PGBA (S4) 02-2

Management of Financial Services

SEMESTER - IV

BUSINESS ADMINISTRATION

BLOCK - 2

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER IN BUSINESS ADMINISTRATION

Management of Financial Services

Block 2

DETAILED SYLLABUS

Unit 8: Merchant Banking Services:

Merchant Banking, Origin of Merchant Banking; Services of Merchant Banking, Project Counselling Services, Corporate Advisory Services, Corporate Restructuring Services, Capital Restructuring Services, Credit Syndication Services, Issue Management Services, Portfolio Management Services, Private Equity Services, Mezzanine Financing, Structured Product Services; Distinction between Commercial and Merchant Banks; SEBI Guidelines for Merchant Banking, Categories of Merchant Bankers and Capital Adequacy Requirement, Suspension/Cancellation of Registration, Code of Conduct; Merchant Banking in India

Unit 9: Mutual Funds:

Mutual Funds Industry in India; Structure of Mutual Fund; Important Concepts of Mutual Fund; Classification of Mutual Fund, Classification by Operations, Classification by Investment Objectives, Other Funds; Advantages of Mutual Fund Investment; Disadvantages of Mutual Fund Investment; Guidelines for Mutual Funds, Guidelines Related to Mutual Fund Schemes, Mutual Funds Industry in India, Structure of Mutual Fund; Important Concepts of Mutual Fund, Classification of Mutual Fund, Classification by Operations, Classification by Investment Objectives, Other Funds; Advantages of Mutual Fund Investment; Disadvantages of Mutual Fund Investment; Guidelines for Mutual Funds. Guidelines Related to Mutual Fund Schemes, Guidelines Related to Mutual Fund Investments, Guidelines Related to Winding up of Mutual FundScheme; Expenses Related to Mutual Fund Scheme, Guidelines Related to the Asset Management Company, Guidelines Related to Accounting Requirements.

Unit 10: Insurance Services and IRDA:

Benefits of Insurance, Benefits to Insured, Benefits to Society, Benefits to the Nation; Basic Features of Insurance Contracts; Types of Insurance Products, Life Insurance, General Insurance; Structure of Indian Insurance Sector, Life Insurance Companies- Public Sector, Life Insurance Companies- Private Sector, Non-Life Insurance (General Insurance)

Companies- Public Sector, Non-Life Insurance (General Insurance) Companies- Private Sector; Insurance Regulatory Development Authority (IRDA)

Unit 11: Leasing and Hire Purchase:

Concept and Classification of Lease, Classification on the Basis of Duration , Classification on the Basis of Nature ; Advantages of Leasing; Limitations of Leasing; Leasing Industry in India; Hire Purchase, Difference Between Hire Purchase and Installment sale,Difference Between Hire Purchase and Lease Financing.

Unit 12: Corporate Restructuring:

Forms of Corporate Restructuring- Merger, Motives of Merger, Types of Mergers; Forms of Corporate Restructuring- Acquisitions/ Takeovers, Methods of Acquisition, Hostile Takeover; Financing Mergers and Acquisitions; Forms of Corporate Restructuring- Divestitures/ Demergers, Methods of Divestiture/ Demerger; Forms of Corporate Restructuring- Buyouts ; Forms of Corporate Restructuring- Buyback of Securities , Reasons for Buyback of Shares, Advantages of Buyback of Shares, Limitations of Buyback of Shares

Unit 13: Securitization, Factoring and Forfaiting:

Securitization, Parties Involved in Securitization Process, Steps in Securitization Process, Advantages of Securitization, Securitization in India;Factoring, Process of Factoring, Functions of the Factor, Benefits of Factoring; Difference Between Bill Discounting and Factoring; Forfaiting, Process of Forfaiting; Difference between Factoring and Forfaiting

Unit 14: Depository Custodial Services:

Constituents of the Depository System, Functions of Depository, Advantages of the Depository System, Regulation with Regard to Depository System, Depository- NSDL & CDSL, Custodial Services, Distinction Between Depository and Custodial Services

Unit 15: Credit Rating Services:

Features of Credit Rating, The Scope of Credit Rating; The Process of Credit Rating; Advantages of Credit Rating; Disadvantages of Credit Rating; Credit Rating Agencies in India; SEBI guidelines for Credit Rating Agencies in India

BLOCK INTRODUCTION:

This is the second block of the course 'Management of Financial Services". The Block is divided into 8 units and is primarily a learner oriented Self learning material, as it satisfies the requirements of the learners in the filed of Accounting.

This block comprises of the following eight units:

The first unit of this block, that is unit eight introduces us to Meaning and Concept of Merchant Banking **Services**

The second unit gives us a broad idea of Mutual Fund.

The third unit gives us an idea on Insurance Services and IRDA.

The fourth unit will help us in understanding the concept of Leasing and Hire purchase.

The fifth unit gives us a broad idea of Corporate Restructuring.

The sixth unit will help us in understanding scrutinization, Factoring and Forfaiting

The seventh unit of this block explains about Depository custodial services

The last unit of this block is about Credit Rating Services.

Each unit of these blocks includes some along-side boxes to help you know some of the difficult, unseen terms. You may find some boxes marked with: "LET US KNOW". These boxes will provide you with some additional interesting and relevant information. Again, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be helpful for you if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with "ANSWERS TO CHECK YOUR PROGRESS" given at the end of each unit. This will help you in making your learning more active and efficient. And, at the end of each section, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your understanding.

The Block is devided into seven units:

Unit 8: Merchant Banking Services

Unit 9: Mutual Funds

Unit 10: Insurance Services and IRDA

Unit 11: Leasing and Hire Purchase

Unit 12: Corporate Restructuring

Unit 13: Securitization, Factoring and Forfaiting

Unit 14: Depository Custodial Services

Unit 15: Credit Rating Services

UNIT 8: MERCHANT BANKING SERVICES

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Merchant Banking

- 8.3.1 Origin of Merchant Banking

8.4 Services of Merchant Banking

- 8.4.1 Project Counselling Services
- 8.4.2 Corporate Advisory Services
- 8.4.3 Corporate Restructuring Services
- 8.4.4 Capital Restructuring Services
- 8.4.5 Credit Syndication Services
- 8.4.6 Issue Management Services
- 8.4.7 Portfoloi Management Services
- 8.4.8 Private Equity Services
- 8.4.9 Mezzanine Financing
- 8.4.10 Structured Product Services

8.5 Distinctions between Commercial and Merchant Banks

8.6 SEBI Guidelines for Merchant Banking

- 8.6.1 Categories of Merchant Bankers and Capital Adequacy Requirement
- 8.6.2 Suspension/Cancellation of Registration
- 8.6.3 Code of Conduct

8.7 Merchant Banking in India

8.8 Let Us Sum Up

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8.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- know the concept and origin of Merchant Banking
- list the various services of Merchant Banking

- distinguish between Commercial and Merchant Banks
- discuss the SEBI guidelines with respect to Merchant Banking
- know the various categories of Merchant Bankers and their capital adequacy requirements
- discuss the process of Cancellation/Suspension of registration
- explain the Code of conduct with respect to merchant banking functions
- To know about the progress of Merchant Banking in India.

8.2 INTRODUCTION

Merchant banking is a combination of banking with consultancy services. It provides advisory services and guidance to its clients for financial, marketing, managerial and legal matters against a fee. It helps a new business in raising finance and an existig business in expansion and modernization. It also helps in restrusturing and revival of a business.

In present business world merchant banking service play a very important role particularly in promoting new ventures. In this unit we will discuss the meaning of merchant banker, services, provided by merchant banker and various regulatory aspects related to merchant banker.

8.3 MERCHANT BANKING

Merchant banking is an institution which covers a wide range of activities, such as, portfolio management, management of customer services, credit syndication, counseling, insurance and so on. In India many commercial banks (both public and private sector), financial intermediaries, foreign companies provide merchant banking services. Important among them are State Bank of India, Punjab National Bank, ICICI Bank, Yes Bank, HDFC Bank, Bajaj Capital Limited, Tata Capital Markets Limited, Goldman Sachs (India) Securities Pvt. Ltd., Morgan Stanley India Company Pvt. Ltd. and so on.

8.3.1 Origin of Merchant Banking

The origin of merchant banking can be traced back to the

period when people used to deposit their valuables and money with the local grain merchant for safe custody before going on a trip. With the passage of time, the merchants realized that the money kept with them can be used for lending and thus they started lending money to the needy in the area and charged interest on such lending. Some merchant even shared their interest income with the depositors. Soon people who were not going out of town started depositing money with the merchant for interest. The merchant, in turn, used that money for lending purpose and made good amount of profits. Some merchant earned so much money that they started financing kings, emperors and even governments. To fight wars, kings used to borrow money from such merchants. Gradually, lesser known merchants started requesting big merchants to guarantee the bills to be accepted by them against some fee. This is how merchants got engaged in the business of banking and became merchant bankers. They were also involved in other commercial activities such as sale and purchase of commodities. Merchant bankers were also known as commission agents.

Merchant banking business became lucrative during the industrial revolution in England. Gradually, many players entered the field and merchant banking business became more competitive. Hence the merchant bankers diversified into new lines of business like discounting of bills, managing issues of corporate securities, arranging finance for projects, consultation on mergers and takeovers and capital restructuring.

After the Second World War, industrial activity picked up and development activities accelerated in many countries. As the business of merchant banking grew, the organizational structure also changed from being family owned businesses to professionally managed businesses. Thus, merchant banking became a specialized and professional financial services business. The merchant bankers started opening more number of branches and entered new line of business such as leasing, corporate counseling, portfolio management and venture capital.

8.4 SERVICES OF MERCHANT BANKING

Today, merchant bankers provide a wide spectrum of financial and related services to their clients. However, all merchant bankers do not provide every service. The most popular services provided by merchant banks across the globe are as follows:

8.4.1 Project Counseling Services

Projects can be short-term as well as long-term. They are specific time bound programmes undertaken with a motive to earn profit or doing development activity. Project counseling involves imparting technical advice to the management on various aspects of the projects. A project involves various stages such as planning, analysis, selection, implementation and review. In all these stages technical expertise is required. Over the years, merchant banks have developed expertise in different areas of project management. As we already discussed that a single merchant bank may not provide all the services, there are merchant banks who are specializes in particular area of operation. For example, a particular merchant bank may have expertise in conducting feasibility study and preparing project reports. Another merchant bank may have expertise in the field of project implementation. So different merchant banks are specialized in different aspect of project management and, accordingly the client appoints merchant bankers as per their requirement and expertise.

8.4.2 Corporate Advisory Services

Merchant banks provide wide variety of corporate advisory services to their clientele. Some of the corporate advisory services includes diversification of products and product lines, strengthening the existing product lines, reviving or taking over of sick units. They also provide services relating to location of plants, conducting market

surveys, demand forecasting, new product development, pricing of products, brand management, logistics, cost reduction etc.

In certain cases, merchant bankers also negotiate deals on behalf of their clients. They also help in settling disputes in family owned businesses. Merchant banks are recognized as good mediator in cases of differences within the family.

8.4.3 Corporate Restructuring Services

The liberalization and globalization demands corporate to restructure their businesses to meet the global demand and customer preference. Corporate restructuring refers to the changes in operation of assets or ownership of a firm. Corporate restructuring may involve mergers, acquisitions, takeovers, buy back of shares, capital restructuring etc. The objectives of corporate restructuring may be to limit competition, gain economies of scale, accelerate business growth, reduce tax liability, to provide better customer service and so on.

Corporate restructuring in any form is a long-term strategy and takes time to implement. It requires relentless search for the right opportunities and putting in serious efforts in materializing the identified opportunities. If the organization goes for acquisition of another company, a sound strategy has to be designed and followed to integrate the acquired business with the existing business. In this context, merchant banks play an important role in advising its clientele on various aspects of corporate restructuring. Merchant banks also help in identifying firms with similar characteristics and assist in preparation of restructuring proposals. They also assist in dealing in legal formalities and in obtaining approvals from concerned authorities. Merchant banks may also assist its client in negotiating mergers.

8.4.4 Capital Restructuring Services

The financial structure of a company refers to various means

of financing the assets of the company. Capital structure is a variant of the firms financial structure which refers to the proportionate relationship between debt and equity of the company. Capital structure decisions are very important from the standpoint of shareholder's return and risk. Whenever a firm decides to raise funds to finance its project, the capital structure decision is very vital. It involves the analysis of various factors that influence the capital structure of the firm. With regard to capital restructuring, merchant banks may formulate financial restructuring schemes and monitors its implementation. Any demand for new capital envisages a new capital structure. In other words, any change in the quantity and forms of financing would amount to capital restructuring. Therefore any new financial decision of the firm may influence the debt- equity structure, which in turn, has implications for the value of the firm.

The merchant banks offer their services for capital restructuring; they design the capital structure for their client. Merchant banks use their expertise and advise their client on how to maintain optimum capital structure.

8.4.5 Credit Syndication Services

Many a times for big projects, the fund requirements are quite high for certain organization. In such cases, it is not feasible for a single credit institution to disburse such a huge amount of credit. Therefore, under such situation, a group of financial agencies/ institutions forms a syndicate to disburse the requisite funds. The process of providing credit by a syndicate of credit institutions is known as credit syndication. It involves estimation of total fund requirement for the project, drawing financial plan for the entire credit requirement, selecting banks or credit institutions for participation in financing the project, completion of legal formalities and so on. Credit syndication also involves financing working capital requirements.

Merchant banks play a very important role in credit syndication. They offer services from identifying and assessing the

funds requirements of the client firm to completing the formalities for the withdrawal of the sanctioned loan amounts.

8.4.6 Issue Management Services

In order to meet investment needs, corporate firms raise funds from the primary market through issue of different kinds of securities such as equity shares, preference shares, debentures and bonds. Merchant banks actively involved in management of public issues. They helps the issuer in preparing the action plan, formulate the budget for the issue, preparation of application to SEBI, drafting of the prospectus, selection of intermediaries, obtaining approvals from SEBI and other organizations and so on.

It is mandatory from regulatory perspective that every issue should have lead managers. The number of lead managers for an issue is depending on the size of the issue. The merchant bank plays the role of a lead manager in new issues, they assume almost the entire responsibility of the public issue.

8.4.7 Portfolio Management Services

It refers to management of investment portfolios for others by professionals in investment management. In absence of lack of skills or knowledge of the capital market, they appoint merchant bank's professionals to advise them on best possible investment. These banks invest and manage the funds on behalf of the clients by keeping in view the investment objectives of the client. They also helps in maintaining all documents relating to investments for their client.

8.4.8 Private Equity Services

Private equity refers to investments which is generally large in number, made in a closely held unlisted company by a firm comprised of high networth individuals and institutional investors.

Hence equity investment made in a company that is not publicly traded is a private equity and the firm who deals in private equity is known as private equity firm.

Private equity is good source to access capital very quickly. Generally private equity funds acquire private companies, nurture them and fuel their growth. Subsequently the private equity funds either sell these companies to other investors or make them public. Merchant banks play an important role in arranging private equity or participating in private equity.

8.4.9 Mezzanine Financing Services

In this type of financing, the debt holder (the provider of finance) is given the right to convert his debt into equity, if the debt is not repaid as per terms of the loan agreement. The debt holder may reserve the right to take over an ownership interest in the borrower company if the loan is not paid on time and in full. Mezzanine financing can be provided very quickly with little due diligence on the part of the lender. This type of financing also makes it easier for the borrowers to obtain further loans from other sources. A mezzanine financing is treated like equity on company's balance sheet, which make the borrower to raise further debt. However to do so, the borrower company should have a good track record including history of profitability and genuine business expansion plans. Merchant banks may play an active role in arranging mezzanine financing for their clients.

8.4.10 Structured Product Services

These are special kind of financial instruments designed to possess different combinations of risk-return characteristics. These products are different from conventional securities such as equity shares, debentures and bonds. The structured products have embedded features of options, swaps, forward and futures. These

products are customized products designed to suit the needs of specific objectives and risk profiles of investors.



CHECK YOUR PROGRESS

Q 1: Fill in the Blanks

a) The process of providing credit by a syndicate of credit institutions is known as .....

b) ..... refers to the changes in operation of assets or ownership of a firm.

c) Capital structure refers to the proportionate relationship between ..... and equity of the company.

d) ..... involves imparting technical advice to the management on various aspects of the projects.

e) ..... service refers to management of investment portfolios for others by professionals in investment management.

8.5 DISTINCTIONS BETWEEN COMMERCIAL AND MERCHANT BANKS

Commercial banks are those financial institutions which accept deposits from the public that are withdrawable by cheques. The commercial banks further lends money to the individual and institutions in the form of credit. On the other hand merchant banks are those institutions which offer a wide range of services such as corporate counseling, project counseling, portfolio management, new public issue management, credit syndication and so on. There are quite a number of differences between commercial banks and merchant banks. These are summarized below:

Sl No.	Commercial Banks	Merchant Banks
1	Commercial banks mainly deal with credit and credit related finance.	Merchant Banks mainly deal with equity and equity related finance. They are governed by merchant
2	They are governed by the banking regulations. They operate under the control of RBI.	banking rules. These rules are generally issued by the Ministry of Finance and SEBI.
3	The clientele of commercial banks includes retail individuals, high networth individuals (HNI), small, medium and large institutions.	The clientele of merchant banks are mostly medium and big institutions and high networth individuals (HNI).
4	With regard to risk taking capacity, commercial banks are risk averter compared to merchant banks.	Merchant banks are risk takers. They structured risky product to earn higher margins.
5	Activities of commercial banks are asset- oriented.	Activities of merchant banks are management- oriented.
6	Commercial banks can create credit and make a multiple expansion of credit.	Merchant banks cannot create credit.
7	Commercial banks mostly deal in short term credit, hence they mainly engaged in money market.	Merchant banks mainly engaged in capital market.
8	As per the requirement of RBI, commercial banks need to maintain certain percentage statutory liquidity ratio (SLR) and cash reserve ratio (CRR) on their deposit.	Merchant banks do not have to maintain any such requirement.

9	Commercial banks main source of revenue are interest on loans provided and fee income from other services offered.	Merchant banks main source of revenue are from fee income from their services.
10	Commercial banks are mainly financiers for business houses and firms.	Merchant bank not only arranges finance for their clients but also offers consultation and advice to the management. They act as a guide to the management.

8.6 SEBI GUIDELINES FOR MERCHANT BANKING

To regulate the activities of merchant banks, SEBI issued certain rules and regulations for the first time in 1992. These rules have been revised many a time to suit the changing scenario. As per the new regulation, no institution can act as a merchant banker unless it holds a certificate from the SEBI. In order to grant certificate to any merchant banker, they have to fulfill certain conditions. The important conditions are:

- All merchant banks shall abide by the rules and regulations made under the SEBI Act, 1992, with respect to the activities carried on by merchant banks.
- It should pay the fee for registration and renewal as per the prescribed norms.
- The merchant banks has to take adequate steps for the redressal of grievances of the investors within one month of date of receipt of the complaint.

An institution that wants to act as merchant banker should be a corporate body other than a non-banking finance company, as defined under the RBI Act, 1934.

8.6.1 Categories of Merchant Banks and their Capital Adequacy Requirements

Merchant banks are classified into four categories depending on their net worth as follows.

