation with the merchant bankers. An existing listed company and a new company set up by an existing company with 5 year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with 2 ½ years track record of constant profitabi lity can freely price the issue. The premium can be determined after taking into consideration net asset value, profit earning capacity and market price. The price and premium has to be stated in the prospectus.

Post-issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedures, mailing of allotment letters, share certificates and refund orders. Merchant bankers help the company by co-ordinating the above activities.

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.

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 counselling and filing tax returns through tax consultants.

7. 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 takeover 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 offered and offer or. 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. consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

8. 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.

9. 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:

10. 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.

11. 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.

12. 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.

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

14. 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.

(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.

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.

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.

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.

MODULE -4
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(a person who leases or lets a property to another; a landlord) 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. Easy way vendors can increase sales.

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

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.

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 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) **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.

1) **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.

2) **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.

3) **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 providedin 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.

AN OVERVIEW OF VENTURE CAPITAL, FACTORING,

VENTURE CAPITAL

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

Origin/History of Venture Capital

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

concept has undergone a change and, as it stands today, it implies pooled investment to unlisted companies.

Meaning of Venture Capital

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

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

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

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

When venture capitalists invest in a business, they typically require a seat on the company's board of directors. But professional venture capitalists act as mentors and provide support and advice on a number of issues relating to management, sales, technology etc. They assist the company to develop its full potential. They help the enterprise in the early stage until it reaches the stage of profitability. When the business starts making considerable profits and the market value of the shares go up to considerable extent, venture capitalists sell their equity holdings at a high value and thereby make capital gains.

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

Characteristics of Venture Capital

The important characteristics of venture capital finance are outlined as 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:

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.

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.

MODULE -5

CREDIT RATING AND FACTORING SERVICES

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 overthe period of the rated instrument. It is a judgment about a firm's financial and business prospects. In short, credit rating means assessing the creditworthiness of a company by an independent organization.

"an estimate of the ability of a person or organization to fulfil their financial commitments, based on previous dealings."

Importance of Credit Rating

Here are the benefits of credit rating for money lenders and borrowers:

For Lenders

- **Better Investment Decision**: No bank or money lending companies would like to give money to a risky customer. With credit rating, they get an idea about the creditworthiness of a company (that is borrowing the money) and the risk factor attached with them. By evaluating this, they can make a better investment decision.
- **Safety Assured**: High credit rating means an assurance about the safety of money and that it will be paid back with interest on time.

For Borrowers

- **Easy Loan Approval**: With a high credit rating, you will be seen as a low/no risk customer. Therefore, banks will approve your loan application easily.
- **Competitive Rate of Interest**: You must be aware of the fact that every bank offers loans in a particular range of interest rates. One of the major factors that determine the rate of interest on the loan you take is your credit history. Higher the credit rating, lower the rate of interest.

Benefits of Credit Rating to Company

(1) Lower cost of borrowing:
(2) Wider audience for borrowing:
(3) Rating as marketing tool:
(4) Reduction of cost in public issues:
(5) Motivation for growth:
(6) Unknown issuer:

Limitation of credit Rating

1) Biased rating and misrepresentations:
2) Static study:
3) Concealment of material information:
4) Rating is no guarantee for soundness of company:
5) Human bias:
6) Reflection of temporary adverse conditions

CHARACTERISTICS OF CREDIT RATING

1. Assessment of issuer's capacity to repay. It assesses issuer's capacity to meet its financial obligations i.e., its capacity to pay interest and repay the principal amount borrowed.

2. Based on data. A credit rating agency assesses financial strength of the borrower on the financial data.

3. Expressed in symbols. Ratings are expressed in symbols e.g. AAA, BBB which can be understood by a layman too.

4. Done by expert. Credit rating is done by expert of reputed, accredited institutions.

5. Guidance about investment-not recommendation. Credit rating is only guidance to investors and not recommendation to invest in any particular instrument.

FUNCTIONS/IMPORTANCE OF CREDIT RATING

1. **It provides unbiased opinion to investors.** Opinion of good credit rating agency is unbiased because it has no vested interest in the rated company.

2. **Provide quality and dependable information.** Credit rating agencies employ highly qualified, trained and experienced staff to assess risks and they have access to vital and important information and therefore can provide accurate information about creditworthiness of the borrowing company.

3. **Provide information in easy to understand language.** Credit rating agencies gather information, analyse and interpret it and present their findings in easy to understand language that is in symbols like AAA, BB, C and not in technical language or in the form of lengthy reports.

