

# PONDICHERRY UNIVERSITY

(A Central University)

## DIRECTORATE OF DISTANCE EDUCATION

### MASTER OF COMMERCE



M.Com – Second Year

Course Code:  
59

Paper Code:  
MCOM2002

**MERCHANT BANKING AND FINANCIAL SERVICES**

**DDE – WHERE INNOVATION IS A WAY OF LIFE**

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**PAPER -XIII****Merchant Banking and Financial Services****Objectives**

- To examine Financial Services management as an important and contemporary area of financial management
- To understand the various financial services and their future
- To determine the most suitable financial service, given the situations and contingencies

**Unit-I**

Financial Services Industry – Emergence – Developments – Fund Based and Non-fund based activities – modern activities – New Financial Products and Services, Innovative Financial Instruments – Challenges Ahead.

**Unit-II**

Merchant Banking - Issues Management Intermediaries – Merchant Bankers/Lead Managers –Underwriters – Bankers, Brokers and Registrars to an Issue and Share Transfer Agents– Debenture /Trustees – Portfolio Managers – Issue Management Activities/Procedures – Eligibility norms – Pricing of Issues – Promoters' contribution – Issue of Indian Depository Receipts (IDR) – Issue Advertisement – Issue of Debt Instruments – Book building – Greenshoe Option – Initial Public Offer through Stock Exchange Online System – Preferential Issues – Qualified Institutional Placement.

**Unit-III**

Factoring and Forfeiting - Modus Operandi, types, functions – Factoring in India - Bills Discounting – Real estate Industry – Housing Finance – Housing Finance system – National Housing Bank – Refinance

scheme for HFCs – Asset Liability Management - Securitisation – Mortgage-Based Securitisation – Reverse Mortgage Loan (RML) Securitisation of Standard Assets.

#### **Unit-IV**

Mutual Funds - Origin, Types of Mutual Funds, Importance, Mutual Funds Industry in India – SEBI's directives for Mutual Funds, Private Mutual Funds, Asst Management company – Unit Trust of India – Evaluation of Performance of Mutual Funds – Money Market Mutual Funds - RBI Guidelines – Venture Capital: Meaning, Origin, Importance, Methods, India Scenario.

#### **Unit-V**

Insurance - Meaning, Types, Insurance Industry in India and related reforms – Other Financial Services - Credit Cards - Credit Rating: Regulatory framework – Credit Rating Agencies – Rating Process and Methodology - Rating symbols/Grades – Pension Plan.

#### **References**

**Khan, M.Y.**, FINANCIAL SERVICES, *Tata McGraw Hill, New Delhi, 2001.*

**Gurusamy**, MERCHANT BANKING AND FINANCIAL SERVICES, *Tata McGraw Hill, New Delhi, 3<sup>rd</sup> ed. 2009.*

## UNIT -1

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### Financial Services Industry

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#### Learning Objectives

*After studying this unit you can be able to:*

- understand the concept of Financial Services
- know the emergence and developments of Financial services in India
- acquire the knowledge of various fund based and fee based financial services
- familiarize about innovative financial products and Instruments
- observe the challenges ahead for financial services sector

#### Unit Structure

Lesson 1.1 - Financial Services Industry – Developments and Activities

Lesson 1.2 - Innovative Financial Instruments and Challenges

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## Lesson 1.1 - Financial Services Industry – Development and Activities

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### Introduction

The development of a sophisticated and matured financial system in India, especially in the era of Liberalization, Privatization and Globalization (LPG), led to the emergence of a new sector known as **Financial Services Sector**. Financial services sector plays a significant role in any modern economy. Its objective is to act as intermediary and facilitate financial transactions of individuals and institutional investors. The bundle of institutions that make up an economy's financial system can be seen as “the brain of the economy”, providing the bulk of the economy's need for many functions.

### Meaning of Financial Services

The term financial service in its broader sense refers to “mobilizing and allocation of savings”. It is identified as all those activities involved in the process of converting savings into investments. Financial services also include **Financial Intermediaries** such as, Merchant Bankers, Venture capitalists, Commercial banks, Insurance Companies etc.

### Definition of Financial Services Industry

It may be defined as “the collection of organizations which intermediate and facilitate financial transaction of individual and institutional investors resulting from their resources allocation activities through time.”

The financial services include all activities connected with the transformation of savings into investment.

### Classification of Financial Services Industry

The financial services industry can be traditionally classified into *two categories*:

- i) Capital market intermediaries, consisting of term lending institutions and investing institutions providing long-term funds.
- ii) Money market intermediaries, including commercial banks, co-operative banks and other agencies, which supply funds for short-term requirements.

Therefore, the term financial services include all kinds of organizations, which act as intermediary and facilitate financial transactions of both individuals and corporate customers.

