

# **MODULE I**

## **FINANCIAL SERVICES**

### **Introduction**

The Indian financial services industry has undergone a metamorphosis since 1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry. In fact, one of the world's largest industries today is the financial services industry.

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

### **Meaning of Financial Services**

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilisation and allocation of savings. Thus, it includes all activities involved in the transformation of savings into investment.

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

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

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 forfaiting
2. Managing investible funds:
  - (a) Portfolio management
  - (b) Merchant banking
  - (c) Mutual and pension funds

3. Risk financing:

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

4. Consultancy services:

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

5. Market operations:

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

6. Research and development:

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

## **Scope of Financial Services**

The scope of financial services is very wide. This is because it covers a wide range of services. The financial services can be broadly classified into two: (a) fund based services and (b) non-fund services (or fee-based services)

### **Fund based Services**

The fund based or asset based services include the following:

1. Underwriting
2. Dealing in secondary market activities
3. Participating in money market instruments like CPs, CDs etc.
4. Equipment leasing or lease financing
5. Hire purchase
6. Venture capital
7. Bill discounting.
8. Insurance services
9. Factoring
10. Forfaiting
11. Housing finance
12. Mutual fund

### **Non-fund based Services**

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

1. Securitisation
2. Merchant banking
3. Credit rating
4. Loan syndication
5. Business opportunity related services
6. Project advisory services
7. Services to foreign companies and NRIs.
8. Portfolio management
9. Merger and acquisition

10. Capital restructuring
11. Debenture trusteeship
12. Custodian services
13. Stock broking

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

#### **A. Asset/Fund Based Services**

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

2. **Hire purchase and consumer credit:** Hire purchase is an alternative to leasing. Hire purchase is a transaction where goods are purchased and sold on the condition that payment is made in instalments. The buyer gets only possession of goods. He does not get ownership. He gets ownership only after the payment of the last instalment. If the buyer fails to pay any instalment, the seller can repossess the goods. Each instalment 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 field of housing finance. Some of the institutions are HDFC, LIC Housing Finance, Citi Home, Ind Bank Housing etc

**6. Insurance services:** Insurance is a contract between two parties. One party is the insured 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 sell 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 a loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager.



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 fulfil 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 II**

### **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 underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks". According to SEBI (Merchant Bankers) Rules 1992, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering corporate advisory services in relation to such issue management". In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

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, takeovers etc., discounting and rediscounting of short-term paper in money markets, managing and underwriting public issues in new issue market and acting as brokers and advisors on portfolio management.

### **Functions (Services) of Merchant Bankers (Scope of Merchant Banking)**

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

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

- (a) Providing guidance in areas of diversification based on the Government's economic and licensing policies.
- (b) Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.
- (c) Rejuvenating old-line companies and ailing sick units by appraising their technology and process, assessing their requirements and restructuring their capital base.
- (d) Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.
- (e) Arranging for the approval of the financial institutions/banks for schemes of rehabilitation involving financial relief, etc.
- (f) Monitoring of rehabilitation schemes.
- (g) Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

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

- (a) Undertaking the general review of the project ideas/project profile.
- (b) Providing advice on procedural aspects of project implementation.
- (c) Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.
- (d) Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consents for implementation of the project.
- (e) Assisting in obtaining approvals/licenses/permissions/grants, etc from government agencies in the form of letter of intent, industrial license, DGTD registration, and government approval for foreign collaboration.
- (f) Identification of potential investment avenues.
- (g) Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.
- (h) Undertaking financial study of the project and preparation of viability reports to advise on the framework of institutional guidelines and laws governing corporate finance.
- (i) Providing assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas, covering the technical, financial and economic aspects of the project from the point of view of their acceptance by financial institutions and banks.
- (j) Advising and assisting clients in preparing applications for financial assistance to various national financial institutions, state level institutions, banks, etc.

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

- (a) Carrying out an in-depth investigation of environment and regulatory factors, location of raw material supplies, demand projections and financial requirements in order to assess the financial and economic viability of a given project.
- (b) Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to promote corporate profitability and growth in the long run.
- (c) Offering a package of services, including advice on the extent of participation, government regulatory factors and an environmental scan of certain industries in India.

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

- (a) Estimating the total cost of the project to be undertaken.
- (b) Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.
- (c) Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.
- (d) Selecting institutions and banks for participation in financing.
- (e) Follow-up of term loan application with the financial institutions and banks, and obtaining the approval for their respective share of participation.
- (f) Arranging bridge finance.
- (g) Assisting in completion of formalities for drawing of term finance sanctioned by institutions by expediting legal documentation formalities, drawing up agreements etc. as prescribed by the participating financial institutions and banks.
- (h) Assessing working capital requirements.

**5. Issue management:** Issue management involves marketing of 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 bring 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 drafted. The copies of consent of experts, legal advisor, attorney, solicitor, bankers, and brokers 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 profitability 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.

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

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

- (a) Undertaking investment in securities.
- (b) Collection of return on investment and re-investment of the same in profitable avenues, investment advisory services to the investors and other related services.
- (c) Providing advice on selection of investments.
- (d) Carrying out a critical evaluation of investment portfolio.
- (e) Securing approval from RBI for the purchase/sale of securities (for NRI clients).
- (f) Collecting and remitting interest and dividend on investment.
- (g) Providing tax counseling and filing tax returns through tax consultants.

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

**9. Foreign currency financing:** The finance provided to fund foreign trade transactions is called 'Foreign Currency Finance'. The provision of foreign currency finance takes the form of export-import trade finance, euro currency loans, Indian joint ventures abroad and foreign collaborations. The main areas that are covered in this type of merchant activity are as follows:

- (a) Providing assistance for carrying out the study of turnkey and construction contract projects.
- (b) Arranging for the syndication of various types of guarantees, letters of credit, pre-shipment credit, deferred post-shipment credit, bridge loans, and other credit facilities.
- (c) Providing assistance in opening and operating bank accounts abroad.
- (d) Arranging foreign currency loans under buyer's credit scheme for importing goods.
- (e) Arranging deferred payment guarantees under suppliers credit scheme for importing capital goods.
- (f) Providing assistance in obtaining export credit facilities from the EXIM bank for export of capital goods, and arranging for the necessary government approvals and clearance.
- (g) Undertaking negotiations for deferred payment, export finance, buyers credits, documentary credits, and other foreign exchange services like packing credit, etc.



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

- (a) Assessment of working capital requirements.
- (b) Preparing the necessary application to negotiations for the sanction of appropriate credit facilities.

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

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

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

- (a) Providing advice on the viability of leasing as an alternative source for financing capital investment projects.
- (b) Providing advice on the choice of a favourable rental structure.
- (c) Providing assistance in establishing lines of lease for acquiring capital equipment, including preparation of proposals, documentations, etc.

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

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

The functions of merchant banker can be summarized as follows:

- (a) Issue management.
- (b) Underwriting of issues.
- (c) Project appraisal.
- (d) Handling stock exchange business on behalf of clients.
- (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 manager 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. They are:

#### **a) Institutional Base:-**

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

#### **b) Banker Base:-**

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

**c) Broker Base:-**

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

**d) Private Base:-**

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

**Categories of Merchant Banks**

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

- (a) **Category – I:** To carry on any activity relating to issue management and act as adviser, consultant manager, underwriter and portfolio manager for capital issues.
- (b) **Category – II:** To act as adviser, consultant, co-manager, underwriter and portfolio manager for capital issues.
- (c) **Category – III:** To act as underwriter, adviser, and consultant to an issue.
- (d) **Category – IV:** To act only as adviser or consultant to an issue.

**Weakness of merchant banks / Problems of merchant banks**

1. SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management. It restricts the scope of merchant bank activities.
2. SEBI guidelines stipulate a minimum net worth of Rs.1 crore for authorisation of merchant bankers. Small but professional merchant bankers are facing difficulty for adhering such net worth norms.
3. Non cooperation of the issuing companies in timely allotment of securities and refund application money is another problem of merchant bankers.
4. Unhealthy competition among large number of merchant banks compels them to reduce their profit margin, commission etc.
5. There is no exact regulatory framework for regulating and controlling the working of merchant banks in India.
6. Fraudulent and fake issue of share capital by the companies are also posing problems for merchant banks who act as lead manager or issue manager of such issues.

