Centre for Distance and Online Education
Punjabi University, Patiala.

Class: MCOM-Part-II Semester: III
Paper : MCOP2306T(Management of Financial Services) Unit :1
Medium: English

Lesson No. Updated on: 28.05.2023

1.1 : Financial System
1.2 : Financial Institutions
1.3 : Development Banks
1.4 : NBFCs
1.5 : RBI : Role, Scope and Objectives
1.6 : SEBI

Department website : www.pbidde.org

Syllabus of M.Com.-II (3rd Semester)

ELECTIVE PAPER

GROUP-II: FINANCE

PAPER MCOP2306T : MANAGEMENT OF FINANCIAL SERVICES

Lectures Delivered : 60	Internal Assessment: 30 Marks
Time Allowed: 3 Hrs.	External Assessment: 70 Marks
	Credit : 5

Instructions for Paper Setter/Examiners

The question paper will consist of three sections. Section A and B (Consist of unit I and II of the syllabus, respectively) will have four questions each from respective units and candidates are required to attempt two questions each from section A and B. Each question in section A and B shall carry 10 marks. Section C will consist of 12 short answer type questions covering entire syllabus and the candidates are required to attempt any ten questions. Each question in section C will carry 3 marks.

Course Objectives:

This course aims at acquainting the students with the developments in the areas of financial services and developing their skills to manage financial services .It will give an insight into the strategic, regulatory, operating and managerial issues concerning various financial services.

UNIT-I

Financial Services: Nature and types; Merchant Banking: Role, Services provided by merchant bankers, Structure of Merchant Banking in India, SEBI regulations, recent developments; Venture Capital: Characteristics, SEBI guidelines, venture capital funds in India; Leasing: Characteristics and types, Leasing and Hire-Purchase. Underwriting: concept, SEBI regulations.

UNIT-II

Mutual Funds: Meaning, types, measuring return of mutual funds, SEBI guidelines, Performance of Mutual Funds in India, current developments; Credit Rating: Meaning, significance, types; SEBI regulations for credit rating, Credit Rating Agencies; Factoring: characteristics and forms, Factoring in India; Forfeiting. Plastic Money: Concept, various forms of plastic money. Growth and Present Scenario of Plastic Money in India.

Course Outcome:

After the completion of this course, the students will develop their knowledge about operations, strategies, regulations and other managerial issues concerning these financial services.

Suggested Readings:

1. Bansal, L.K., Merchant Banking and Financial Services, Tata McGraw Hill.
2. Bhole, L.M., Financial Institutions and Markets: Structure, Growth and Innovations, Tata McGraw-Hill.
3. Gurusamy, S., Financial Markets and Institutions, Thompson Learning.
4. Khan, M.Y., Management of Financial Services, Tata McGraw-Hill.
5. Gordon & Natarajan, Emerging Scenario of Financial Services, , Himalaya Publishing House
6. Avadhani, Management of Financial Services, Himalaya Publishing House.

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FINANCIAL SERVICES

5.1.1 Objectives of the Lesson

- To explain the meaning and scope of financial services.
- To study the features of financial services.

- To discuss the various innovative financial services and its regulation.
- To understand the challenges facing the Financial Services Industry.

5.1.2 Introduction:

Since the initiation of the financial sector reforms, there has been a metamorphosis in the financial services industry. Various innovative financial products and services are emerging. Efficiency of the emerging financial system largely depends upon the quality and variety of financial services provided by the banking and non-banking financial companies. Before analyzing the various types of financial services, it is imperative first understand the meaning and scope of financial services.

5.1.3 Meaning and concept of Financial Services:

The term 'Financial Services' can be defined as, "activities, benefits and satisfactions, connected with the sale of money, that offer to users and customers, financial related value".

Suppliers of financial services include the following types of institutions:

(i) Banks and Financial Institutions

(ii) House Building Societies.

(iii) Insurance Companies.

(iv) Credit Card Issuer Companies

(v) Investment Trusts and Mutual Funds

(vi) Stock Exchanges

(vii) Leasing Companies

(viii) Unit Trust

(ix) Finance Companies, and so on.

Financial services organisations render services to industrial enterprises and ultimate consumer markets. These can be further sub-divided to include government/public sector/private sector, the commercial sector, industry and international markets. Within the financial service industry, the main sectors are banks, financial institutions and non-banking financial companies.

5.1.4. Features of Financial Services:

The financial services have the following characteristics:

(1) Intangible. Financial Services cannot appeal to a buyer's sense of touch, taste, smell, sight or hear. Thus an organisation engaged in providing financial services is largely dependent on the feedback from the public as to effectiveness, quality and attractiveness of the services rendered.

(2) Direct sale: Direct sale is the only possible channel of distribution. There are no middlemen in between. In order to ensure that services are available at the right time and at the right place, simultaneous production and distribution of financial services is undertaken by the service organisations.

(3) Heterogeneity: In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations offer a wide range of products and services. They provide a special one-off management service for industrial customers and retail services covering insurance, money receipt or storage etc.

(4) Fluctuation in demand: The demand for certain categories of financial services e.g., life insurance, do fluctuate significantly, according to the level of general economic activity. This factor puts extra pressures on the roles and functions of marketing in insurance organisations.

(5) Protect customer's interest: The responsibility of any financial services organisation to protect customer's Interest is important not just in banking and insurance, but also in other sectors of the financial services.

(6) Labour intensive: Personalised service versus automation, in fact, is an important issue in financial services. The financial service sector is highly labour intensive. It leads to increase in the costs of production and consequently affects the price of financial products. Because of high personnel costs involved and to enhance customer's convenience increased use of technology is being made.

(7) Geographical dispersion: Financial services must have both appeal and wider application. To ensure this, the service providing organisations

must have massive branch network so that benefits of convenience are enjoyed by international, national and local customers.

(8) Lack of special identity: Customers usually approach a nearby branch of a bank or financial Institution, because it is convenient to them. As the competing products offered by various service organisations are similar, the emphasis is more on the 'package' than the product. The package consists of branch location, staff, services, reputation, advertising and new services offered from time to time.

(9) 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. Costs of processing information are quite relevant in the profitable production of financial services.

(10) Require quality labour: Financial services require huge amounts of high quality labour to deal with information and communication with the market. The types of labour range from workers performing simple tasks to those undertaking complex analysis and negotiations require years of training and experience. The importance of labour costs and the role of human inputs in financial service production can be realised from the salaries paid in this industry.

5.1.5 Scope of Financial Services:

Financial services provided by various financial institutions, commercial banks and merchant bankers can be broadly classified into two categories:

(1) Asset based/fund based services.

(2) Fee based/advisory service.

5.1.5.1 Asset/Fund Based Services:

The asset/fund based services provided by banking and non-banking financial institution are :

1. Equipment Leasing/Lease Financing: Leasing has emerged as another important source of intermediate and long-term financing of corporate enterprises during the recent few decades.

There is no exclusive law/legislation to govern equipment lease financing. The relevant provisions of a number of allied legislations constitute the legislative framework of lease transactions. The lease agreements provide for a number of obligations on the part of the lessee which do not form part of his implied obligations under the legislative framework. The legislative framework and the lease agreements provide the regulatory framework of lease financing in India.

Leasing industry in India is a growing business activity in the country.

2. Hire-Purchase and Consumer Credit:

Hire-purchase is an alternative to leasing as a source for equipment financing. Hire purchase means a transaction where goods are purchased and sold on the terms that (i) payment will be made in installments, (ii) the possession of the goods is given to the buyer immediately, (iii) the property (ownership) in the goods remains with the vendor till the last installment is paid, (iv) the seller can repossess the goods in case of default in payment of any installment, and (v) each installment is treated as hire changes till the last installment is paid. Consumer credit includes all asset-based financing plants offered to individuals to help them acquire durable consumer goods. The main providers of consumer credit are foreign/multinational banks, commercial banks and finance companies and cover items such as cars, scooters, VCRs, TVs, refrigerators, washing machines, home appliances, personal computers, cooking ranges, food processors etc. There is, however, no specific legislation to regulate consumer credit in India.

3. Bill Discounting:

Discounting of bills of exchange is an attractive fund-based financial service provided by the finance companies. Bill discounting has emerged as a profitable business for finance companies and represents a diversification in their activities. After the 1992 Scam, RBI imposed certain restrictions on bill discounting services provided by the banks. The RBI has not permitted banks to rediscount bill amongst themselves and with other financial institutions and finance companies. The finance companies act as bill brokers between the banks and business houses.

4. Venture Capital

The term' venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return.

Venture capital financing involves a high degree of risk. Moreover, the guidelines issued by the government for the setting up of venture capital companies are too restrictive and unrealistic and have come in the way of their growth. In addition to the venture capital companies, the Government of India has been instrumental in setting up a number of new financial agencies to serve the increasing needs of the entrepreneurs in the areas of venture capital.

5. Housing Finance

NHB is an apex/principal housing finance institution in the country and is fully owned subsidiary of the RBI. Till now, a number of specialised financial institutions/companies in the public, private and joint sectors have entered in the field of housing finance such as HDFCs, SBIHF, Canfin Home, LIC Housing Finance, Ind Bank Housing, Citi Home, Gujrat Ambuja, ICICI Housing and so on. These companies have designed suitable schemes for individuals, corporates, builders and promoters.

6. Insurance Services

To cater to the varying needs of the insured, a variety of policies are offered by insurance organisations. The principal life insurance policies are endowment, whole life, joint life etc. The important fire insurance policies, offered by insurance companies are specific policy, comprehensive policy, value policy, third party insurance policy. Marine Insurance policies which insure against marine losses are voyage, time, mixed, value open and unvalued, and floating.

Until 1999, there were only two public sector organisations, namely Life Insurance Corporation of India (LIC) and General Insurance Corporation (GIC) and its four subsidiaries, rendering insurance services: LIC providing protection against risk of life and GIC is providing protection against the accident, loss on account of fire and marine losses, theft etc. But with the setting up of the Insurance Regulatory and Development Authority (IRDA) in 1999, their monopoly has been dismantled and new players have entered the field e.g., HDFC Life Insurance, Prudential ICICI Life Insurance, Max New York Life Insurance, SBI Life Insurance, Birla Sunlife Insurance etc.

7. Factoring.

Factoring, as a fund-based financial service, provides resources to finance receivables as well facilitate the collection of receivables. It is another method of raising short-term finance through account receivable credit offered by commercial banks and factors.

At present, factoring in India is rendered by only a few financial institutions on a recourse basis. However, the Report of the Working Group on Money Market (Vaghul Committee) constituted by the Reserve Bank of India has recommended the banks should be encouraged to set up factoring divisions to provide speedy finance to the corporate entities.

5.1.5.2 Fee-Based Advisory Services

(i) Merchant Banking:

'Fee-based advisory services' includes all those financial services rendered by Merchant Bankers. Merchant bankers play an important role in the financial services sector. Section 2(e) of a SEBI Act, 1992 defines 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 as manager consultant, adviser or rendering corporate advisory service in relation to such issue management.

(ii) Credit Rating:

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise. As a fee-based financial advisory service, credit rating is useful to investors, corporates (borrowers), banks and financial institutions. For the investors, it is an indicator expressing the underlying credit quality of a (debt) issue programme. The investor is fully informed about the company as any effect of changes in business/economic conditions on the company is evaluated and published regularly by the rating agency.In India, there are three major credit rating agencies namely:

- CRISIL (Credit Rating Information Services of India Ltd.)
- ICRA (Investment Information and Credit Rating Agency of India Ltd.)
- CARE (Credit Analysis and Research in Equities)

(iii) Stock-Broking

SEBI was set up to ensure that stock exchanges perform their self-regulatory role properly. Since then, stock broking has emerged as a professional advisory service. Stock broker is a member of a recognized stock exchange who buys, sells or deals in shares/securities. It is mandatory for each stock broker to get him/herself registered with SEBI in order to act as a broker. SEBI has taken rigorous steps to regulate the working of brokers-sub-brokers in terms of compulsory registration with SEBI, code of conduct, duty to investors, brokers, general obligations and responsibilities, procedure for inspection, action in default, capital adequacy norms, relationship with client etc.

Self-check exercise1: What are the fund-based and fee-based financial services?