Type of merchant banker	Minimum net worth
Category I	Rs. 5 Crores
Category II	Rs. 50 Lacs
Category III	Rs. 20 lacs
Category IV	NIL

Category I merchant banks can carry on any activity of issue management. It can also act as the adviser, consultant, manager, underwriter or portfolio manager.

Category II merchant banks can act as the adviser, consultant, co-manager, underwriter or portfolio manager.

Category III merchant banks can act as an underwriter, adviser or consultant to an issue.

Category IV merchant banks can only act as adviser or consultant to an issue.

Every merchant bank has to keep and maintain following books of accounts, records and documents:

- A copy of the balance sheet as at the end of each accounting period;
- A copy profit and loss account for that period;
- A copy of the auditor's report on the accounts for that period; and
- A statement of the financial position

All the merchant banks need to keep their books of accounts and other records for a minimum period of five years.

8.6.2 Suspension/ Cancellation of Registration

SEBI can suspend the certificate of registration issued to any merchant bank under any of the following circumstances.

- If the merchant bank violates the provisions of the SEBI Act, rules and regulations.
- If the merchant bank fail to furnish any information relating to its activities or furnishes wrong/ false information, as required by SEBI.
- If the merchant bank fails to maintain the capital adequacy requirement stipulated by SEBI.
- If the merchant bank fail to pay the prescribed fee.

The certificate of registration may be cancelled by SEBI when:

- The merchant bank indulges in deliberate manipulation or price rigging activities affecting investor's interest.
- The merchant bank is found guilty of fraud or is convicted of a criminal offence; or
- The financial condition of the merchant bank deteriorates to such an extent that its operation is not in the interest of the investors.

8.6.3 Code of Conduct

The following code of conduct, are prescribed by SEBI for all merchant banks in India:

- A merchant bank should not associate in any business other than that of the securities market.
- A merchant bank must observe high standard of integrity in all its dealings.
- A merchant bank should always render high standard of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
- A merchant bank should not involve in any price rigging and manipulation.
- A merchant bank should not disclose any confidential information of their client to other clients or media.

- A merchant bank should ensure that they provide true and adequate information to their client.
- A merchant bank should ensure that any complaints from investors are dealt promptly and within specified time frame.
- A merchant bank must ensure that good governance practices are in place.

8.7 MERCHANT BANKING IN INDIA

During the early years of 19th century, many of the company form of organization started in India. These companies gave the responsibilities of management to a class of managing agents for remuneration. This system of managing a company is known as Managing Agency System. A managing agent can be an individual, firm or company. They perform three main functions:

i. Day to day management of the business
ii. Promoting industrial enterprises
iii. Arranging finance for the company they are managing

For providing the above services, managing agents receives remuneration in the form of a fixed office allowance, a commission for rendering managerial service and additional commission for rendering other subsidiary services. In simple word, managing agents of that time are the merchant bankers of today.

According to the study of R.K. Nigam, there were as many as 3944 managing agents operated in India during 1954-55. As the number of managing agents grows, the amount of unfair practices by managing agents started growing. To bring uniformity and to stop unhealthy practices, the Indian Companies Act, 1956 was passed as per the recommendation of Bhaba Committee (1951). Later in the year 1966, the Patel Committee recommended discontinuation of the managing agency system in the major industries in India.

The merchant banking services were initially introduced in India by foreign banks. The National Grindlays Banks started first merchant banking

operation in India in 1967, followed by Citi Bank in 1970. In the year 1972, the Banking Commission recommended the setting up of merchant banking institutions by commercial banks and non-bank financial institutions.

The State Bank of India was the first bank to set up its merchant banking division in 1972. Later on all the public sector bank as well as private sector banks and other non-bank financial institutions started merchant banking division in India. The merchant banking in India grew rapidly post the liberalization policy of the Government in 1990.



8.8 LET US SUM UP

In this unit we have discussed the following aspects —

- Merchant banking is an institution which covers a wide range of activities, such as, portfolio management, management of customer services, credit syndication, counseling, insurance and so on.
- In India many commercial banks (both public and private sector), financial intermediaries, foreign companies provide merchant banking services.
- Merchant banks provide a variety of Services which include Project Counselling Services,Corporate Advisory Services,Corporate restructuring Services,Capital Restructuring Services, Credit Syndication Services, Issue management Services, Portfoloi management Services, Private Equity Services,Mezzanine Financing and Structured Product Services
- The commercial banks further lends money to the individual and institutions in the form of credit. On the other hand merchant banks are those institutions which offer a wide range of services such as corporate counseling, project counseling, portfolio management, new public issue management, credit syndication and so on.
- To regulate the activities of merchant banks, SEBI issued certain rules and regulations for the first time in 1992. These rules have been revised many a time to suit the changing scenario.

- The merchant banking services were initially introduced in India by foreign banks.
- The State Bank of India was the first bank to set up its merchant banking division in 1972.



8.9 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel &Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



8.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Credit Syndication
b) Corporate restructuring
c) Debt
d) Project counseling
e) Portfoloi Management'



8.10 MODEL QUESTIONS

Q 1: What is Merchant Banking? Discuss its origin.

Q 2: Discuss in detail the Services of Merchant Banking.

Q 3: Distinguish between commercial and Merchant banks.

Q 4: Discuss the SEBI guidelines with respect to Merchant Banking.

Q 5: Discuss the progress of Merchant banking in India.

Q 6: Write Short Notes on:

a. Role of Merchant bankers in Capital restructuring.

b. Caterogies of Merchant bankers and their capital adequacy requirements.

c. Role of Merchant bankers in Issue management.

d. Role of Merchant bankers in Portfoloi management.

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UNIT 9: MUTUAL FUNDS

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.2.1 Mutual Funds Industry in India

9.3 Structure of Mutual Fund

9.4 Important Concepts of Mutual Fund

9.5 Classification of Mutual Fund

9.5.1 Classification by Operations

9.5.2 Classification by Investment Objectives

9.5.3 Other Funds

9.6 Advantages of Mutual Fund Investment

9.7 Disadvantages of Mutual Fund Investment

9.8 Guidelines for Mutual Funds

9.8.1 Guidelines Related to Mutual Fund Schemes

9.8.2 Guidelines Related to Mutual Fund Investments

9.8.3 Guidelines Related to Winding up of Mutual Fund Scheme

9.8.4 Expenses Related to Mutual Fund Scheme

9.8.5 Guidelines Related to the Asset Management Company

9.8.6 Guidelines Related to Accounting Requirements

9.9 Let Us Sum Up

9.10 Further Readings

9.11 Answers to Check Your Progress

9.12 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit you will be able to discuss —

- discuss the mutual fund industry in India
- understand the structure of mutual funds

- explain various concepts of mutual funds
- know the various classifications of Mutual Fund.
- understand the advantages and disadvantages of Mutual funds
- explain the various regulatory guidelines with respect to mutual funds.

9.2 INTRODUCTION

A mutual fund is an entity that pools money from several investors and invests the pooled amount in different kinds of securities or assets. In other words mutual funds are financial intermediaries that mobilize money from investors, particularly retail investors. The pooled money is used to purchase financial assets or securities issued by various companies. Instead of making a direct purchase of shares or debt securities from the primary or secondary market, small investors can purchase those securities through mutual funds. Mutual funds provide a facility to the small investors to manage their hard earned money by professional management. The mutual fund companies professionally manage the funds of individuals and institutions who may not have high degree of financial expertise.

Mutual funds are primarily helpful to investors with small or moderate financial resources. Earlier the small investors were refrained from directly purchasing good quality stocks from the market due to their high price and lengthy formalities. Now with the help of mutual funds they get the benefit of owning a well diversified portfolio.

9.2.1 Mutual Fund Industry in India

Mutual funds originated in United States during 1930's but the concept took root in India only in 1960s. In India, the government realized the need to route the household savings to capital market and thus in 1963, the Unit Trust of India Bill was passed by the Parliament. The Unit Trust of India (UTI) came in to force under the regulatory and administrative control of RBI. However in 1978, UTI came under the regulatory and administrative control of IDBI. UTI launched its first mutual fund scheme in 1964 by the name of US-

64. Subsequently they launched many other mutual fund schemes. The first equity fund launched by UTI was the *'Mastershare'* in 1986.

Non-UTI mutual funds made entry in to India with the establishment of SBI Mutual Fund in 1987 by the State Bank of India. Subsequently many other public sector banks, LIC (Life Insurance Corporation)and GIC (General Insurance Corporation) also set up their mutual fund companies.

In 1993, the private sector mutual funds started its operation. Kothari Pioneer was the first private sector mutual fund in India, registered in July 1993. Later on many other private sector mutual funds, including some multinational mutual funds, were established. In February 2003, UTI was segregated in to two separate entities:

i. **Unit Trust of India:** It functions under rules framed by the Government of India and does not come under the purview of the SEBI Mutual Fund Regulations. The bifurcated Unit Trust of India owned the US-64 schemes along with certain other schemes.

ii. **UTI Mutual Fund:** It is sponsored by the State Bank of India, Punjab National Bank, Bank of Baroda and the Life Insurance Corporation of India. It is registered with SEBI and functions under SEBI Mutual Fund Regulations.

9.3 STRUCTURE OF MUTUAL FUNDS

A mutual fund in India has the following constituents:

- **Fund Sponsor:** The sponsor is the main body that establishes a mutual fund. A sponsor is like the promoter of a company. A sponsor can be a person or an entity. A sponsor should have a good track record of conducting business in the field of financial services for more than five years.
- **Trustees:** A mutual fund company can either be managed by a body of individuals known as *board of trustees,* or by a corporate entity known as *trust company.* The main responsibility of trustee is to ensure that the interest of the unit holders is protected while making sure that

the mutual fund complies with all the regulations of SEBI.

- **Asset Management Company (AMC):** The AMC is a company established by the sponsor of a mutual fund or the trustees that acts like the investment manager of the trust.
- **Custodians:** It is an organization established for safekeeping of securities and other assets of a mutual fund.
- **Registrar and Transfer Agent:** The registrar and transfer agents maintain records of unit holders. A mutual fund company may have its own department or may choose to hire an independent party registered with SEBI to provide such services. The registrar and transfer agents maintain the communication between the mutual fund and its unit holders.
- **Agents/Distributors:** The mutual fund appoints agents to distribute their products.



CHECK YOUR PROGRESS

Q 1: Fill in the Blanks:

a) Mutual funds originated in ..... during 1930's.

b) The first equity fund launched by UTI was the ..... in 1986.

c) UTI launched its first mutual fund scheme in 1964 by the name of .....

d) In February 2003, UTI was segregated in to two separate entities, ... and .....

e) The ..... is a company established by the sponsor of a mutual fund or the trustees that acts like the investment manager of the trust.

9.4 IMPORTANT CONCEPTS OF MUTUAL FUND

It is very essential to know certain key concepts related to mutual funds before proceeding further. Below are some of the important terminologies with regard to the mutual fund industry.

- **Net Asset Value (NAV):** The NAV is basically the unit price of the mutual fund scheme. It is arrived at, on daily basis, by calculating total market value of investments or assets of the MF, subtracting liabilities and dividing by the number of units currently outstanding. Thus,

$$NAV = \frac{\text{Total market value of assets in the portfolio of the fund} - \text{liabilities}}{\text{Number of units issued or outstanding}}$$

- **Entry Load:** It is a charge that investors have to pay when they buy units of a mutual fund scheme. It is also called front-end load or sales load.
- **Exit Load:** It is the charge investors have to pay when they intend to exit from the scheme. In other words, when investors redeem his units in a mutual fund, he needs to pay an exit load specified by the mutual fund in advance. It is also known as 'Repurchase' or 'back-end load'.
- **Sale Price:** It is the price paid by investors at the time of investing in a scheme. It is the purchase price for investors and is also called 'offer price'.
- **Systematic Investment Plan (SIP):** It is an option provided by the mutual fund company to help investors to make regular investment of small amount in their scheme at pre-defined regular intervals.
- **Systematic Transfer Plan (STP) / Systematic Switch Plan (SSP):** It is a plan that allows investor to give consent to the mutual fund to periodically transfer a certain amount/ switch (redeem) certain units from one scheme and invest in another scheme.
- **Systematic Withdrawal Plan (SWP):** It allows an investor to withdraw specified sum of money and units from the fund account at pre-defined regular intervals. The investor can reinvest the redeemed cash in another portfolio or use it as a source of regular income. It is suitable for retirees who are looking for fixed flow of income at regular intervals.

9.5 CLASSIFICATION OF MUTUAL FUND

The schemes launched by mutual funds can be clubbed into three broad categories based on their operations, investment objective and others.

The following are the various schemes under the above mentioned three categories:

9.5.1 Classification by Operations

- **Open-ended Fund:** An open-ended fund is always open to investors. The units are sold and redeemed by the mutual fund on every day basis (working day) at the price determined by the fund's net asset value (NAV). Under open-ended fund, there is no limit on the amount the investors can invest in these funds; similarly investors can also redeem any amounts and the MF are legally bound to repurchase those units. As a result of this, their corpus changes daily.
- **Close-ended Fund:** Under close-ended fund, the size of the corpus and the number of units to be offered to the public is determined in advance. The price of units is also pre determined. Once the subscription reaches the target level, the entry to the fund is closed. The opening and closing dates of subscription are announced to the investing public. Hence the investors cannot participate in these schemes after the initial offer is over. Investors have also limited exit options. They might be allowed to exit at specified period but this comes at a cost in the form of higher exit load. Most of the close-end funds are long term funds and the dividend, interest and capital gains received on investment in the fund shall be distributed to the unit holders.
- **Interval Fund:** This category of funds possesses the characteristics of both open-ended funds and close-ended funds. These type of funds can either be traded on stock exchange or may be open for sale during pre-determined intervals at NAV. The units/shares of interval funds are not traded on secondary market, rather these funds are offered to repurchase at a price based on the NAV. These offers are made

generally every 3, 6 or 12 months, as disclosed in the fund's prospectus and annual report.

9.5.2 Classification by Investment Objectives

- **Growth Fund:** Growth funds primarily focus on achieving capital appreciation over medium to long term. Generally under such scheme, a higher portion of fund is invested in equity and equity linked instruments and the remaining portion is invested in debt and money market instruments.
- **Income Fund:** The portfolio of income fund primarily hold a major portion of fixed income securities such as corporate bonds/debentures, government securities, money market instruments and so on. They maintain a small exposure to the equity market. The objective of investing in income fund is to avoid high risk and receive regular and constant income by the investors.
- **Balanced Fund:** The objective of balance fund is to provide both capital appreciation and periodic returns to the investors over a long period of time. Usually, a balance fund invests 60% of its net assets in equity and 40% in fixed income securities. The riskiness of these funds is less in comparison to growth funds.
- **Money Market Mutual Funds:** These funds invest their money in highly liquid instruments such as treasury bills, commercial papers, certificate of deposits and interbank call money. These funds provide low risk with higher liquidity. Institutional clients would like to park their surplus funds in this type of fund to earn a better return.
- **Gilt Funds:** These funds exclusively put their funds in government securities which includes central government dated securities, state government securities and treasury bills. Gilt funds can be both short-term and long-term depending on their investment horizon.

- **Floating Rate Funds:** These types of funds invest in securities that pay floating rate interest such as bank loan, bonds and other debt securities. Unlike traditional bonds which provide fixed rate of interest, floating rate securities give a variable rate of interest.
- **High Yield Debt Funds:** Under this type of funds, the mutual fund invests the money in high coupon debt instruments. The high coupon bearing debt instruments are having lower credit rating and considered risky in comparison to high credit rating debt instruments.
- **Fixed Maturity Plans:** These are close-ended mutual fund schemes in which the portfolio is held till maturity of the assets. This type of schemes has less risk of capital loss than equity funds, since their investments are mainly in debt and money market instruments.
- **Monthly Income Plan:** These funds invest in fixed income securities to generate steady income and distribute the same to the holders of the funds. The objective of such fund is to provide regular income to the investors. A small portion of capital gets invested in equity instruments for capital gain.
- **Sector Funds:** These types of funds invest in only a particular sector such as pharmaceutical, Banking and financial services industry, media and entertainment and so on. The gain from these funds depends on the risk and return profile of the sector in which the fund is invested. As these funds concentrate only on one sector, the risk is more in comparison to other well diversified portfolio.

9.5.3 Other Funds

- **Index Fund:** These funds are designed to replicate the performance of a well established stock market index such as Nifty or Sensex. They invest in all stocks that comprise in

proportions equal to the weightage of those stocks in the index. The advantages in investing in index fund are that the investors are indirectly able to invest in a portfolio of blue chip stocks that constitutes the index. They also offer diversification across different sectors of the economy. Index funds are considered appropriate for conservative long term investors looking at moderate risk and moderate return arising out of a well diversified portfolio.

- **Tax saving Funds:** These funds are also known as equity-linked saving schemes (ELSS). Under section 88 of the Income Tax Act, these funds offer rebates in taxes. These funds generally have a lock in period of 3 years. The tax saving funds benefits investors by providing an opportunity to invest in market linked instruments and at the same time claim tax benefit. The dividend earned in tax saving funds are also tax free.
- **Exchange Traded Funds (ETFs):** The ETFs are similar to index mutual funds, but are traded more like a stock. They represent a basket of securities that are traded on an exchange. Unlike open-ended funds, ETFs can be bought and sold like any other stock. ETF provide investors a fund that closely tracks the performance of the index with the ability to buy and sell on an intra-day basis.
- **Gold ETFs:** As the name suggest, they are exchange traded funds that are meant to track closely the price of physical gold. Each unit of ETF is equivalent to 1 gram of gold. Thus investing in Gold ETF allows and investor to purchase the value of gold without physically owning it. It also provides liquidity and marketability, which is a major limitation of possessing physical gold.
- **Fund of Fund (FOF):** Under this type of fund, instead of investing in equities or in debt instruments, the mutual fund invest in schemes of other mutual funds. Thus it achieves

double diversification. First the individual mutual fund invest in various debt or equity instruments and secondly, the FOF invest in various mutual fund schemes. FOF becomes useful for those who want to invest in different MFs but do not have time or inclination to track their performance.

- **Capital Protection Fund:** These funds are usually close ended funds where major portion is invested in fixed income instruments and the balance is being invested in equities. These funds are suitable for those investors who want to protect the downside risk and capture the upside in equities with a minimum three year perspective.
- **Arbitrage Fund:** These funds earn return from the price difference between cash and future derivative market. For example, a fund may purchase equity in cash market and simultaneously sell the same in the future market. The difference in prices of the stock is the return earned by the scheme. These funds can generate higher returns when the volatility in equity market is high.
- **Life Style Fund:** It is a special type of fund where asset mix is determined by the level of risk and return that is appropriate for an individual investor. The asset mix is based on several factors such as client's age, risk appetite, investment horizon etc.

9.6 ADVANTAGES OF MF INVESTMENTS

The advantages of mutual fund investments can be summarized into following points.

i. Mutual funds are managed by highly skilled professional managers. Every mutual fund has a dedicated research team which constantly observes the market, carry out in-depth analysis and suggest fund managers for efficient portfolio management.

ii. Mutual funds enable diversification; they allocate their funds across industries and sectors. In this way, investors hold diversified portfolio

even with a small amount of investment that would otherwise require substantial amount.

iii. Mutual funds makes investing easy, it helps to avoid many problems such as bad deliveries, delayed payments, follow up with brokers and so on.

iv. The cost of investment in mutual fund is less compared to directly investing in capital market as brokerage, custodial and other fees are relatively less.

v. Mutual funds schemes are found to be more liquid than other investment alternatives. In open-ended fund, an investor can buy or sell any units at the prevailing NAV. Thus it provides enough liquidity.

vi. The mutual fund regularly updates their clients about the performance of their fund and all other related information with regard to the scheme.

vii. With the help of features such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SIP), dividend reinvestment plans, an investor can systematically invest or withdraw funds according to his requirement.

viii. Many mutual funds offer switching facility from one fund to another. Thus, if an investor risk-return appetite changes, he can switch from one fund to another.

ix. Mutual funds are highly regulated and they function within the provisions of strict regulations of SEBI. Thus it protects the interest of investors.