## **MODULE III**

### **MUTUAL FUNDS**

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 proportion 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

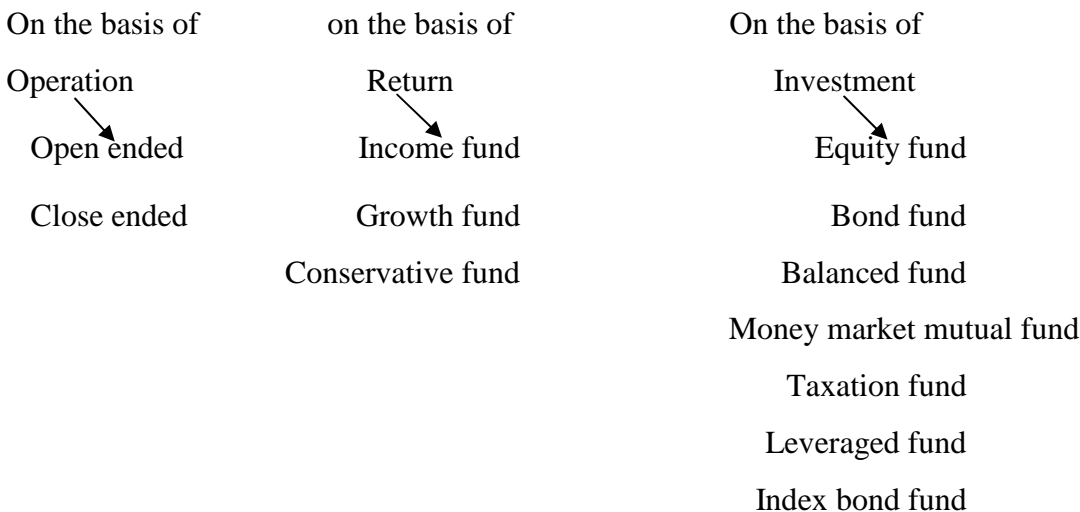
Mutual fund possesses the following features:

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



These may be briefly described as follows:

### **A. On the basis of Operation**

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

#### **Features of Close ended Funds**

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

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

#### **Features of Open-ended Funds**

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

#### **Difference between Open-ended and Close-ended Schemes**

1. The close-ended schemes are open to the public for a limited period, but the open-ended schemes are always open to be subscribed all the time.
2. Close-ended schemes will have a definite period of life. But he open-ended schemes are transacted in the company.

3. Close-ended schemes are transacted at stock exchanges, where as open-ended schemes are transacted (bought and sold) in the company.
4. Close-ended schemes are terminated at the end of the specified period. Open-ended schemes can be terminated only if the total number of units outstanding after repurchase fall below 50% of the original number of units.

### **B. On the basis of return/ income**

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

#### **Features of Income Funds**

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

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

#### **Features of Growth Funds**

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

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



### C. On the basis of Investment

1. **Equity fund:** it mainly consists of equity based investments. It carried a high degree of risk. Such funds do well in periods of favourable capital market trends.
2. **Bond fund:** It mainly consists of fixed income securities like bonds, debentures etc. It concentrates mostly on income rather than capital gains. It carries lower risk. It offers secure and steady income. But there is no chance of capital appreciation.
3. **Balanced fund:** It has a mix of debt and equity in the portfolio of investments. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.
4. **Fund of fund scheme:** In this case funds of one mutual fund are invested in the units of other mutual funds.
5. **Taxation fund:** This is basically a growth oriented fund. It offers tax rebates to the investors. It is suitable to salaried people.
6. **Leverage fund:** In this case the funds are invested from the amounts mobilized from small investors as well as money borrowed from capital market. Thus it gives the benefit of leverage to the mutual fund investors. The main aim is to increase the size of the value of portfolio. This occurs when the gains from the borrowed funds are more than the cost of the borrowed funds. The gains are distributed to unit holders.
7. **Index bonds:** These are linked to a specific index of share prices. This means that the funds mobilized under such schemes are invested principally in the securities of companies whose securities are included in the index concerned and in the same proportion. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.
8. **Money market mutual funds:** These funds are basically open ended mutual funds. They have all the features of open ended mutual funds. But the investment is made in highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills etc. These are money market instruments.
9. **Off shore mutual funds:** The sources of investments for these funds are from abroad.
10. **Guilt funds:** This is a type of mutual fund in which the funds are invested in guilt edged securities like government securities. It means funds are not invested in corporate securities like shares, bonds etc.

### Objectives of Mutual Funds

1. To mobilise savings of people.
2. To offer a convenient way for the small investors to enter the capital and the money market.

3. To tap domestic savings and channelize them for profitable investment.
4. To enable the investors to share the prosperity of the capital market.
5. To act as agents for growth and stability of the capital market.
6. To attract investments from the risk averters.
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 diversifies its risks by investing in a variety of securities (equity shares, bonds etc.) The small and medium investors cannot do this.
- 3. Provide better returns:** Mutual funds can pool funds from a large number of investors. In this way huge funds can be mobilized. Because of the huge funds, the mutual funds are in a position to buy securities at cheaper rates and sell securities at higher prices. This is not possible for individual investors. In short, mutual funds are able to give good and regular returns to their investors.
- 4. Better liquidity:** At any time the units can be sold and converted into cash. Whenever investors require cash, they can avail loans facilities from the sponsoring banks against the unit certificates.
- 5. Low transaction costs:** The cost of purchase and sale of mutual fund units is relatively less. The brokerage fee or trading commission etc. are lower. This is due to the large volume of money being handled by mutual funds in the capital market.
- 6. Reduce risk:** There is only a minimum risk attached to the principal amount and return for the investments made in mutual funds. This is due to expert supervision, diversification and liquidity of units.
- 7. Professional management:** Mutual funds are managed by professionals. They are well trained. They have adequate experience in the field of investment. Thus investors get quality services from the mutual funds. An individual investor would never get such a service from the securities market.

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

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

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

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

### **Mutual Fund Risks**

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

- 1. Market risks:** These risks are unavoidable. These arise due to fluctuations in share prices.
- 2. Investment risks:** Generally mutual funds make investments on the advice sought from Asset Management Company. If the advice goes wrong, the fund has to suffer a loss.
- 3. Business risk:** Mutual funds invest mostly in equity shares of companies. If the business of the companies suffers any set back, they cannot declare dividend. Ultimately, such companies may be wound up. As a result, mutual funds will suffer.
- 4. Political risk:** Change in government policies brings uncertainty in the economy. Every player including mutual funds has to face this risk and uncertainty.
- 5. Scheme risks:** There are certain risks in the schemes themselves. Risks are greater in certain schemes, e.g., growth schemes.

### **Operation of Mutual Funds**

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

also made in money market instruments like treasury bills, commercial papers etc. Usually the money is invested in diversified securities so as to minimize the risk and maximize return. The income earned on these securities (after meeting the fund expenses) is distributed to unit holders (investors) in the form of interest as well as capital appreciation. The return on the units depends upon the nature of the mutual fund schemes.

### **Mutual Funds in India**

In India the first mutual fund was UTI. It was set up in 1964 under an Act of parliament. During the year 1987-1992, seven new mutual funds were established in the public sector. In 1993, the government changed its policy to allow the entry of private corporates and foreign institutional investors into the mutual fund segment. Now the commercial banks like the SBI, Canara Bank, Indian bank, Bank of India, Punjab National Bank etc. have entered into the field. LIC and GIC have also entered into the market. By the end of March 2000, there was 36 mutual funds, 9 in the public sector and 27 in the private sector. However UTI dominated the mutual fund sector. In India mutual funds are being regulated by agencies like SEBI. Mutual funds play an important role in promoting saving and investment within the country. 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.
6. Investors do not know that units are low-risk long term investment. They do not have the patience to wait for long time to get good returns. They always want return in the short run. Hence units are not much popular in India.

## **MODULE IV**

### ***LEASE FINANCING***

#### **Meaning of leasing**

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

Lease can be defined as the following ways:

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

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. Lease 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 dominance, 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, financial leases are very popular with high-cost and high technology equipment.

### **2) Operational lease**

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

### **3) Sale and lease back**

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

#### **4) Leveraged leasing**

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

#### **5) Direct leasing**

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

#### **Other types of leasing:**

- 1) **First Amendment Lease:** The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.
- 2) **Full Payout Lease:** A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.
- 3) **Guideline Lease:** A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.
- 4) **Net Lease:** A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.
- 5) **Open-end Lease:** A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.
- 6) **Sales-type Lease:** A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.
- 7) **Synthetic Lease:** A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.



- 8) Tax Lease: A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition of this tax incentive.
- 9) True Lease: A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

### **Differences between financial lease and operating lease**

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

### **Regulatory frame work for Leasing in India**

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

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

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

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

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

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

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

### **Problems of leasing in India**

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

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

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

**3. Tax Consideration-** In reality, the lessee's tax shelter is lessors' burden. The lease becomes economically viable if lessors effective tax rate is low. more over taxes like sales

tax, wealth tax, additional tax, surcharge etc, add to the cost of leasing. It makes leasing relatively more expensive.

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

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

## **HIRE PURCHASE**

### **Concept and Meaning of Hire Purchase**

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

The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as

“An agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

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

### **Legal framework of Hire purchase transactions**

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

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

### **Rights of the hirer**

The hirer usually has the following rights:

1. To buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate
2. To return the goods to the owner — this is subject to the payment of a penalty.
3. with the consent of the owner, to assign both the benefit and the burden of the contract to a third person.
4. Where the owner wrongfully repossesses the goods, either to recover the goods plus damages for loss of quiet possession or to damages representing the value of the goods lost.

Additional rights-

1. Rights of protection
2. Rights of notice
3. Rights of repossession
4. Rights of Statement
5. Rights of excess amount

### **Obligations of hirer**

The hirer usually has following obligations:

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

### **Owner's rights**

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

This entitles the owner:

1. To forfeit the deposit.
2. To retain the instalments already paid and recover the balance due.
3. To repossess the goods (which may have to be by application to a Court depending on the nature of the goods and the percentage of the total price paid).