5.1.6 Causes for Financial Innovation

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

(i) Low profitability: The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition: The entry of many financial intermediaries in the financial sector market has led to severe competition among themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic Liberalisation: The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

(iv) Improved communication technology: The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer Service: Now-a-days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations thus help them in soliciting new business.

(vi) Global impact: Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks.

As a consequence, many innovations have taken place in the global financial sector which has its own impact on the domestic sector also.

(vii) Investor awareness: With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

5.1.7 Innovative Financial Instruments:

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been briefly discussed hereunder:

(i) Commercial Paper: A commercial paper is a short-term negotiable money market instrument also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value, since its denomination is very high; it is suitable only to institutional investors and companies.

(ii) Treasury Bills: A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-day bills and 364-day bills.

(iii) Certificates of deposit: The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

(iv) Inter-bank Participations (IBPs): The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days to 180 days. This may be 'with risk' participation or 'without risk' participation. However only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per center per annum. This is also a money market instrument.

(v) Zero interest convertible debenture/bonds: As the very name suggests, these instruments carry no interest till the time of conversion which is after a fixed period of time. These instruments are converted into equity shares after a period of time.

(vi) Deep discount bonds: There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs. 2,00,000 was issued at a deep discounted price of Rs. 5300 with a maturity period of 25 years. Of course, provisions are there for early, withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

(vii) Index-linked guilt bonds: These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation – free instruments.

(viii) Option bonds: These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.

(ix) Secured Premium Notes: These are instruments which carry no interest for three years. In other words, the interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

(x) Medium term Debentures: Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

(xi) Variable rate debentures: Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula.

(xii) Non-convertible Debentures with equity warrants: Generally, debentures are redeemed on the date of maturity. But, these debentures are redeemed in full at a premium in installments as in the case of anticipated insurance policies. The installments may be paid at the end of 5^{th}, 6^{th}, 7^{th} and 8^{th} year from the date of allotment.

(xiii) Equity with 100% safety net: Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs. 50/- per share (nominal value of Rs.10/- per share), the company is ready to get it back at Rs. 50/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs. 30/- there is 100% safety net and hence the company will get it back at Rs. 50/-

(xiv) Cumulative convertible preference shares: These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

(xv) Convertible bonds: A convertible bond is one which can be converted into equity shares at a pre-determined timing either fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

(xvi) Debentures with 'call and 'Put' feature: Sometimes debentures may be issued with 'Call' and 'Put' features. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with, 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.

(xvii) Easy Exit Bond: This bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paying a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years.

(xviii) Retirement Bond: This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period'. The longer the wait-period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity.

(xix) Regular Income Bond: This bond offers an attractive rate of interest payable half yearly with the facility of early redemption.

(xx) Infrastructure bonds: It is a kind of debt instrument issued with a view of giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under the Income Tax Act.

5.1.8 Regulation of Financial Services Industry:

With the initiation of financial sector reforms in 1991, the volume of business in both the primary and secondary segments of the capital market increased. A multi-crore securities scam rocked the Indian financial system in 1992. The then existing regulatory framework was found to be fragmented and inadequate and hence a need for an autonomous, statutory and integrated organization to ensure the smooth functioning of capital market was felt. To fulfill this need SEBI was conferred statutory powers in 1992, SEBI has introduced numerous measures to protect the interests of investors. With a view to creating an awareness among issuers and intermediaries of the need to redress investor grievances quickly, SEBI issues fortnightly press releases, publishing the names of companies against whom maximum number of complaints have been received. To ensure that no malpractice takes place in the allotment of shares, norms have been prescribed by SEBI. SEBI has framed regulations for almost all types of financial services, viz. mutual funds, merchant banking, credit rating etc.

SEBI has introduced automated complaints handling system to deal with investor complaints. The complaints received by SEBI from investors have been divided in categories as:

Type I: Non-receipt of refund order/allotment letters/stock invest

Type II: Non-receipt of dividend.

Type III: Non-receipt of share certificates/bonus shares.

Type IV: Non-receipt of debenture certificates/redemption of debentures.

Type V: Non-receipt of annual reports, rights forms.

Type VI: Complaints related to plantation scheme.

RBI is the apex banking institution and regulator the financial, monetary and banking transactions in India. Umbrella Acts are:

(i) Reserve Bank of India Act 1934, governs the RBI's functions.

(ii) Banking Regulation Act, 1949, governs the financial sector Acts governing specific functions.

(iii) Acts governing Banking operations.

(iv) Companies Act, 1956, governs banks as companies.

(v) Banking companies (Acquisition and Transfer of Undertaking) Act, 1970 relates to nationalization of banks.

(vi) Bankers' Books Evidence Act.

(vii) Banking Secrecy act.

(viii) Negotiable Instruments Act, 1881.

Acts covering Individual institutions:

(ix) State Bank of India, 1954.

(x) Industrial Development Bank of India Act.

(xi) Industrial Finance Corporation of India Act.

(xii) National Housing Bank Act.

Self-check exercise 2: How are financial services regulated?

5.1.9 Financial Intermediaries Rendering Financial Services:

Financial intermediaries play an important role in the financial system. They provide a whole range of financial services to the entities who want to raise funds from the markets or else where. Intermediaries act as facilitators for smooth functioning of the system by making investors and borrowers meet. They also provide services to entities seeking advice on various issues ranging from restricting to diversification plans. Financial intermediaries can be divided into following three categories:

(A) Specialised Financial Institutions or Development Banks

(B) Commercial Banks

(C) Merchant Bankers.

A. Specialised Financial Institutions or Development Banks:

After independence a number of financial institutions has been set up at all India and regional levels for accelerating the growth of industries by providing financial and other assistance required.

The financial institutions include:

(a) All India Development Financial Institutions.

(b) The State Level Development Financial Institutions.

(c) The Insurance Companies.

These specialised financial institutions are also called Development Banks because they provide not only finances but also help in promotion of new enterprises. These institutions have to play a very significant role in the industrial development of our country for the following reasons:

(i) Absence of organised capital markets.

(ii) Lack of entrepreneurial talent.

(iii) Low capital formation.

(iv) Shyness of capital, i.e. people prefer to invest only in traditional areas and are reluctant to take risk in new ventures.

(v) Inadequacy of financial facilities to meet huge requirements of funds for industrial development, and

(vi) Planned economic development to achieve the socio-economic objectives.

At present there are four important financial institutions at the national level i.e., the Industrial Finance Corporation India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), the Industrial Reconstruction Corporation of India (IRCI) now called Industrial Investment Bank of India Ltd. (IIBIL). In addition, there are 19 State Financial Corporations (SFCs) and 24 State Industrial Development Investment Corporation. Apart from these specialised financial institutions, commercial banks, industrial co-operatives, small industrial development corporations, Unit Trust of India, Life Insurance Corporation, National Industrial Development Corporation, etc. also provide finance for the development of industries in the country. Besides these institutions, commercial banks provide short-term as well long-term finance. The Reserve

Bank of India is also providing industrial finance through other financial institutions.

These are some international financing institutions like World Bank and its affiliates such as International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC) and Asian Development Bank (ADB). All these institutions also provide industrial finance, some through member countries while others directly to the enterprises. The help rendered by all such institutions has accelerated the pace of industrialization.

There are many advantages of raising loans from the specialised financial institutions, such as:

(a) Availability of finance for development schemes.

(b) Reasonable security requirements.

(c) Availability of finance during periods of depression.

(d) Easy repayment facility.

(e) Underwriting facility.

Such institutions help in promoting new companies; expansion and development of existing companies and meeting the financial requirement of companies during economic depression.

To enable the financial service industry to play a dynamic role and to face the global competition in an effective way, the Government of India has recently taken the following steps:

(i) Privatization of public sector undertaking.

(ii) Shifting of pricing issued from the Controller of Capital Issues to free pricing.

(iii) Full convertibility of Indian Rupee on current account.

(iv) Permitting private sector to participate in banking and mutual funds.

(v) De-regulation of interest rates.

(vi) Signing of the GATT agreement and the affirmation of the WTO Financial Services Sector agreement.

(vii) Creation of SEBI to regulate the securities market so as to protect the investor's interest.

It is time for the financial service agencies to exploit the opportunities that lie ahead in tune with the developing pace of the economy. It requires them to adopt new instruments and innovative means of financing to meet the growing financial requirement of the various segments of the economy. The commercial banks and merchant bankers have been discussed in later chapters.

5.1.10 Challenges Facing the Financial Services Sector:

However, the financial services sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are:

(i) Lack of qualified personnel: The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and a comprehensive training must be given to the various financial intermediaries.

(ii) Lack of investor awareness: The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.

(iii) Lack of transparency: The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency.

(iv) Lack of specialisation: In the Indian scene, each financial intermediary seems to deal in different financial service lines without specialising in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments.

(v) Lack of recent data: Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'. Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

(vi) Lack of efficient risk management system: With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilisation of multi-currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfill the growing requirements of their customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

5.1.11 Present Scenario of Financial Services

(1) Conservatism to dynamism:

The main objective of the financial sector reforms is to promote an efficient competitive and diversified financial system in the country. This is very essential to raise the locative efficiency of available savings, increase the return on investment and thus to promote and accelerated growth of the economy as a whole. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies has transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market: Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating: The concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

(i) Credit Rating Information Services of India Ltd. (CRISIL)

(ii) Credit Analysis and Research Ltd. (CARE) and

(iii) Investment Information and Credit Rating Agency (ICRA).

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalisation:

Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era before 1996. Hence, there is every possibility of introduction of more and more innovation and sophisticated financial services in our country.

(v) Process of Liberalisation

Realising all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing issues by the Controller of capital issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized.

5.1.12 Summary:

Presently, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector, the main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promoter the accelerated growth of the economy as a whole. At present numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies has transformed the financial services sector from being a conservative industry to a very dynamic one.

5.1.13 Answers to self-check exercises

Self-check exercise 1: Refer paras 1.4.1 and 1.4.2

Self-check exercise 2: Refer para 1.7

5.1.14 Glossary

Factoring: It is another method of raising short-term finance through account receivable credit offered by commercial banks and factors.

Fee-based services: 'Fee-based advisory services' includes all those financial services for which fees is charged, such as factoring, stock broking.

5.1.15 Suggested Readings

Emerging Scenario of Financial Services by E. Gordon & K. Natrajan

Financial Services by M.Y.Khan

5.1.16 Short and long Questions for exercise:

1. What do you mean by financial service?
2. State the causes for financial innovation in the financial services sector.
3. Analyze the present position of the financial service sector in India and enlist the challenges it has to face.
4. Discuss the various types of financial pservices provided by financial institutions.

LESSON NO. 5.2 AUTHOR : DHIRAJ SHARMA

MERCHANT BANKING

5.2.1 Objectives
5.2.2 Introduction and Meaning
5.2.3 Nature of Merchant Banking
5.2.4 Functions of Merchant Banker
 5.2.4.1 Service-Based Functions
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5.2.9 Glossary
5.2.10 Self check exercise
5.2.11 Suggested Readings
5.2.12 Short and long Questions

5.2.1 Objectives : The objectives of this lesson are :

- To understand the meaning of merchant banking
- To study its functions
- To examine the regulations made by the Government for merchant banking alongwith its categories.

5.2.2 Introduction:

The term "Merchant Banking" has its origin in the trading methods of countries in the late eighteenth and early nineteenth century when trade between them was financed by bill of exchange drawn by merchanting houses. With the growth in international trade the lesser known merchants wanted to import goods from abroad, the established merchants 'lent their names' to the newcomers by agreeing to accept bill of exchange on their behalf. Acceptance business thus became and to a degree always has been hallmark of true merchant banks. The second historical characteristic of merchant banks was the raising of capital for foreign Governments through the issue of stocks and bonds.

Meaning:

There is no statutory or authoritative definition for the term ' Merchant-Banking'. For many it means managing capital issues of companies and some confuse this with investment banking and an issue house.

Webster's Dictionary defines a Merchant-Banker as "a bank that specialises in bankers' acceptances and underwriting or syndicating equity or bond-issues".

Rosenberg M.J. has defined as "an organisation that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial-ventures."

Cox D. has defined the merchant-banker as saying that "Merchant-banks are the financial institutions providing specialist services which generally include the acceptance of bills-of-exchange, corporate-finance, portfolio-management and other banking - services".

Financial Service is rendered through numerous intermediaries who are known by different names. One of the prominent intermediaries is known as merchant banker. Their scope of operation differs from country to country.