9.7 DISADVANTAGES OF MF INVESTMENTS

Though mutual funds provide a lot of advantages to investors, however, it suffers from following limitations.

i. The performance of a mutual fund scheme depends on fund manager's capabilities. If fund managers fail to perform, the investors will not get the desired result on their investments.

ii. Although mutual fund reduces risk through diversification, but it does not guarantee any fixed return. The investors are prone to loss, if market corrects significantly.

iii. Mutual fund account for different kinds of charges such as management fee, brokerage, commission, entry load, exit load and so on, which resulted in a lower NAV.

iv. Mutual funds usually maintain a good portion as cash reserves to meet unexpected redemption requests. Although this ensure liquidity, but the amount set aside as cash does not earn good returns and it ultimately affects in overall return of the fund.



CHECK YOUR PROGRESS

Q 2: State True or False:

a) In case of Gold ETF, instead of investing in equities or in debt instruments, this fund invest in schemes of other mutual funds.

b) Index Funds are designed to replicate the performance of a well established stock market index such as Nifty or Sensex.

c) Gilt funds can be both short-term and long-term depending on their investment horizon.

d) Under close-ended fund, the size of the corpus and the number of units to be offered to the public is not determined in advance.

e) Systematic Investment Plan (SIP) is an option provided by the mutual fund company to help investors to make regular investment of small amount in their scheme at pre-defined regular intervals.

9.8 GUIDELINES FOR MUTUAL FUNDS

On February 14, 1992, the Government of India issued various guidelines for mutual funds. These guidelines are applicable to all mutual funds that invest primarily in the capital market and also partly in money market instruments subject to the following:

i. Money market mutual funds that would invest exclusively in money market instruments would be regulated by RBI. However, money market schemes of the other mutual fund would be regulated by SEBI.

The regulation of SEBI with regard to money market schemes are in conformity with the regulation of RBI.

ii. Offshore funds that have non-resident investors and are regulated by the provisions of the countries where they are registered shall be outside the purview of these guidelines.

iii. Mutual Funds with special characteristics such as funds dealing with assets other than securities are exempted from the purview of these guidelines.

The salient features of the guidelines are as follows:

- Mutual funds shall be authorized for business by SEBI.
- The company which sponsors the mutual fund has to be with sound track record.
- The mutual fund has to be established in the form of trust under Indian Trusts Act.
- The trust will be authorized to float different schemes under which units shall be issued to the investors.
- Mutual funds shall be operated by separately established asset management companies (AMCs).

9.8.1 Guidelines related to Mutual Fund Schemes

The guidelines with regard to mutual fund schemes are as follows:

- Each scheme floated by a mutual fund should have prior registration with SEBI.
- The asset management company (AMC) should prepare a prospectus for each scheme and get it approved by SEBI before inviting public participation.
- Mutual funds should be allowed to start and operate both close-end and open-end schemes.
- Mutual funds should not be permitted to keep close-ended schemes open for subscription for more than 45 days. For open-ended schemes, the first 45 days of the subscription period should be considered for determining minimum size of the scheme.

- Mutual fund should provide continuous liquidity.
- Close ended schemes should be listed on exchanges.
- For open-ended schemes, mutual fund shall sell and repurchase units at the net assets value (NAV) rate.
- Each fund should have a clearly identified and responsible fund manager.

9.8.2 Guidelines related to Mutual Fund Investments

- Mutual funds will be allowed to invest only in transferable securities either in money market or in the capital market.
- Mutual funds can also invest in privately placed debentures or securitized debt, however the total holdings in such securities shall not exceed 10% in the case of growth funds and 40% in the case of income funds.
- Mutual funds should invest only in rated debt instruments. In case the mutual fund decides to invest in non rated instruments, they have seek approval from the board of the AMC.
- Mutual funds should not be allowed to give term loans for any purpose.
- No individual scheme of a mutual fund should invest more than 5% of the corpus in any one particular company's share.
- No mutual fund under all its schemes own more than 5% of any company's paid-up capital carrying voting rights.
- No mutual fund under all its schemes combined should invest more than 10% of its funds in shares or debentures or other securities of a single company.
- No mutual fund under all its schemes combined should invest more than 15% of its funds in the shares and debentures of any specific industry unless the scheme is floated for investments in one or more specified industries.
- No scheme should invest in or lend to another scheme under the same AMC.

9.8.3 Guidelines related to Winding up of Mutual Fund Schemes

Every close- ended scheme should have a fixed tenure in terms of the number of years. After the end of the tenure, the close-ended scheme should be wound up or extended with the permission of SEBI. On the other hand, an open-ended scheme shall be would up if the total number of units outstanding after repurchases at a point of time falls below 50% of the originally issued number of units.

9.8.4 Guidelines related to Mutual Fund Scheme

The AMC may charge management and advisory fee subject to the following conditions.

i. For net assets below INR 100 crores: 1.25% of the weekly average net assets outstanding in the current year for the scheme.

ii. For net assets above INR 100 crores: 1% of the excess amount over INR 1 billion.

In addition to the above, the AMC may charge the mutual fund the following fee

i. Initial issue costs of sponsoring the fund and its schemes, and

ii. Other recurring expenses such as marketing and selling expenses and registration services for transfer of shares sold or redeemed.

9.8.5 Guidelines related to the Asset Management Company

The AMC shall be authorized for business by SEBI subject to fulfillment of following criteria.

- The directors of the AMC should be persons of high repute and having at least 10 years of professional experience in the

field of portfolio management, investment analysis and financial administration.

- At least 50% of the board members should be independent directors not connected with the sponsoring organization.
- The AMC should at all times have a net worth of INR 5 crores.
- SEBI has to approve the memorandum of association and articles of association of the AMC.
- The AMC can be changed by either the trustee company/ board or by 75% of the investors in the fund.

9.8.6 Guidelines related to Accounting Requirements

- Mutual funds have to properly segregate their earnings as current income, short-term capital gains and long-term capital gains.
- Accounting for all the schemes has to be done for the same year ending.
- For all quoted securities, mutual fund must calculate the weekly NAV at the last available closing market price.
- For any unquoted securities, the valuation may be done once a week either at cost or by any other method approved by SEBI.



9.9 LET US SUM UP

The following espects have been discussed in this unit —

- Mutual funds are financial intermediaries that mobilize money from investors, particularly retail investors. The pooled money from retail investors is used to purchase financial assets or securities issued by various companies.
- Mutual funds originated in United States during 1930's but the concept took root in India only in 1960s.
- UTI launched its first mutual fund scheme in 1964 by the name of US-64.

- Kothari Pioneer was the first private sector mutual fund in India, registered in July 1993.
- The sponsor is the main body that establishes a mutual fund.
- The AMC is a company established by the sponsor of a mutual fund or the trustees that acts like the investment manager of the trust.
- The NAV is basically the unit price of the mutual fund scheme. It is arrived at, on daily basis, by calculating total market value of investments or assets of the MF, subtracting liabilities and dividing by the number of units currently outstanding.
- The schemes launched by mutual funds can be clubbed into three broad categories based on their operations, investment objective and others.
- On February 14, 1992, the Government of India issued various guidelines for mutual funds. These guidelines are applicable to all mutual funds that invest primarily in the capital market and also partly in money market instruments.



9.10 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel &Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



9.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1:

a) United States

b) 'Mastershare'

c) US-64

d) Unit Trust of India; UTI mutual fund

e) Asset Management Company

Ans to Q No 2:

a) False

b) True

c) True

d) False

e) True



9.12 MODEL QUESTIONS

Q 1: What are Mutual Funds? Write about its background in India.

Q 2: Explain the structure of Mutual Funds in detail.

Q 3: Define the following:

a. Net Asset Value;

b. Entry Load;

c. Exit Load,

d. Sale Price;

e. Systematic Investment Plan(SIP)

Q 4: Write Short Notes on:

a. Indexed Fund

b. Tax Saving Fund

c. Exchange Traded Fund

d. Fund of Fund

Q 5: Discuss the classification of Mutual Funds on the basis of Operations.

Q 6: Discuss the classification of Mutual Funds on the basis of Investment Objectives.

Q 7: Discuss the advantages and disadvantages of Mutual Funds.

Q 8: List certain guidelines with respect to Mutual Fund Schemes.

Q 9: List certain guidelines with respect to Mutual Fund investments.

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UNIT 10: INSURANCE SERVICES AND IRDA

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Benefits of Insurance

- 10.3.1 Benefits to Insured
- 10.3.2 Benefits to Society
- 10.3.3 Benefits to the Nation

10.4. Basic Features of Insurance Contract

10.5. Types of Insurance

- 10.5.1 Life Insurance
- 10.5.2 General Insurance

10.6. Structure of Indian Insurance Sector

- 10.6.1 Life Insurance Companies- Public Sector
- 10.6.2 Life Insurance Companies- Private Sector
- 10.6.3 Non-Life Insurance (General Insurance) Companies- Public Sector
- 10.6.4 Non-Life Insurance (General Insurance) Companies- Private Sector

10.7 Insurance Regulatory and Development Authority of India (IRDA)

10.8 Let Us Sum Up

10.9 Further Reading

10.10 Answers to Check Your Progress

10.11 Model Questions

10.1 LEARNING OBJECTIVES

After going through the unit you will be able to —

- state the meaning and purpose of Insurance
- explain key terminologies used in an insurance contract
- know about the benefits of insurance to the insured, society and to the nation as a whole
- discuss the basic features of an insurance contract
- know the types of life and general insurance products

- know the structure of the Indian Life as well as General insurance sector
- understand the role of the Insurance Regulatory and Developmental Authority of India (IRDA).

10.2 INTRODUCTION

Insurance can be defined as a protection against a financial loss, arising on the happening of an unexpected event. It is a contract between two parties whereby one party is called *insurer,* who charges a fixed sum called *premium*, in exchange to pay the other party (*policy holder*) on the happening of a certain event. Any loss is paid out of this premium collected from the insured public. The insurance company acts as a trustee for the amount collected through these premiums. Insurance is generally classified into two main categories- life insurance and general insurance. Thus insurance allows individuals, business and other entities to protect themselves against any potential losses. The insurance policy is a contract between the insured (policy holder) and the insurer (insurance company). Few of the key terminology used in an insurance contract are given below:

- **Policy:** It is the contract sold by the insurance company.
- *Premium:* The amount to be paid by the insured person to enter into the contract or to maintain continuity of the policy.
- **Sum assured:** The amount promised by the insurance company in case of claim at maturity, as in the case of life insurance or when the actual loss occurs, as in the case of general insurance.
- **Surrender value:** It is applicable to life insurance policy, where the policy holder decides to discontinue the policy after paying premiums for few years but before maturity, the insurance company would pay back the surrender value of the policy.
- **Insurance versus Assurance:** Insurance refers to protection against loss that may or may not happen, as in the case of fire, theft or accident. Assurance is protection against an event that is bound to happen sooner or later. Hence ‘life assurance’ is possible but not ‘fire assurance’.

10.3 BENEFITS OF INSURANCE

Insurance is important because both human life and business environment are characterized by risk and uncertainty. Insurance plays a key role in mitigation of risks. The benefits of insurance are discussed below:

10.3.1 Benefits to the Insured

1. Insurance provides security against risk and uncertainty.
2. It enables the insured to concentrate on his work without fear of loss due to risk and uncertainty.
3. It inculcates regular savings habit, as in the case of life insurance.
4. The insurance policy can be mortgaged and funds raised in case of financial requirements.
5. Insurance policies, especially pension plans provide for income security during old age.
6. The insured gets tax benefits for the amount of premium paid.
7. Insurance of goods may be a mandatory requirement in certain contracts.

10.3.2 Benefits to the Society

1. Insurance is an important risk mitigation device.
2. Insurance companies provide the required funds for infrastructure development.
3. It provides a sense of security.
4. Life insurance provides security to the insured during his/her life and to the dependents after death of the insured.
5. It provides employment opportunities. With the entry of private insurers employment opportunities have increased greatly.
6. Insurance provides a sense of livelihood to those who might otherwise not have an income source — housewives, retired people, students etc can work as agents and earn commission.

7. Insurance works on the principle of pooling of risks and distributes risks over many people.
8. Insurance is an invaluable aid to trade.

10.3.3 Benefits to the Nation

1. Insurance provides funds to the government for providing basic facilities and to develop infrastructure.
2. It has enabled the country to get foreign exchange (49% FDI is permitted in the insurance sector in India from the year 2014).
3. Insurance relieves the government of the burden of supporting a family, in case of the untimely demise of the breadwinner.
4. Insurance promotes trade and industry by providing risk cover.
5. Insurance companies pay taxes out of profits earned. This is an important revenue source to the government.
6. Insurance companies are permitted to invest a certain percentage of the funds in the capital market and Such investments develop the capital market.



CHECK YOUR PROGRESS

Q 1: Name the following:

a) The amount to be paid by the insured person to enter into the contract or to maintain continuity of the policy.

b) The amount promised by the insurance company in case of claim at maturity or on the happening of a particular event.

Q 2: State two benefits of insurance to the Insured:

.....

.....

Q 3: State the difference between insurance and assurance:

.....

.....

10.4 BASIC FEATURES OF INSURANCE CONTRACT

An insurance contract must contain certain essential features. The following are the characteristics that every insurance contract should contain.

1. **Insurable interest:** The person (buyer of insurance or policyholder) entering into the contract should have valid interest in the item being insured. This is called 'insurable interest'. The 'insurable interest' clause implies that the policyholder should be able to establish that a loss incurred in the item being insured would lead to direct monetary loss to the policyholder. For example, in the case of life insurance of a person the spouse and dependents should have insurable interest in the life of the person. In the case of general insurance like motor insurance, insured must be the owner both at the time of entering into insurance contract and at the time of accident.
2. **Utmost good faith:** Both the parties to the insurance contract i.e, insurer and insured should enter into the contract in good faith. The insurer should voluntarily disclose all the facts related to the subject matter of the contract. Any material facts that are not disclosed to the other party having a direct or indirect relationship to the contract will make it null and void. For example, a person who is a smoker did not disclose about his smoking habit at the time of doing the life insurance policy, later on he died of heart attack. In such an instance, the insurance company may reject his claim on the ground of principle of utmost good faith.
3. **Indemnification:** Every contract of insurance is contract of indemnity, where the indemnifier provides assurance to save the counterparty from loss, caused by the action of indemnifier or a third party. As per indemnity principle, the insured may not collect more money than the actual loss in the event of damage covered by an insured peril. This implies, that the insured should not make profit from the insurance contract. This principle serves to control moral hazard problem. This principle does not apply for the life insurance contract.
4. **Subrogation:** The principle of subrogation is the right of the insurer to

take the place of the insured, after settlement of a claim by the insurer, to enforce the right of recovery from the source that caused the loss. In other words, if the insured suffers a loss due to the action of a third party and the insurance company has settled the insured's claim, the insurance company can step into the shoes of the insured to recover the loss from third party that caused the loss. Hence the subrogation clause ensures that all rights in respect of the insured asset are transferred to the insurance company once the loss is indemnified. Similar to the indemnification, subrogation does not apply to life insurance contract.

5. **Warranties:** Warranties are the conditions that are written by the insured in the insurance contract. Warranties are classified as (a) express warranties, and (b) implied warranties. Express warranties are stated in the contract and implied warranties are not found in the contract but are assumed by parties to the contract. For example, in marine insurance, an express warranty may be that the ship is seaworthy for a particular journey, or it would take a specified route to its destination. The implied warranty in this case would be that the ship is in perfect working condition, properly equipped and is not overloaded. The insurance company will not be liable to compensate loss to the ship if express or implied warranties are violated.

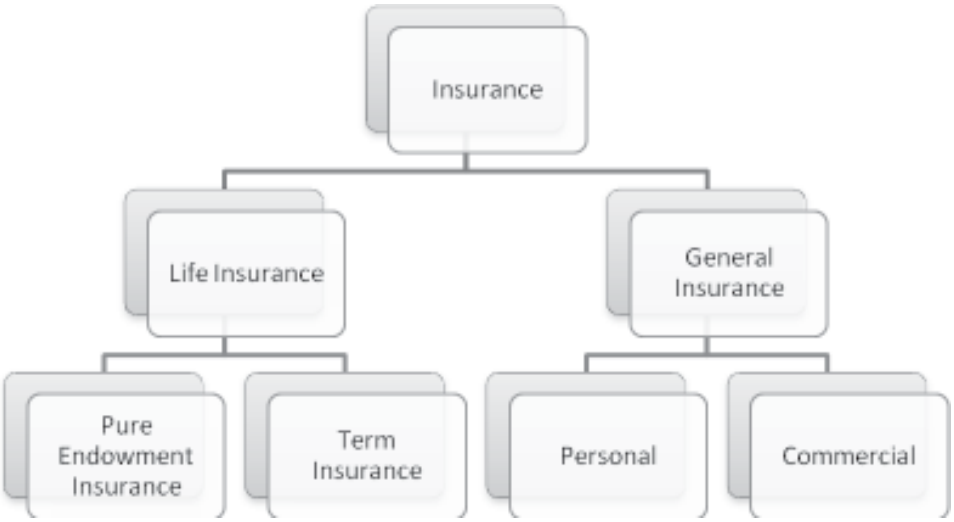
6. **Proximate Clause:** It is the 'immediate clause' of the event that caused the loss. For example, if a machine is insured against floods and damage to the machine is caused by the collapse of the building, in that case, the insurance company is not liable to compensate even if the building collapse due to floods. The proximate clause in this case was 'building collapse' and not 'floods' as specified in the contract. However if the building collapse was included as an insured peril, the insurance would be liable to compensate the loss.

7. **Assignment and nomination:** Both life and general insurance policies can be assigned as securities for loans granted to the insured. If an assignment is made, the assignor (the insured) ceases to be the owner of the policy. However, once the purpose for which the policy has been

assigned is fulfilled, the insured becomes the owner of the policy again. On the other hand nomination is a process by which the nominee i.e, in whose favor nomination is made, is entitled to receive the proceeds of the policy without cumbersome legal documents.

10.5 TYPES OF INSURANCE

The types of insurance can broadly be classified as given in the following diagram:



10.5.1 Life Insurance

It is contract between the insurance company and the policyholder, wherein the insurer will pay a specified amount of money at the end of the term of the policy or in case of death of the insured whichever is earlier. In order to make the contract valid, the insured needs to pay a premium, the amount of which is determined based on the insured's age and health. At the end of the term or on the death of the insured, the amount along with bonus is paid to the insured or his family.

There are basically two basic types of plans under life insurance- pure endowment and term assurance. These two plans are the building blocks of life insurance plans. All the plans offered

by life insurance companies are variants of these two plans. Under the pure endowment (and its variants), the sum assured is paid on survival of the life assured for the term of the policy. Whereas, under the term insurance plans, the sum assured is paid only on death of the insured during the term of the policy.