4. To claim damages for any loss suffered.

### Features of Hire Purchase

1. **Immediate possession**-under HP, the buyer takes immediate possession of goods by paying only a portion of its price.
2. **Hire Charges**- under HP, each instalment is treated as hire charges.
3. **Property in goods** - ownership is–passed to the hirer only after paying last or specified number of instalments
4. **Down payment**- hirer has to pay 20 to 25% of asset price to the vendor as down payment.
5. **Repossession**- Hire vendor, if default in payment of instalment made by hirer, can reposes the goods and he can resell the goods.
6. **Return of goods**- hirer is free to return the goods without being required to pay further instalment falling due after the return.
7. **Depreciation**- depreciation and investment allowances can be claimed by the hirer even though he is not an exact owner.

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

### Differences between lease and Hire purchase

1. **Ownership**- in lease, ownership rests with the lessor throughout and the hirer of the goods not becomes owner till the payment of specified instalments.
2. **Method of financing**- leasing is a method of financing business assets whereas HP is financing both business and non-business assets.
3. **Depreciation**- in leasing, depreciation and investment allowances cannot be claimed by the lessee, in HP, depreciation and IA can be claimed by the hirer.
4. **Tax benefits**- the entire lease rental is tax deductible expense. Only the interest component of the HP instalment is tax deductible.
5. **Salvage value**- the lessee, not being the owner of the asset, doesn't enjoy the salvage value of the asset. The hirer, in HP, being the owner of the asset, enjoys salvage value of the asset.
6. **Deposit**- lessee is not required to make any deposit whereas 20% deposit is required in HP.
7. **Nature of deal** - with lease w– rent and with HP we buy the goods.

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

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

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

### **RBI guidelines for HP business**

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

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

### **Advantages of HP:**

1. **Spread the cost of finance** – Whilst choosing to pay in cash is preferable,. A hire purchase agreement allows a consumer to make monthly repayments over a pre-specified period of time;
2. **Interest-free credit** – Some merchants offer customers the opportunity to pay for goods and services on interest free credit.
3. **Higher acceptance rates** –The rate of acceptance on hire purchase agreements is higher than other forms of unsecured borrowing because the lenders have collateral.
4. **Sales** – A hire purchase agreement allows a consumer to purchase sale items when they aren't in a position to pay in cash.
5. **Debt solutions** -Consumers tha– buy on credit can pursue a debt solution, such as debt engagement plan, should they experience money problems further down the line.

## Problems of HP business in India

Hire purchase transactions are very uncommon transactions in India. Meaning there by the awareness of this concept is very lesser in India. All segment of India's population treat the hire purchase transaction as a hypothecation loan but there is a slight differentiation among all processes related to hire purchases. Almost for the population of India the hire purchase transaction is very similar to the loans & hypothecation. Person who wants to purchase any asset then the best option & way for him or her would be loan or hypothecation. Because the public is not aware with transaction named hire purchases. Hire purchase transaction is of two types the cash credit & asset hire purchases. People do not go for hire purchases in India because in India business people are very less so they can not hire the assets for a longer period of time. Finally, we would like to end up over here that, lack of awareness leads to occurrence of problem in dealing with hire purchase. Other problems of HP are as follows:

1. **Personal debt** - A hire purchase agreement is yet another form of personal debt it is monthly repayment commitment that needs to be paid each month;
2. **Final payment** - A consumer doesn't have legitimate title to the goods until the final monthly repayment has been made;
3. **Bad credit** - All hire purchase agreements will involve a credit check. Consumers that have a bad credit rating will either be turned down or will be asked to pay a high interest rate;
4. **Creditor harassment** - Opting to buy on credit can create money problems should a family experience a change of personal circumstances;
5. **Repossession rights** - seller is entitled to 'snatch back' any goods when less than a third of the amount has been paid back.

## FACTORING

When a firm sells goods on credit, cash is not received immediately. This means there is a time gap between sale of goods/services and receipt of cash out of such sale. The outstanding amounts get blocked for a period. This period depends upon the credit period allowed to buyers. The outstanding amounts are called 'Debtors' or 'Accounts Receivables'. If the debts are not collected in time, the firm will be handicapped due to lack of sufficient working capital. The other side is that if the debts were collected speedily the amount could be used productively. Further, it is very difficult to collect debts. Moreover, there is the problem of defaults (i.e. bad debts). In short, debtors or accounts receivables involve risks. So, business enterprises are always looking for selling the debtors for cash, even at a discount. This is possible through a financial service. Such a financial service is known as factoring.

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

## 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.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

### **Types of Factoring**

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

1. **Recourse Factoring:** In this type of factoring, the factor only manages the receivables without taking any risk like bad debt etc. Full risk is borne by the firm (client) itself.
2. **Non-Recourse Factoring:** Here the firm gets total credit protection because complete risk of total receivables is borne by the factor. The client gets 100% cash against the invoices (arising out of credit sales by the client) even if bad debts occur. For the factoring service, the client pays a commission to the factor. This is also called *full factoring*.
3. **Maturity Factoring:** In this type of factoring, the factor does not pay any cash in advance. The factor pays clients only when he receives funds (collection of credit sales) from the customers or when the customers guarantee full payment.
4. **Advance Factoring:** Here the factor makes advance payment of about 80% of the invoice value to the client.
5. **Invoice Discounting:** Under this arrangement the factor gives advance to the client against receivables and collects interest (service charge) for the period extending from the date of advance to the date of collection.
6. **Undisclosed Factoring:** In this case the customers (debtors of the client) are not at all informed about the factoring agreement between the factor and the client. The factor performs all its usual factoring services in the name of the client or a sales company to which the client sells its book debts. Through this company the factor deals with the customers. This type of factoring is found in UK.
7. **Cross boarder factoring:** It is similar to domestic factoring except that there are four parties, viz,
  - a) Exporter,
  - b) Export Factor,
  - c) Import Factor, and
  - d) Importer.

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

### **Process of Factoring (Factoring Mechanism)**

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

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

### **Features (Nature) of Factoring**

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

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

## Functions of a Factor

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

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

## Advantages of Factoring

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

- 1. Improves efficiency:** Factoring is an important tool for efficient receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.
- 2. Higher credit standing:** Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.
- 3. Reduces cost:** The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.
- 4. Additional source:** Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.
- 5. Advisory service:** A factor firm is a specialised agency for better management of receivables. The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.
- 6. Acceleration of production cycle:** With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.
- 7. Adequate credit period for customers:** Customers get adequate credit period for payment of assigned debts.
- 8. Competitive terms to offer:** The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

## Limitations of Factoring

The main limitations of factoring are outlined as below:

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.

3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.
5. Factoring may impose constraints on the way to do business. For non - recourse factoring most factors will want to pre- approve customers. This may cause delays. Further ,the factor will apply credit limits to individual customers.

## **Forfaiting**

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

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

### **Meaning of Forfaiting**

The term 'forfait' is a French word. It means 'to surrender something' or 'give up one's right'. Thus forfeiting 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 recourse' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money. Under forfeiting 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 forfeiting.

Forfaiting is not the same as international factoring. The tenure of forfeiting transaction is long. International factoring involves short term trade transactions. In case of forfeiting, 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 forfeiting are:

1. It is 100% financing without recourse to the exporter.

2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'aval').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

### **Advantages of Forfaiting**

The following are the benefits of forfaiting:

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

### **Difference between Factoring and Forfaiting**

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

<b>Factoring</b>	<b>Forfaiting</b>
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.   |
| 7. A bulk finance is provided against a number of unpaid invoices.  | 7. It is based on a single export bill resulting from only a single transaction. |
| 8. No minimum size of transaction is specified.   | 8. There is a minimum specified value per transaction.                           |

### **Bills discounting**

Bill discounting is book debt financing. This is done by commercial banks.

### **Meaning of Bills Discounting**

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

### **Advantages of Bill Discounting/Bill Financing**

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

### **Difference between Bill Discounting and Factoring**

<b>Bills Discounting</b>	<b>Factoring</b>
1. Finance alone is provided.	1. In addition to the provision of finance, several other services like maintenance of sales ledger, advisory services etc. are provided.
2. Advances are made against bills.	2. Receivables are purchased by assignment
3. Drawer or holder is the collector of receivables.	3. Factor is the collector of receivables.
4. It is individual transaction-oriented.	4. Bulk finance is provided (i.e., based on whole turnover).
5. It is not an off-balance sheet method of finance.	5. It is off-balance sheet method finance.
6. Stamp duty is charged on bills.	6. No stamp duty is charged on invoices.
7. The grace period for payment is usually 3 days.	7. The grace period is higher.
8. Does not involve assignment of debts.	8. It involves assignment of debts.
9. Bills discounted may be rediscounted several times before the due date.	9. Debts purchased cannot be rediscounted; they can only be refinanced.
10. It is always with recourse.	10. It may be with or without recourse.