4. **Provide information free of cost or at nominal cost.** Credit ratings of instruments are published in financial newspapers and advertisements of the rated companies. The public has not to pay for them. Even otherwise, anybody can get them from credit rating agency on payment of nominal fee. It is beyond the capacity of individual investors to gather such information at their own cost.

5. **Helps investors in taking investment decisions.** Credit ratings help investors in assessing risks and taking investment decision.

6. **Disciplines corporate borrowers.** When a borrower gets higher credit rating, it increases its goodwill and other companies also do not want to lag behind in ratings and inculcate financial discipline in their working and follow ethical practice to become eligible for good ratings, this tendency promotes healthy discipline among companies.

7. **Formation of public policy on investment.** When the debt instruments have been rated by credit rating agencies, policies can be laid down by regulatory authorities (SEBI, RBI) about eligibility of securities in which funds can be invested by various institutions like mutual funds, provident funds trust etc. For example, it can be prescribed that a mutual fund cannot invest in debentures of a company unless it has got the rating of AAA.

FACTORS CONSIDERED IN CREDIT RATING

1. **Issuer's ability to service its debt.** For this credit rating agencies calculate
   a) Issuer Company's past and future cash flows.
   b) Assess how much money the company will have to pay as interest on borrowedfunds and how much will be its earnings.
   c) How much are the outstanding debts?
   d) Company's short term solvency through calculation of current ratio.
   e) Value of assets pledged as collateral security by the company.
   f) Availability and quality of raw material used, favorable location, cost advantage.
   g) Track record of promoters, directors and expertise of the staff.

2. **Market positon of the company.** What is the market share of various products of the company, whether it will be stable, does the company possess competitive advantage due to distribution net- work, customer base research and developmentfacilities etc.

3. **Quality of management.** Credit rating agency will also take into consideration track record, strategies, competency and philosophy of senior management.

4. **Legal position of the instrument.** It means whether the issued instrument is legally valid, what are the terms and conditions of issue and redemption; how much the

instrument is protected from frauds, what are the terms of debenture trust deed etc.

5. **Industry risks.** Industry risks are studied in relation to position of demand and supply for the products of that industry (e.g. cars or electronics) how much is the international competition, what are the future prospects of that industry, is it goingto die or expand?

6. **Regulatory environment.** Whether that industry is being regulated by government (like liquor industry), whether there is a price control on it, whether there is government support for it, can it take advantage of tax concessions etc.

7. **Other factors.** In addition to the above, the other factors to be noted for credit rating of a company are its cost structure, insurance cover undertaken, accounting quality, market reputation, working capital management, human resource quality, funding policy, leverage, flexibility, exchange rate risks etc.

CREDIT RATING PROCESS

In India credit rating is done mostly at the request of the borrowers or issuer companies.The borrower or issuer company requests the credit rating agency for assigning a rankingto the proposed instrument. The process followed by most of the credit rating agenciesis as follows:

1. **Agreement.** An agreement is entered into between the rating agency and the issuer company. It covers details about terms and conditions for doing the rating.

2. **Appointment of analytical team.** The rating agency assigns the job to a team of experts. The team usually comprises of two analysts who have expert knowledge in the relevant business area and is responsible for carrying out rating.

3. **Obtaining information.** The analytical team obtains the required information from the client company and studies company's financial position, cash flows, nature and basis of competition, market share, operating efficiency arrangements, managements track cost structure, selling and distribution record, power (electricity) and labour situation etc.

4. **Meeting the officials.** To obtain clarifications and understanding the client's business the analytical team visits and interacts with the executives of the client.

5. **Discussion about findings.** After completion of study of facts and their analysis by the analytical team the matter is placed before the internal committee (which comprises of senior analysts) an opinion about the rating is taken.

6. **Meeting of the rating committee.** The findings of internal committee are referred to the “rating committee" which generally comprises of a few directors and is the final authority for assigning ratings.

7. **Communication of decision.** The rating decided by the rating committee is communicated to the requesting company.

8. **Information to the public.** The rating company publishes the rating through reports and the press.

9. **Revision of the rating.** Once the issuer company has accepted the rating, the rating agency is under an obligation to monitor the assigned rating. The rating agency monitors all ratings during the life of the instrument.