10.5.2 General Insurance

It consist all those kinds of insurance contracts that cover non-life subjects. Health insurance is also a part of general insurance. An illustrative list of general insurance policies is as follows.

- **Motor Insurance:** There are two types of motor insurance policies (i) Third party insurance- which only insures the party other than the owner in the case of an accident and (ii) Comprehensive- which insures the owner as well as third party involved.
- **Property Insurance:** It is an insurance covers land, building and the contents of the buildings.
- **Fire Insurance:** It is a comprehensive policy. It covers not only loss on account of fire but also covers loss on account of earthquake, riots, strike, malicious intents and floods.
- **Health Insurance:** The policy holder of health insurance can claim cash less hospitalization as well as reimbursement of medical expenses.
- **Burglary:** This insurance covers all losses arising out of burglary committed in one's premises.

10.6 STRUCTURE OF INDIAN INSURANCE SECTOR

Insurance business in India broadly be classified into two categories (i) Life insurance business and (ii) General insurance business. In both the categories public sector and private sector companies are present.

10.6.1 Life Insurance Companies-Public Sector

In this category, we have only one company present, which is Life Insurance Corporation of India (LICI). LICI was setup under the LIC Act, 1956. In the same year, the Government of India nationalized the life insurance business in India. On 1st September 1956, LICI was formed as an autonomous organization.

10.6.2 Life Insurance Companies-Private Sector

The Government of India opened the insurance industry for private players in 1999. With the privatization of life insurance sector many players have entered the insurance sector. The names of some private sector life insurance companies operating in India, they are stated below:

Sl. No.	List of Life Insurance Companies in India
1	Aegon Life Insurance Co. Ltd.
2	Aviva Life Insurance Co. India Ltd.
3	Bajaj Allianz Life Insurance Co. Ltd.
4	Bharti AXA Life Insurance Co. Ltd.
5	Birla Sun Life Insurance Co. Ltd.
6	Canara HSBC Oriental Bank of Commerce Life Insurance Co. Ltd.
7	DHFL Pramerica Life Insurance Co. Ltd.
8	Edelweiss Tokio Life Insurance Co. Ltd
9	Exide Life Insurance Co. Ltd.
10	Future Generali India Life Insurance Co. Ltd.
11	HDFC Standard Life Insurance Co. Ltd.
12	ICICI Prudential Life Insurance Co. Ltd.
13	IDBI Federal Life Insurance Co. Ltd.
14	IndiaFirst Life Insurance Co. Ltd
15	Kotak Mahindra Old Mutual Life Insurance Ltd.

16	Max Life Insurance Co. Ltd.
17	PNB MetLife India Insurance Co. Ltd.
18	Reliance Life Insurance Co. Ltd.
19	Sahara India Life Insurance Co. Ltd.
20	SBI Life Insurance Co. Ltd.
21	Shriram Life Insurance Co. Ltd.
22	Star Union Dai-Ichi Life Insurance Co. Ltd.
23	Tata AIA Life Insurance Co. Ltd.

10.6.3 General Insurance Companies-Public Sector

Under the non-life insurance sector, we have the following companies.

- **General Insurance Corporation of India (GICI):** The GICI has been working exclusively as a re-insurance company since 2002. It had four subsidiaries up to the year 2002. However post 2002, the four erstwhile subsidiaries are now carrying on general insurance business as independent companies. They are

I. The National Insurance Company Ltd.

II. The New India Assurance Company Ltd.

III. The Oriental Insurance Company Ltd.

IV. The United India Insurance Company Ltd.

All the above four companies operate all over India and undertake the general insurance business of fire, marine, motor and miscellaneous insurance.

In addition to the above, there are two other general insurance companies in the public sector, they are

- Employee State Insurance Corporation
- Agriculture Insurance Corporation

10.6.4 General Insurance Companies-Private Sector

In this category, as on 31st March 2018, the following non-life (General insurance) companies are operating in India.

Sl. No.	List of Non-Life Insurance Companies in India
1	Aditya Birla Health Insurance Co. Ltd.
2	Apollo Munich Health Insurance Co. Ltd.
3	Bajaj Allianz General Insurance Co. Ltd.
4	Bharti Axa General Insurance Co. Ltd.
5	Cholamandalam MS General Insurance Co. Ltd.
6	Cigna TTK Health Insurance Co. Ltd.
7	Future Generali India Insurance Co. Ltd.
8	HDFC ERGO General Insurance Co. Ltd.
9	ICICI Lombard General Insurance Co. Ltd.
10	IFFCO Tokio General Insurance Co. Ltd.
11	Kotak Mahindra General Insurance Co. Ltd.
12	L&T General Insurance Co. Ltd.
13	Liberty Videocon General Insurance Co. Ltd.
14	Magma HDI General Insurance Co. Ltd.
15	Max Bupa Health Insurance Co. Ltd.
16	Raheja QBE General Insurance Co. Ltd.
17	Reliance General Insurance Co. Ltd.
18	Religare Health Insurance Co. Ltd.
19	Royal Sundaram Alliance Insurance Co. Ltd.
20	SBI General Insurance Co. Ltd.
21	Shriram General Insurance Co. Ltd.
22	Star Health and Allied Insurance Co. Ltd.
23	Tata AIG General Insurance Co. Ltd.
24	Universal Sompo General Insurance Co. Ltd.



CHECK YOUR PROGRESS

Q 4: Name two Private sector Life Insurance Companies:

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Q 5: Explain the Principle of Insurable Interest:

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.....

10.7 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (IRDA)

In order to provide better insurance cover to citizens and to increase the flow of long term sources of financing infrastructure, the IRDA Act was enacted in 1999 to provide for the establishment of the IRDA to protect the interests of policy holders, to regulate, promote and ensure proper growth of the insurance industry.

The IRDA would consist of a chairperson and not more than nine members of whom not more than five would be full time members, to be appointed by Central Government.

10.7.1 Powers and functions of IRDA

I. To issue certificate of registration to the applicant. They also have the right to renew, modify, withdraw, suspend or cancel any registration.

II. To protect the interest of the policyholders in matters relating to assignment of policy, nomination by policy holders, insurable interest, settlement of claims, surrender value of policy, and other terms and conditions of insurance contracts.

III. Stipulating requisite qualifications and training hours for insurance intermediaries and agents.

IV. Specifying the code of conduct for surveyors and loss

assessors.

V. Promoting efficiency in the conduct of insurance business.

VI. Regulating and promoting professional organizations connected with the insurance and reinsurance business.

VII. Seek information, undertaking inspection of, conducting investigations, audit of insurers, intermediaries and other organizations connected with the insurance business.

VIII. Specifying the form and manner in which books of accounts would be maintained.

IX. Regulating investment of funds by insurance companies.

X. Adjudication of disputes between insurers and intermediaries.

XI. Specifying the percentage of life insurance and general insurance business to be undertaken by the insurer in the rural and social sector.

XII. Exercising such other powers as may be prescribed.



10.8 LET US SUM UP

In this unit we have discussed the following aspects —

- Insurance can be defined as a protection against a financial loss, arising on the happening of an unexpected event.
- Insurance is important because both human life and business environment are characterized by risk and uncertainty. Insurance plays a key role in mitigation of risks.
- The person (buyer of insurance or policyholder) entering into the contract should have valid interest in the item being insured. This is called ‘insurable interest’.
- The parties to the insurance contract i.e, insurer and insured should enter into the contract in good faith.
- Every contract of insurance is contract of indemnity, where the indemnifier provides assurance to save the counterparty from loss, caused by the action of indemnifier or a third party.This principle does

not apply for the life insurance contract.

- Nomination is a process by which the nominee i.e, in whose favor nomination is made, is entitled to receive the proceeds of the policy without cumbersome legal documents.
- There are basically two basic types of plans under life insurance- pure endowment and term assurance. These two plans are the building blocks of life insurance plans.
- General Insurance consist all those kinds of insurance contracts that cover non-life subjects like Motor Insurance, Fire Insurance, Property Insurance etc. Health insurance is also a part of general insurance.
- Insurance business in India broadly be classified into two categories (i) Life insurance business and (ii) General insurance business. In both the categories public sector and private sector companies are present.



10.9 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development, Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



10.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Premium b) Sum Assured

Ans to Q No 2: 1) Insurance provides security against risk and uncertainty.

2) Life insurance inculcates regular savings habit.

Ans to Q No 3: Insurance refers to protection against loss that may or may not happen, as in the case of fire, theft or accident. Assurance is protection against an event that is bound to happen sooner or later. Hence 'life assurance' is possible but not 'fire assurance'.

Ans to Q No 4: i) Bajaj Allianz Life Insurance Co. Ltd.

ii) SBI Life Insurance Co. Ltd.

Ans to Q No 5: The 'insurable interest' clause implies that the policyholder should be able to establish that a loss incurred in the item being insured would lead to direct monetary loss to the policyholder. For example, in the case of life insurance of a person the spouse and dependents should have insurable interest in the life of the person.



10.11 MODEL QUESTIONS

Q 1: Define the following:

a. Premium

b. Sum Assured

c. Policy

d. Surrender Value

Q 2: Mention few benefits of insurance to the insured.

Q 3: Mention few benefits of insurance to the society.

Q 4: Mention few benefits of insurance to the nation.

Q 5: Discuss in detail the structure of the Indian insurance sector.

Q 6: Discuss the powers and functions of the Insurance Regulatory and Development Authority of India (IRDA).

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UNIT 11: LEASING AND HIRE PURCHASE

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Concept and Classification of Lease

- 11.3.1 Classification on the Basis of Duration
- 11.3.2 Classification on the Basis of Nature

11.4 Advantages of Leasing

11.5 Limitations of Leasing

11.6 Leasing Industry in India

11.7 Hire Purchase

- 11.7.1 Difference Between Hire Purchase and Installment sale
- 11.7.2 Difference Between Hire Purchase and Lease Financing

11.8 Let Us Sum Up

11.9 Further Reading

11.10 Answers to Check Your Progress

11.11 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- know the origin of the concept of Leasing
- state the meaning of Lease and its classification
- know the advantages and disadvantages of Leasing
- know about the growth of the leasing industry in India.
- know about the concept of the Hire purchase system.
- distinguish between Hire purchase and Installment Sale
- distinguish between Hire purchase and Lease financing.

11.2 INTRODUCTION

Leasing is an age old concept across the globe. The first leasing transaction is believed to have occurred during 1066, when William the conqueror rented ships for intrusion into Britain. Since then the concept of leasing is in operation. Traditionally, land, animals, agricultural tools were the assets mostly involved in leasing. But over time, the business of leasing included high value items like cars, railroad equipment, aircraft, ships as well as low value items like computers, small transport vehicle, office equipment and so on.

In the ancient times, leasing was the last-resort financing option. But over time, it has become a primary method of financing assets. Leasing is particularly used as an alternative to debt financing. When a firm acquires an asset, either by way of purchasing or leasing, the maximum output from the asset is important for the firm and not the title to the asset. It is not always necessary for a person to own an asset in order to use it. Leasing can be an alternative to buying. Thus the concept of leasing gained momentum over the years and it has become one of the most useful source of financing assets.

11.3 CONCEPT AND CLASSIFICATION OF LEASE

Leasing is an arrangement between two parties, the leasing company (lessor) and the user (lessee), whereby the lessor arranges to buy capital equipment for the use by the lessee in accordance with the lessee's requirements and specifications. The consideration for the transaction is either in the form of periodic rent and/or in the form of down payment. The rentals are predetermined and payable at fixed intervals of time.

A lease can also be defined as a contract between two parties for the hire of a specific asset where the lessor retains ownership of the asset while the lessee has possession and use of the asset upon payment of the specified rentals over a period of time.

A Lease can be classified in the following manner:

i. On the basis of duration

ii. On the basis of its nature

This has been explained in detail below:

11.3.1 Classification on the basis of Duration

Under this category, lease can broadly be categorized into operating lease and financial lease.

I. Operating Lease: It refers to a short-term lease of an asset. As the term of the operating lease is shorter than the economic life of the asset, the lease rentals paid under the lease agreement is not sufficient to recover the full cost of the assets by the lessor. Hence the lessor recovers the full cost of the asset by subsequent re-leasing of the asset or by selling the asset. An operating lease might contain a cancellation clause according to which the lessee has the right to cancel the lease agreement and return the asset to the lessor before the expiry of the lease agreement. It is typically for asset such as computers, air-conditioner or cars which have high depreciation potential. Such asset are given for a limited time period, sometimes even on per day basis. Operating leases are for a period of two to three years.

II. Financial Lease: It is a long-term lease, the period which is generally coincides with the economic life of the asset. Financial lease are fully amortized which implies that the lessor receives the cost of the asset and a return thereon from the lessee. The financial lease generally has the following characteristics.

- The financial lease is for a basic term during which the lease is non-cancellable. The length of this basic lease period is determined primarily by the economic life of the asset.
- It provides periodic rental payment during this period.

- The cost of insurance, maintenance and other related expenses to be borne by the lessee.
- The lessee generally provides some means by which the firm may continue to use the asset, after the expiration of the basic lease period.

11.3.2 Classification on the basis of Nature

Lease can also be categorized on the basis of its nature as follows:

I. **Sale type lease:** In this type of lease, the lessor usually the manufacturer or dealer of the asset, leases the asset instead of selling it. This type of lease is structured so that the lessor not only earns an interest income but also earns a profit on the transaction.

II. **Direct financing lease:** Under this type of lease, the lessor usually a bank or a financial institution, buys an asset from the manufacturer and then leases it to lessee. It is an alternative to the commercial loan in which a borrower uses the bank loan proceeds to purchase an asset.

III. **Leveraged leasing:** There are three parties involved in such leasing (a) lessor (equity investor), (b) Lender and (c) Lessee. The leasing company (equity investor) buys the asset by providing only a percentage of the capital needed and takes out a loan from the lender for the balance amount. The lender (loan participants) obtains an assignment of the lease and the rentals to be paid by the lessee and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt-service component of the rental to the loan participants and the balance to the lessor.

IV. **Cross-border leasing:** This type of lease takes place between a lessor and a lessee who are in two different countries. It is also known as international leasing. It enables the parties to

take advantage of tax concessions and incentives offered by different countries.

V. **Sale-and-lease-back:** It is a type of lease agreement whereby a firm that owns an asset sells it to another party and then takes it back on lease for a fixed period. Here the lessor buys the asset from the lessee instead from the vendor. Under this lease agreement, the lessee get the sale proceeds of the asset immediately for its other uses and at the same time enjoys the economic use of the asset.

11.4 ADVANTAGES OF LEASING

The following are the main advantages of leasing business

I. Leasing is more advantageous to the lessee, he can shift the burden and cost of potential obsolescence on the lessor.

II. Leasing on a short term basis is more advantageous than acquisition of an asset.

III. If an asset is required by a firm for a definite period of time, leasing makes more sense than acquisition.

IV. Leasing offers flexibility to both the lessor and the lessee. Both the parties can negotiate the terms and conditions in such a way that benefit both of them.

V. Leasing is relatively easy method of financing than borrowing from financial intermediaries, as borrowing involves long and complicated procedures and formalities.

VI. The lessor, being an expert in maintenance and specialized services, can provide efficient services at a lower cost.

VII. The lesse might be required to pay lower lease rentals when the lessor is benefitted with investment related tax shields.

VIII. In purchasing an asset, the lessor can enjoy economies of scale which he might transfer to the lessee in form of lower rentals.

IX. If a lesse goes bankrupt, the lessor can get back his asset. Whereas in case of borrowing, the same is a cumbersome process for the lender of the asset.

X. Leasing is beneficial where there is uncertainty about the demand of the product exist and thus about how long the asset will be needed.

XI. Cross border leasing facilitates transfer of foreign technology to domestic industry.

11.5 LIMITATIONS OF LEASING

I. A long term leasing of assets can be more expensive to the lessee.

II. Companies which cannot borrow from the capital market are forced to enter into leasing agreement.

III. Miscellaneous expenses relating to the leasing are often to be borne by the lessee.

IV. If interest rate decline, debentures can be refunded to lower interest cost. But in case of leasing rentals are fixed.

V. If a lessee is not able to honour the obligations of the lease, the lessor would suffer loss.

VI. The interest cost of lease financing is generally higher than the debt financing.

VII. The asset lease is owned by the lessor. The lessee has neither the use nor the ownership of the asset at the termination of the lease.

VIII. Some lease contracts contain restrictive covenants relating to the use of the asset. This can put the lessee in a disadvantage situation.

IX. The non cancellable clause of the lease can become disadvantage for the lessee, particularly when the technology is changing fast.

11.6 LEASING INDUSTRY IN INDIA

The leasing industry has played an important role in the economic development of the country. It has become a source of financial strength to many industries in India like the consumer goods industry, small scale industries, automobile industry, aviation industry, railways and so on. The leasing industry in India has achieved an annual growth rate of more than 30 percent and has become 13th largest leasing industry in the world and 3rd largest in Asia after Japan and Korea. The annual leasing business in India

is estimated to be an more than $3.6 billion industry.

The First Leasing Company of India Ltd. was the pioneer leasing company incorporated on September 10, 1973. For several years, First Leasing Company was the only leasing company in India, later on during early 80's many other companies like 20th century Finance Corporation Ltd., Jayabharat Credit Ltd. Sundaram Finance Ltd. has entered the leasing industry market.

Unlike the rest of the world where banks are front runners in the leasing market, In India very few banks are in this space. Only State Bank of India and Canara Bank are in the leasing business through their subsidiaries. Few other specialized financial institutions are in this field. The post liberalization era has witnessed a steady increase in foreign investment in Indian leasing industry. Presently there are more than 400 leasing players in India; about 10 percent of them operate on a large scale basis. On the recommendation of the Dahotre Committee, RBI formed guidelines on commercial banks funding to leasing companies. Leasing companies are categorized under the non-banking finance companies (NBFC's) as per RBI classification.

The important factors which has facilitates the growth of leasing business are as follows

- Until 1996 there were no entry barriers to the leasing business. It was only in 1997 that make it mandatory for NBFC's to have proper registration with Reserve Bank of India.
- The liberalization measures of the Government of India encouraged many new ventures which resulted in growth of leasing business in the country.
- Tax concession is another major boost for the growth of leasing business. The lessee is allowed to claim lease rentals as expense as well as lessor are allowed a depreciation allowance.
- The rapid development of technology is another reason for growth this industry as many firms increasingly resorting to leasing.

However, there are few challenges facing by leasing industry at present, they are

- Many leasing companies rely extensively on public deposits for their fund requirement. Most of the public deposits are for short tenure of one to two year. Whereas, the funds deployed by the leasing companies are for longer duration. This has created a mismatch in the asset-liability of the leasing companies.
- There is no separate act that governs lease transactions exclusively. Hence any dispute arising from lease transaction has to dealt under the provisions of Indian Contract Act, 1872.
- Some states in India treats a lease agreement at par with sale of immovable property and charged stamp duty accordingly, which works out to be a significant amount.



CHECK YOUR PROGRESS

Q 1: What is Operating Lease?

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Q 2: What is sale-and-lease-back?

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.....

Q 3: Mention two advantages of Leasing?