### **Securitisation of Debt/Assets**

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*. Securitization 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 securitized.

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

### **Parties to a Securitisation Transaction**

There are primarily three parties to a securitisation deal, namely -

**a. The Originator:** This is the entity on whose books the assets to be securitised exist. It is the prime mover of the deal i.e. it sets up the necessary structures to execute the deal. It sells the assets on its books and receives the funds generated from such sale. In a true sale, the Originator transfers both the legal and the beneficial interest in the assets to the SPV.

**b. The SPV:** The issuer also known as the SPV is the entity, which would typically buy the assets (to be securitised) from the Originator. The SPV is typically a low-capitalised entity with narrowly defined purposes and activities, and usually has independent trustees/directors. As one of the main objectives of securitisation is to remove the assets from the balance sheet of the Originator, the SPV plays a very important role in as much as it holds the assets in its books and makes the upfront payment for them to the Originator.

**c. The Investors:** The investors may be in the form of individuals or institutional investors like FIs, mutual funds, provident funds, pension funds, insurance companies, etc. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per agreed pattern. Besides these three primary parties, the other parties involved in a securitisation deal are given below:

**a) The Obligor(s):** The Obligor is the Originator's debtor (borrower of the original loan). The amount outstanding from the Obligor is the asset that is transferred to the SPV. The credit standing of the Obligor(s) is of paramount importance in a securitisation transaction.

**b) The Rating Agency:** Since the investors take on the risk of the asset pool rather than the Originator, an external credit rating plays an important role. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by the

process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.

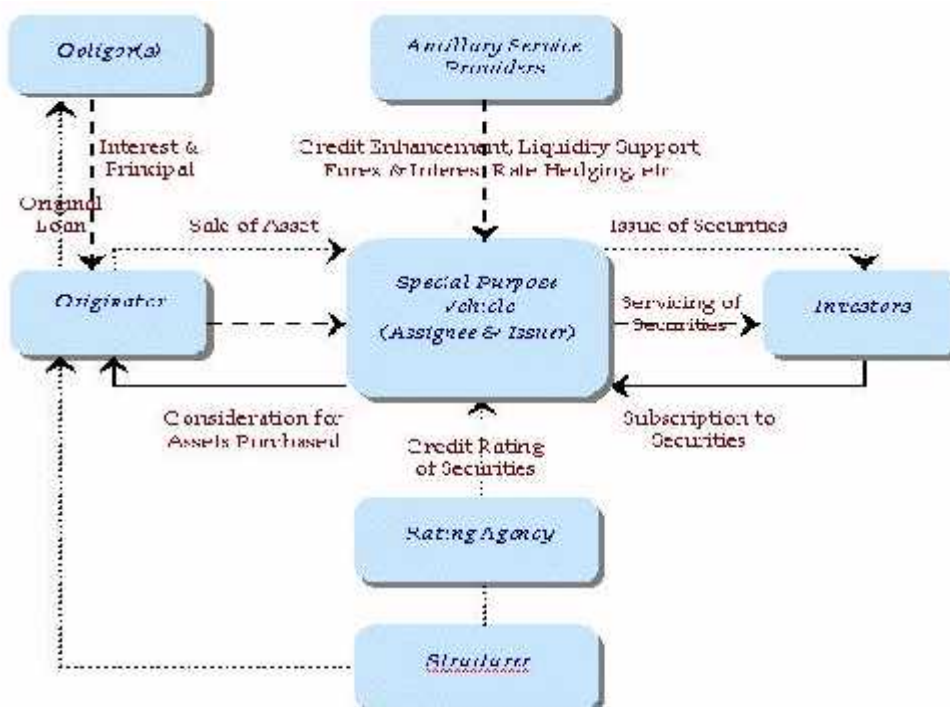
**c) Administrator or Servicer:** It collects the payment due from the Obligor/s and passes it to the SPV, follows up with delinquent borrowers and pursues legal remedies available against the defaulting borrowers. Since it receives the instalments and pays it to the SPV, it is also called the Receiving and Paying Agent.

**d) Agent and Trustee:** It accepts the responsibility for overseeing that all the parties to the securitisation deal perform in accordance with the securitisation trust agreement. Basically, it is appointed to look after the interest of the investors.

**e) Structurer:** Normally, an investment banker is responsible as structurer for bringing together the Originator, credit enhancer/s, the investors and other partners to a securitisation deal. It also works with the Originator and helps in structuring deals.

The different parties to a securitisation deal have very different roles to play. In fact, firms specialise in those areas in which they enjoy competitive advantage. The entire process is broken up into separate parts with different parties specialising in origination of loans, raising funds from the capital markets, servicing of loans etc. It is this kind of segmentation of market roles that introduces several efficiencies securitisation is so often credited with.

### Basic process of securitization



**Note:** Continuing flow of funds from the Obligor to the SPV is routed through the Originator in its capacity as administrator. Any other party appointed by the SPV/Trustee can also perform the role of administrator. It is also possible that the SPV receives the amounts directly from the Obligors.

**The advantages of securitisation:**

- 1. Additional source of fund** – by converting illiquid assets to liquid and marketable assets.
- 2. Greater profitability-** securitisation leads to faster recycling of fund and thus leads to higher business turn over and profitability.
- 3. Enhancement of CAR-** Securitisation enables banks and financial institutions to enhance their capital adequacy ratio(CAR) by reducing their risky assets.
- 4. Spreading Credit Risks-** securitisation facilitates the spreading of credit risks to different parties involved in the process of securitisation such as SPV, insurance companies(credit enhancer) etc.
- 5. Lower cost of funding-** originator can raise funds immediately without much cost of borrowing.
- 6. Provision of multiple instruments** – from investors point of view, securitisation provides multiple instruments so as to meet the varying requirements of the investing public.
- 7. Higher rate of return-** when compared to traditional debt securities like bonds and debentures, securitised assets provides higher rates of return along with better liquidity.
- 8. Prevention of idle capital-** in the absence of securitisation, capital would remain idle in the form of illiquid assets like mortgages, term loans etc.

**Retail banking services**

“Retail banking is typical mass-market banking where individual customers use local branches of larger commercial banks. Services offered include: savings and checking accounts, mortgages, personal loans, debit cards, credit cards, and so”. The Retail Banking environment today is changing fast. The changing customer demographics demands to create a differentiated application based on scalable technology, improved service and banking convenience. Higher penetration of technology and increase in global literacy levels has set up the expectations of the customer higher than never before. Increasing use of modern technology has further enhanced reach and accessibility. The market today gives us a challenge to provide multiple and innovative contemporary services to the customer through a consolidated window as so to ensure that the bank’s customer gets “Uniformity and Consistency” of service delivery across time and at every touch point across all channels. The pace of innovation is accelerating and security threat has become prime of all electronic transactions. High cost structure rendering mass-market servicing is prohibitively expensive. Present day tech-savvy bankers are now more looking at reduction in their operating costs by adopting scalable and secure technology thereby reducing the response time to their customers so as to improve their client base and economies of scale. The solution lies to market demands and challenges lies in innovation of new offering with minimum dependence on branches – a multi-channel bank and to eliminate the disadvantage of an inadequate branch network. Generation of leads to cross sell and creating additional revenues with utmost customer satisfaction has become focal point worldwide for the success of a Bank.

Retail banking means mobilizing deposit from individuals and providing loan facilities to them in the form of home loans, auto loans, credit cards, etc, is becoming popular. This used to be considered by the banks as a tough proposition because of the volume of operations involved. But during the last couple of years or so, banks seem to have realized that the only sustainable way to increase deposits is to look at small and middle class consumer retail deposit and not the price sensitive corporate depositors. With financial sector reforms gathering momentum, the banking system is facing increasing companies from non-banks and the capital market. More and more companies are tapping the capital market directly for finance. This is one of the main reasons for the banks to focus vigorously on the much ignored retail deposits. Another reason is the current liquidity the margins are 1 to 2 percent above the prime rate; in retail market they are 3to4 percent.

Today's retail banking sector is characterized by three basic characteristics:

1. Multiple products (deposits, credit cards, insurance, investments and securities)
2. Multiple channels of distribution (call centre, branch, internet)
3. Multiple customer groups (consumer, small business, and corporate).

### **Scope for Retail Banking In India**

All round increase in economic activity Increases the purchasing power. The rural areas have the large purchasing power at their disposal and this is an opportunity to market Retail Banking. India has 200 million households and 400 million middle class populations. More than 90% of the savings come from the house hold sector. Falling interest rates have resulted in a shift. "Now People Want To Save Less And Spend More.". Nuclear family concept is gaining much importance which may lead to large savings. Large number of banking services to be provided are day-by-day increasing. Tax benefits are available for example, in case of housing loans the borrower can avail tax benefits for the loan repayment and the interest charged for the loan.

### **Advantages of Retail Banking**

Retail banking has inherent advantages. Advantages are analyzed from the resource angle and asset angle.

#### **Resource side**

- Retail deposits are stable and constitute core deposits.
- They are interest insensitive and less bargaining for additional interest.
- They constitute low cost funds for the banks.
- Effective customer relationship management with the retail customers built a strong customer base.
- Retail banking increases the subsidiary business of the banks.