Merchant banking as it is known in present days, had its origin in U.K. and U.S.A. in early fifties. But the roots of this service rendering industry can be traced as back as in late eighteenth century and early nineteenth century. There were merchants who traded overseas, built-reputation and later shared their goodwill with newer traders to facilitate their merchant activities especially by providing guarantees for payments. Subsequently, they entered any field which added to their business depending on the demand of time. Thus, as time changed their role changed, consequently it has never been possible to pinpoint their role. As Sir Edward Reid of Baring Brothers & Co. commented, it is (merchant banking) sometimes applied to banks which are not merchants, merchants who are not banks and sometimes to houses who are neither merchants nor banks:' *Report of the Committee on the Working of Monetary System* (1961) observed that origin of merchant bankers is associated with a variety of financial services including accepting. This is why merchant bankers are popular as *'issue houses' or 'accepting houses' in U.K.* In U.S.A investment bankers have been performing the task being performed by merchant bankers elsewhere. Whether these are called accepting house or investment banker or merchant bankers, their common object is to facilitate trade and industry. Meeting their diverse and dynamic needs with the change in time and complexities in business has always been a challenge for merchant banking.

Despite the fact that merchant banking is emerging as one of the prominent segment of financial service sector, it is difficult to define what merchant banking is. The reason is very obvious as its limits have never been adequately and strictly defined and it caters to wide variety of financial activities. *Dictionary of Banking and Finance* explains merchant bank as an organisation that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. *Securities and Exchange Board of India (Merchant Bankers) Rules 1992* defines merchant bankers *as* "any person who is engaged in the business of issue management either by making arrangement regarding selling. Buying or subscribing to securities or acting as manager, *consultant,* adviser or rendering corporate *advisory services in relation to such issue management".* The Guidelines for Merchant Bankers (issued by Ministry of Finance, Deptt. of Economic Affairs, Stock Exchange Division on 9-4-1990) instead of defining merchant banking stated that these guidelines shall apply to those presently engaged in *merchant banking activity including as managers to issue and undertake authorised activities.* These activities interalia include underwriting, portfolio management etc. Thus, to define merchant bankers a definite better approach is to include those agencies as merchant bankers which do what a merchant banker does.

5.2.3 Nature of Merchant Banking

To understand nature of merchant banking well, *a contrast may be involved between commercial banking and merchant banking.* Although the terms ' Merchant' and ' Commercial' have similar connotations yet commercial banking and merchant banking are different. Commercial banking is basically a financing agency whereas merchant banks provide basically financial (not financing) services. Commercial banking is comparatively retail banking activity whereas merchant banking is a wholesale banking (even i f it provides financing services also). A merchant banking firm does not undertake commercial banking whereas its reverse is possible. Commercial banking involves collections of savings and putting it to optimum use as per plans and guidelines whereas merchant banking refers to just an agency facilitating transfer capital from those who own to those who can use it without handling the amount of its own. Merchant bankers are more of an intermediary. In the same context, a merchant bank can be distinguished from a development bank since the latter is more involved in fund raising and lending. Like commercial banks, development banks may also have separate merchant banking division.

5.2.4 Functions of Merchant Banker

Setting up of new industrial units, expansion, diversification and modernisation of existing units have been the central plank of the rapid industrialisation in any economy. This process besides adequate financial resources, requires sound technical and managerial inputs. Though, a number of financial agencies are instituted to cater to the needs of rapid industrialisation, the task of financing has become more complicated, thus requiring a fresh look. In view of increasing specialisation in every sphere the process of industrialisation from the primary planning stages of setting up a new unit to that of research and development including expansion, diversification or modernisation requires the services of specialists or professionals. Thus, the need for having expert advice, guidance of specialists or professionals in the field has become an absolute necessity with rapid economic growth and spectacular industrial development in India. It has also been necessitated by the plethora of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, Companies Act, SEBI, Government policy regarding backward area development, export promotion and import substitution etc. A few agencies are able to provide expert advice in the diversified areas mentioned above. But it is inconvenient to entrepreneurs/industrialists to knock at the doors of several agencies in getting the guidance of specialists and professionals. Hence, it is highly essential to provide expert advice in diversified areas under a single roof to provide a comfortable cushion to entrepreneurs to accelerate industrial development. This is where merchant bankers come to picture. Although it is very difficult to spell out all the areas where merchant bankers can interact, yet, some important areas where merchant bankers have decisive role are discussed here. These roles can broadly be divided into two parts. One is *service based* another *is fund based.*

5.2.4.1 Service based Functions

(i) Project Counselling

The first step to launch business units is selection of a viable project.

Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counselling covers a variety of sub-assignments. Illustrative list of services which can be rendered under this category are :-

- Guidance in relation to project viability, i.e., *project identification* and counselling. It may be for setting up new units, expansion or improvement of existing facilities.
- Selection of consultants for *preparation of project reports/* market surveys etc. Sometimes, merchant bankers also engage in preparation of project reports or market surveys.
- Advice on various procedural steps including *obtaining of governmental approvals* clearance etc., e.g. for foreign collaboration.
- Proposing a *suitable capital structure* laying broad as well as specific features.
- *Techno-economic soundness* of the project and marketing aspects. *Financial engineering,* i.e., selection of right mix of financing pattern specifically for short-term requirements.
- *Organisation and management set up* for a strong base and efficient working of the project.

(ii) Credit Syndication

Normally, every project has to raise debt funds for different sources as per need. Substantial debt raising may be required for a new and capital intensive project. For such projects, merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are:

- Preparing applications for financial assistance to be submitted to financial institutions and banks.
- Monitoring the sanction of funds while acting as a specialised liaison agency.
- Negotiating the term of assistance on behalf of client.
- Post-sanction formalities with these institutions and banks.
- Assistance in grant of term loans and or bridging loans.
- Assessing working Capital requirements and arranging it.

Need of syndication arises due to the fact that specially in big projects one institution may hesitate to meet the whole debt requirement of the project, They want to spread the risk. Further, shortage of funds, availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The *modus operandi* of a syndication is really quite simple. The borrower approaches several banks which might be willing to syndicate a loan, specifying the amount and the tenor for which the amount and the tenor for which the loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower; all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a *firm commitment basis* or on a *best-efforts basis.* The former is akin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility.

Best- efforts, as the name suggests, l imits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan. However, more often than not, the syndicator would try to fulfil his commitments for the inability to do so would tarnish his reputation.

Once the syndicator has been awarded a mandate, the borrower has to sign a '*clear market clause*' which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three-four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicating the loan. It can do this on a 'broadcast' basis, by sending telexes to the concerned banks inviting participation. If the company is well-known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporate tends to keep a low profile and the loan structure is complicated, the syndicate manager would have to woo the participant banks with *offer documents or* an information memorandum on the company. The document is similar to a prospectus but less detailed. Nevertheless drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts."

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

(iii) Issue Management

Traditionally, this is one of the main functions of merchant banker. Whenever an issue is made whether it is public issue or private placement and further whether it is for equity shares, preference shares or debentures, the merchant banker has a crucial role to play. Raising of funds from public has many dimensions and formalities which are not possible for the concerned companies to comply with, where merchant banker comes to their rescue. Marketing efforts to convince the prospective investor needs special attention. Here again merchant bankers are specialists. The specific activities related to *issue management* performed by merchant banks are :

- Advise the company about the quantum and terms of raising funds.
- Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.
- Advise as to whether a fresh issue to be made or right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from government or other authorities.
- Advice on the appointment of bankers, brokers to the issue.
- Advice on the selection of issue house or Registrar to the issue, printer advertising agency etc.
- Fixing the terms of the agencies engaged to facilitate making a public issue.
- Preparation of a complete action plan and budget for total expenses of the issue.

- Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.
- Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.
- Advise the company for the issue period and days of opening and closing the issue.
- Monitoring the collection of funds in public issue.
- Co-ordination with underwriters, brokers and bankers to the issue and stock exchange etc.
- Strict compliance of post-issue activities.

(iv) Corporate Counselling

Although the functions discussed up till now are also covered under corporate counselling but here other dimensions will be deliberated. Corporate counselling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercise smooth. They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant bankers are :

- Rejuvenating old line and ailing/sick units or appraising their technology and process, assessing their requirements and restructuring their capital base.
- Evolving rehabilitation programmes/ packages which can be acceptable to the financial institutions and banks.
- Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BIFR) and other authorities under the Sick Industrial Companies (special provisions) Act 1985 (SICA).
- Monitoring implementation of schemes of rehabilitation.
- Advice on financial restructuring involving redeployment of corporate assets to refocus companies line of business.
- Advice on rearranging the portfolio of business assets through acquisition etc.
- Assisting in valuing the assets and liabilities.
- Identifying potential buyers for disposal of assets, if required.
- Identify the candidates for take over.
- Advice on tactics in approaching potential acquisition.

- Assisting in deciding the mode of acquisition whether friendly or unfriendly or hostile.
- Designing the transaction to reap the maximum tax advantages.
- Acting as an agent for leveraged Buyout (LBO) involving heavy use of borrowed funds to purchase a company or division of a company.
- Facilitating Management Buyouts (MBO), i.e., selling a part of business to their own managers by a company.
- Clearly spelling out organisation goals.
- Evolving corporate strategies to achieve the laid down goals.
- Designing or restructuring the organisational pattern and size.
- Evolving Management Information System.

Corporate advisory services should offer *real value addition* to the client. Highly specialised in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire-purchase. In India corporate advisory has a good potential. The Indian industry is going through an unprecedented churning, bracing itself for global competition. The Indian corporate sector has been on a restructuring spree. Groups have been shedding companies. Companies, in turn, have been dropping divisions as they struggle to become fit to survive in the new milieu. Free pricing of issues and the opportunity to tap the international market through the Euro-issue route has greatly enhanced the need for expert advisory services. In areas of *restructuring, strategic alliances and corporate planning is* now advising foreign companies in their plans for development of infrastructure in India. Merchant bankers have a great role to play.

Strategic product consolidation is another recent phenomenon. Units in which the company does not plan to become a market leader are spun off to others. A good corporate advisor is always on the alert to seize such opportunities. The process of acquisition cannot be done overnight. It requires a patient search for the right company which can be acquired, the proper evaluation of the financial impact of the acquisition, a sound strategy in blending the business acquired within the fold of the group, followed by negotiation and execution of the agreement. Occasionally, advisory services are required in cases of splits within the family group. In such cases, there is a need to split the company into different units amongst the disputing family members. At the same time, the shareholders' interest is to be kept in mind by the corporate advisor.

(v) Portfolio Management

Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practiced as an investment management counselling in which the investor is advised to seek financial assets, like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and/or provide income. The investors whether local or foreigner with substantial amount for investment in securities seek portfolio management services of authorised merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include:

- Advising what and when to sell and buy.
- Arranging sale or purchase of securities.
- Communicating changes in investment market to the client investors.
- Compliance of regulations of different regulating bodies for sale of purchase of portfolio.
- Collection of returns and reinvest as per directions of clients.
- Evaluating the portfolio at regular intervals or at direction of investors.
- Advising on tax matters pertaining to income from and investment in portfolio.
- Safe custody of securities.

(vi) Stock broking and Dealership

The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for Over The Counter trading. To venture into this area it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub-brokers and sub-dealers to ensure wider network of their operations. They can be broker for inland as well as foreign stock exchanges. In India, the merchant bankers who desire to act as brokers are regulated by *SEBI*

(Stock- Broker and Sub-brokers) Rules 1992.

(vii) Foreign Joint Ventures

Depending on economic and political considerations, many countries may permit joint ventures by local businessmen abroad. Here, again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno-economic surveys, legal documentations under local as well as foreign legal provisions etc.

(viii) Debenture Trusteeship

The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redressal of grievances of debenture holders. They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call for periodical reports from the body corporate. They charge fee for such services.

5.2.4.2 Fund based Functions

(i) Bill Discounting

Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and Merchant bankers can specify what types of bills they entertain. They charge commission for these services.

(ii) Venture Capital

Venture capital is the organised financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type of investment. Since certain ingredients necessary for success of such projects are missing in the beginning but are added later on. Merchant bankers undertake to arrange and if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study such proposals before releasing the money. At opportune time, such investment can be disinvested to keep the cycle of venture capital more on.