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11.7 HIRE PURCHASE

Hire purchase is a form of financial agreement whereby the owner (intending seller) provides an asset to the hirer (intending purchaser) on hire for a consideration of payment known as hire charges in installments for a specified period. The ownership of the asset is transferred to the hirer on payment of the last installment. However, the hirer gets the possession of the asset at the time of signing the hire purchase agreement. However the hirer has the right to terminate the agreement at any time before the transfer of ownership of the asset. In other words, the hirer has the option to purchase the asset. In case, the hirer decides to terminate the agreement,

he has to either —

I. Return the asset and stop making future payment of installments.

II. Pay the future installments both fully or at a discount as mutually agreed upon and take ownership of the asset.

In case a finance company is the hiree, the finance company purchases the equipment from the supplier or manufacturer and then let it out on hire to the hirer. Usually the hirer has to make a down payment of a certain percentage of the cost of the equipment and pay the balance amount as installments (inclusive of interest) either in advance or in arrear.

Hire purchase has most commonly been used for vehicles. In fact, in India hire finance become the only mode of external finance for commercial vehicles. The hire purchase industry has become synonymous with truck financing.

A hirer is required to make payments in equated periodical installments spread over a certain period. The interest component of each installment is determined with reference to a specified flat rate of interest.

11.7.1 Differences between Hire Purchase and Installment Sale

The following are the main differences between hire purchase and installment sale:

Hire Purchase	Installment Sale
The parties to the hire purchase agreement are called hiree (owner) and the hirer.	The parties to the contract are called buyer and seller
The ownership of the asset is transferred to the hirer on payment of the last installment.	The legal ownership of the asset is transferred to the buyer as soon as agreement is made and first installment is paid
The hirer has the right to terminate the agreement at any time before the transfer of ownership of the	The buyer cannot escape the liability for payment of future installments by returning the goods.

asset and thus free from paying any future installments.	
The hirer cannot hire out, sell transfer, destroy or damage the goods before the transfer of ownership of the assets.	As an owner of the asset, the buyer can dispose the assets in any manner he likes.

11.7.2 Differences between Hire Purchase and Lease Financing

Hire Purchase	Lease Financing
The ownership of the asset is transferred to the hirer on payment of the last installment.	The lessor is the owner and the lessee is entitled to the economic use of the leased asset. The ownership is never transferred to the lessee.
Hirer is entitled to claim depreciation benefit.	The lessor is entitled to claim depreciation benefit.
The magnitude of funds is relatively lower. The cost of acquisition is relatively low, that is, automobile, office equipment and so on.	The magnitude of funds under lease financing is huge. Lease financing is used generally to acquire aircraft, ship, big machinery etc.
Margin money to the extent of 20% to 25% of the cost of equipment is required to be paid by the hirer.	It is invariably 100% financing and no margin money is required to be paid by the lessee.
The cost of maintenance is borne by the hirer.	The cost of maintenance is borne by the lessor.
The hirer is allowed the depreciation claim and finance charge and the seller may claim any interest on borrowed funds to acquire the asset for tax purpose.	The lessor is allowed to claim depreciation and the lessee is allowed to claim the rentals and maintenance cost against taxable income.



11.8 LET US SUM UP

The following aspects have been discussed in their unit—

- The first leasing transaction is believed to have occurred during 1066, when William the conqueror rented ships for intrusion into Britain. Since then the concept of leasing is in operation.
- In the ancient times, leasing was the last-resort financing option. But over time, it has become a primary method of financing assets.
- Leasing is an arrangement between two parties, the leasing company (lessor) and the user (lessee), whereby the lessor arranges to buy capital equipment for the use by the lessee in accordance with the lessee's requirements and specifications. The consideration for the transaction is either in the form of periodic rent and/or in the form of down payment.
- On the basis of duration leases can broadly be categorized into an operating lease and financial lease.
- Leases can also be categorized on the basis of its nature as sale type lease, direct financing lease, leveraged lease etc.
- Leasing has many advantages like the lessee can shift the burden and cost of potential obsolescence to the lessor, also leasing on a short term basis is more advantageous than acquisition of an asset.
- The leasing industry in India has achieved an annual growth rate of more than 30 percent and has become 13th largest leasing industry in the world and 3rd largest in Asia after Japan and Korea. The annual leasing business in India is estimated to be an more than $3.6 billion industry.
- Hire purchase is a form of financial agreement whereby the owner known as "hiree" provides an asset to the "hirer" on hire for a consideration of payment known as hire charges in installments for a specified period. The ownership of the asset is transferred to the hirer on payment of the last installment.



11.9 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
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5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



11.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: It refers to a short term lease of an asset. As the term of the operating lease is shorter than the economic life of the asset, the lease rentals paid under the lease agreement is not sufficient to recover the full cost of the assets by the lessor. Hence the lessor recovers the full cost of the asset by subsequent re-leasing of the asset or by selling the asset.

Ans to Q No 2: It is a type of lease agreement whereby a firm that owns an asset sells it to another party and then takes it back on lease for a fixed period. Here the lessor buys the asset from the lessee instead from the vendor. Under this lease agreement, the lessee get the sale proceeds of the asset immediately for its other uses and at the same time enjoys the economic use of the asset.

Ans to Q No 3: i) The lessee can shift the burden and cost of potential obsolescence to the lessor,

ii) Leasing on a short term basis is more advantageous than acquisition of an asset.



11.11 MODEL QUESTION

Q 1: Discuss the background and the concept of Leasing.

Q 2: Explain the classification of Leasing on the basis of duration.

Q 3: Explain the classification of Leasing on the basis of its nature.

Q 4: Discuss the advantages of leasing.

Q 5: Discuss the limitations of leasing.

Q 6: Discuss about the growth and development of the leasing industry in India.

Q 7: Discuss the terms and conditions of a hire purchase agreement.

Q 8: Distinguish between hire purchase and installment sale system.

Q 9: Distinguish between hire purchase and lease financing.

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UNIT 12: CORPORATE RESTRUCTURING

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Forms of Corporate Restructuring- Merger

- 12.3.1 Motives of Merger
- 12.3.2 Types of Mergers

12.4 Forms of Corporate Restructuring- Acquisitions/ Takeovers

- 12.4.1 Methods of Acquisition
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12.6 Forms of Corporate Restructuring- Divestitures/ Demergers

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12.8 Forms of Corporate Restructuring- Buyback of Securities

- 12.8.1 Reasons for Buyback of Shares
- 12.8.2 Advantages of Buyback of Shares
- 12.8.3 Limitations of Buyback of Shares

12.9 Let Us Sum Up

12.10 Further Reading

12.11 Answers to Check Your Progress

12.12 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- state the meaning of Capital Restructuring
- state the motives behind Mergers
- know the different types of Mergers
- know the various methods of Acquisitions
- state the concept of Hostile Takeovers
- explain the process of financing Mergers and Acquisitions

- know the methods of Divestiture/ Demerger
- describe the concept of Buyouts
- know the reasons, advantages and limitations of Buyback of shares.

12.2 INTRODUCTION

Corporate restructuring implies any change in ownership, capital structure or operations that happens outside the normal course of business. It involves restructuring of business, assets and ownership. Whenever there is any change in the asset mix of the company, it can be referred to as 'restructuring of assets'. Similarly when there is a change in the ownership of a company due to mergers or takeovers, it can be termed as 'restructuring of ownership'. 'Restructuring of businesses involves reorganization of strategic business units in a company. Corporate restructuring can be brought through a variety of mechanisms including mergers, acquisitions, divestitures and spin-offs. The basic objective of corporate restructuring is to ensure increasing wealth for the shareholders through optimal utilization of resources.

12.3 FORMS OF CORPORATE RESTRUCTURING-MERGER

In simple terms, a merger refers to the combination of two or more companies into one company. It is a strategy through which two firms agree to integrate their operations. The terms merger and amalgamation can be used interchangeably. It is also stated that the companies that are merged are referred to as amalgamating company and the company with which they merge or which is formed as a result of the merger is called the amalgamated company. Some of the recent mergers in India are the Vodafone- idea merger, Airtel-telenor merger, Tata Motors- Jaguar Land Rover merger etc.

12.3.1 Motives of Mergers

The following are the motives behind corporate mergers:

- **Synergy:** The synergy is one of the prime motives of merger. Through synergy, the combined corporate wants to acquire more market share as well as reduce the costs. The idea of such merger is to increase the value of the combined firm, which is the sum of the values of the individual firms. There are various types of synergy such as managerial synergy, operating synergy and financial synergy. The synergy can be achieved through one or more ways.
- **Pure diversification:** A merger which results in diversification of products and services will reduce cyclical fluctuations in earnings and cash flows. Pure diversification strengthens the capabilities of the combined firm in facing unforeseen factors that could otherwise threaten the survival of the individual entity.
- **Market dominance:** A merged entity will have increased market share which results in dominance in the market. The increased market share will lead to improved profitability and reduction in cost.
- **Tax benefits:** When a profit making company merges with a loss making entity, the merged firm gets the tax benefits. By merging with a profitable firm, it might be possible for the combined entity to utilize the carry-forward losses and thereby get tax benefits.

12.3.2 Types of Mergers

Mergers can broadly be classified into following categories:

- **Horizontal Merger:** It is a merger of two entities in the same field (industry) and at the same stage of the industrial process. The main objective of horizontal merger is to achieve economies of scale in production, which results into more profit and increase in shareholders wealth. The merger of Lipton India Limited with Brooke Bond in the year 1996 is an example of horizontal merger.

- **Vertical Merger:** In this type of merger two firms that are in different stages of production or distribution merges together. The idea of vertical merger is to expand its business forward towards the ultimate consumer or backward towards the source of raw material. The merger of Tata Estate Ltd with Brooke Bond Ltd is an example of vertical merger.
- **Conglomerate Merger**: It is a merger between firms that are totally involved in interrelated business activity. Conglomerate merger can be pure conglomerate merger which involves firms with nothing common or it can be mixed conglomerate merger, which involves firms that are looking for product extensions or market extensions. The merger between Pepsi co and Pizzahut is an example of conglomerate merger.

12.4 FORMS OF CORPORATE RESTRUCTURING-ACQUISITIONS/ TAKEOVERS

An acquisition is an act of acquiring effective control over the assets or management of a firm by another firm. A forced acquisition or unwilling acquisition is called 'takeover'. An acquisition is also a strategy through which one company buys a controlling or 100 percent stake in another firm.

There may be various reasons for acquisitions. One of the prominent reasons is to achieve greater market share. Another reason for acquisition might be to overcome entry barriers. By acquiring a firm who tries to enter international market, the acquiring firm can stop a new entrant into the new market. Acquisitions are also a means by which a firm gets access to new products, attain product diversification or reduce competition in the market.

12.4.1 Methods of Acquisition

A firm may take over another firm by making offers directly to the shareholders of the target company in any of the following ways:

- **Tender offer:** It is an offer to the shareholders of the target

company to purchase their shares at a fixed price which is usually higher than the current market price. The incentive for the shareholders to tender their shares to the company intending to acquire the firm, is the premium offered over current market price.

- **Partial offer:** In this type of offer, the acquiring company specifies the maximum number of shares to be accepted without mentioning the plans with respect to the remaining shares.
- **Any-or-all offers:** Under this method, maximum number of shares is not specified and none will be purchased if the conditions of the offer are not met.

12.4.2 Hostile Takeovers

Acquisitions can be friendly or hostile. Hostile acquisitions are generally known as takeovers. When the target company does not want to be acquired, it can be termed as hostile takeover. There may be several reasons why the target company might not want to be taken over. One prominent reason may be that the existing management of the target company might want to retain the control of the company or the shareholder/management might feel that post acquisition, value of the company would go down or they might be out of business. On the other hand the acquirer is of the opinion that the target company could generate more profit in future due to which they want to acquire the firm. Through hostile acquisitions, the acquirer wants access to distribution channels, customer base, technology etc.

Due to the stringent norms of the Indian regulator, hostile takeovers has been largely alien to Indian listed companies. However, few attempts has been made in the past for hostile takeover. Among them the Swaraj Paul-Escort, DCM in 1980's was prominent. In this case, London-based NRI Swaraj Paul sought to control the

management of two Indian companies, Escorts Limited and DCM (Delhi Cloth Mills) Limited by picking up their shares from the stock market. Though Swaraj Paul failed to fulfill his dream of controlling Escorts and DCM, but his hostile threat sent shockwaves through the otherwise complacent Indian business world.



CHECK YOUR PROGRESS

Q 1: Explain a Horizontal Merger with an example.

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Q 2: Explain a Vertical Merger with an example.

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12.5 FINANCING MERGERS AND ACQUISITIONS

Once the merger deals between two companies are finalized and the merger value is determined, the next step in the process is the method of payment. Both mergers and acquisition can be financed either by cash or by exchange of shares or a combination of cash, debt and shares. Some of the methods are discussed below:

1. **Payment by cash:** This is one of the easiest and quickest method of financing a merger or acquisition. Under this method the acquiring firm uses the surplus cash to acquire the shares or assets of the target company. Availability of cheap and easy institutional finance can also influence the decision of opting for cash transaction. But employing more debt could be risky for the firm sometime in the future.
2. **Stock swaps:** Under this method, the acquiring company issues its shares to the shareholders of the target company at a negotiated exchange ratio. When the shares are issued the acquiring company shares its ownership with the shareholders of the target company. If the shareholders of the target company receive stock in exchange for their existing stockholdings, it is not taxable till the time shareholders

sell the shares they have received. It has become one of the most popular methods of financing mergers and acquisitions in recent times.

3. **Other methods of financing:** The acquiring company can also issue debt securities like convertible debentures and preference shares to acquire the target company. The issue of convertible securities works to be a better option in some cases, when the shareholders of the target company need immediate protection of their incomes with growth potential of equity shares.

Issuing junk bonds is another way of financing merger. Junk bonds are those bonds whose ratings are below the investment grade. An acquiring company can raise the required funds for the merger or acquisition by issuing junk bonds at a rate far above than the market rate.

Some companies follow deferred payment plan to finance mergers and acquisitions. Under this plan, an initial payment is made to the shareholders of the target company with an undertaking that additional payments will be made or additional shares will be issued over a course of time in the event of the acquiring company being able to increase its earnings post merger.

12.6 FORMS OF CORPORATE RESTRUCTURING-DIVESTITURES / DEMERGERS

A divestitures/demerger involves selling of some of the assets like plant, division, product line, subsidiary and so on. Divestiture may lead to contraction of the business operation but it may not entail decrease in its profits. On the contrary, it is believed that the value of the firm is enhanced due to divesting/demerger some of its assets, divisions or operating units which were causing losses or giving miniscule return to the overall business.

12.6.1 Methods of Divestiture/Demerger

A divestiture can take any one of the following forms:

- **Sell-off:** It consist of selling of the entire company or the selling

of some business unit such as a subsidiary unit, a product line or a business segment. The sell off can be a partial sell-off, where a part of the company is sold.

- **Spin-off:** Unlike sell-off, in which a business unit is sold for cash or securities, a spin off involves the separation of a business unit from the company and distributing the shares of the business unit to the shareholders of the company on a pro rata basis. Through distribution of shares under spin off, the existing shareholders can maintain the same proportion of ownership in the newly created firm (for the purpose of spin off) as they had in the original firm.
- **Split-up:** If a firm has a number of divisions and if each division is split out as a separate legal entity, it is known as split-up. In other words, a split-up consist of a number of spin-offs and the original firm ceases to exist once all the spin-offs come into existence.
- **Equity carve-out:** When a minority stock in a subsidiary is sold to the public while the parent company continues to retain the controlling interest in the subsidiary, it is known as equity carve-out. Generally the parent company sells the shares of the subsidiary to the public through initial public offer (IPO). Thus, the subsidiary has a separate stock price and public trading.

12.7 FORMS OF CORPORATE RESTRUCTURING-BUYOUTS

Buyout can be *management buyouts* (MBOs) or *employee buyouts* (EBOs). In the case of MBO, the management of a company buys the company from its owners. On the other hand, in EBO, the employees of a company buy the company from its owners. Under MBO, the management may be from the same firm or may be from outside (entrepreneurs) or may assume a hybrid form, which is a combination of management from the existing firm as well as outside.

Generally, in case of management buyout, the acquiring management team does not have adequate financial resources of its own to pay the acquisition price. In that case, they seek financial support from other sources, say, private investors, institutions, venture funds, banks and so on. When finance is arranged by outside investors, it is quite normal that they seek representation on the board of the company where they are investing. When debt forms a substantial part of the total financing ,such buyout is referred as *leveraged buyout* (LBO). A leveraged buyout is an acquisition that is financed principally, sometimes more than 90 percent, by borrowing on a secured basis.

12.8 FORMS OF CORPORATE RESTRUCTURING-BUYBACK OF SECURITIES

In the wake of many takeover bids, buying back of shares has assumed a lot of importance in recent years. A buyback is an arrangement through which a company purchases its own equity shares from its shareholders. A company may purchase its own shares through "buy-back" out of :

I. Its free reserves; or

II. The securities premium account; or

III. The proceeds of any shares or other specified securities.

No company shall purchase its own shares or other specified securities unless such buy-back is authorized by its articles and a special resolution has been passed in the general meeting of the company authorizing the buy-back.

12.8.1 Reasons for Buyback of Shares

There may be various reasons for buyback of shares. It can be any one or more of the following:

- To improve the earning per share (EPS). The EPS is calculated by dividing the company's net income with its total number of outstanding shares.

- To enhance the long term shareholder value.
- To provide an additional exit route to shareholder, if shares are under-valued or are thinly traded
- To enhance consolidation of stake in the company.
- To prevent unwelcome takeover bids.
- To return surplus cash to shareholders.
- To achieve optimum capital structure.
- To support share price during periods of sluggish market conditions.
- To service the equity more efficiently.

12.8.2 Advantages of Buyback of shares

- If the stock prices of the company are illiquid or thinly traded, it is advantageous for the shareholders if the company buy back its shares at an attractive rate.
- Buyback helps in substituting equity capital with debt capital and thereby derive tax advantages.
- It gives a clear indication that the shares of the company are underpriced.
- When the market is down for a long period, buy back of shares gives confidence to the shareholders.

12.8.3 Limitations of Buyback of Shares

- When buy back results into capital reduction, the debt-equity ratio of the company increases. Thus, it might sends a red signal to the lenders particularly financial institutions who expects the company to always have a high net worth.
- Buy back of shares might lead to increase in insider trading and price manipulation.
- If a company buys back a substantial portion of shares, the remaining shares might become illiquid.
- Contrary to the popular belief that buyback improves share

price, in many cases the share price dropped below the buyback price post buyback of shares by the company.

- The buyback of shares can also be a stumbling block in the process of takeovers and the replacement of existing unprofessional management.



CHECK YOUR PROGRESS

Q 3: Define management buyouts and employee buyouts?

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Q 4: List two limitations of buyback of shares?

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12.9 MERGERS AND ACQUISITION IN INDIA

Mergers and acquisitions have gained momentum in the Indian corporate world, following the economic reforms initiated by the Government of India in 1991. Mergers and acquisitions were prominent in the sectors such as telecom, finance, FMCG, construction materials, automobile industry and steel industry. Acquisition of foreign firms by Indian businesses has been the latest trend in Indian corporate sector. Acquisition of Corus by Tata steel is an example of Indian firms acquiring large international companies. Tata Steel acquired 100% stake in Corus Group on January 30, 2007. It was an all cash deal which cumulatively amounted to $12.2 billion.