### **Assets side**

- Retail banking results in better yield and improved bottom line for a bank.
- Retail segment is a good avenue for funds deployment
- Consumer loans are presumed to be of lower risk and NPA perception.
- Helps economic revival of the nation through increased production activity.
- Improves lifestyle and fulfils aspirations of the people through affordable credit.
- Innovative product development credit.
- Retail banking involves minimum marketing efforts in a demand –driven economy.
- Diversified portfolio due to huge customer base enables bank to reduce their dependence on few or single borrower
- Banks can earn good profits by providing non fund based or fee based services without deploying their funds.

### **Disadvantages of retail banking**

- a. Designing own and new financial products is very costly and time consuming for the bank.
- b. Customers now-a-days prefer net banking to branch banking. The banks that are slow in introducing technology-based products, are finding it difficult to retain the customers who wish to opt for net banking.
- c. Customers are attracted towards other financial products like mutual funds etc.
- d. Though banks are investing heavily in technology, they are not able to exploit the same to the full extent.
- e. A major disadvantage is monitoring and follow up of huge volume of loan accounts inducing banks to spend heavily in human resource department.
- f. Long term loans like housing loan due to its long repayment term in the absence of proper follow-up, can become NPAs.
- g. The volume of amount borrowed by a single customer is very low as compared to wholesale banking. This does not allow banks to exploit the advantage of earning huge profits from single customer as in case of wholesale banking.

### **Retail banking Products/services**

Banks keep on introducing new services and new products aimed at satisfying the varied requirements of retail customers. To quote a few:

1. Housing finance
  2. Vehicle loans
  3. Doctor's loans
  4. Teacher's loans
  5. Gold loans
  6. Rental loans
  7. Loans for women
  8. Loans for Solar Water Heaters
  9. Loans for pensioners
  10. Consumer loans
  11. Personal loans
  12. Educational loans
  13. Marriage loans, consumption loans etc.
1. **Housing finance/loan**

Providing shelter to the needy, poor, disabled and backward classes is one of the important economic activities of the Government. Besides this, investment in housing has become a necessity for one's own shelter and for his family. Moreover, investment in housing is considered as a hedge against inflation, since, in most cases the rise in land values is more than the rise in inflation rates. In spite of these advantages, housing development has been rather slow in many developing countries. It is so because housing is a huge investment requiring long term finance. Housing construction is a special category of industry which neither comes under manufacturing sector nor under services sector. However, housing is important to development in both economic and welfare terms.

### **Risks in Housing Finance**

Till recently, housing finance was considered to be a risky venture from the point of view of financial institutions due to the following reasons:

#### **2. Large Investment**

Generally, house construction or purchase of land/home requires a large amount of investment. Hence, lending institutions hesitate to lock up their funds heavily on one project inviting huge risk.

### **(ii) Long term advance**

Again house construction or purchase requires finance for a longer period say 20 to 25 years. Since most of the resources of the lending institutions are short term in nature, they hesitate to lock up their funds for longer periods.

***(iii) High Inflation Rate***

In many countries, the inflation rates are going up like anything which eats away the interest rates charged by the lending institutions.

***(iv) High Stamp Duty***

Creating a legal charge in the houses/lands is very costly since the stamp duties are very heavy. Again, properties have to be reconvened on repayment of loans. It also calls for additional stamp duties.

***(v) Defective Title***

It is very difficult to ascertain the legal title of the borrower. Succession laws, Tenancy laws etc., vary from region to region and from religion to religion. It becomes all the more difficult to find out the genuine title of the borrower.

***(vi) High Delinquency Rate***

In recent times, non-performing loans are on the increase in the housing finance sector. The growing non-repayment problem causes much concern to the lending institutions.

***(vii) Keen Competition***

There is a keen competition in the housing finance sector resulting in very low interest rates also.

**HOUSING FINANCE—A DOMINANT RETAIL FINANCING**

Today one can witness a paradigm shift to housing finance. Housing finance has become a lucrative business to many banking and non-banking companies. Almost all financial institutions seem to concentrate on 'retail financing' rather than 'wholesale financing'. Lending to corporates and big institutional borrowers is called wholesale lending or financing. On the other hand, lending to individuals and group of individuals come under the category of 'retail financing'. In retail financing, housing finance grows at an impressive rate due to various reasons. Easy access at affordable rates has accelerated the tempo of housing activities in recent times. Different financial products have been introduced to cater to the vast housing requirements of varied people. Housing loans are given not only for construction, but also for extension, improvements etc. Loans are given for furnishing houses and also for paying stamp duties. Banks have come forward to waive the processing fees. Housing loans are sanctioned with flexible repayment schedule which can be decided by the customers themselves. Housing loans are sanctioned for family planning clinics, health centers, educational, social, and cultural and other institutions also. Shopping centers in residential areas can also avail of housing loan facilities.

**Housing / home loan products**



**Generally, the following financial products are available in the housing market.**

3. Housing loan for purchase of homes – This product is available purely for the purchase of either new houses or flats or existing ones.
  - (ii) *House construction loan* – This product is available only for the construction of new houses.
  - (iii) *Home extension loan* – This is available purely for expanding an already existing home.
  - (iv) *Home improvement loan* – This is granted for renovating an existing home.
  - (v) *Flexible repayment plan* – This type of housing loan permits the borrower to fix the repayment schedule as per his option.
  - (vi) *Flexible loan installment plan* – Under this type of housing loan, the borrower can decide the amount of installment to be paid according to his discretion on the basis of his future earnings.
  - (vii) *Home transfer or conversion loan* – This product is available to those who have already availed of housing loans and want to move to another house for which additional funds are required. Under this type, the existing housing loan is transferred to the new housing loan amount without the necessity of settling the previous loan account.
  - (viii) *Home furnishing loan* – This product is available to furnish a house fully.
  - (ix) *Housing repayment or refinance loan* – This loan is available to redeem the prior debts incurred for the purchase of homes from friends, relatives and other private sources.
  - (x) *Housing loan transfer plan* – This loan is available to pay off an existing housing loan with a higher interest rate and enjoy a new loan with a lower rate of interest.
  - (xi) *Bridge loan for housing* – This product is available to those who wish to sell their old homes and purchase another. This loan is available for the new home until a suitable buyer is found for the old home.
  - (xii) *Stamp duty / Documenting Loan* – this is the HL product meant for payment of stamp duty and other documentation charges in connection with house purchases.

**Housing finance institutions**

A number of institutions play a dominant role in the field of housing finance. The most important ones are the following:

- I. National Housing Bank (NHB)
- II. Commercial Banks
- III. Cooperative Banks
- IV. Housing and Urban Development Corporation Ltd. (HUDCO)



V. Housing Development Finance Corporation (HDFC) and other Private Finance Companies

VI. Insurance companies.

### **National Housing Bank**

The National Housing Bank was set up on July 9, 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions, both on regional and local levels. It was established as a subsidiary of the RBI with a view to coordinating and developing housing finance schemes. Following are the main functions of the NHB:

4. To promote and develop specialized housing finance institutions for mobilizing resources and supplying credit for house construction.

(ii) To provide refinance facilities to housing finance institutions and scheduled banks.

(iii) To provide guarantee and underwriting facilities to housing finance institutions.

(iv) To promote schemes for mobilization of resources and extension of credit for housing especially for economically weaker sections of the society.

(v) To co-ordinate the working of all agencies connected with housing.

### **Commercial Banks**

For a long time, the commercial banks were rather reluctant to enter into the field of housing finance since it is of a long-term nature. But, today, both public and private sector banks have changed their outlook completely and they have started to look at housing finance as a very lucrative business. Many banks have set up their own subsidiaries exclusively for providing housing finance especially to meet the housing requirements of the lower and middle income groups. Some of the subsidiaries established by commercial banks to provide housing finance are the following:

<i>Name of the Bank</i>	<b>Name of the Housing Finance Company (Subsidiary companies)</b>
(i) State Bank of India	State Bank of India Housing Finance (SBIHF)
(ii) Punjab National Bank	Punjab National Bank Housing Finance Ltd. (PNBHFL)
(iii) Andhra Bank	Andhra Bank Housing Finance Ltd. (AHFL)
(v) Canara Bank	Can Fin Homes Ltd. (CFHL)
(vii) Vijaya Bank	VBank Housing Finance Ltd. (VHFL)
(viii) Bank of India	Indian Bank Housing Finance Ltd. (IBHFL)

### **Co-operative Banks**

Besides providing finance, these banks/ societies pay a special attention to the provision of all amenities necessary for a comfortable living. These societies also extend finance for purchase of residential plots developed by them. The State Level Apex Co-operative Housing Finance Society (ACHFS) co-ordinates the housing financial requirements of various cooperative housing societies. It is eligible to get refinance facility from the NHB.

### **Housing and Urban Development Corporation Ltd.**

The HUDCO was incorporated as a fully owned Government Company with the main objective of financing the urban infrastructure development projects, approved by the Government. Since the problem of housing is very acute in urban areas, it concentrates on urban development projects by providing shelter to the poor and for low income groups. It is the nodal agency for implementing various government housing programmes.