(iii) Bought-out Deals

When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and place the shares of company initially with him which are offered to public at a later stage, this route is known as bought-out deal. Many a times, a syndicate of merchant bankers jointly sponsor a bought- out deal to spread the risk involved. In contrast to venture capital, there is no role to be played by non-traditional technology. Such bought shares by sponsor can be disposed off at an opportune time on 'over the counter' or other stock exchanges.

(iv) Lease Financing and Hire-Purchase

Depending on the funds available, merchant bankers can also enter the field of lease or hire-purchase financing. Lease is an agreement whereby the lessor (merchant banker in this case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand, in hire-purchase, the user at the end of the agreed period has an option to purchase the asset which he has used till date. The merchant bankers can advise the client to go in for leasing or hire-purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on merchant banker for acquiring the needed asset and complying with all formalities.

(v) Factoring

Factoring is a novel financing innovation. It is a mixed service having financial as well as non-financial aspects. On one hand, it involves management and collection of book debts which arise in process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit etc. On the other hand, there is involvement of finance. Against factored debts, the merchant banker may provide advance with a certain margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to-

- Maintain the books of accounts pertaining to credit sales.
- Make a systematic analysis of relevant information for credit monitoring and control.
- Provide full or partial protection against bad debts and accepting the risk of non-realization.
- Provide financial assistance to the client.
- Provide information about prospective buyers.
- Provide financial counselling and assisting managing the liquidity.

(vi) Underwriting

It refers to a contract by means of which merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting, make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating, viz. :

- Company's standing and its past record.
- Competence of the management.
- Purpose of the issue.
- Potentials of the project being financed.
- Offer price and terms of the issue.
- Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission.

These are some of the prominent activities being undertaken by merchant bankers world over. The practices may differ from country to country depending on maturity of financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalisation of economies, merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways.

5.2.5 REGULATIONS FOR MERCHANT BANKERS

SEBI (Merchant Bankers') Regulations 1992 define 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, adviser or rendering corporate advisory service in relation to such issue management." Thus, regulations are applicable only to limited activities undertaken by merchant banker. On the basis of regulations, merchant banking activities can be categorised as ' authorised' and ' not authorised' activities. The merchant bankers are required to get themselves registered under regulations only for authorised activities. The *authorised activities are undertaking issue management assignment,* as *manager, consultant, adviser, underwriter portfolio manager.*

(a) Merchant Banking Activities not requiring SEBI's registration are:

- Project Counselling
- Corporate Counselling
- Factoring
- Credit Rating
- Bill acceptance and discounting
- Loan syndication
- Merger and amalgamation.

(b) Merchant Banking Activities requiring SEBI's registration under different regulations but not under Merchant Banking regulations :

- Venture Capital
- Mutual Funds
- Depository
- Portfolio Management
- Trusteeship of debentures
- Share Broking
- Custodian Service
- Foreign Institution of Investors
- Share Transfer.

Another angle from which authorized activities can be identified is the activities specified for each category of merchant banker.

5.2.5.1 Categories of Merchant Bankers

The merchant banking regulations require that anybody seeking registration as merchant banker has to apply in one of the following four categories: Recently multiple categories of merchant bankers have been abolished and there is only one category of merchant bankers in India. However if a merchant bankers wants to function as portfolio. Managers, It requires separate registrations uner SEBI (Portfolio manager) rules regulaions 1993.

Registration

Any agency to operate as merchant banker has to register itself under SEBI Regulations. Application is to be submitted in the prescribed format 'Form A'. To get registration and certificate to operate as merchant banker, the agency has to fulfil *two sets of criteria.*

(i) Operational capabilities, (ii) Capital adequacy.

(i) Operational Capabilities

As mentioned earlier, the regulations desire the merchant banker to be professional, fair and competent to serve investors. In this context, SEBI, before granting certificate to operate as 'merchant banker' makes sure that concerned agency is competent on these parameters. To be more specific these are :

(a) It is necessary that to serve the clients and investors the merchant banker should have sufficient physical infrastructure. It is desired that the applicant has the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities.

(b) To ensure that services rendered are the best, SEBI desires the applicant to have atleast two persons who have the experience to conduct the business of the merchant banker.

(c) In order to avoid excessive registration, SEBI makes sure that a person directly or indirectly connected with the applicant has not been already granted registration. Such persons include an associate, subsidiary, interconnected or group company of the applicant.

(d) The applicant or his partner or director should be man of integrity. SEBI requires that applicant or its main officials should not he involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant. They should not at any time be convicted for any offence involving moral turpitude or has been found guilty of any economic offence. The applicant is to have professional qualification from any recognised institution. SEBI is to make sure that such registration should be in the interest of investors. Only those applicants who qualify on all these points are granted registration.

(ii) Capital Adequacy

In the categories wherein fund-based activities are involved, SEBI desires them to have sufficient capital. The concept of adequate capital is expressed in terms of 'net worth'. 'Net worth' means the value of capital contributed to the business plus free reserves. At the time of registration as well as subsequently, following pattern of 'net worth' should be at least maintained.

Those applicants who qualify on both fronts are granted registration. The registered applicants are granted certificate of registration in 'Form B' in which SEBI specifies for which category registration has been granted. If the applicant is granted a category lower than applied for, the applicant is free to approach SEBI for higher category but within one year from the date of such registration. When certificate is finally granted, the registered merchant bankers are to submit required fees. Registration is granted for three years at one time. To keep the registration operative, merchant bankers are to pay registration fee. The *registration fee* pattern is as under:

Once registration granted is about to expire, merchant bankers are to get this registration renewed. Application for such renewal is again to be made. To ensure that there is no break in registration, such application has to be made within 3 months before the expiry of the certificate. Although it is termed as renewal, but application is processed as for new registration, that is why application is again made in 'Form A'. Once registration is renewed, due fee is to be paid which is as under:

5.2.5.2 Code of Conduct

Once merchant bankers are registered to ensure that they maintain high standard of services, regulations require them to adhere to a code of conduct specified in Schedule III of the Regulations. While acting as merchant bankers some important provisions of code are as under:

- Maintain high standard of service.

- Exercise due diligence, ensure proper care and exercise independent professional judgement.
- Disclose to the clients, possible sources of conflicts of duties and interests while providing unbiased services.
- Conduct business observing high standard of integrity and fairness in all his dealings with clients and other merchant bankers.
- Maintain secrecy about client.
- Do not engage in unfair competition.
- Not to make misrepresentation.
- Provide true and adequate information to investors.
- Not to create false market or engage in price rigging.

5.2.5.3 Regulations for Lead Manager

It is required under regulations that every issue should be managed by atleast one merchant banker acting as ' lead manager.' Such lead manager is not required if the issue is rights issue and if the size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead managers can be appointed but their *number is* subject to norms laid down by SEBI.

	Size of issue	Maximum number of lead managers
(a)	Less than rupees fifty crores	Two
(b)	Rupees 50 crores but less than Rs. 100 crores	Three
(c)	Rs.100 crores but less than Rs.200 crores	Four
(d)	Rs.200 crores but less than Rs.400 crores	Five
(e)	Rs.400 crores and above	Five or more as agreed by SEBI

Duties of Merchant Banker/Lead Manager

(a) In case more than one merchant bankers are engaged as lead managers, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibility of lead manager for a particular activity, a co-ordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on *'pre-issue activities'* and *'post-issue activities'.* SEBI requires that post- issue activities should be the responsibility of one lead manager. It involves essential follow up steps like finalisation of basis of allotment/weeding out multiple applications, listing of instrument, dispatch of certificates and refunds etc.

(b) A merchant banker cannot be a lead manager to an issue made by any body corporate which is an associate of the lead merchant banker.

(c) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

(d) A lead manager who is category I merchant banker has to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or Rs. 25 lakh whichever is less. This is to ensure his financial involvement in the issue.

(e) It is his duty to submit SEBI a due diligence certificate in 'Form C'. This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

(f) SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

(g) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

(h) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

(i) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referred to as insider trading.

(j) SEBI is to be informed by merchant banker about the acquisition of securities of the body corporate whose issue is being managed by that merchant banker, within 15 days from the date of entering into such transaction.

(k) A merchant banker has to disclose to SEBI the following information namely:

(i) his responsibilities with regard to the management of the issue.

(ii) any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.

(iii) the name of body corporate whose issues he has managed or has been associated with.

(iv) any default in capital adequacy requirements.

(v) his activities as a manager, underwriter, consultant or adviser to an issue, as the case may be.

(l) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance-sheet, income statement, auditor' s report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half-yearly unaudited financial results when required by SEBI, with a view to monitor the capital adequacy of the merchant banker.

(m) When SEBI initiates inspection of the said records, the merchant banker has to co-operate. SEBI shall give notice before inspection.

Liabilities of Merchant Bankers

Many provisions are incorporated in the MB Regulations to regulate the activities of merchant bankers. To make them more responsible and accountable SEBI has provisions to impose penalty in case of defaults by them. The merchant bankers are subject to penalty, if they :

(a) fail to comply the conditions subject to which certificate has been granted.

(b) fail to comply with the provisions of the concerned rules and regulations.

Two types of penalties can be imposed by SEBI on defaulting merchant bankers. One is suspension of registration and second is cancellation of registration.

5.6 MERCHANT BANKING: INTERNATIONAL SCENARIO

(a) United Kingdom

The merchant banking on professional lines had its roots in United

Kingdom where it started at the dawn of nineteenth century. Its main reason has been the fact that by that time international trade in UK had flourished due to its colonial trade links, the major activity undertaken by them was aranteeing the payments of exports. Thus, bill discounting emerged. Consequently emerged acceptance houses, and discount houses. By the end of nineteenth century they diversified their business of financing foreign trade to provide risk capital to projects both in land and abroad. Post-World War I scenario opened other more challenging areas for them like issue management of public companies, reorganisation of corporate units. Slowly they entered the field of management of investment trusts. They also granted term loans to governments of other countries due to their money muscle. Over the period business areas like trusteeship, insurance, leasing of industrial equipment, chartering ships, air-crafts, counselling corporate units were taken up by these merchant bankers. Banks were permitted to take up merchant banking activities by 'Bank of England' in late 1960s but only through their subsidiaries. During late 1970s, merchant bankers in Britain started participating in 'over the counter' deals, bought-out deals, venture capital, international equity market, information services business etc.

(b) United States of America

Merchant banking business in USA was given direction by English and European merchant bankers who opened their offices in U.S.A. During early nineteenth century, USA was involved in creating infrastructure and developing industrial set up which involved huge amount. These merchant bankers from outside America lent supporting hand. Thus, merchant banking emerged in U.S.A as investment banking. Over a period these investment bankers took over the activities earlier undertaken by brokers. They also emerged as promoters. This diversification of investment bankers on a large scale in the area of issue of securities led to many ill practices by virtue of which a lot of investors were at a loss. This was due to the fact that investment bankers activities were hardly regulated. As a result 'Blue Sky Laws' were enacted in Kansas state and slowly many other states adopted such laws to safeguard interests of investors from fraudulent promoters. It improved the investment culture along with other remedial measures initiated by government. By 1920 again investment bankers were undertaking almost all the activities of merchant bankers in Europe and UK. But 'Great Crash' of 1929 again caused a setback to investment activities. U.S. Government again was active to build up interest of investors and came out with Securities Commission under Securities Exchange Act, 1934 along with Glass Steagall Act, 1933 . These legislations were amended as and when needed to meet the changing needs of the economy. There are many changes in provisions over a period restricting or expanding the scope of investment banking. For example about twenty years back investment bankers dealing in stock market directly were debarred to act as investment advisor or fund managers for Pension Funds. Investment bankers of U.S. now are in dominating position in international market.

(c) Other Countries

Almost all other countries had merchant banking activities after these were well tried and got matured in the U.S. and U.K. Merchant bankers along with branches of banks from these two countries sowed the seed of merchant banking in other countries. Free ports like Singapore and Hong Kong offered tremendous potential for merchant bankers. Obviously in such countries merchant bankers specialise in foreign exchange dealings covering deals like swaps and forward exchange contracts. Local agencies hardly emerged in this field. Majority of merchant bankers are joint ventures. Merchant banking is operating in these countries on UK pattern. Similarly, in South Africa, British merchant bankers have sound footings. Here again, their main emphasis is on facilitating international business. In developed countries like Germany, initially merchant banking was under the English influence as their business was predominant in colonial countries. But soon they evolved their own model. Commercial banks and merchant banks have strong links that is why branch network of merchant bankers in the country is widespread. Australian merchant bankers also had British colouring. Due to liberal economic policies a special feature of merchant banking is their dominance in money market transactions.