TYPES OF CREDIT RATING

1. **Rating of bonds and debentures.** Rating is popular in certain cases for bonds and debentures. Practically, all credit rating agencies are doing rating for debentures andbonds.

2. **Rating of equity shares.** Rating of equity shares is not mandatory in India but credit rating agency ICRA has formulated a system for equity rating. Even SEBI has no immediate plans for compulsory credit rating of initial public offerings (IPOs).

3. **Rating of preference shares.** In India preference shares are not being rated, however Moody's Investor Service has been rating preference shares since 1973 and ICRA has provision for it.

4. **Rating of medium term loans (Public deposits, CDs etc.).** Fixed deposits taken by companies are rated on regular scale in India.

5. **Rating of short-term instruments [Commercial Papers (CPs)**. Credit rating of short term instruments like commercial papers has been started from 1990. Credit rating for CPs is mandatory which is being done by CRISIL, ICRA and CARE.

6. **Rating of borrowers.** Rating of borrowers, may be an individual or a company is known as borrower's rating.

7. **Rating of real estate builders and developers.** A lot of private colonisers and flat builders are operating in big cities. Rating about them is done to ensure that they will properly develop a colony or build flats. CRISIL has started rating of builders and developers.

8. **Rating of chit funds.** Chit funds collect monthly contributions from savers and give loans to those participants who offer highest rate of interest. Chit funds are rated on the basis of their ability to make timely payment of prize money to subscribers. CRISIL does credit rating of chit funds.

9. **Ratings of insurance companies.** With the entry of private sector insurance companies, credit rating of insurance companies is also gaining ground. Insurance companies are rated on the basis of their claim paying ability (whether it has high, adequate, moderate or

weak claim-paying capacity). ICRA is doing the work of rating insurance companies.

10. **Rating of collective investment schemes.** When funds of a large number of investors are collectively invested in schemes, these are called collective investment schemes. Credit rating about them means (assessing) whether the scheme will be successful or not. ICRA is doing credit rating of such schemes.

CREDIT RATING AND INFORMATION SERVICES OF INDIA LIMITED(CRISIL)

- It is India's first credit rating agency which was incorporated and promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions in 1987.
- After 1 year, i.e. in 1988 it commenced its operations
- It has its head office in Mumbai.
- It is India's foremost provider of ratings, data and research, analytics and solutions, with a strong track record of growth and innovation.
- It delivers independent opinions and efficient solutions.
- CRISIL's businesses operate from 8 countries including USA, Argentina, Poland, UK, India, China, Hong Kong and Singapore.
- CRISIL's majority shareholder is Standard & Poor's.
- It also works with governments and policy-makers in India and other emerging markets in the infrastructure domain.

CRISIL, was the first credit rating agency in India, introduced in 1988 by the ICICI and UTI jointly with share capital coming from SBI, LIC and United India Insurance Company. In April 2005, US based credit rating agency S&P acquired the majority shares of company

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. Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e. credit control, sales accounting etc.

Thus factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.). The balance is the profit of the factor for the factoring services.

Factoring can take the form of either a factoring agreement or an assignment (pledging) agreement. The factoring agreement involves outright sale of the firm's receivables to a finance company (factor) without recourse. 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. The discount is its commission. From this its expenses and losses (collection, bad debt etc.) are met. The balance represents the profit of the factor.

In an assignment (pledging) agreement, the ownership of the receivables is not transferred; the receivables are given to a finance company (factor) with recourse. The factor advances some portion of the receivables value, generally in the range of 50 – 80%. The firm (client) is responsible for service charges and interest on the advance (due to the factor) and losses due to bad debts. 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.

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,

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 problemsrelating 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.

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

Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount to a forfaiter, a specialized finance firm or a department in a bank.

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. Under forfaiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount. Here the exporter passes to the forfaitor all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately. Thus he gets the benefit of cash sale. However, the forfaitor deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfaitor. The forfaitor may be a bank or any other financial institution.

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

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

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.

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. Thisincreases 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
1. Used for short term financing.	1. Used for medium term financing.
2. May be with or without recourse.	2. Always without recourse.
3. Applicable to both domestic and export receivables.	3. Applicable to export receivables only
4. Normally 70 to 85% of the invoice value is provided as advance.	4. 100% finance is provided to the exporter.
5. The contractor is between the factor and the seller.	5. The contract is between the forfaitor and the exporter.
6. Other than financing, several other things like sales ledger administration, debt collection etc. is provided by the factor.	6. It is a financing arrangement only.