### **HDFC and Other Private Housing Finance Companies**

The Housing Development and Finance Corporation (HDFC) was set up in the private sector in 1977 by institutions like ICICI, IFC (International Finance Corporation) etc. Today it has become the largest provider of housing finance in India. It has pioneered a variety of housing loans like group loans, housing complexes, housing societies etc. It lends to companies employers and institutions to finance their house construction requirements for their employees, staff quarters etc. It also provides loans to individuals, groups and societies. Apart from the HDFC, many housing finance corporations have come into existence in the private sector. Some of these institutions are:

- a. Birla Home Finance Ltd. (NHFL)
- b. Sundaram Home Finance Ltd. (SHFL)
- c. Global Housing Finance Corporation Ltd. (GHFCL)
- d. Dewan Housing Finance Corporation Ltd. (DHFCL)
- e. Maharishi Housing Finance Corporation Ltd. (MHFCL)
- f. Home Trust Housing Finance Corporation Ltd. (HHFCL).

These institutions have designed some innovative housing finance products so as to cater to the requirements of various types of borrowers.

### **Insurance Companies**

The LIC has set up the LIC Housing Finance Ltd. in 1989 with the objective of providing long-term finance for purchase/construction of houses/flats to its policyholders directly throughout India. It offers a variety of housing loans for re-constructions, renovations etc. It has designed special schemes for professionals, NRIs etc.

The General Insurance Corporation is also actively engaged in providing housing finance indirectly through other institutions like HUDCO or through State Governments. It has also set up a

separate company viz., GIC Housing Finance Ltd. to activate the home loan process. Thus, the insurance companies have emerged as vibrant housing finance institutions in recent years.

### **Reasons for the Popularity of Housing Finance (Advantages)**

The bank finance to the housing sector has become an attractive channel due to the following reasons:

#### *5. Safety Advances*

Housing finance, though a long-term finance is considered to be a safe advance since it is backed by mortgage of house.

#### *(ii) Refinance Facility*

Almost all banks are eligible to get refinance from the NHB for their advances to the housing sector. Hence, there will be no financial crunch on the part of the bankers.

#### *(iii) Asset-Liability Management (ALB)*

The longer tenures of housing finance facilitate ALB. Since the RBI's guidelines permit banks to elongate repayment periods quoting variable interest rates, the ALM becomes an easy task.

#### *(iv) Priority Sector Advance*

Housing loans up to Rs.10 lakhs have been brought under the category of priority sector advances. It enables the commercial banks to fulfill their priority sector advances target.

#### *(v) Low Default*

Banks have found out that the default risk is very low in the case of housing finance. Hence, there is no problem of NPA management.

#### *(vi) Reduction in Risk Weightage*

Again, the RBI has reduced the risk weightage from 100% to 50% for loans granted for acquiring residential houses. It helps commercial banks to satisfy the capital adequacy norms also.

#### *(vii) Passing of SARFAESI Act-2002*

The passing of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act has paved way for the commercial banks to directly deal with the security by giving wide process, instead of undergoing a cumbersome procedure of approaching a court to deal with such securities in case any default is committed by borrowers.

#### *(viii) Establishment of Asset Reconstruction Company (ARC)*

The establishment of ARC has given another boost to housing finance since it facilitates securitization of mortgaged housing loans.

*(x) Mortgaged Credit Guarantee Scheme*

The NHB has come forward to give guarantee to the debentures, bonds and other securities issued by commercial banks for the purpose of raising adequate resources for housing finance.

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

**(II) CONSUMER LOAN / CONSUMER CREDIT**

The services of banks which facilitate finance for purchasing consumer durables is called consumer loan or credit or finance. It refers to the raising of finance by individuals for meeting their personal expenditure or for the acquisition of durable or semi durable goods. It is an important asset based financial service in India. The objective of consumer finance is to provide credit easily to the consumer at his door steps. This include credit merchandising deferred payments, instalments, instalment buying, hire purchase, payout of income scheme, pay-as-you earn scheme, easy payment, credit buying, instalment credit plan, credit cards etc.

**Features of consumer credit**

1. **Acquisition of durable assets-** it is a method of financing for acquiring durable and semi-durable assets
2. **Individual financing-** under consumer credit scheme, finance is provided to individual or to joint individuals.
3. **Immediate possession-**consumer get possession of assets immediately when a fraction of price is paid
4. **Payment in instalments** – under consumer credit scheme assets price is paid through number of instalments.
5. **Short or medium term finance-** duration of finance normally ranges between 3 months to 5 years.
6. **Agreement** – when there are only 2 parties to the contract, it is called a bipartite agreement (customer and dealer cum financier) and where there are three parties, such agreement called tripartite agreements (the customer, dealer and financier).
7. **Multiple structure-** structure of financing may by way of hire purchase, conditional sale or credit sale.
8. **Down payment-** it involves down payment normally ranging from 20 to 25% of asset price.

**Forms / Types of Consumer credit**

- 1. Revolving Credit:** it is an ongoing credit arrangement. It is similar to overdraft facility. Here a credit limit will be sanctioned to the customer and the customer can avail credit to the extent of that limit. Eg. Credit card.
- 2. Cash loan:** the buyer consumer get ready cash from banks and financial institutions.
- 3. Secured Credit:** in this form, the financier advances money on the security of appropriate collateral.
- 4. Unsecured credit:** when financier advances fund without any security such advances called unsecured credit. But it is allowed only to reputed customers.
- 5. Fixed credit:** in this form, finance is made available to the customers as a term loan for fixed period say, for one year, for 5 years and so on.

### **Advantages of Consumer Credit**

- 1. Compulsory saving:** it promotes compulsory saving habit among the people. To make periodical installments knowingly or unknowingly people cut short their other expenses and save.
- 2. Convenience:** considering nature and types of consumers, credit facility offers schemes to the convenience of the consumers. Eg. “Walk in, Drive out”, “Pay as you earn”.
- 3. Emergencies:** Consumer credit is also available to meet personal urgent requirements like family requirements, festival requirements, marriage requirements etc.
- 4. Assists to meet target:** when the dealer themselves arrange credit facility to the consumers, more and more customers will be attracted so that sales target can be easily achieved.
- 5. Assists to make dreams to reality:** Consumer credit facilitates an opportunity to possess and own those dreams on convenient terms.
- 6. Enhances living standard:** consumer credit enhances living standard of the people by providing latest articles and amenities at reasonable and affordable terms.
- 7. Accelerates Industrial Investments:** increasing demand for consumer durables results into flow of more investment in related industry.
- 8. Economies of large scale production:** More demand leads to more production which leads to large scale operation and thus leads to price reduction for consumers.
- 9. Economic Development and national Importance:** above said factors will promotes employment opportunities, national income, economic balance etc. of a country.

### **Disadvantages of Consumer Credit**

1. **Promotes blind buying-** facility to purchase at somebody else's money tempts people to buy blindly and unnecessary articles.
2. **Leads to Insolvency:** blind buying of goods make these people insolvent/ bankrupt within a short span of time.
3. **It is costlier:** along with the convenience that it offers it charge the customers for all these convenience offered. Thus it becomes costlier.
4. **Artificial boom:** the economic development posed by the impact of consumer credit is not real but artificial.
5. **Bad debt Risk:** by whatever name called credit is always have inherent credit risk. Default is a major threat of consumer credit.
6. **Economic Instability:** artificial boom and depression leads to economic instability and causes chaos in economic progress.

### (iii) VEHICLE LOANS

Vehicle loans are given to purchase a new or used vehicle of any make to individuals, professionals and business people.

#### Features

- Purpose: Vehicle loans are offered to purchase four wheelers and two wheelers such as motor bikes and scooters.
- Eligibility: Individuals, professionals and businessmen with minimum gross salary/income of Rs.75,000 p.a. and salaried persons with 40% net take home salary after loan deduction are eligible for this loan. Private banks have fixed the minimum amount of Rs. 1,20,000 p.a. for this facility.
- Loan Amount: New Vehicle-90% of the invoice value with no ceiling on maximum amount.
- Old Vehicle-75% of the original value or negotiated purchase price of assessed vehicle whichever is the least subject to a maximum of Rs.6 lakh. Some private sector banks have fixed the maximum limit to Rs.20 lakh for new vehicle and Rs.3 lakh for used cars.
- Repayment period: Maximum repayment period is 72 months in public sector banks. In private banks it is restricted to five years.
- Security-Hypothecation of vehicle and personal guarantee. 15% of Road price for new vehicle and 40% of the purchase price or market value whichever is low generally for old vehicle.

### (IV) GOLD LOANS

- **Purpose:** To meet the medical expenses and other unforeseen commitments/contingencies, investment purposes and domestic purposes.
- **Eligibility:** The customer should be a Savings Bank account holder. New customers introduced by well-known persons and creditworthy borrowers are also eligible.
- **Quantum of Loan:** Minimum Rs.5,000 and maximum amount upto Rs.3 lakh. Some private bankers provide gold loan upto Rs.5 lakh.
- **Repayment:** 24 months to 30 months depending on the convenience of the borrower in Equated Monthly Installments.
- **Security:** Gold ornaments, gold jewellery and gold coins.