5.2.7 Merchant Banking in India

In Indian context, not going in details of merchant banking like activities in pre-independence period, post-independence period scene is reviewed here. Before the enactment of Companies Act 1956, *managing agency system* was discharging merchant banker's functions like promoting, financing, providing risk capital, floating issues, guaranteeing bank loans, inter-corporate deposits, arranging foreign collaboration etc. But their unregulated activities led to concentration of wealth. Consequently, the said Act abolished the managing agency system to develop a free capital market in the country. Since finance is the backbone of industry, government of India immediately after independence started creating a network of specialised financial institutions known as development banks both at national as well as state levels. They played a significant role in promoting capital market in the country. They, besides providing term lending, entered the field of underwriting the capital issue of corporate units as well. Over a period of time, the approach to capital market for raising funds by corporate sector became popular. This scene was further characterised by important enactments like Capital Issue (Control) Act, Securities Contract (Regulation) Act, FERA, MRTP, Tax laws etc. which gave a specific direction to fund raising activities. This growing need of funds through capital market under given legal framework resulted in the increasing demand of merchant banking activities in India. It may be observed from the fact that in period from January 1951 to December 1954 only 5 .8 per cent of the amount actually offered to public was underwritten and this percentage increased to 38.9 per cent in the period January 1955 to June 1959. This pace continued and in 1969 this percentage was 65 and it rose to 90 per cent in 1969. In India, it was Grindlays Bank in 1967 which formally started a merchant banking division. It sought permission from Reserve Bank of India and Ministry of Finance to render services under this division like corporate counselling on capital structure, takeover and mergers, making public issues and managing them, arranging underwriting assignment etc. Thereafter, City Bank entered this field in 1970. In a span of two years, these two foreign banks made serious inroads into merchant banking.

Banking Commission Report, 1972 emphasised the need of creating specialised institutions to cater financial requirements of different sectors exclusively and examined the need of setting up merchant banking institution. It observed that to boost industrial set-up, especially sophisticated and complex industries, there was need of specialised services. Even for small and medium industry there was a wide gap of technical and financial advice. Vacuum created by abolition of managing agency system in India needed to be filled. There was a need to facilitate joint ventures abroad by Indian enterprise. Thus, the commission recommended the setting up of merchant banking institutions. Getting a green signal, SBI launched merchant banking division late in 1972. Thereafter, many banks as well as financial institutions, at national and state level, created their own merchant banking divisions. As the number increased merchant banking firms in private sector started gearing up to meet the challenge posed by big banks and financial institutions in this field.

Narasimham Committee Report took stock of merchant banking as "Beginning with the seventies, several commercial banks, both Indian and foreign, set up merchant banking divisions and in course of time some of these divisions have been hived off to separate merchant banking subsidiaries. More recently, some private financial service companies have also been set up-some of them in association with foreign banking and money market institutions. There have also been a few merchant banks set up by firms and individuals engaged in brokerage and financial advisory business. These merchant banks perform the usual functions associated with institutions such as the management and underwriting of new issues, syndication of credit and provision of advisory services to corporate clients on fund raising and other financial aspects. While the merchant banks which are affiliated to or are subsidiaries of commercial banks have an advantage in drawing on the resource base of the parent institution the other merchant banks lacking this particular advantage have tended to concentrate more on advisory and brokering functions. Unlike merchant banks abroad, merchant banks in India- both the subsidiaries of banks and the individual entities are not authorised to undertake banking business such as deposit taking, lending and foreign exchange services.

The *committee sees considerable potential for the operation of merchant banks in the framework of a deregulated industrial economy.* The Committee believes that the emergence of well-capitalised, financially strong and independent merchant banks would complement in the role of the merchant banks promoted by the banks and financial institutions and help to make the merchant banking sector in the country more active, diversified and competitive. The formation of joint ventures with well-reputed international merchant and investment banks should also be encouraged. In course of time, merchant banks could be permitted like some other non-bank financial intermediaries to access the market for deposits and borrowed resources subject to the stipulation of minimum capital and liquidity and their observance of prudential norms specially tailored to the conduct of their business". Commenting on the then prevailing environment for merchant banking the committee observed that 'Merchant banking in India is regulated by more than one authority. While SEBI seeks to authorise and regulate all merchant banks, those which are subsidiaries or are affiliates of Commercial banks are additionally supervised by the Reserve Bank of India. Further, SEBI focuses on issue activity and portfolio management business of merchant banks rather than on the totality of their activity. On the other hand if merchant banks were to raise deposits, they would be subject to guidelines issued in this regard by Reserve Bank of India." To make merchant banker more professional and responsible, the committee envisaged that it would be for the merchant bankers who should offer professional advice on a particular issue, on the nature of instrument, its terms and pricing and for the issuer to decide on these matters.

5.2.8 Summary

The merchant banker' s role has increased in view of multitude of enactments, rules and regulations, guidelines and offshoot press releases and instructions brought out by the government at different times. The move of liberalisation further gave a boost to merchant banking activities. Merchant banking activities were regulated by guidelines of SEBI and Ministry of Finance, Companies Act 1956, Securities Contract (Regulation) Act 1956 and Listing guidelines of stock exchange. In its wisdom, SEBI came out in December 1992 with Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992 , a comprehensive enactment to regulate merchant banking activities. While issuing these regulations it was emphasised that such enactment will make primary market more disciplined. By regulating merchant banking activities, investor's confidence in primary market is built up. It is expected that these regulations will go a long way for an orderly growth and development of the capital market. These regulations since their enactment, have been amended many a, times to make them more transparent, to increase the degree of investors protection, increase the standard of services and professional competence.

5.2.9 Glossary

Lead manager-merchant banker

5.2.10 Suggested Readings

Finanicial Markets and Services	:	By Gordon & Natrajan
Financial Services	:	By M.Y. Khan

5.2.11 Short and long Questions

1. Discuss the nature and functions of merchant banking.
2. Discuss the policy of the Government towards merchant banking in India.
3. What is merchant banker?
4. Explain role of merchant banker?

Lesson No. 5.3 Author : Dr. Jasmindeep Brar

Venture Capital

5.3.0 objective

the main objective of this lesion is to understand about the venture capital .
importance of venture capital
regulation system if venture capital n india

5.3.1 INTRODUCTION :

The venture capital sector is the most vibrant industry in the financial market today. Venture capital institutions which emerged the world over to fill gaps in the conventional financial mechanism focused on new entrepreneurs, commercialisation of new technologies and support to small and medium enterprise. Venture capital is risk money, which is used in risky enterprises either as equity or debt capital. It can be defined as equity investment in a growth-oriented business to enable investors to accomplish corporate objectives, in return for minority shareholding in the business or the irrevocable right to acquire it. According to a widely accepted definition, venture capital is described as a separate asset class, often labelled as private equity.

Venture capital was originated and popularised in USA in 1960's. It is a post-war phenomenon in the business world, mainly developed as sideline activity of the rich in USA. To connote the risk and adventure and some element of investment, the generic name of "Venture Capitals' was coined. In the late 1960's, a new class of professional investors called capitalists emerged whose speciality was to combine risk capital with entrepreneurial management and to use advance technology to launch new products and companies in the market place.

5.3.2.1 FEATURES OF VENTURE CAPITAL

1. It is equity finance for new companies when it is too early to go to capital market and raise funds. However, it can also be made in form of loan finance, convertible debt.
2. It is long-term investment in growth-oriented small/medium firms.
3. It also provides active investment of promoters by which promoters also impart business skills to the firm which is termed as 'handsom' approach.
4. It involves high risk spectrum.

5.3.2.2 Factors Affecting investment decision

1. Strong Management Team : Venture capital firms ascertain the strength of the management team in terms of adequacy of level of skills, commitment and motivation that creates a balance between members in areas such as marketing, finance and operations, research and development, general management, personnel management and legal and tax issues.
2. Business Plan : The business plan should concisely describe the nature of the business, the qualifications of the members of the management team, and business projections and precasts.
3. A Viable Idea : Venture capital firms consider the viability of project or idea as it establishes the market for the product or service.
4. Market Prospects : Marketing research, market size share and future market prospects have to be considered while taking this decision.
5. Project Cost and Returns : Project cost, scheme of financing, sources of finance, cash inflows have to be studied carefully.
6. Technology : Technological agreements entered into by the promoters also affect the investment decision.

5.3.2.3 Importance of Venture Capital

I Advantages to the Investing Public

1. The investing public will be able to reduce risk significantly

against unscrupulous management, if the public invest in venture fund, who in turn will invest in equities of new business.

2. Investors have no means to vouch for the reasonableness of claims made by the promoters about profitability of the business. VC funds equipped with necessary skills will be able to analyse the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently.

The venture fund having representatives on the Board of Directors of the company would overcome it.

II Advantages to promoters

1. The entrepreneur for the success of public issue is required to convince many underwriters, brokers, investors to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

2. Public issue of equity shares has to be preceded by a lot of efforts viz. necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issues of equity shares offer range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues.

5.3.3. STEPS IN VENTURE CAPITAL

Selection of investment for venture capital includes

(i) Stages of Financing.

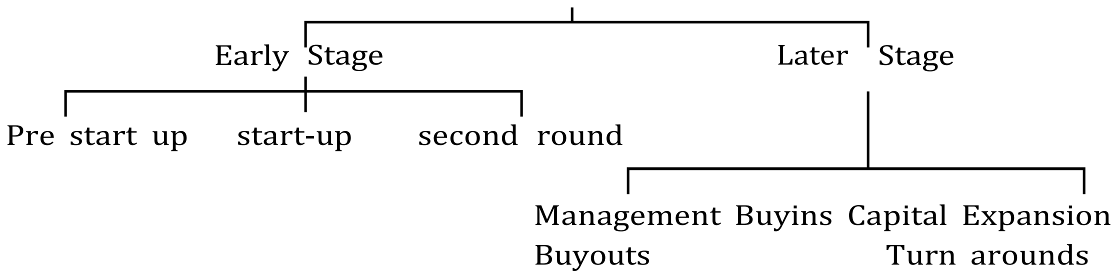
(ii) Methods to evaluate deals and financial.

(iii) Instruments to structure a deal.

5.3.3.1 STAGES OF FINANCING :

There are two stages of financing (i) early stage, (ii) later stage

Stages of Financing



1. Early Stage Financing

   i) Pre startup capital or seed capital - Before initializing a project, promoter conducts research where his ideas and concepts form the base of pre- commercialisation project. This stage is full of risk related to marketing. However, very few invest in this seed capital stage.

   ii) Start up - In this stage commercial, manufacturing has to commence. It includes several types of new projects based on highly advanced technology, new business in which entrepreneur has experience and knowledge, new projects by established companies.

   iii) Second Round Financing - At this stage, product has been already launched but business is not profitable to attract public offerings. The promoter has invested funds but infusion of funds by venture capital institutions is necessary which is provided in second round.

2. Later Stage Financing

   i) Mezzanine/ development Capital - Arrangement of capital by venture capital institutions is done for developmental purpose like purchase of new equipment/ plants, expansion, distribution, marketing facilities penetrating in new market.

   ii) Bridge/ Expansion - For expansion of business by growth of their own asset or by acquisition of other firms, these funds are required.

   iii) Buyouts and turnarounds - Venture capital institutions provide funds to enable the current operating management to acquire an existing product line/business.

5.3.3.2. Valuation of Portfolio

The valuation methods for equity instruments or VCUS are (i) Cost

Method, and (ii) Market Value based methods.

Cost Methods : According to this method the value of equity holding is computed at the historical cost of acquisition until it is disposed of market value base methods. Such methods can be divided into (i) quoted metket value (ii) fair market value

Quoted Market Value Method : This is based on market quotations of securities. It is relevent only to organisations listed on stock exchanges. Moreover market value may not be available for infrequently traded shares.

Fair Market Value Method : This considers the fair price as the basis of portfolio valuation and is used where the quoted market value does not reflect the correct value of the venture caital investment.

5.3.3.4. STRUCTURAL ASECTS

This includes :

Limited Partnership : This form of structure emerged in USA to cater to the needs of venture capital industry. It can be structured as limited partnership and one more partnership acting as general partner can be formed.