Different factors such as favorable government policies, buoyancy in the economy, liquidity in the corporate sector etc. have played an important role in facilitating mergers and acquisitions in India. Increased competition in the domestic as well as global markets has prompted companies to opt for mergers and acquisitions as an important strategic choice.

Some of the biggest mergers and acquisitions by Indian companies in recent years are enumerated below:

- Vodafone purchased administering interest of 67% owned by Hutch-Essar for a total worth of $11.1 billion on February 11, 2007.
- India Aluminium and copper giant Hindalco Industries purchased Canada-based firm Novelis Inc in February 2007. The total worth of the deal was $6-billion.
- Indian pharma industry registered its first biggest in 2008 M&A deal through the acquisition of Japanese pharmaceutical company Daiichi Sankyo by Indian major Ranbaxy for $4.5 billion.
- The Oil and Natural Gas Corp purchased Imperial Energy Plc in January 2009. The deal amounted to $2.8 billion and was considered as one of the biggest takeovers after 96.8% of London based companies' shareholders acknowledged the buyout proposal.
- In November 2008 NTT DoCoMo, the Japan based telecom firm acquired 26% stake in Tata Teleservices for USD 2.7 billion.
- India's financial industry saw the merging of two prominent banks - HDFC Bank and Centurion Bank of Punjab. The deal took place in February 2008 for $2.4 billion.
- Tata Motors acquired Jaguar and Land Rover brands from Ford Motor in March 2008. The deal amounted to $2.3 billion.
- 2009 saw the acquisition Asarco LLC by Sterlite Industries Ltd's for $1.8 billion making it ninth biggest-ever M&A agreement involving an Indian company.



12.10 LET US SUM UP

The following aspects have been discussed in this unit—

- Corporate restructuring implies any change in ownership, capital structure or operations that happens outside the normal course of business It involves restructuring of business, assets and ownership.
- Corporate restructuring can be brought through a variety of mechanisms including mergers, acquisitions, divestitures and spin-offs.

- The basic objective of corporate restructuring is to ensure increasing wealth for the shareholders through optimal utilization of resources.
- In simple terms, a merger refers to the combination of two or more companies into one company. It is a strategy through which two firms agree to integrate their operations. The terms merger and amalgamation can be used interchangeably.
- Mergers may be Horizontal Mergers, Vertical Mergers or Conglomerate Mergers.
- An acquisition is an act of acquiring effective control over the assets or management of a firm by another firm. A forced acquisition or unwilling acquisition is called 'takeover'.
- A firm may take over another firm by making offers directly to the shareholders of the target company through the process of Tender Offer, Partial Offer or All-in-one –Offer.
- A divestitures/demerger involves selling of some of the assets like plant, division, product line, subsidiary and so on. Divestiture may lead to contraction of the business operation but it may not entail decrease in its profits.
- A divestiture can take any one of the following forms, namely, Sell off, Spin Off, Split up and Equity carve out.
- Buyout can be *management buyouts* (MBOs) or *employee buyouts* (EBOs). In the case of MBO, the management of a company buys the company from its owners. On the other hand, in EBO, the employees of a company buy the company from its owners.
- A buyback is an arrangement through which a company purchases its own equity shares from its shareholders.
- Mergers and acquisitions have gained momentum in the Indian corporate world, following the economic reforms initiated by the Government of India in 1991.
- Mergers and acquisitions were prominent in the sectors such as telecom, finance, FMCG, construction materials, automobile industry and steel industry.



12.11 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



12.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The main objective of horizontal merger is to achieve economies of scale in production, which results into more profit and increase in shareholders wealth. The merger of Lipton India Limited with Brooke Bond in the year 1996 is an example of horizontal merger.

Ans to Q No 2: In this type of merger two firms that are in different stages of production or distribution merges together. The idea of vertical merger is to expand its business forward towards the ultimate consumer or backward towards the source of raw material. The merger of Tata Estate Ltd with Brooke Bond Ltd is an example of vertical merger.

Ans to Q No 3: In the case of MBO, the management of a company buys the company from its owners. On the other hand, in EBO, the employees of a company buy the company from its owners.

Ans to Q No 4:

- Buy back of shares might lead to increase in insider trading and price manipulation.
- If a company buys back a substantial portion of shares, the remaining shares might become illiquid.



12.13 MODEL QUESTIONS

Q 1: What is Corporate restructuring?

Q 2: What are Mergers? Discuss the motives behind Mergers.

Q 3: What are the different types of Mergers?

Q 4: What is an Acquisition? Discuss the different methods of Acquisitions.

Q 5: Write a short note on :

a) Hostile takeovers.

b) Buyouts

Q 6: Discuss the various methods of financing Mergers and Acquisitions.

Q 7: What is Divestiture? Discuss the various methods of divestiture.

Q 8: What is “buyback of securities” ? What could be the various reasons for Buyback of securities?

Q 9: Discuss the advantages and limitations of Buyback of securities.

Q 12: Write a note on Mergers and Acquisitions in India.

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UNIT 13 : SECURITIZATION,FACTORING AND FORFAITING

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Securitization

- 13.3.1 Parties Involved in Securitization Process
- 13.3.2 Steps in Securitization Process
- 13.3.3 Advantages of Securitization
- 13.3.4 Securitization in India

13.4 Factoring

- 13.4.1 Process of Factoring
- 13.4.2 Functions of the Factor
- 13.4.3 Benefits of Factoring

13.5 Difference Between Bill Discounting and Factoring

13.6 Forfaiting

- 13.6.1 Process of Forfaiting

13.7 Difference between Factoring and Forfaiting

13.8 Let Us Sum Up

13.9 Further Reading

13.10 Answers to Check Your Progress

13.11 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- state the concept of Securitization
- know about the parties involved in the Securitization process
- know about the advantages of Securitization
- explain the process of factoring
- describe the functions of a Factor
- state the benefits of factoring
- distinguish between Factoring and Bill Discounting

- explain the process of Forfaiting
- distinguish between Factoring and Forfaiting.

13.2 INTRODUCTION

Securitization is a recent financial innovation which has created revolutionary changes in the global financial market. Securitization is process of transforming illiquid assets (receivables/ future cash flows) into financial instruments that can be traded in the financial market.

Financial institutions, banks, NBFCs provide loans to both individual as well institutional clients. Similarly, manufacturing or service industry also sell goods or services to their clients either in cash or in credit. When a firm sells good or services to their customers on credit, it may result into either sundry debtors (selling goods on credit to customer, who are supposed to pay outstanding amount as per mutually agreed time frame) or bills receivables (a written evidence (promissory note) of debt, stating that the debtor owes the holder of the bill the amount stated on that bill). The loans and advances, sundry debtors, bills receivables are all shown as assets in the balance sheet of the respective organizations. However all these assets take time to convert into cash? It may happen that few of such assets become non-performing or illiquid, if the borrower or customer fails to honor their commitments. So such financial assets might become risky assets for the organization holding them. Thus securitization comes into play which addresses the credit risk as well the recycling of such funds.

13.2 CONCEPT OF SECURITIZATION

Securitization is a structured process through which financial assets such as loans and advances, bills receivables, sundry debtors can be packaged into homogeneous assets or cash flow. The term homogenous assets or cash flow means asset of same class and nature. For example, auto loans of similar maturity or credit card receivables etc. Some of the assets that can be securitized are loans like car loans, housing loans, personal loans and future cash flows like ticket sales, credit card payments,

car rentals or any other form of future receivables. Once the assets are identified, a type of marketable securities backed by these pools of receivables is created. These pools of assets are then sold to interested investors. In other words, fresh funds are generated from these set of new investors against the pooled assets or receivables whose collaterals would be future stream of cash flows. For example Mr Ravi wants to open a multiplex and is in need of funds for the same. To raise funds, Mr Ravi can sell his future cash flows (cash flows arising from sale of movie tickets and food items in the future) in the form of securities to raise money from interested public. This will benefit investors as they will have a claim over the future cash flows generated from the multiplex. Mr Ravi will also benefit as loan obligations will be met from cash flows generated from the multiplex itself.

For the purpose of distinction, if mortgage loans are converted into marketable securities, such securitization is known as 'mortgage backed securitization'. Similarly if financial assets such as sundry debtors are converted into marketable securities, such securitization is known as 'assets backed securitization'; and if cash flow streams are converted into marketable securities, such securitization is known as 'cash-flow securitization'

13.3.1 Parties involved in Securitization Process

The parties involved in securitization process primarily are:

- **Originator:** The originator is the organization that goes in for securitization. This is the entity on whose books the assets to be securitized exist. It sells the assets on its books and receives the funds generated from such sale. The scheduled commercial banks and the housing finance companies, which lend for the housing, are originator in securitization transaction.
- **Obligor:** The borrower or customers who owe money to the originator are called obligor. The due from the obligors are the assets that are transferred under securitization to the SPV. The quality of the assets depends upon the credit standing of the obligors.

- **Special Purpose Vehicle (SPV):** It is the entity, which buys the assets to be securitized from the originator. An SPV is an organization formed exclusively to deal with securitization process. It is usually formed as a trust. However depending on the objective of the originator, a SPV can be a company or a subsidiary of the originator company. The SPV holds the assets in its books and makes the upfront payment for them to the originator.
- **Credit rating agency:** in order to market the securities issued by SPV (known as pass through certificates), it is essential that the assets are rated by sound credit rating agency. Credit rating helps the investors select securities that suit their risk preferences.
- **Administrators or servicer:** They help the originator or SPV in collecting the amount due from the obligors. The administrator or servicer might follow up with the delinquent parties and pursue legal remedies against defaulting parties. The servicer usually collects receivables on a regular basis and transferring the funds to the accounts controlled by SPV.
- **Investors:** The investors under securitization deals can be individuals, financial institutions, mutual funds, provident funds, pension funds, and the insurance companies. These investors buy a participating interest in the total pool of receivable and receive their payments in the form of interest and principal as per agreement.
- **Structurer:** A typical securitization deal involves a structurer, who is usually a financial institution involved in structuring the securitization deal.

13.3.2 Steps in Securitization process

The following are the various steps involved in securitization process:

I. **Identification process:** The first step is the identification of

assets or cash flows that can be pooled for the purpose of securitization. The lending financial institution either a bank or any other institution for that matter which decides to go in for securitization of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved frequency of repayments and marketability. The borrowers or customers who owe money to the originator are called 'obligors'

II. **Transfer process:** After identification of assets or cash flows, the selected pools of assets are then pass through to another institution. This institution is called 'special purpose vehicle' (SPV) or the trust, which is exclusively set up to deal with securitization. The pass through transaction between the originator and the SPV is either by way of outright sale basis. This process of passing through the selected pool of assets by the originator to a SPV is called transfer process and once this transfer process is over the assets are removed from the balance sheet of the originator.

III. **Issue process:** After acquisition of the assets, the SPV takes up the onerous task of converting these assets to various type of different maturities. On this basis SPV will issue securities to investors. The SPV actually splits the packages into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV are called by different names like 'Pay through Certificates', 'Pass through Certificates' etc. The securities are structured in such a way that the maturity of these securities may synchronies with the maturity of the securitized loans or receivables.

IV. **Redemption process:** The redemption and payments of

interest on these securities are facilitated by the collections by the SPV from the securitized assets. The task of collection of dues is generally entrusted to the originator or a special service agent can be appointed for this purpose. This agency paid certain commission for the collection service rendered. Thus under securitization the role of the originator gets reduced to that of the collection agent on behalf of SPV in case he is appointed as a collection agent. The holder of a pass through certificate has to look the SPV for payment of the principal and interest on the certificate held by him. Thus the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment of interest and principal to the investors.

V. **Credit rating process:** The passed through certificate has to be publicly issued, they required credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence these certificates have to be rated at least by one credit rating agency at the end of process of securitization.

13.3.3 Advantages of Securitization

Securitization offered various advantages to the parties involved in the process. The advantages of securitization are given below:

- Securitization increases liquidity for the originator by converting illiquid assets into liquid marketable securities.
- Once non-performing assets are securitized, the originator can remove it from their balance sheet, which results in enhancement of capital adequacy for the originator.
- Cash inflows arising on the sale of illiquid assets can be utilized for repayment of other borrowings by the originator.
- Banks can convert higher risk weighted assets to lower risk weighted assets through securitization.

- Securitization widens the basket for investors to invest in new financial assets.
- Securitization helps organizations to diversify their funding base and tap new investors.
- Securitization helps organizations to focus on their core business by off loading bad loans to an SPV.
- It offers a source of fee based income for many organizations.
- Banks can minimize their asset and liability mismatch through securitization.
- Securitized financial instruments are tradable in secondary market, which widens the financial market of the country.

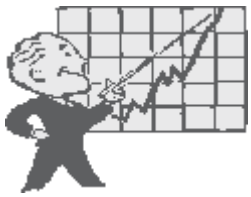
13.3.4 Securitization in India

Securitization is relatively a new concept in Indian financial market. The first deal of securitization in India was structured during 1991. During that era, commercial banks and financial institutions has large exposure in housing and infrastructure project. In order to offload their exposure, banks and financial institutions entered into securitization. This resulted the start of mortgage- backed securitization (MBS). During the same period NBFCs also entered in a big way in retail lending like auto loans, leasing finance. This led to the development of asset-based securitization (ABS).

One of the main purpose of securitization in India was to minimize the mismatched of asset and liabilities in the banking sector. Hence the SPV acquires the illiquid assets from the banks and other financial assets by issuing bonds and debentures to the originator. The SPV then create and issue security receipts (SR) to qualified institutional buyers (QIB) to invest in the securitization.

Securitization of auto loans was the mainstay of Indian securitization market during 90's due to higher volumes, homogeneous nature of receivables and perceived credit risk. Over time it has spread to other class of financial assets such as housing loans, corporate loans, project receivables, toll revenues, property

rental receivables and so on. Growing retails assets portfolio of the public sector and private sector banks made Asset-based securitization (ABS), the highest product class. ABS deals are mainly backed by assets such as car loans, commercial vehicle loans, construction equipment loans, two-wheeler loans and personal loans. On the other hand the Mortgage-backed securitization (MBS) market has been rather slow in picking up in India despite the growth of housing finance market due to lack of investors' interest in long-term securities and lack of secondary market liquidity.



CHECK YOUR PROGRESS

Q 1: Choose the correct answer from the brackets:

a) Securitization is a ..... (structured / unstructured)process through which financial assets such as loans and advances, bills receivables, sundry debtors can be packaged into homogeneous assets or cash flow.

b) The term ..... (heterogeneous / homogenous) assets or cash flow means asset of same class and nature.

c) The borrower or customers who owe money to the originator are called ..... (Obligor / SPV).

d) Banks can convert ..... risk weighted assets (higher / lower) to ..... risk weighted assets (higher / lower) through securitization.

13.4 FACTORING

One of the techniques of managing receivables is factoring. It is an agreement between a firm (client) and factoring organization (factor) under which the sales ledger administration and receivables collection of the firm (client) are entrusted to an external agency called the factor. Factoring is a specialized financial service that involves working capital financing, sales ledger administration, accounts receivables collections and credit risk

protection. Factoring is also known as invoice financing and sales financing.

13.4.1 Process of Factoring

A factoring arrangement consists of a factor agreeing to purchase the invoices of the client as they arise in the normal course of trading. The steps involved in factoring are as follows:

I. Customers place orders for goods or services with the firm (client) and request for trade credit.

II. The firm (client) transmits the order to the factor for approval.

III. If the factor approves the credit sale, the firm sells the goods on credit to the customer.

IV. The firm (client) sends the invoice to the client with notice to pay the due amount to the factor.

V. The firm (client) also sends a copy of the invoice to the factor.

VI. Factor pays advance of the invoice amount (Generally 80-90 percent of the invoice amount) to the client firm.

VII. Factor sends periodical statements to the customers.

VIII. Factor follows up the unpaid book debts.

IX. Customer makes payment to the factor.

X. The factor remits the balance amount after deducting the factor commission and other charges, if any to the firm (client).

13.4.2 Functions of the Factor

The following are the important functions of the factor:

I. Credit evaluation: Credit evaluation is basically the assessment of creditworthiness of the customer or debtor to whom the factor is considering to provide trade credit. A factor, usually a bank with wide network of branches, is likely to have access to credit intelligence of the particular customer. Once the factor is satisfied with the creditworthiness of the customer, it sanctions trade credit to the customer.

II. Sales ledger administration: It involves recording all credit

sales transactions, analysis of credit sales data and preparing reports for monitoring and management of credit collection.

III. **Collect book debts:** The factor undertakes collection of accounts receivables from the customers as and when they become due.

IV. **Assume risk of default:** Since the factor takes the responsibility of collecting receivables from the customers, it provides full protection to the client-firm against bad debts.

V. **Provide finance:** The factor usually can provide finance to the client-firm up to 90% of the invoice value of the factored receivables. Hence the client-firm received funds immediately upon signing the agreement. This helps the client to manage their working capital more efficiently.

VI. **To provide information:** Since the factor is a professional with expertise, they can provide valuable information to the client-firm on various related topics such as sales analysis, invoice analysis, market trends, implications of government trade policies and so on.

13.4.3 Benefits of Factoring

The following are the benefits of factoring:

I. Through factoring the client firm can get payment from the factor faster than a bank loan.

II. The client firm need not worry about the bad and doubtful debts as the factor undertakes the responsibility of collecting receivables from the customers.

III. The client firm can outsource its credit department and thus converting the fixed cost of maintaining a credit department in to variable cost.

IV. Factoring increases the borrowing capacity of the client-firm.

V. The client-firm can focus purely on its core business by assiging the collection of receivables to a factor.

VI. Since the factor is a professional and specialized agency, it can reduce expenditure on sales ledger administration and

collection of debts.

VII. As the working capital needs of the client firm increase with the increase in the volume of its receivables, the factor increases the advance to be extended to the firm and vice versa.

VIII. Factoring is a simple method of financing compared to a bank loan. The client has to fulfill the necessary formalities for every time they approach the bank for a loan. Whereas under factoring, once the agreement is signed, the client firm can sell its invoices to the factor again and again without getting it approved each time.

IX. In the case of international trade, the exporter needs to deal with only one factor (the export factor) regardless of the location of their sales. This saves a lot of factoring costs besides avoiding delays.

X. International factoring is better option for an exporter in terms of costs, delays and credit protection as compared to other options such as letter of credit and documents against acceptance.

13.4 DIFFERENCE BETWEEN BILL DISCOUNTING AND FACTORING

Bill Discounting	Factoring
Bill discounting means to trade bill before it becomes due for payment at par value.	Factoring means to sell its bool debt to the financial transaction to the factoring company at a discount.
In bill discounting, the bill is discounted and paid when the transaction takes place.	In factoring, the financer gives a maximum amount as an advance when a transaction takes place the remaining amount at the time of settlement.
The parties to a bill discounting are drawer, drawee and a payee.	The parties to a factoring are factor, debtor and client.

A financer charges fees in the form of discounting charges or interest.	Financer gets fees in the form of interest for the financial services and commission for extra services facilitate.
Bill discounting comes under the Negotiable instrument act, 1881.	There is no such specific law for factoring.

13.6 FORFAITING

Forfaiting is technique by which a financing agency, usually a bank or specialized financial institution, discounts an export bill and pays ready cash to the exporter. The financing agency is known as the forfaitor and the arrangement is called forfaiting. Under the forfaiting arrangement, the exporter is protected against the risk of non- payment of debts by the importer. The forfaitor undertakes the responsibility of collection of export bills at a discount rate plus other charges, if any applicable.