## (V) EDUCATIONAL LOANS

Educational loans are extended by banks to meritorious students to pursue their higher studies and thereby spreading education in the country.

### *Features*

- Purpose: Loans are given to meritorious students who study in schools, colleges and also foreign universities..
- Quantum of Loan: Maximum: Rs.7.5 lakh for study in India. Rs.15 lakh for study abroad.
- Margin: Upto Rs.4 lakh – Nil Above Rs.4 lakh – 5% in India – 15% abroad on estimate.
- Interest: Upto Rs.2 lakh – 11%, Above Rs.2 lakh upto Rs.7.5 lakh – 11.5%, Above Rs.7.5 lakh – 10%
- Security: No security is insisted upon for educational loan.

Some banks offer 1% concession in interest in case of security given for the loan:

- Repayment: Six months after completion of the course. If the student gets employed in six months after completion, repayment starts immediately.

Repayment period is 5 to 7 years depending upon generation of income. Interest is charged for the amount disbursed and to be paid during the course of study.

### *Advantages*

From the students point of view the following are the advantages:

- ✓ **Timely Finance:** Students are able to pursue their studies as finance is no problem for them. Loans are granted for the total expenses of the study covering the college fee, examination fee and also hostel expenses. The students avail loans easily as the formalities connected with the sanctioning of the loan is simple.

- ✓ **No Security:** No security is insisted for education loan. So poor, but meritorious students can avail of this facility.
- ✓ **No burden for Parents:** The parents are relieved from the burden of arranging money for the payment of exam fees, mess charges and other expenses as and when they arise.
- ✓ **Creates Confidence:** The obligation to repay the loan amount after completion of the course makes the students serious about their studies and creates confidence in them.

**Advantages For Banks:** The advantages of extending Educational Loan for banks are the following:

- It helps spreading of education, particularly higher education among poor but meritorious candidates.
- By this, the banks are fulfilling the social objective of spreading education and thereby discharging their social responsibility.

#### **Disadvantages**

There are certain disadvantages in giving Educational Loan from the point of view of banker's.

- **Repayment:** Loans are sanctioned in the student's name. The interest during the holiday period i.e., during course of study is to be paid by the parents concerned. Many parents are unable to pay the interest during the period.
- **Follow up:** The follow up and recovery is a major problem in this type of loan. The beneficiaries fail to intimate the banks about the change of address, place of employment etc. Hence, the banks could not follow and recover the dues.
- **Recovery:** As no security is offered by the students the bankers have no holdings and recovery is a problem.

#### **(Vi) DOCTOR'S LOANS/MEDICAL SERVICE LOANS**

- **Purpose:** To construct hospital building, hospital building cum-residence, setting up of nursing home, polyclinics etc., for expansion/modernization of existing hospital premises. To purchase medical equipments, ambulance and other items necessary for the hospital.
- **Eligibility:** Individuals, partnership firms, limited companies and Trusts. In case of firms, companies and Trusts, one of the partners/directors/trustees should be a medical practitioner or they should engage the services of Registered Medical Practitioner in the hospital.
- **Quantum of Credit:** Upto a maximum of Rs. 15 lakh.
- **Repayment:** Repayment shall be fixed on the basis of income generation of the borrower and the period shall not exceed 7 years.



- **Security:** The security is the one created out of finance. In some cases collateral security is also insisted by the banker.
- **Margin:** Generally, 10% to 25% margin is prescribed for this type of loan.

#### **(VII) TEACHERS' LOANS**

- **Purpose:** To meet the pressing needs like educational expenses of children, medical treatment of self and family, marriages of children etc.
- **Eligibility:** Teaching and non-teaching staff in confirmed service in schools and colleges drawing salaries through the branches concerned.
- **Quantum of Loan:** Generally 6 months net salary or Rs.1 lakh whichever is less.
- **Repayment:** Repayment upto 36 months. **Security:** Co-obligation of suitable person.

#### **(VIII) RENTAL LOANS**

- **Purpose:** To meet the financial requirement of the owner of the building.
- **Eligibility:** Owners of buildings and commercial properties in semi urban/urban/metro areas which are to be rented or already rented to business houses, banks and reputed corporates.
- **Loan Amount:** 75% of the rent receivable less TDS if any, over a period of 36 months or residual lease/rent agreement period whichever is lower subject to a maximum of Rs.50 lakh.
- **Security:** The building against the rentals of which the loan is sanctioned. Assignment of rent receivable from lessor is necessary. In case, the lessee agrees to remit the rent directly to the loan account of the borrower, a power of attorney will be obtained from the lessor and lessee.
- **Repayment:** 5 years or residual lease/rent agreement period whichever is less.
- **Margin:** 25% on future rent to be received less TDS or residual lease/rent agreement period whichever is lower.

#### **(IX) LOANS FOR WOMEN**

This is an exclusive loan scheme for women. Working and non-working women between the age group of 18 and 55 are eligible for this loan.

This loan enables women to avail credit up to Rs.50,000 to meet personal needs such as buying household articles, gifts, jewellery etc. Repayment 2 to 3 years.

#### **(X) LOAN FOR PENSIONERS**

- **Purpose:** To meet medical and other genuine personal needs of pensioners.

- **Eligibility:** Pensioners of Central/State Government, public sector undertakings, corporate pensioners and pensioners of banks drawing pensions through the branch.
- **Quantum of Loan:** Upto 6 months pension amount or Rs.50,000 ‘ ’ whichever is less.
- **Repayment:** Repayment upto 24 months.
- **Security:** Co-obligation of spouse/suitable person.

**(xi) PERSONAL LOANS**

- **Purpose:** For meeting genuine needs of finance. **Eligibility:** Employees (confirmed service) of
  - a) Public sector undertakings.
  - b) Private and public limited companies.
  - c) Central and State Government employees.
  - d) Teachers in colleges and universities.
  - e) Employees drawing salary through banks. Net take home salary to be 40% of the gross salary.
- **Quantum of Loan:** Up to 6 months gross salary or Rs. 1 lakh whichever is less.
- **Repayment:** Repayment in 60 equated monthly instalments.
- **Security:** Co-obligation of a suitable person.

**Credit Card and Debit Card**

A credit card is a small plastic card issued to users as a system of payment. It allows its holder to buy goods and services based on the holder’s promise to pay for these goods and services. The issuer of the card creates a revolving account and grants a line of credit to the consumer (or the user) from which the user can borrow money for payment to a merchant or as a cash advance to the user.

Credit card can be defined in many ways with different senses. It is difficult to give a perfect definition of credit card. Following statements are attempts to help you derive its narrow and broad meaning.

6. In **General** sense,

“Credit card is a suitable alternative for cash payment or credit payment or deferred (instalment) payment. It is used to execute those transactions which are compiled through electronic devices like a card swapping machine, computer with internet facility, etc.”

7. In a **Financial** perspective,

“Credit card is a facility provided by a bank or non-banking financial company (NBFC) which gives its customer a preference to have a short-term borrowing of funds usually at the point of transaction (while purchasing something or carrying out sale).”

8. In terms of **Business**,

“Credit card is a laminated plastic card issued by a bank or non-banking financial company (NBFC) to give its cardholder a preference to borrow funds on a short-period basis. Interest is imposed for lending short-term finance to the cardholder. This interest is generally charged either after a month or 30-45 days later, once credit-card transactions have occurred. The card limit is pre-communicated in written correspondence with cardholder.”

### **Features of credit card**

9. Alternative to cash

Credit card is a better alternative to cash. It removes the worry of carrying various currency denominations to pay at the trade counters. As an alternative, credit card helps a cardholder to travel anywhere in the world without a need to carry an ample amount of cash. It also reduces the possible risk of money theft and gives its user a complete peace of mind.

10. Credit limit

The credit cardholder enjoys the facility of a credit limit set on his card. This limit of credit is determined by the credit card issuing entity (bank or NBFC) only after analyzing the credit worthiness of the cardholder.

The credit limit is of two types, viz.,

1. Normal credit limit, and
2. Revolving credit limit.

Normal credit limit is usual credit given by the bank or NBFC at the time of issuing a credit card. Revolving credit limit varies with the financial exposure of the credit cardholder.

11. Aids payment in domestic and foreign currency

Credit card aids its cardholder to make payments in any currency of choice. In other words, it gives its holder a unique facility to make payments either in domestic (native) currency or if necessary, also in foreign (non-native) currency, that too as and when required. Credit card reduces the cumbersome process of currency conversion.

12. Record keeping of all transactions

Credit card issuing entities like banks or NBFCs keep a complete record of all transactions made by their credit cardholders. Such a record helps these entities to raise appropriate billing amounts payable by their cardholders, either on a monthly or some periodic basis.