Investment Company : This is organized as limited company and liable for double taxation (both investment company and shareholder).

Investment Trust : This is a company, not liable to tax on chargeable gains/ dividends.

Offshore investment company : This is incorporated in country other than the country in which offshore company makes an investment. The tax liability depends on residential status of company.

5.3.3.5 Disinvest Mechanism

The objective of venture capitalist is to sell-off the investment made by him at substantial capital gains. The disinvestment options available in developed countries are :

(i) Promoter's buyback

(ii) Public Issue

(iii) Sale to other Venture Capital Funds

(iv) Sale in OTC (Over the Counter) Market

(v) Management Buyouts

In India, the most popular investment route is promoter's buyback, which permits the ownership and control of the promoter intact.

The Risk Capital and Technology Finance Corporation CAN-VCF etc, in India allows promoters to buyback equity of their enterprise.

The public issue would be difficult and expensive since first generation entrepreneurs are not known in the capital market. The option involves high transaction costs and also less feasible for small ventures on account of high listing requirements of the stock exchange.

The OTC exchange in India has been set up in 1992, which would provide disinvestment oppurtunities to venture capital firms.

5.3.4. VENTURE CAPITAL IN INDIA

In 1973, a committee on the development of small and medium enterprises highlighted the need to foster venture capital as a source of funding new entrepreneurs and technology.

The origin of modern venture capital in India can be traced to setting up of technology development fund (TDF) in 1987-88. TDICI (new ICICI ventures) and Gujarat Venture Finance Ltd. (GVFL) were formed. In 1996, SEBI declared guidelines for venture capital funds which paved the way for entry of foreign venture funds. Venture capital industry in India is at growth phase which is continuosly increasing e.g. Risk capital & Technology Finance Corporation Limited (RCTC).

Gujarat venture finance Ltd. (GVFL), Canara Bank Venture Capital fund, India venture Management Limited, SBI capital venture-capital fund 2011 century venture capital fund. The main thrust areas for venture capital industry are software, biotechnology, pharmaceutical drugs, food processing, telecommunications, advertising etc.

5.3.5. REGULATORY SYSTEM

Venture Capital in India is governed by SEBI.

SEBI Regulations for Venture Capital.

A venture capital fund means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which

— has a dedicated pool of capital
— raised in manner specified in the regulations
— invests in venture capital undertaking in accordance with regulations.

Venture capital means a domestic company :

- — whose shares are not listed on a recognized Stock exchange.
- — which is engaged in business and does not include sectors/ activities specified in negative list by SEBI. Negative list include
- — Real Estate, NBFC, Gold financing, activity not permitted underindustrial policy of Govt.

Any company or trust or body corporate proposing to carry activity as a VC fund must apply to SEBI for grant of certificate of carrying out venture capital activity in India. An application for grant of certificate must be in form A and fee of Rs. 25,000. Registration fee for grant of certificate is Rs. 5,00,000.

Procedure for grant of certificate

The certificate granted shall be subject to the following conditions :

- — The VC shall abide by the provisions of the SEBI act and these regulations.
- — The VC fund shall not carry out any other activity other than that of VC fund.
- — The VC fund shall inform SEBI in writing of any information or details previously submitted to SEBI which changed after grant of certificate.
- — If the information/ details are found to be false or are misleading in any particular manner, suitable penal action can be taken.

If SEBI is of the opinion that the certificate cannot be granted under law, it may reject the application after giving reasonable opportunity to applicant of being heard and the effect of non granting of certificate by SEBI is that applicant cannot carry out the activity of venture capital.

Investment conditions and restrictions

A VC may raise money from any source Indian/foreign or NRI by way of issue of units. No VC fund shall accept any investment from any investor less than Rs. 5,00,000. However, this condition is not applicable to :

- — employee, principal, officer or director of vc fund, or directors of trustee company or trustees. where the venture capital fund had been established as a trust.
- — employees of fund manager or asset management company Each scheme launched or fund set up by a venture capital fund shall have a firm commitment from the investors for

contribution of amount of atleast Rs. five crores before start up of operations.

Prohibition on listing

No VC fund shall be entitled to get its securities or units listed on any recognized stock exchange upto the expiry of three years from the issue of securities or units by VC funds.

General obligations and Responsibilities

No VC fund shall issue any documents or advertisement inviting offers from the public for the subscription of the purchase of any of its securities or units.

Private Placement

Before issuing any securities or units VC fund must file with SEBI a placement memorandum.

Maintenance of books and records

Every VC fund must maintain for a period of 8 years books of accounts, records and documents which must give a true and fair picture of state of affairs of VC fund.

Power to call for information

SEBI may, at anytime, call for any information from the VC fund in respect to any matter relating to its activity as VC fund.

Winding up

A scheme of VC fund set up as a trust shall be wound up :

— When the period of the scheme as a mentioned in the placement memorandum is over.

— If, in the opinion of trustees it is in the interest of investors.

— If 75% of the investors in the scheme pass a resolution at a meeting of unit holders of the scheme that scheme be wound up.

— If SEBI so evicts.

The VC fund set up as company shall be wound up under companies Act 1956.

5.3.6 Difficulties of Venture capital in India

1. The rigid financial and regulatory framework is a major inpediment in the development of venture capital industry in India.
2. There is dearth of private sector insurance companies gathering regular premium income and virtually no private banks willingly contribute to venture capital funds.

3. The absence of a proper system of financing such companies has been a hurdle in the Indian capital market.
4. The rigidity and bureaucratic government delays and strict parameters for priority lending often create problems for entrepreneurs in high technology areas.
5. Venture capital financing involves financing relatively new projects with no past record and market acceptability. This makes venture capital financing unattractive.
6. No tax incentives are being given to venture capitalists which has also retarded the growth of venture capital industry.

5.3.7 summary:

Venture capital, as a fund-based financial service, has emerged the world over to fill gaps in the conventional financial mechanism, focussing on new entrepreneurs, commercialisation of new technologies and support to small/ medium enterprises in the manufacturing and service sector. In India it is still at nascent stage which are sponsored by namely central and state level, DFI, banks, private sector and overseas financial institutions. Important among them are IDBI-VCF, TDICI, RCTC, SBI caps VCF etc. In India, VCF are governed by SEBI guidelines and in 2000, SEBI has set up Chandrasekhar Committee to promote the growth of VC in India.

5.3.8 Glossary

RCTC- risk capital & technology finance corporation limited
GVFL- Gujarat venture finance ltd.

5.3.9 Short and long QUESTIONS

1. Define Venture Capital funds and discuss the Indian Scenario.
2. What are the different stages of VC funds?
3. Highlight the role of SEBI in governing Venture Capital in India.
4. Explain Venture capital?

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LESSON NO. 5.4 AUTHOR : DR. PATWANT

LEASING

Lesson structure

5.4.1 Objectives

The purpose of this chapter is to explain the basic characteristics of equipment leasing, the different types of leasing and hire purchase, growth, leasing as tax planning instrument and recent developments relating to leasing industry in India.

5.4.2 Introduction

A lease may be defined as a contractual arrangement/transaction in which a party owning an asset/equipment (lessor) provides the asset for use to another/transfers the right to use the equipment to the user (lessee) over a certain/for an agreed period of time for consideration in the form of/in return for periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset/equipment reverts back to the lessor unless there is a provision for the renewal of the contract. Leasing essentially involves the divorce of ownership from the economic use of an asset/equipment. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (financier) from a manufacturer/vendor selected by the lessee. The lessee has possession and use of the asset on payment of the specified rentals over a predetermined period of time. Leasing is, thus, a device of financing/money lending. The position of a lessee is akin to that of a person who owns the same asset with borrowed money. The real function of a lessor is not renting of asset but lending of funds/finance/credit and lease financing is, in effect, a contract of lending money. The lessor (financier) is the nominal owner of the asset as the possession and economic use of the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor does not take recourse of the equipment as long as the rentals are regularly paid to him.

5.4.3 TYPES OF LEASING FINANCE:

An equipment lease transaction can differ on the basis of I, the extent to which the risks and rewards of ownership are transferred, II number of parties to the transactions, and III domicile of the equipment manufacturer, the lessor and the lessee and so on. Risk with reference to leasing refers to the possibility of loss arising on account of underutilisation or technological obsolescence of the equipment, while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realisation of the anticipated residual value on the expiry of the economic life. On the basis of these variations, leasing can be classified into the following types.

5.4.3.1 FINANCE LEASE AND OPERATING LEASE:

According to the International Accounting Standards (IAS-17), in a finance lease, the lessor transfers to the lessee substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancellable lease period, sufficient in total to amortise the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason that such leases are also called as full payout leases as they enable a lessor to recover his investment in the lease and earn a profit. Types of assets included under such lease are, ships, aircraft, railway wagons, lands, buildings, heavy machinery, diesel generating sets and so on.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when-

1. The ownership of the equipment is transferred to the lessee by the end of the lease term, or
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and at the stipulation of the lease it is reasonably certain that the option will be exercised, or
3. The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of its (i) physical life in terms of the period for which it can perform its function (ii) technological life in the sense of the period in which it does not become obsolete and (iii) product market life defined as the period during which its product enjoys satisfactory market. The criterion/cut-off point is that if the lease term exceeds 75% of the useful life of the equipment, it is a finance lease, or
4. The present value of the minimum lease payment is greater than, or substantially equal to, the fair market value (cost of equipment) of the asset at the inception of the lease. The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90% of the fair market value of the equipment. The present value should be computed by using a discount rate equal to the rate implicit in the lease in the case of the lessor and, in the case of the lessee, the incremental borrowing rate.

In India, however, a lease is finance lease if one of the last two conditions is satisfied. A lease agreement with any of the first two conditions is treated as hire-purchase agreement.

A finance lease is structured to include the following features:

1. The lessee (the intending buyer) selects the equipment according to his requirements, from its manufacturer or distributor.
2. The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment and so on.
3. The lessor purchases the equipment either directly from the manufacturer or distributor (under straightforward leasing) or

from the lessee after the equipment is delivered (under sale and lease back).

4. The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.
5. A finance lease may provide a right or option, to the lease, to purchase the equipment at a future date. However, this practice is rarely found in India.
6. The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancellable period called the primary lease period during which the lessor seeks to recover his investment alongwith some profit. During this period cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.
7. The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.
8. As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance of the equipment rests with the lessee.

According to the IAS-17, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortised during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease is also called service lease. The lease rentals in an operating lease include a cost for the ‘services’ provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, some other equipments, telephones, and so on.

An operating lease is structured with following features:

1. An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may

be even on hourly, daily, weekly or monthly basis. The lease is cancellable by either party during the lease period.

2. Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortise the cost of the assets.
3. The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.
4. Operating leases normally include the maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support staff, fuel, and so on.

Examples of operating leases are:

Providing mobile cranes with operators, chartering of aircrafts and ships including the provision of crew, and support services, hiring of computers with operators, hiring a taxi for a particular travel, which includes service of driver, provision for maintenance, fuel, immediate repairs, and so on.

5.4.3.2 SALE AND LEASE BACK AND DIRECT LEASE:

Sale and lease back is an indirect form of leasing. The owner of an equipment/asset sells it to a leasing company (lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits vaults by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank subleases the lockers to its customers. The lease back arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease .

In Direct lease, the lessee, and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.

Bipartite Lease: There are two parties in the lease transaction : (i) equipment supplier-cum-lessor and (ii) Lessee. Such a type of lease is typically structured as an operating lease with inbuilt facilities, like upgradation of the equipment (Upgrade Lease) in addition to the original equipment configuration and so on.

The lessor maintains the asset and, if necessary, replaces it with a similar equipment in working conditions (Swap Lease).

Tripartite Lease: Such type of lease involves three different parties in the lease agreement : equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various forms by:

- Providing reference about the customer to the leasing company;
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company;
- Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of the lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

5.4.3.3 SINGLE INVESTOR LEASE AND LEVERAGED LEASE:

There are only two parties to the lease transaction, the lessor and the lessee in the Single Investor Lease. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, that is, in the case of default in servicing the debt by the lessee, leasing company is not entitled to payment from the lessee.