13.6.1 Process of Forfaiting

I. Once the exporter and importer negotiate on a sales deal, the exporter approaches the forfaitor for discounting of accounts receivables that would arise from the trade.

II. The forfaitor then collects information about the importer and details of the sale. The forfaitor generally seek information as to the type of goods sold, value of goods, expected shipment date, repayment terms, guarantees, business of the importer and so on.

III. Once the forfaitor collects the required information and completes the risk appraisal, the forfaitor informs the discount rate and other charges, if any to the exporter.

IV. The exporter then incorporates the discount rate into the selling price of the goods and informs the importer. If both the party agrees to the price, they sign commercial contract and execute a forfaiting contract with the forfaitor.

V. The exporter ships the goods to the importer and collects necessary documents such as promissory notes, bills of exchanges and letter of credit, if any.

VI. The exporter then submits the necessary documents (as required by the forfaitor) to the forfaitor.

VII. The forfaitor makes payment to the exporter as agreed in the commitment.

VIII. The forfaitor than holds the credit instruments until maturity or sells it to another investor on a non-recourse basis. At the time of maturity of the instruments, the holder of the instrument presents the same to the guaranteeing bank or importer's bank for payment.



CHECK YOUR PROGRESS

Q 2: Fill In the blanks:

a) ..... is a specialized financial service that involves working capital financing, sales ledger administration, accounts receivables collections and credit risk protection.

b) ..... is technique by which a financing agency, usually a bank or specialized financial institution, that discounts an export bill and pays ready cash to the exporter.

c) Factoring is also known as ..... financing and sales financing.

d) The parties to ..... are drawer, drawee and a payee.

13.7 DIFFERENCES BETWEEN FACTORING AND FORFAITING

Factoring	Forfaiting
Factoring covers mostly smaller claims for consumer goods and services.	It is related to financing of the export of capital goods, commodities and projects.

A factor takes the responsibility of sales ledger administration, providing advisory service and financing receivables.	The forfaitor only takes the responsibility of financing trade credit.
It can be domestic as well as international factoring.	Forfaiting is always related to international trade transactions.
Factoring is a method of short term financing.	Forfaiting is used for financing the claims of terms between a few months and several years.
Factoring except international factoring covers only credit risk.	Forfaiting covers several risks such as credit risk, exchange rate risk, interest rate risk and sovereign risk.
Factoring covers ongoing volume of business. Once the factoring agreement is signed, it can be an ongoing business as per the terms of the agreement	Forfaiting is a one-time deal. It is a one contract basis and a new contract has to be signed in for every deal.
International factoring usually avoid high-risk countries.	Forfaiting involves purchasing foreign account receivables from high-risk countries.



13.8 LET US SUM UP

- Securitization is process of transforming illiquid assets (receivables/ future cash flows) into financial instruments that can be traded in the financial market.
- The parties involved in securitization process primarily are: Originator, Obligor, Special purpose vehicle, Credit rating agency, administrators, investors and structure.
- Once non-performing assets are securitized, the originator can remove it from their balance sheet, which results in enhancement of capital adequacy for the originator.

- Securitization is relatively a new concept in Indian financial market. The first deal of securitization in India was structured during 1991.
- One of the main purpose of securitization in India was to minimize the mismatched of asset and liabilities in the banking sector.
- Factoring is a specialized financial service that involves working capital financing, sales ledger administration, accounts receivables collections and credit risk protection.
- Forfaiting is technique by which a financing agency, usually a bank or specialized financial institution, discounts an export bill and pays ready cash to the exporter. The financing agency is known as the forfaitor and the arrangement is called forfaiting.



13.9 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



13.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Structured b) Homogenous

c) Obligor d) Higher; lower

Ans to Q No 2: a) Factoring b) Forfaiting

c) Invoice d) Bill discounting.



13.11 MODEL QUESTIONS

Q 1: What is Securitization? Discuss the parties involved in the Securitization process.

Q 2: Discuss the advantages of Securitization.

Q 3: What is Factoring ? Discuss the process of factoring.

Q 4: What are the functions of a Factor?

Q 5: What are the benefits of factoring?

Q 6: Distinguish between Factoring and Bill Discounting.

Q 7: What is Forfaiting? Discuss the process of Forfaiting.

Q 8: Distinguish between Factoring and Forfaiting.

Q 9: Write a note on Securitization in India.

*** ***** ***

UNIT 14: DEPOSITORY AND CUSTODIAL SERVICES

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Constituents of the Depository System

14.4 Functions of Depository

14.5 Advantages of the Depository System

14.6 Regulation with Regard to Depository System

14.7 Depository- NSDL and CDSL

14.8 Custodial Services

14.9 Differences Between Depository and Custodial Services

14.10 Let Us Sum Up

14.11 Further Reading

14.12 Answers to Check Your Progress

14.13 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- state meaning and the constituents of the Depository System
- know the functions of Depository
- list the advantages of the Depository System
- explain the regulation with regard to Depository System
- know about NSDL and CDSL
- state the meaning of Custodial Services
- distinguish between Depository and Custodial Services.

14.2 INTRODUCTION

During the last two decades, the Indian capital market has undergone many changes. Post liberalization, there was an unprecedented change in the investment activity of the country. There has been a large

number of capital issues every year, accompanied by an unprecedented growth in the stock market turnover. With the growth in the stock market, certain problems have surfaced such as delays in the transfer of ownership of securities, bad deliveries and irregular settlement, and so on. In this context, many initiatives were taken. The major ones include the screen-based trading and depository system. In 1994, National Stock Exchange (NSE) launched its online electronic trading system. This was followed by the Bombay Stock Exchange's (BSE) launch of the Bombay Online Trading (BOLT) system. However the problem with settlement and delivery of securities persist, as securities transaction takes place in physical form. The process of settlement of trades and transfer of ownership often involve long delays due to 'bad delivery', faulty paperwork, signature mismatch and so on. In addition to this, loss of physical security certificate by the investor is another major hassle for the investors.

To put an end to the problems associated with physical handling of securities, the government introduced the depository system under the Depositories Act, 1996, to enable holding and dealing of shares and securities in electronic form. The Depositories Act, 1996 primarily provides for:

I. A multi-depository system.

II. Dematerialization of securities and

III. Appointment of depository participants.

The Depositories Act, 1996, enables the setting up of several depositories in the country. All the operations of the depositories are governed by the regulations and provisions of the Depositories Act, 1996.

14.3 CONSTITUENTS OF THE DEPOSITORY SYSTEM

The below are the main constituents of the depository system in India:

1. **The Depository**: A depository is an institution similar to a bank, not for funds but for securities. When an investor deposits securities with a depository, the investor account (demat account) is credited

and the physical securities are sent to the issuer for transfer in the name of the depository. Hence the legal ownership of the securities is with the depository but all the beneficial ownership of the securities are with the investor. Thus depository's name is entered in the register of the issuer of securities. The depository has no voting rights or any other rights with respect to the securities held by it. The investor, being the beneficial owner is entitled to all the corporate benefits such as interest, dividend, bonus shares, right shares, voting rights. However one important point to note, is that the functions of the depository are carried out through another entity known as *'depository participants'*

The first depository in India was the National Securities Depository Limited (NSDL) established in November 1996 by NSE, IDBI and UTI jointly. Subsequently, in February 1999, India's second depository, the Central Depository Services Limited (CDSL) was set up by BSE jointly with some leading commercial banks.

2. **The Depository Participants (DP)**: The Depository Participants commonly known as the DP is the intermediary between the depository and the investor. The investor's first point of contact is the DP. A broker, a bank, a financial institution or a company registered with SEBI can become a DP, provided it fulfills all the eligibility criteria as prescribed under Depositories Act. Since the entire process of the depository system is electronic, the DP should have adequate infrastructure, competent staff, effective procedures and risk management systems.

3. **Registrar and Transfer Agents (RTA)**: The RTA is an important constituent of the depository system. They maintain ledger records of all security holders of a company. They also undertake processing of interest, dividend warrants, rights issue, bonus issue and dispatch of notices and annual reports among other functions. The business of RTAs is governed by the regulations and guidelines issued by SEBI.

4. **The Clearing Corporation/ Clearing House**: The clearing corporation or the clearing house is an organization associated with a stock exchange to handle the confirmation, settlement and delivery of transactions. They coordinate among the following entities:
    - Stock exchange for executed trades
    - The clearing members and custodians for bringing in necessary funds and securities to be settled.
    - The clearing banks for fund settlement and
    - The depository for securities settlement.

The clearing corporation also ascertains the pay-in and pay-out of brokers who have traded the securities on the stock exchange.

14.4 FUNCTIONS OF DEPOSITORY

The following are the key functions that a depository provides.

1. **Dematerialization of Securities**: Dematerialization or commonly known as Demat is the process by which the investor converts his physical securities into electronic form. In order to dematerialize the physical certificates, the investor has to open a demat account with the depository participants (DP). The investor has to surrender the securities, he wishes to dematerialize with the DP and fill and sign the completed dematerialization request form (DRF). The DP then verifies the form and the physical certificates. If they found to be in order, the DP issues an acknowledgement slip to the investor. The DP entered the details of the securities into the software and forwards the details to the depository. The DP also dispatched the defaced certificates along with the request form to the issuer of the certificates or to the registrar and transfer agents (RTA). If no objection is received from the issuer or the RTA, the software at the depository level creates appropriate credit balance in the investor's demat account.
2. **Rematerialization of Securities:** It is the opposite of dematerialization of securities, where the investor can convert his electronically held securities into physical certificates. For

rematerialization, the investor has to submit duly filled and signed rematerialization request form with the DP, where he holds his demat account. If the investor has that much of securities in his demat account, the DP enters the request in their software, which blocks the investor's holdings to that extent. The DP then forwards the same to the depository and simultaneously sends the request form to the issuer of the certificates or the RTA. The issuer/ RTA prints the certificates and dispatched them to the investor. Simultaneously the depository is informed; so that the investor's demat account is debited by the number of securities that are rematerialized.

3. **Transfer of Securities:** The depository facilitates the transfer of securities resulting from the settlement of trades between beneficial owners of securities by recording entries in the respective accounts of the beneficial owners. It may be noted that the transfer of beneficial ownership of securities occurs merely by making book entries in the electronic records of the depository.

4. **Pledge and Hypothecation of Securities:** An investor who wishes to secure a loan or other credit facilities from bank or financial institution can give the securities held in demat form as collateral. If the securities are in physical form, the investor (borrower) has to deliver the securities physically to the lender (banks/ financial institutions). However, physical securities offered as collateral are subject to a lot of scrutiny at the level of the lender which involves considerable time and money. But the depository system makes the process simple and cost effective. If the client of the depository wishes to create a pledge on the securities owned by him, he can do so by making an application in the specified form. The DP, after being satisfied that the securities are eligible for pledge, shall do the necessary formalities.

5. **Transmission of Securities:** The depository shall make the transmission of demat balances of any client due to death, lunacy, bankruptcy and insolvency. In case the client has nominated any person, such securities shall automatically be transferred in the

name of the nominee upon the death of the nominating person. In the case where the deceased was one of the joint holders of a demat account, the surviving client can operate such account subject to the terms and conditions as prescribed by the depository. In the case where the deceased was the sole holder of the demat account, the demat balances shall be transferred to his/her legal heir(s) or the legal representative(s) subject to the fulfillment of the terms and conditions related to such cases

6. **Freezing of Account**: The depository system has a provision according to which a DP can freeze the demat account maintained with the DP. Whenever any written instruction is received from the government, SEBI, or any court or any statutory authority, the DP has the right to freeze the account of the investor. Similarly a DP's account can also be frozen on disciplinary grounds or if the DP becomes insolvent, bankrupt or a body corporate being wound up. In such a case, the client of the DP has the option to either rematerialize their holdings or transfer them to a different demat account with another DP.

14.5 ADVANTAGES OF THE DEPOSITORY SYSTEM

There are several advantages of the depository system. The key ones are as follows:

1. The depository system eliminates the chances of bad delivery. Bad deliveries such as invalid transfer deeds, forgery of signatures, fake certificates or any other defects in the certificates are eliminated with the introduction of depository system.
2. It reduces paper work which further reduces cost and time.
3. Depository system eliminates the risk associated with physical securities such as the loss, theft, mutilation and destruction of securities.
4. No stamp duty needs to be paid on transfer of shares through depository.

5. Depository system enhances the marketability of securities through faster settlement and greater liquidity.
6. It is easier for investor to keep records of securities maintained in demat form.
7. Depository system enables small investor to trade and invest even a single share.
8. If an investor wants to pledge or hypothecate his/her securities, it is easy to do so in demat mode.
9. Transaction in demat mode reduces the office work of the brokers.
10. Depository system has almost eliminated the storage requirement for certificate of securities.
11. Under depository system settlement of trade happens instantaneously. This has prompted investors, specially institutional ones to trade more frequently, leading to increased volume of trade.
12. It has helped investors, who keep their securities in demat form, to receive benefits such as dividend, bonus share, right share quickly and efficiently.
13. Brokerage charges are less for securities in demat form as it does not require to back office cost of handling paper certificates.
14. It has helped investors to monitor and control their portfolios since DPs regularly sends reports to their clients on their holdings and transactions.



CHECK YOUR PROGRESS

Q 1: Fill in the blanks:

a) The ..... Act, 1996, enabled the holding and dealing of shares and securities in electronic form.

b) Dematerialization or commonly known as .....

c) The first depository in India was the ..... established in November 1996 by NSE, IDBI and UTI jointly.

d) The intermediary between the depository and the investor is known as .....

e) ..... is the opposite of dematerialization of securities, where the investor can convert his electronically held securities into physical certificates.

Q 2: State two advantages of depository system.

.....

.....

14.6 REGULATION WITH REGARD TO DEPOSITORY SYSTEM

The Depositories Act, 1996 provides guidelines with regard to regulations governing the registration of depository, the certificate of commencement of business, registration of participants, rights and obligations of various constituents of the depository system and inspection. The salient features of these regulations are given below:

1. **Regulation relating to Registration of Depository:** Every depository needs to obtain a certificate of registration and certificate of commencement of business from SEBI by fulfilling certain conditions. SEBI will consider any application for depository, provided the sponsor belongs to one of the following categories:
    - A public financial institution
    - A scheduled commercial bank
    - A foreign bank operating in India
    - A recognized stock exchange
    - A body corporate engaged in providing financial services. Minimum 75% of the equity capital of such body corporate has to be held by any institutions mentioned above, either jointly or severally.
    - A body corporate constituted under any law in force in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Government of India.
    - An institution engaged in providing financial services

established outside India and approved by the Government of India.

The sponsor shall, at all time, hold at least 51% of the equity capital of the depository and the balance can be held by its participants. However no participants can hold more than 5% of the equity capital at any point of time with the depository.

The depository needs to have a net worth of minimum INR 100 crores. It shall have its own automatic data processing system. The network of the depository through which electronic means of communication will be maintained with its participants, issuer's and issuer's agent must be secure against any unauthorized entry or access.

2. Regulation relating to Registration of Depository Participant: As per SEBI regulations, registration of a depository participant with the SEBI is mandatory. The entity willing to enroll as a DP must apply for certificate of registration with SEBI in the prescribed form. The applicant shall belong to one of the following.

- A public financial institution
- A scheduled commercial bank
- A foreign bank operating in India
- A state financial corporation
- An institution engaged in providing financial services, promoted by prescribed institution as mentioned in the Depository Act, jointly or severally.
- A custodian of securities who has been granted a certificate of registration by SEBI
- A clearing corporation or clearing house of a stock exchange.
- A stockbroker who fulfills the criteria to apply for DP.
- A non banking finance company (NBFC) with net worth of not less than INR 50 lacs.
- A registrar to an issue or share transfer agent who has

a minimum net worth of INR 10 crores and who has been granted certificate of registration by SEBI.

3. **Eligible securities for Demat:** The following securities are eligible to convert into dematerialized form:
    - Shares, stocks, bonds, debentures, debenture stock or other marketable securities of similar nature of any incorporated company or body corporate.
    - Commercial paper, certificate of deposits, money market instruments, government securities, securitized debt, units of mutual funds, venture capital funds and unlisted securities.
    - Any other securities as prescribed by SEBI from time to time.

14.7 DEPOSITORY- NSDL AND CDSL

1. **National Securities Depository Limited (NSDL):** The NSDL was the first depository in India, setup in August 1996. Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchage (NSE) are the main promoters of NSDL. The services provided by the NSDL are:
    - Account maintenance,
    - Dematerialization of securities
    - Rematerialization of securities
    - Settlement of trades.
    - Pledge and hypothecation of securities
    - Automatic delivery of securities to clearing corporations,
    - Distribution of cash and corporate benefits such as bonus shares, right shares to the rightful owners.
    - Dematerialization of warehouse receipts
    - Launch of internet based services such as SPEED-e & IDeAS
    - Launch of Securities Trading- Information Easy Access and Delivery (STEADY) to digitally transmit signed

encrypted trade information across market participants through internet.

As on 31st March 2018, NSDL has more than 1.70 crores investors account with 30385 DP service centers across the country.

2. **Central Depository Service Limited (CDSL):** The CDSL is the second depository in India established in February 1999. It was mainly promoted by Bombay Stock Exchange (BSE) along with State Bank of India (SBI), Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Axis Bank and the Union Bank of India. The services provided by CDSL are similar to the services offered by NSDL. As on 31st March 2018, CDSL has 594 registered DPs across 17473 DP locations. It has more than 1.48 crores investors account. The DPs are directly connected to the CDSL, which provides investors to an online and efficient depository service.

14.8 CUSTODIAL SERVICES

With the rapid growth of investors, the demand for custodial services is at its peak. Custodial services play an important role in the development of the financial market. Custodial services include safekeeping of valuables, settlement of trades, income collection, processing corporate entitlements, cash management, foreign exchange management and so on. They also offer certain value added services such as risk management, performance measurement, compliance monitoring etc. Many institutions including some commercial banks, have entered the business of custodial service. However, Foreign banks operating in India are the major players in the business. They bring their overseas relationships into the country. Most of the business comes from foreign institutional investors (FIIs) who have business relations with the international offices of these banks. Most of these players have strong domestic as well as international businesses.

14.9 DIFFERENCES BETWEEN DEPOSITORY AND CUSTODIAN

In the financial world, the role of depository and custodian is becoming similar and so there is a thin line to differentiate between the two. In general, a custodian is a bank or a financial institution that holds financial securities such as stocks, bonds, gold, etc. of its customers. Basically, custodians are involved in having the custody of securities/ shares. For example, if customer of Yes bank has 1000 shares of a company, and those shares are held with Yes bank. Here Yes bank acts as a custodian of these shares/ securities .

On the other hand, depositories are the ones who have the custody of the securities as well as also the legal ownership of those securities. Custodians do not have legal ownership of securities. To understand this further, if a custodian A transfers securities to custodian B and for those securities the Depository is X, then at depository level, the total amount of securities remains same (depository will just change legal ownership) but at Custodian level, custodian A will see a reduction in number of securities while custodian B will see an increase in number of securities. So, basically the main difference is that the legal ownership of assets lie with Depository and not with custodian.

Some of the custodians of securities in India are:

- Stock Holding Corporation of India Limited
- Kotak Mahindra Bank
- ICICI bank
- SBI (State bank of India)
- HDFC Bank
- Standard Chartered Bank
- IL&FS Securities Services Ltd.
- Axis Bank Limited.