13. Regular charges

Regular charges are basic routine charges charged by the credit card issuing entity on the usage of credit card by its cardholder. These charges are nominal in nature. The regular charges are primarily classified into two types, viz.,

1. Annual charges, and
2. Additional charges.

14. Grace period

The grace period is referred to those minimum numbers of additional days within which a credit cardholder has to pay his credit card bill without incurring interest or financial charges.

15. Higher fees on cash withdrawals

Credit-card issuer makes charges on cash withdrawals made through credit card at the ATM outlets and other desks. Generally, cash withdrawal fees are quite higher than fees charged by the bank or NBFC for the other regular credit transactions.

16. Additional charges for delay in payment

The credit card payment is supposed to be made within a due date as mentioned on the bill of a credit card. If payment is not paid on time, then a credit-card issuer charges some additional costs, which are resulted due to delay in payment.

17. Service tax

Service tax is included in the total amount charged to the credit cardholder. This mandatory service tax imposed by the government also increases the final end cost borne by a credit cardholder.

10. Bonus points

The competition among the credit card providers is unbending (adamant). Offering various incentives is usually a trendy (fashionable) way to improve the sale of the products in the ordinary course of business. Following this trend, credit card providers also give bonus points on the financial value of the transactions compiled by their customers.

At a later stage (i.e. after crossing pre-determined number of bonus points) accumulated bonus points are redeemed either by converting them into gifts, cash back offers, or any other similar compelling offers. To collect many bonus points, the credit cardholder has to carry out a considerable number of transactions through his credit card.

### **Elements /parts / anatomy of credit card**

The front side of a credit card shows following details:

18. Logo of issuing entity.
19. Logo of payment processor.
20. Hologram.
21. Expiration date.
22. Cardholder's name.
23. Card number.
24. Individual account identifier number.
25. Issuer identifier number (IIN).
26. Embedded microchip.
27. Major industry identifier (MII).
28. Issue date
29. Bank identification number (BIN).

The back side of a credit card shows following details:

1. Security code (card verification number).
2. Magnetic stripe.
3. Signature panel.
4. Additional information.

### **Types of Credit Card**

Credit cards now are of various types with different fees, interest rates and rewarding programs. When applying for a credit card, it is important to learn of their diverse types to know the one best suited to their lifestyle and financial status. Different types of credit cards available by banks and other companies/organizations are briefly described below.

1. **Standard Credit Card:** This is the most commonly used. One is allowed to use money up to a certain limit. The account holder has to top up the amount once the level of the balance goes down. An outstanding balance gets a penalty charge.
2. **Premium Credit Card:** This has a much higher bank account and fees. Incentives are offered in this over and above that in a standard card. Credit card holders are offered travel

incentives, reward points, cash back and other rewards on the use of this card. This is also called the Reward Credit Card. Some examples are: airlines frequent flier credit card, cash back credit card, automobile manufacturers' rewards credit card. Platinum and Gold, MasterCard and Visa card fall into this category.

3. **Secured Credit Card:** People without credit history or with tarnished credit can avail this card. A security deposit is required amounting to the same as the credit limit. Revolving balance is required according to the 'buying and selling' done.
4. **Limited Purpose Credit Card:** There is limitation to its use and is to be used only for particular applications. This is used for establishing small credits such as gas credits and credit at departmental stores. Minimal charges are levied.
5. **Charge Credit Card:** This requires the card holder to make full payment of the balance every month and therefore there is no limit to credit. Because of the spending flexibility, the card holder is expected to have a higher income level and high credit score. Penalty is incurred if full payment of the balance is not done in time.
6. **Specialty Credit Card:** is used for business purposes enabling businessmen to keep their businesses transactions separately in a convenient way. Charge cards and standard cards are available for this. Also, students enrolled in an accredited 4-year college/university course can avail this benefit.
7. **Prepaid Credit Card:** Here, money is loaded by the card holder on to the card. It is like a debit card except that it is not tied up with a bank account

#### **Advantages of credit card**

1. They allow you to make purchases on credit without carrying around a lot of cash. This allows you a lot of flexibility.
2. They allow accurate record-keeping by consolidating purchases into a single statement.
3. They allow convenient remote purchasing – ordering/shopping online or by phone. They allow you to pay for large purchases in small, monthly instalments.
4. Under certain circumstances, they allow you to withhold payment for merchandise which proves defective.
5. They are cheaper for short-term borrowing – interest is only paid on the remaining debt, not the full loan amount.
6. Many cards offer additional benefits such as additional insurance cover on purchases, cash back, air miles and discounts on holidays.

### **Disadvantages of credit card**

1. You may become an impulsive buyer and tend to overspend because of the ease of using credit cards. Cards can encourage the purchasing of goods and services you cannot really afford.
2. Credit cards are a relatively expensive way of obtaining credit if you don't use them carefully, especially because of the high interest rates and other costs.
3. Lost or stolen cards may result in some unwanted expense and inconvenience.
4. The use of a large number of credit cards can get you even further into debt.
5. Using a credit card, especially remotely, introduces an element of risk as the card details may fall into the wrong hands resulting in fraudulent purchases on the card. Fraudulent or unauthorized charges may take months to dispute, investigate, and resolve.

### **Debit card**

A debit card (also known as a bank card or check card) is a plastic card that provides the cardholder electronic access to his or her bank account/s at a financial institution. Some cards have a stored value against which a payment is made, while most relay a message to the cardholder's bank to withdraw funds from a designated account in favour of the payee's designated bank account. The card can be used as an alternative payment method to cash

when making purchases. In some cases, the cards are designed exclusively for use on the Internet, and so there is no physical card. In many countries the use of debit cards has become so widespread that their volume of use has overtaken or entirely replaced the check and, in some instances, cash transactions. Like credit cards, debit cards are used widely for telephone and Internet purchases. However, unlike credit cards, the funds paid using a debit card are transferred immediately from the bearer's bank account, instead of having the bearer pay back the money at a later date. Debit cards usually also allow for instant withdrawal of cash, acting as the ATM card for withdrawing cash and as a check guarantee card. Merchants may also offer cash back facilities to customers, where a customer can withdraw cash along with their purchase.

### **Debit card and ATM cards**

Obviously there is a difference between an ATM card and a debit card. An ATM card only allows you to draw cash from your account through an ATM (Automated Teller Machine). A debit card allows you to make financial transactions (purchases mostly) without paying cash. The payment is made by swiping your debit card in a machine at a shop where you made the purchase. The value of your purchase is automatically deducted from your balance in your bank account.

Nowadays, banks provide ATM debit cards, which can be used for both the purposes mentioned above. Similarly, ATM credit cards are also available. A credit card also allows you to make payments on purchases without paying cash. But instead of debiting the value of the purchases to the balance in your bank account after swiping the card at a shop, the bank settles the bill on its

own and sends you a statement showing the different transactions entered into by you using your credit card. You have to settle the amount with the bank within a stipulated time. Additionally, credit cards allow you to make cash withdrawals up to certain limits from ATMs using your ATM credit card which has to be repaid within a stipulated period. Obviously credit cards have no relation to your bank balance.

**Differences between Credit card and Debit card**

	<b>Credit card</b>	<b>Debit card</b>
1	It is a “pay later product”	It is “pay now product”
2	The card holder can avail of credit for 30-45 days	Customers account is debited immediately
3	No sophisticated communication system is required for credit card operation	sophisticated communication network/system is required for debit card operation ( eg.ATM)
4	Opening bank account and maintaining required amount are not essential	Opening bank account and maintaining required amount are essential
5	Possibility of risk of fraud is high	Risk is minimised through using PIN



## MODULE V

### VENTURE CAPITAL

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

#### 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 Rockefeller 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 has 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.

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

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

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

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

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

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

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

### **Stages of Venture Capital Financing**

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

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

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

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

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

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

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

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

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

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

### **Advantages of Venture Capital**

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

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

## Venture Capital in India

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

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

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

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

### Legal Aspects of Venture Capital

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

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

### Guidelines for the Venture Capital Companies

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

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

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

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

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

- (a) has a dedicated pool of capital;
- (b) raised in the manner specified under the Regulations; and
- (c) to invest in venture capital undertakings in accordance with the Regulations.

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

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

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

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

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

- (a) Disclosure of investment strategy;
- (b) Maximum investment in single venture capital undertaking not to exceed 25% of the corpus of the fund;
- (c) Investment in the associated companies not permitted;
- (d) At least 75% of the investible funds to be invested in unlisted equity shares or equity linked instruments.
- (e) Not more than 25% of the investible funds may be invested by way of;
  - (i) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year.
  - (ii) Debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

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

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

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



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

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

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

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

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

**b. Eligibility criteria:** Entity incorporated and established outside India in the form of investment company, trust partnership, pension fund, mutual fund, university fund, endowment fund, asset management company, investment manager, investment management company or other investment vehicle incorporated outside India would be eligible for seeking registration from SEBI. SEBI for the purpose of registration shall consider whether the applicant is regulated by an appropriate foreign regulatory authority; or is an income tax payer; or submits a certificate from its banker of its or its promoters' track record where the applicant is neither a regulated entity nor an income tax payer.

**C. Investment criteria:**

(a) Disclosure of investment strategy;

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

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

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

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



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

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

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

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