There are three parties to the transaction: (i) Lessor (equity investor), (ii) Lender, and (iii) Lessee in Leveraged Lease. In such a lease, the leasing company (equity investor) buys the asset through substantial borrowing with full recourse to the lessee and without any recourse to itself. The lender (loan participant) obtains an assignment of the lease and the rentals to be paid by the lessee are first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from lessee, the trustee remits the debt-service component of the rental to the loan participant and the balance to the lessor.

Like other lease transactions, leverage lease entitles the lessor to claim tax shields on depreciation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (Profit after tax divided by networth) is therefore, high.

From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircraft, ships and so on.

5.4.3.4 DOMESTIC LEASE AND INTERNATIONAL LEASE:

Domestic Lease: A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

International Lease: If the parties to the lease transactions are domiciled in different countries it is known as international lease. This type of lease is further sub-classified into import lease and cross-border lease.

In an import lease, the lessor and the lessee are domiciled in the same country but the equipment supplier is located in a different country. The lessor imports the assets and leases it to the lessee.

When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease. The domicile of the supplier is immaterial.

5.4.4 Advantages of Leasing to the Lessee

1. Avoidance of Initial Cash Outlay. The lessee can avail 100% finance from lease financing and avoid even initial investment in margin money as required under loan financing.
2. Minimum Delay : Generally leasing companies take much lesser time in processing the lease proposal as compared to the lengthy procedure involved in the term-loan financing.
3. Shifting the Risk of Obsdescence : The lessee can easily transfer the risk upon the lessor by acquiring the use of the asset on lease rather than buying the same.
4. Greater Liquidity : Lease financing enhances the liquidity position by realising cash from the sale of fixed assets and retaining the use of the same.
5. Tax Planning & Differential Tax Advantage : The lease rentals are a revenue expense while determining taxable profits and help in minimising tax liabilities.

6. No Floatation Costs : The costs involved in the issue of shares and debentures for raising finance is saved.

Advantages of Leasing to the Lessor

1. Higher Profits : The lessor can make high profits from leasing as the capital and risk involved are covered.
2. Quick Returns : The lessor is assured of quick returns in the form of lease rentals.
3. Higher Sales : Lease financing through third parties has helped manufactures to increase their sales.

1.4.5 DIFFERENCE BETWEEN HIRE-PURCHASE AND LEASE FINANCING:

In the case of hire-purchase transaction, the goods are delivered by the owner to another person on the agreement that such person pays the agreed amount in periodical instalments. The property in the goods passes to such person only on the payment of the last instalment. In a hire-purchase transaction, therefore, theoretically the seller continues to retain the title to the asset. The ownership has, however, to ultimately pass to the buyer unless the buyer exercises the option not to buy the asset by stopping payments of future instalments. The buyer can claim depreciation on the cost of the asset and interest as an expense for tax purposes. On the other hand, in case of lease financing, the lease rent is deducted as an expense for tax purposes. Depreciation on the leased asset is claimed by the lessor.

In case of a hire-purchase, on completion of the contract, the residual value of the asset goes to the buyer. While in case of a lease financing, the residual value goes to the lessor, in case where the lessee has a right to cancel the arrangement as in the case of vehicles or aircraft leases. However, in case of a finance lease where the financing is made for purchase of equipment useful only to the lessee, there is no provision for cancellation of the lease agreement. In such a case, the residual value devolves on the lessee. The residual value in such a case is zero or if positive it will be treated as miscellaneous income and be subject to taxation.

5.4.6 LEASING AS TAX PLANNING INSTRUMENT:

By suitable structuring of lease rentals, a lot of tax advantage can be derived. If the lessee is in a tax paying position, the rental may be increased to lower his taxable income. The cost of asset is, thus, amortised more rapidly than in a case where the asset is owned by the lessee, since depreciation is allowable at the prescribed rates. If the lessor is in tax paying position, the rentals may be lowered to pass on a part of the tax benefit to the lessee. Thus, the rentals can be adjusted suitably for postponement of taxes.

The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor is in high tax bracket, he can lease out asset with high depreciation rates and, thus, reduce his tax liability substantially. Besides, the rentals can be suitably structured to pass on some tax benefit to the assessee.

5.4.7 LEASING IN INDIA:

Leasing has proved to be an effective system for financing capital equipment in Europe, Japan and USA. It is now gaining popularity in India also. Of course, land leasing has been quite prevalent in our country from old times. However, leasing of capital equipments is of a recent origin. As a formal instrument of industrial finance, the country witnessed the emergence of leasing companies in the early 1970s. The pioneer in this field was "First Leasing Company of India Ltd." (FLC) based in Madras. The company started its business in 1973 and it has slowly grown over years. Since then, a number of other leasing companies have come into existence. They are Mazda Leasing, Twentieth Century Leasing Company, Ross Morarka Leasing Company Pioneer Leasing, Express Leasing Co. etc. As a matter of fact, in the last ten years, the pace at which the number of companies are entering into the leasing business, it can be said that there are about more than 600 leasing companies in India providing a package of financial services and more are expected to enter the capital market in the coming years. As a result of amendment in the Banking Regulation Act, 1949, a large number of nationalised banks are also expected to participate directly in the leasing business.

Structure of leasing in India

They can been categorised into following groups :

Independent Leasing Companies :

A major past of their income is derived from leasing. Some of them have financial/technical collaboration with overseas parties. Such services are being offered by adervitsers, reasonal contacts, lease browers including foreign banks and merchant banks.

Manufacturer Lessons :

A no. of manufacturing companies have either set up indeqendent leasing outfits or through separate divisions carry on leasing business because of tax advantage.

Manufacturer Lessons A no. of manufactruing companies have either set up independent leasing outfits or through separate divisions carry on leasing business to promote the sale of their own products.

Financial Institutions :

The development finance institutions, both all India and State level, provide leasing faclity.

In house lessons some big business houses have formed captive leasing companies for providing lease finance to group companies.

4. Group Related Leasing Companies:

These include Companies promoted by various industrial groups such as Cholamandal Investment and Finance Company Limited (TI Group), Investment Trust Company Limited and Oriental Leasing Limited (Kothari Group,Madras), DCL Finance Limited (DCL Group, Hyderabad), and Anagram Finance Limited (Kasturibhai Lalbhai Group, Ahmedbad).

Reasons for Popularity:

The leasing industry is steadily gaining popularity in India on account of the following reasons:-

1. A greater role in industrial investment has been envisaged in the Ninth Plan for the private sector.
2. Greater emphasis on priority sector lending by Banks has resulted in reduced availability of Bank finance for private sector.
3. Reduced availability of funds for private sector lending with the financial institutions and greater emphasis by the Government on the Private Sector to generate its own resources.
4. As a result withdrawal of investment allowance w.e.f. April 1,1990, it is more beneficial for a manufacturer to get the plant and equipment on lease as compared to purchasing it.

5.4.8 The Growing Trend in Leasing in USA:

Since the 1986 tax bill eliminated several incentives for capital expenditures such as Investment Tax Credits and accelerated depreciation, many large companies have altered the manner in which they acquire the use of expensive equipment to run their business perhaps the most dramatic changes are taking place in the airline business which has seen a steep increase in the practice of leasing aircraft from operating lease companies. Major airlines companies such British Airways, Lufthansa, Singapore Airlines, Malaysian Airlines and even small companies such as the Seattle-based Alaska Air Group have leased much of their aircraft needs. 1981 about 7% of all commercial aircraft deliveries when to lease companies in the first-half of 1988 this figure has already exceeded 50%.

Many of these companies have found leasing to be a more attractive alternative than an outright purchase through debt. Managers have argued that leasing increases their 'flexibility' and many small under capitalized companies have found it easier to lease than to buy aircraft. Of course, these smaller companies pay a higher lease rate, but apparently, they still find leasing attractive. America West Airlines, for example, says that its launch in 1983 would not have been possible if it had to purchase outright its $ 70 million of aircraft.

With the growing demand for leased aircraft the lessor market has seen some major new players. International Lease Finance Corporation of Beverly Hills, California, which pioneered the operating lease industry in 1972 received orders for $ 6.6 billion of aircraft in May 1988 alone. The GPA Group Ltd. based in Shannon, Ireland is another major leasing company currently managing $ 1.7 billion in aircraft that has been leased. Aircraft manufacturers themselves are becoming lessors– American Airlines March 1987 $ 2.5 billion acquisition of 25 Airbus A 300s and 15 Boeing 767s were leased from the manufacturers. A more interesting concept is the joint venture McDonnell Douglas Corporation has formed with GPA, known as Irish Aerospace, to facilitate leasing of its new MD-II Jumbo Jets.

How long this leasing boom will survive is not clear. With increased demand for leased aircraft, lease rates have already started rising. Alaska Air Group found that its leasing rates shot up by 14% in one year Alaska Air has now begun to rely less on leasing its aircraft. United Airlines, is another case in point; its chief financial officer argues that 'the cost is too much vis-a-vis the flexibility. It is easy to get leases, but you pay a lot of money for them.'

Source: Compiled from information in "For Air Plane Lessors, Business Is Greater." *The Wall Street Journal*, May 20,1988

5.4.9 Problems of Leasing :

Leasing in India faces serious handicaps which may mar its growth in future viz,

(i) **Unhealthy Competition :**

The market for leasing has not grown with the same pace as the number of lessors. As a result, there is over-supply of lessors leading to competition. With the leasing business becoming more competitive, the margin of profits for lessors has reduced.

(ii) **Lack of Qualified Personnel :**

Leasing requires qualified and experienced people at the helm of its affairs. Leasing is a specialised business and persons constituting its top management should have expertise in accounting, finance, legal and decision areas.

(iii) **Tax Considerations :**

Most people believe that lesses prefer leasing because of the, tax benefits it offers. In reality, it only transfers, the benefit, i.e. the lessees tax shelter is lessor's burden. The lease becomes economically viable only when the transfer's effective tax rate is low.

(iv) **Stamp Duty :**

A heavy stamp duty is levied on lease documents which adds to the burden of leasing industry.

(v) **Delayed Payment and Bad Debts :**

The problem of delayed payment of rents and bad debts add to the costs of lease. The lessor does not take into consideration this aspect while fixing the rentals at the time of lease agreement.

5.4.10 Summary

Leasing has become an important source of finance for business concerns due to the advantages it offers. As a result of th amendment in the Banking Regulation Act, 1947 banking companies have also entered the area for providing lease financing.

5.4.11 glossary

lessor- a lessor or landlord legally owns the asset or property

lessee- a lessee or tenant pays rent for the right to occupy or use the property.

5.4.12 Self check exercise

Explain leasing

Hire purchase

5.4.13 Suggested Readings

Financial Markets and Services	:	By Gordan and Natrajan
Financial Services	:	By M.Y. Khan

5.4.14 short and long Questons

1. What do you understand by leasing? State its advantages and limitations.
2. Discuss the various kinds of leasing.

3. What do you understand by hire purchase? How is it different from leasing?

4. What is higher purchase?

5. what is the problems in leasing?

LESSON NO. 5.5 DHIRAJ SHARMA

UNDERWRITING

STRUCTURE OF THE LESSON:

5.5.1 CONCEPT OF UNDERWRITING

Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 percent on shares and 2.5 percent in case of debentures. Underwriters get their commission irrespective of whether they have to buy a single security or not.

Underwriting refers to the process that a large financial service provider (bank, insurer, investment house) uses to assess the process of providing access to their product like providing equity capital, insurance or credit to a customer. The name derives from the Lloyd's of London insurance market in London, United Kingdom. Financial bankers, who would accept some of the risk on a given venture (historically a sea voyage with associated risks of shipwreck) in exchange for a premium, would literally write their names under the risk information which was written on a Lloyd's slip created for this purpose.

In banking, underwriting is the detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history, which is detailed in a credit report; and the lender's evaluation of the borrower's credit needs and ability to pay. Underwriting can also refer to the purchase of corporate bonds, commercial paper, Government securities, municipal general obligation bonds by a commercial bank or dealer bank for its own account, or for resale to investors. Bank underwriting of corporate securities is carried out through separate holding company affiliates, called securities affiliates, or Section 20 affiliates.

5.5.2 ADVANTAGES OF UNDERWRITING

Underwriting has become very important in recent years with the growth of the corporate sector. It provides several benefits to a company:-

* It relieves the company of the risk and uncertainty of marketing the securities.
* Underwriters have an intimate and specialized knowledge of the capital market. They offer valuable advice to the issuing company in the preparation of the prospectus, time of floatation and the price of securities, etc. They also provide publicity service to the companies which have entered into underwriting agreements with them.
* It helps in financing of new enterprises and in the expansion of the existing projects.
* It builds up investors' confidence in the issue of securities. The association of well-known underwriters lends prestige to the company and the investors feel that the issue is sound enough for profitable investment. Also, the securities underwritten by reputed underwriters receives better response from the public.