14.10 LET US SUM UP

The following aspects have been discussed in this unit —

- To put an end to the problems associated with physical handling of securities, the government introduced the depository system under the Depositories Act, 1996, to enable holding and dealing of shares and securities in electronic form.
- A depository is an institution similar to a bank, not for funds but for securities.
- The Depository Participants commonly known as the DP is the intermediary between the depository and the investor.
- The RTA maintains ledger records of all security holders of a company. They also undertake processing of interest, dividend warrants, rights issue, bonus issue and dispatch of notices and annual reports among other functions.
- The business of RTAs is governed by the regulations and guidelines issued by SEBI.
- The clearing corporation or the clearing house is an organization associated with a stock exchange to handle the confirmation, settlement and delivery of transactions.
- The main functions of the depositories include dematerialization of securities, rematerialization of securities, transfer of securities etc.
- The Depositories Act, 1996 provides guidelines with regard to regulations governing the registration of depository, the certificate of commencement of business, registration of participants, rights and obligations of various constituents of the depository system and inspection.
- The NSDL was the first depository in India, setup in August 1996. Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchage (NSE) are the main promoters of NSDL.

- CDSL is the second depository in India established in February 1999. It was mainly promoted by Bombay Stock Exchange (BSE) along with State Bank of India (SBI), Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Axis Bank and the Union Bank of India.
- Custodial services include safekeeping of valuables, settlement of trades, income collection, processing corporate entitlements, cash management, foreign exchange management and so on.
- Depositories are the ones who have the custody of the securities as well as also the legal ownership of those securities. Custodians do not have legal ownership of securities.



14.11 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
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6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



14.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1:

a) Depositories

b) Demat

c) National Securities Depository Limited (NSDL)

d) Depository participant.

e) Rematerterialization.

Ans to Q No 2:

- To put an end to the problems associated with physical handling of securities, the government introduced the depository system under the Depositories Act, 1996, to enable holding and dealing of shares and securities in electronic form.
- A depository is an institution similar to a bank, not for funds but for securities.



14.13 MODEL QUESTIONS

Q 1: Discuss the constituents of the Depository System.

Q 2: What are the functions of Depository ? Discuss.

Q 3: Discuss the advantages of the Depository System.

Q 4: Discuss the regulation with regard to Depository System

Q 5: Write short notes on :

a. NSDL

b. CDSL

Q 6: What are Custodial Services?

Q 7: State the difference between Depository and Custodian?

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UNIT 15: CREDIT RATING SERVICES

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Features of Credit Rating

15.4 The Scope of Credit Rating

15.5 The Process of Credit Rating

15.6 Advantages of Credit Rating

15.7 Disadvantages of Credit Rating

15.8 Credit Rating Agencies in India

15.9 SEBI guidelines for Credit Rating Agencies in India

15.10 Let Us Sum Up

15.11 Further Reading

15.12 Answers to Check Your Progress

15.13 Model Questions

15.1 LEARNING OBJECTIVES

After going through this unit you will be able to —

- state the features of Credit Rating
- know the scope of Credit Rating
- explain the process of Credit Rating
- list the advantages of Credit Rating
- list the disadvantages of Credit Rating
- know about Credit Rating Agencies in India
- know the SEBI guidelines for Credit Rating Agencies in India.

15.2 INTRODUCTION

Credit rating is an important financial service. It helps investors in making investment decisions. The rating assigned by various credit rating agencies indicates whether the issuer of securities will be able to meet their obligation with respect to payment of interest and principal as per the terms

and conditions stated in the certificate of securities. In simple words, companies and government raise money from the public by issuing financial securities. They offer to pay interest on their securities; the rating agencies evaluate the creditworthiness of the issuer by evaluating various aspects of the issuing company or organization. The rating of debt instruments ranges from 'AAA' to 'D', where 'AAA' denotes highest safety and 'D' denotes least safety.

A credit rating agency, after assessing the issuer of securities or borrower of funds, indicates the likelihood of an issuer of securities making timely payments on a financial obligation. The credit rating agency collects data about the organization from various sources and provides guidance to the investors in matters of credit risks associated with these securities.

A credit rating agency may assess an issuer of securities in two ways:

a) By assessing the issuer on likelihood of default on their financial obligation, in general or

b) By assessing only a particular security issued by the issuing organization.

Generally, the securities with higher credit rating such as "AAA" offer lower interest rate and securities with lower credit rating offer higher interest rates to attract investors. Although investors in general are risk averse, some may prefer to take additional risk provided there is commensurate premium for the risk taken. Thus the objective of credit rating agencies is to inform the investors about the financial standing of the company so as to provide guidance to the investors on investments. Credit rating service is a fee based activity, the fee being paid by the borrowing entity.

15.3 FEATURES OF CREDIT RATING

The following are the main concept/ features of credit rating:

- Credit rating is an assessment of the capacity of an issuer of debt instruments to repay the debt on time. The assessment is done by independent agency known as the credit rating agency.
- The credit rating agency employs both qualitative and quantitative criteria for assessing the creditworthiness of the issuer.

- The ratings are expressed in symbols or code numbers so that it can be understood by a lay man. Symbols such “AAA”, “A+”, “BBB”, “B-” or 1,2,3,4 may be used for rating.
- Credit rating can be done for a specific debt instruments or for the organization that issues the securities.
- Credit rating is not a one-time evaluation of credit risk but it is an ongoing and continuous process.
- Credit rating agencies neither perform an audit work of a company nor does it attest the genuineness of the information provided by the borrower.

15.4 THE SCOPE OF CREDIT RATING

Conventionally, credit rating is done for the following instruments:

- Bonds
- Commercial papers
- Fixed deposits/ certificate of deposit/ inter-corporate deposit/ term deposits.
- Fully convertible debentures to be converted before eighteen months of issue.
- Partly convertible debentures maturing before eighteen months of issue.
- Preference shares
- Structured obligation

  In addition to the above, of late, the scope of credit rating agencies has been expanded into the following new areas.
- Rating of Initial Public Offer (IPO’s)
- Rating of real estate projects.
- Rating of collective investments schemes.
- Grading of health care institutions.
- Corporate governance rating
- Line of credit rating
- Rating of Indian states

- Rating of claims paying ability by various institutions
- Sovereign ratings or rating of countries.

Thus, credit rating is not just confined to rating of capital issues but is applicable in a much broader sense.

15.5 THE PROCESS OF CREDIT RATING

The rating process begins at the request of the organization. Credit rating agencies generally do not undertake unsolicited rating, however in certain specific cases, they may conduct unsolicited ratings also. Once the rating agency receives request from the company, they constitute different teams to carry out the assignment. The teams obtain the required data from the company and other stake holders. They may also visits the factories and warehouses to get first hand information about the company being rated.

A rating agency generally assesses business as well as financial risks after taking into consideration various factors that could affect the creditworthiness of the issuer of securities. Besides quantitative factors, qualitative aspects such as management ethics and integrity play a crucial role in determining the rating of a particular issuer. Different credit rating agencies may follow different criteria for assessing various kinds of capital issues. However, the following are the broad and basic aspects that are covered in any evaluation process.

a) **Background and History**: The rating agency analyses and reviews the background and history of the organization by studying its ownership, geographical spread, size, product line, organization structure and so on. Although the history of the issuer is not a guide to its future performance but it certainly provides input as to why an organization performed the way it did, what problems it faced previously, management's response to such problems and other such issues.

b) **Management:** The track record of the management, mission and goals of the management, succession plans, recruitment and training process, management's attitude towards risk, integrity and ethics and similar factors are seriously considered in the rating process.

c) **Business Analysis**: The rating team also considers various other

factors related to the business such as nature of the product, demand and supply of the product, availability of raw materials, supply of skilled and unskilled labor, level of competition, cyclical or seasonal factors, government's regulation to the specific industry, selling and distribution structure and so on.

d) **Financial Analysis**: The financial analysis involves various factors related to future earnings growth, profitability ratios, earning in relation to fixed income charges, adequacy of cash flow in relation to working capital needs, ability to raise funds in case of emergency, sustainability of cash flow and so on. The proper financial analysis provides much of input related to the creditworthiness of the organization.

e) **Other factors with regard to banks and NBFCs**: In addition to the above, the following factors are considered for banks and finance companies.

- Regulatory framework of the financial system.
- Trends in regulation and their impact on the financial entities.
- Relationship of the issuer with government and RBI.
- Capital adequacy of the entity being reviewed.
- Quality of non-performing asset (NPA) of the institution, system of monitoring credit, management of credit risk of the entity, sector risk, exposure of the institution to individual borrowers etc. are considered by the credit rating agencies.
- Capital structure, assets liability management, liquidity position are also important factors in determining the rating of the financial institution.
- Exposure to interest rate changes, tax law changes and hedge against interest rate.

15.6 ADVANTAGES OF CREDIT RATING

The advantages of credit rating services can be divided under following three heads.

a) **Benefits to investors:**

- Credit rating is done by an independent firm, hence it offers a

superior and more reliable source of information on credit risk.

- Credit rating encourages greater information disclosure, better accounting standards and improved financial information. All these helps in invetor's protection.
- Credit rating simplifies the information for investors. Investors need not go into the details of financial statements to understand the risk associated with particular instrument or issuer.
- Credit rating saves time for the investors by helping them to take quick decisions on investments.

b) Benefits to Issuer Company:

- It imposes a healthy discipline on borrower companies to maintain a good image in the public.
- Credit rating acts as a guide to companies which receives lower rating. It warns the management about the probable future risk associated with the business.
- Credit rating helps small and relatively unknown companies to use their rating to bring confidence in investors. Moreover companies with higher credit rating can command funds at lower rate of interest.
- Credit rating agency provides unbiased opinion regarding creditworthiness of the company.
- Credit rating helps issuer of debt instruments to price their issues correctly. They can do so after knowing the rating of their instruments.

c) Benefits to Capital market and its participants:

- Professionally rated debt instruments provide more rational risk-return trade-off in the capital market. The financial intermediaries are in a better position to take decisions with regard to underwriting an issue, loan syndication, corporate counseling and so on.
- Credit rating promotes development of capital market by raising the confidence and interest among investors. Investors are now keen to put money in to good rated instruments.

- Proper credit rating helps merchant bankers, brokers, regulators and other participants, in discharging their functions related to debt instruments.
- Accurate credit rating helps the market regulator in promoting stability and efficiency in the security market.

15.7 DISADVANTAGES OF CREDIT RATING

There are certain problems associated with credit rating process, they are as follows.

- Perfect credit rating is a challenge. A host of inter-related factors needs to taken into account to arrive at accurate rating. Inefficient and inexperienced people doing the rating process can result in inappropriate rating.
- The scope of biasness can prevail in credit rating process as it does not involve any mathematical formula. The element of subjectivity prevails in credit rating process.
- In many cases, the companies provide false and misleading financial information to the rating agencies. Therefore, such rating cannot be accurate.
- The officials of the rating agency may be offered bribe by the company to get better rating.
- The rating of the instruments are not permanent, they are subject to change with the change in the economy. Investors may not know the rating of the different instruments every time they are investing.
- Sometimes, companies give misleading advertisement about the rating symbols of their instruments. They advertise the best rated instruments, while conceal the less rated instruments in their advertisement. Common people will then be easily misguided.



CHECK YOUR PROGRESS

Q 1: Mention Two advantages of Credit ratings to investors:

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Q 2: Mention Two disadvantages of Credit ratings:

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15.8 CREDIT RATING AGENCIES IN INDIA

Presently there are seven credit rating agencies in India.

They are as follows:

1. **Credit Rating Information Services of India Limited (CRISIL):** CRISIL was the first credit rating agency in India set up in January 1988. It was established jointly by ICICI, UTI, LICI, GICI and Asian Development Bank (ADB). The main objective of CRISIL is to rate, on request from companies, their debentures, FDs, short term debt instruments and preference shares. Apart from credit rating, CRISIL also provides corporate reports on public and private sector companies on a regular basis. These reports contain information of their financial, business and technical aspects. In addition to this, CRISIL also undertakes industry studies on request from various industries. CRISIL constantly monitors their ratings and do the necessary changes (upgrade, downgrade, withdrawn) depending on new developments in the concerned company, industry or in the economy.
2. **Investment Information and Credit rating Agency of India Limited (IICRA):** IICRA was the second credit rating agency in India established in January 1991. IICRA was setup by Industrial Finance Corporation of India Limited (IFCI). It is a public limited company with initial paid up capital of ₹s. 35 crores subscribed by IFCI, UTI, LICI, GICI, SBI and 17 other banks. The primary objective of IICRA is to rate short-term, medium-term and long-term debt instruments. However from 1995, it

has been doing equity rating to a certain extent. The rating of the debt instruments is undertaken at the instance of the issuer, while rating of the equities are done at the instance of the investor.

3. **Credit Analysis and Research in Equity in India Limited (CARE):** The CARE was set up in November 1993. It was set up by IDBI in collaboration with few other banks and financial service companies. CARE provides rating services mainly to four types of instruments. They are i) Debentures, ii) Certificates of deposits (CDs), iii) Commercial papers (CPs) and iv) Fixed Deposits. CARE also rates companies for the use by bankers and other lenders and business enterprises.

4. **Onida Individual Credit Rating Agency Limited (ONICRA):** ONICRA was established in November 1993. It has been sponsored by Onida Finance Limited. ONICRA was setup with the objective to assess credit worthiness of individuals seeking finance for purchase of consumer durables or meeting trade deficit. Unlike other credit rating agencies, which rates different instruments of corporate houses, ONICRA rates mainly individual borrowers. In retail credit products like credit card, housing loan, hire purchase agreements and so on involves some risk of default. Hence the lender wants to know the creditworthiness of the individuals seeking above mentioned types of credit. ONICRA does the credit rating for the borrowers. However, ONICRA does not rate individuals seeking credit; it helps the lenders know the amount of risk associated with a credit given to an individual.

5. **Fitch India Limited:** Duff and Phelps Credit Rating India Private Limited was the first joint venture rating company established in 1995. It was promoted by JM Financials, Alliance Group and the international rating agency Duffs and Phelps. With the acquisition of Duff and Phelps Credit Rating Company in April 2000 by Fitch Ratings, it has become Fitch India Limited from 2000. Fitch India rates public securities and private placement securities. It also rates long-term debt, medium term notes, commercial paper and preferred stocks. Its corporate group rates securities of companies engage in various fields.

6. **Brickwork Ratings India Private Limited:** It was founded in 2007 by a group of professionals to provide rating of public issues and others to help investors take informed decisions. The Brickwork Ratings India Private Limited offers following services.
   - Rating of issuer such as state governments, companies, fianancial institutions and banks.
   - Rating of short-term securities such as Certificate of deposits (CDs) and Commercial papers (CPs)
   - Rating of long term instruments such as bonds, debentures and structured products.
   - Rating of Initial Public Offer (IPOs)
   - Rating of FDs, mutual funds, insurance company, Small and Medium Enterprises (SMEs)
   - Rating of bank loan, corporate governance, real estate projects, real estate developers and training and research services.
7. **SME Rating Agency of India Limited (SMERA) :** SMERA is a joint venture started by Small Industry Development Bank of India (SIDBI), Dun and Bradstreet Information Services India Private Limited (D&B) and several leading banks in India. It is the first rating agency in India that focuses primarily on Small and Medium Enterprises (SMEs). The main objective of rating SMEs is to facilitate easier and greater flow of credit to SMEs from banking and financial sector. The SMERA rating categorizes SMEs according to size so as to enable fair evaluation. In general SMERA makes two types of analysis- business risk analysis and financial risk analysis. The factors considered in each type of analysis are different for various categories of industries. For this purpose, it has divided the industries into eight categories like auto ancillary, chemical, engineering, food & food processing, IT & ITES, Logistic, Steel and textile industry.

15.9 SEBI GUIDELINES FOR CREDIT RATING AGENCIES IN INDIA

Credit rating agencies in India are regulated by SEBI. They need to maintain certain regulations. The relevant regulations stipulated by SEBI may be summarized as follows:

- It is mandatory for all credit rating agencies to register with SEBI. They must obtain certificate from SEBI to perform their activities.
- To qualify for registration, the rating agency should comply with the provisions of the SEBI Act, regulations and guidelines of SEBI.
- The certificate of registration is valid for 3 years. The certificate needs to be renewed with SEBI after expiry of registration.
- As per SEBI guidelines, only the following types of organization can promote credit rating agency in India
  - Public financial institutions as per Companies Act, 1956
  - Scheduled commercial bank
  - Foreign bank operating in India
  - Foreign credit rating agency having at least an experience in credit rating activities for five years
  - Any company having net worth of at least ₹s. 100 crore and incorporated under the Companies Act, 1956
- The applicant shall also fulfill certain eligibility criteria. The important ones are mentioned below
  - The applicant is set up and registered as a company under the Companies Act, 1956
  - The applicant has a minimum net worth of ₹s. 5 crore
  - The applicant has adequate infrastructure to enable it to provide rating services in accordance with the provisions and regulations of SEBI.
  - The applicant and the promoters of the applicant have professional competence, financial soundness and general reputation of fairness and integrity in business transactions to the satisfaction of SEBI.



15.10 LET US SUM UP

In this unit we have discussed the following aspects —

- Credit rating is an important financial service. It helps investors in making investment decisions.
- The rating assigned by various credit rating agencies indicates whether the issuer of securities will be able to meet their obligation with respect to payment of interest and principal as per the terms and conditions stated in the certificate of securities.
- The credit rating agency employs both qualitative and quantitative criteria for assessing the creditworthiness of the issuer.
- The ratings are expressed in symbols or code numbers so that it can be understood by a lay man. Symbols such “AAA”, “A+”, “BBB”, “B-” or 1,2,3,4 may be used for rating.
- Credit rating can be done for a specific debt instruments or for the organization that issues the securities.
- The rating process begins at the request of the organization.
- A rating agency generally assesses business as well as financial risks after taking into consideration various factors that could affect the creditworthiness of the issuer of securities.
- CRISIL, IICRA, ONICRA, CARE etc are few credit rating agencies in India.
- Credit rating agencies in India are regulated by SEBI.



15.11 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
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6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.



15.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) Credit rating is done by an independent firm, hence it offers a superior and more reliable source of information on credit risk.

ii) Credit rating encourages greater information disclosure, better accounting standards and improved financial information. All these helps in invetor's protection.

Ans to Q No 2: i) Perfect credit rating is a challenge. A host of inter-related factors needs to taken into account to arrive at accurate rating. Inefficient and inexperienced people doing the rating process can result in inappropriate rating.

ii. The scope of biasness can prevail in credit rating process as it does not involve any mathematical formula. The element of subjectivity prevails in credit rating process.



15.13 MODEL QUESTIONS

Q 1: Discuss the features of Credit Rating.

Q 2: What is the scope of Credit Rating.

Q 3: Discuss the Process of Credit Rating.

Q 4: List the advantages of Credit Rating.

Q 5: List the disadvantages of Credit Rating.

Q 6: Write short notes on:

a. CRISIL

b. IICRA

c. ONICRA

d. CARE

Q 7: Discuss the SEBI guidelines for Credit Rating Agencies in India.

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1) Financial Services (2011) by ThummuluriSiddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), byJaydebSarkhel&SeikhSalim; McGraw Hill Education (India) Pvt. Ltd.
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