* The issuing company is assured of the availability of funds. Important projects are not delayed for want of funds.
* It facilitates the geographical dispersal of securities because generally, the underwriters maintain contacts with investors throughout the country.

5.5.3 TYPES OF UNDERWRITING

5.5.3.1. Syndicate Underwriting

Syndicate Underwriting is one in which, two or more agencies or underwriters jointly underwrite an issue of securities.

Such an arrangement is entered into when the total issue is beyond the resources of one underwriter or when he does not want to block up large amount of funds in one issue.

5.5.3.2. Sub-Underwriting

Sub-Underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting. The name of every under-writer is mentioned in the prospectus along with the amount of securities underwritten by him.

5.5.3.3. Firm Underwriting

Firm Underwriting is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters. The underwriter need not take up the whole of the securities underwritten by him. For example, if the underwriter has underwritten the entire issue of 5 lakh shares offered by a company and has in addition applied for 1 lakh shares for firm allotment. If the public subscribes to the entire issue, the underwriter would be allotted 1 lakh shares even though he is not required to take up any of the shares.

5.5.3.4 Insurance Underwriting

Underwriting may also refer to insurance; insurance underwriters evaluate the risk and exposures of the prospective clients. They decide how much coverage the client should receive, how much they should pay for it, or whether to even accept the risk and insure them. Underwriting involves measuring risk exposure and determining the premium that needs to be charged to insure that risk. The function of the underwriter is to acquire-or to "write"-business that will make the insurance company money, and to protect the company's book of business from risks that they feel will make a loss.

In simple terms, it is the process of issuing insurance policies.

Each insurance company has its own set of underwriting guidelines to help the underwriter determine whether or not the company should accept the risk. The underwriters can either decline the risk, or may decide to provide a quotation in which the premiums have been loaded, or in which various exclusions have been stipulated, which restrict the circumstances under which a claim would be paid. Depending on the type of insurance product (line of business) insurance companies use automated underwriting systems to encode these rules, and reduce the amount of manual work in processing quotations and policy issuance. This is especially the case for certain simpler life or personal lines (auto, homeowners) insurance. For more complex risk (for example industrial or commercial property or casualty, engineering or marine insurance) individual, case by case underwriting is usually required to evaluate the risk.

5.5.3.5 Others

Underwriting may also refer to financial sponsorship of a venture, and is also used as a term within public broadcasting (both public television and radio) to describe funding given by a company or organization for the operations of the service, in exchange for a mention of their product or service within the station's programming. For more on underwriting in public broadcasting, please see underwriting spot.

5.5.4 TYPES OF UNDERWRITERS

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. The lead taken by public financial institutions has encouraged banks, insurance companies and stock brokers to underwrite on a regular basis.

The various types of underwriters differ in their approach and attitude towards underwriting:-

Development banks like IFCI, ICICI and IDBI:- they follow an entirely objective approach. They stress upon the long-term viability of the enterprise rather than immediate profitability of the capital issue. They attempt to encourage public response to new issues of securities.

Institutional investors like LIC and UTI:- their underwriting policy is governed by their investment policy. Therefore agencies like brokers private investment and Insurance companies, commercial banks and other financial institutions provide underwriting services.

Financial and development corporations:- they also follow an objective policy while underwriting capital issues.

Investment and insurance companies and stock-brokers:- they put primary emphasis on the short-term prospects of the issuing company as they cannot afford to block large amount of money for long periods of time.

5.5.5 RECENT DEVELOPMENTS AND SEBI REGULATIONS

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters.

Under it, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

Underwriting services have been traditionally provided by financial institutions, banks, brokers who are members of stock exchanges, merchant bankers, mutual funds and persons with adequate financial capacity, appropriate standing and experience. As per rule 3(1) of the Securities and Exchange Board of India (Underwriters) Rules, 1993 no person can act as underwriter unless he holds a certificate granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. Rule 3(2) exempts every stockbroker or merchant banker holding a valid certificate of registration under section 12 of Securities and Exchange Board of India Act, 1992 to obtain separate certificate for underwriting. As per rule 4(b) of the Securities and Exchange Board of India (Underwriters) Rules, 1993, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity.

In the Securities and Exchange Board of India (Underwriters) Regulations, 1993-(i) in regulation 2 -

a. after the opening part and before clause (b), the following clauses shall be inserted, namely:-

"(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(aa) "body corporate" shall have the meaning assigned to it in or under clause (7) of section 2 of the Companies Act, 1956 (1 of 1956);

(ab) "certificate" means a certificate of registration issued by the Board;

(ac) "change of status or constitution" in relation to an underwriter means any change in its status or constitution of whatsoever nature and includes -

(i) in case of a body corporate -

(A) amalgamation, demerger, consolidation or any other kind of corporate restructuring falling within the scope of section 391 of the Companies Act, 1956 (1 of 1956) or the corresponding provision of any other law for the time being in force;

(B) change in its managing director or whole-time director; and

(C) any change in control over the body corporate;

(ii) any change between the following legal forms - individual, partnership firm, Hindu undivided family, private company, public company, unlimited company or statutory corporation and other similar changes;

(iii) in case of a partnership firm any change in partners not amounting to dissolution of the firm; "change in control", in relation to an underwriter being a body corporate, means:-

(i) if its shares are listed on any recognised stock exchange, change in control within the meaning of regulation 12 of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997;

(ii) in any other case, change in the controlling interest in the body corporate;

Explanation: For the purpose of sub-clause (ii), the expression "controlling interest" means an interest, whether direct or indirect, to the extent of at least fifty one percent. of voting rights in the body corporate;"

b. after clause (c), the following clause shall be inserted, namely:- "(ca) 'issue' means an offer of sale of securities by any body corporate or by any other person or group of persons on its or his or their behalf, as the case may be, to the public, or, the holders of securities of such body corporate or person or group of persons;"

c. for clause (f), the following clauses shall be substituted, namely:-

"(f) 'underwriter' means a person who engages in the business of underwriting of an issue of securities of a body corporate;

(fa) 'underwriting' means an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them;"

d. in clause (g), the words "and the rules" occurring after the words "defined in the Act" and the words "or the rules, as the case may be" occurring at the end shall be omitted;

(ii) regulation 3 shall be renumbered as regulation 3A and before the regulation so renumbered, the following regulation shall be inserted, namely:-

Registration as underwriter

3. (1) No person shall act as underwriter unless he holds a certificate granted by the Board under these regulations.

(2) Notwithstanding anything contained in sub-regulation (1), every stock broker or merchant banker holding a valid certificate of registration under section 12 of the Act, shall be entitled to act as an underwriter without obtaining a separate certificate under these regulations.

(3) A stock broker or merchant banker acting as an underwriter under sub-regulation (2) shall be governed by these regulations in other respects."

(iii) in regulation 3A, so renumbered, after sub-regulation (1), the following sub-regulation shall be inserted, namely:-

"(1A) An application for registration made under sub-regulation (1) shall be accompanied by a non-refundable application fee as specified in Schedule II."

(iv) in regulation 4, in sub-regulation (2), for the words "regulation 3" occurring at the end, the words "regulation 3A" shall be substituted;

(v) in regulation 5, for the words "sub-regulation (2) of regulation 3", the words "sub-regulation (2) of regulation 3A" shall be substituted;

(vi) in regulation 9, after sub-regulation (1), the following sub-regulation shall be inserted, namely:-

"(1A) An application for renewal made under sub-regulation (1) shall be accompanied by a non-refundable application fee as specified in Schedule II."

(vii) after regulation 9, the following regulations shall be inserted, namely:-

Conditions of registration

9A. (1) Any registration granted under regulation 8 or any renewal granted under regulation 9 shall be subject to the following conditions, namely:-

(a) where the underwriter proposes to change its status or constitution, it shall obtain prior approval of the Board for continuing to act as such after the change;

(b) it shall enter into a valid agreement with the body corporate on whose behalf it is acting as underwriter;

(c) it shall pay the fees for registration or renewal, as the case may be, in the manner provided in these regulations;

(d) it shall maintain capital adequacy requirements specified in regulation 7 at all times during the period of the certificate or renewal thereof;

(e) it shall abide by the regulations made under the Act in respect of the activities carried on by it as underwriter.

(2) Nothing contained in clause (a) of sub-regulation (1) shall affect the obligation to obtain a fresh registration under section 12 of the Act in cases where it is applicable.

Period of validity of certificate :

9B. The certificate of registration granted under regulation 8 and its renewal granted under regulation 9, shall be valid for a period of three years from the date of its issue to the applicant."

(viii) in regulation 14,

a. in the opening paragraph, for the words, brackets and figures "clause (b) of rule 4", the words, brackets and figures "clause (b) of sub-regulation (1) of regulation 9A" shall be substituted;

b. after clause (i), the following clause shall be inserted, namely:-

"(ia) the allocation of duties and responsibilities between the underwriter and the client;"

(ix) in regulation 15, in sub-regulation (3), for the words, brackets and figures "clause (b) of rule 4", the words, brackets and figures "clause (b) of sub-regulation

(1) of regulation 9A" shall be substituted;

(x) in regulation 16, in sub-regulation (3), for the words, brackets and figures "clause (b) of rule 4" wherever they occur, the words, brackets and figures "clause

(b) of sub-regulation (1) of regulation 9A" shall be substituted;

(xi) in Schedule II -

a. in paragraph 1, for the words "Rupees five lacs", the words "ten lakh rupees" shall be substituted;

b. in paragraph 2, for the words and figures "Rs. 2 lacs", the words "five lakh rupees" shall be substituted;

c. after paragraph 3, the following paragraph shall be inserted, namely:-

"3A. The non-refundable fee payable along with an application for registration under sub-regulation (1A) of regulation 3A or an application for renewal of registration under sub-regulation (1A) of regulation 9 shall be a sum of twenty five thousand rupees."

d. in paragraph 4, for the words and figures "paragraphs 1 and 2" the words and figures "paragraphs 1, 2 and 3A" shall be substituted.

The Securities and Exchange Board of India (Underwriters) Regulations, 1993, the Principal Regulations were published in the Gazette of India on October 8, 1993.

The Securities and Exchange Board of India (Underwriters) Regulations, 1993 was subsequently amended -

* on November 28, 1995 by the Securities and Exchange Board of India (Payment of Fees) (Amendment) Regulations, 1995.
* on January 17, 1997 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1997.
* on January 5, 1998 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1998.
* on September 30, 1999 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 1999.
* on March 28, 2000 by the Securities and Exchange Board of India (Appeal to the Securities Appellate Tribunal) (Amendment) Regulations, 2000.
* on May 29, 2001 by the Securities and Exchange Board of India (Investment Advice by Intermediaries) (Amendment) Regulations, 2001.
* on September 27, 2002 by the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.
* on December 10, 2002 by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2002.
* on March 10, 2004 by the Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004.

5.5.6 Summary

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 percent on shares and 2.5 percent in case of debentures. Underwriters get their commission irrespective of whether they have to buy a single security or not. To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters.

5.5.7 Glossary

Clue- comprehensive loss underwriting exchange

4c's – capacity, credit, collateral, capital

5.5.8 Self check exercise

Explain underwriting?

Explain 4c's?

5.5.9 Short and long Questions for Exercise

1. How does underwriting boost performance of financial system? Discuss.
2. What is underwriting?
3. What are its various types? Discuss.
4. Differentiate between Sub-Underwriting and Firm Underwriting.
5. Explain different types of Underwriters.
6. Discuss recent developments in the area of Underwriting.
7. Write and discuss major SEBI Regulations regarding underwriting.
8. What is the significance of underwriting in our financial system? Discuss.

5.5.10 References and Suggested Readings

* Amit, R. & Glosten, L. & Muller, E. 1993. Challenges to Financial Theory Development. Journal of Management Studies 30: 5, 815 - 833.
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* Davidsson, P. 1989. Continued Entrepreneurship and Small Firm Growth. Stockholm School of Economics, The Economic Research Institute.
* Khan, M. Y.: Financial Management
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