The entities that provide these services are classified into the following categories:

- Non-Banking Finance companies (NBFCs)
- Commercial banks and
- Investment bank

### **Emergence and Development of Financial Services in India**

Financial services sector is blooming in India and it has passed through various phases as mentioned below:

- i) Initial phase (1960-80) – Merchant Banking Era
- ii) Second phase (1980-90) – Investment Companies Era
- iii) Third phase (1990-2002) – Modern Services Era

#### **i) Initial Phase**

Innovative services like Merchant banking, Insurance and Lease Finance are introduced at the initial phase. The functions of Merchant bankers start from project appraisal and end at mobilization of funds. It includes underwriting of shares for public issues and listing of shares in the stock exchange. These functions are initiated by LIC, GIC, and UTI. In addition to this, leasing service is also initiated in the year 1970. Leasing service was started with *equipment lease financing*. Slowly, the leasing companies engaged in other types of lease such as, financial lease and operating lease.



## **ii) Second Phase**

Value added services like, over the counter share transfers, pledging of shares, mutual funds, factoring, discounting, venture capital and credit rating are introduced in the second phase. The major contribution to the industry is from mutual fund in the developed countries. Capital market malpractices have come down due to the introduction of credit rating services. Initially the rating was applied only to debt instruments and now-a-days, it is mandatory for the instruments, commercial papers and fixed deposits.

## **iii) Third Phase**

In the era of post liberalization, financial services sector introduced new financial instruments and set up new institutions. During this phase, the contemporary issues like depositories, online trading, paperless trading, dematerialization, stock lending schemes and book building method of stock issues are initiated. Book building method of stock issues has become popularized because it helps both investors and issuing companies. Foreign Institutional investors (FIIs) are allowed to enter into the Indian capital market.

## **Present Scenario**

### **i) Conservatism to Dynamism**

The liberalization of financial sector has built the revolutionary changes in the Indian financial system. This reform is made to bring an efficient, competitive and diversified financial system in the country. Present trend of Indian financial services sector is moving towards dynamism.

### **ii) Emergence of Primary Equity Market**

Raising finance through capital market is the major phenomena. Indian primary markets have become very active since the entrance of the private sectors in the financial services industry.

**iii) Concept of Credit Rating**

The debt instruments are rated by Credit rating agencies. It helps the investors in finding a profitable and safe debt investment. The rating symbols indicate safety and risk of the instruments. Now-a-days, rating service is extended to equity securities also, which helps the investors to cautiously invest their savings.

**iv) Process of Globalization**

The entry of innovative and sophisticated financial products is possible in our country due to globalization. The obstacles in Indian financial sector are slowly eliminated by the Government of India. It paves the way for introducing innovative financial products.

**v) Process of liberalization**

The financial services reform is initiated by Government of India. Reformation is made in the mode of liberalization activities like deregulation of interest rate, privatization of banking and mutual fund sectors and amendment of companies act, MRTP act, Income tax act etc.

**Nature and Characteristics of Financial Services**

- Service provider and user (individual or firm) are involved in the process of financial services.
- Financial institutions are acting as intermediaries in the flow of funds.
- Corporate sector procure public funds smoothly and within the required time with the help of financial services sector.
- Services are based on customers' needs.
- They are consistently dynamic and convincing services.

**Functions of Financial Services Institutions**

- They help the firm or corporate not only to raise fund but also for efficient deployment of funds.
- They help to construct the capital structure of the company.

- They also do the factoring and forfaiting services.
- They do both traditional services like financing, bills discounting and contemporary services like e-commerce, securitization of debts etc.,
- The specialized services like credit rating, venture capital, lease financing, factoring, mutual funds, merchant banking, stock lending, depository, credit cards, housing finance etc., are also provided by them.

### **Constituents of Financial Services**

The major components in the financial system are:

- a) Financial instruments
- b) Market players
- c) Specialized Institutions
- d) Regulatory bodies

#### **a) Financial Instruments**

Financial instruments in the Indian financial system may be categorized into *Money Market instruments and capital Market instruments*.

#### ***Money Market Instruments***

The instruments which deal in the money market are of short-term nature. Their maturity period usually varies between 14 and 364 days. Money market instruments are:

- Treasury Bills
- Bills of Exchange or Trade bills
- Finance bills or usance promissory notes
- Commercial Paper
- Certificates of Deposits

***Capital Market instruments***

The instruments which deal in Capital market are of long-term nature. There are various types of securities such as:

- Equity shares
- Preference shares
- Debentures
- Gilt-edged securities
- Zero coupon bonds
- Deep discount bonds
- Option bonds
- Derivative securities - options, futures etc.,

**b) Market players**

The players in the market include:

- i. Commercial banks
- ii. Finance companies
- iii. Stock brokers
- iv. Consultants
- v. Underwriters
- vi. Market makers

***i. Commercial Banks***

In the developed countries, commercial banks are not only providing loans but also participating in the debt and equity finance of the corporate sector. Now-a-days all commercial banks in developing countries are also engaged in merchant banking services, hire purchasing finance, leasing, factoring, mutual funds, insurance and other services.

***ii. Finance companies***

The role of Finance companies is vital in the economic growth. It is also called as Non-banking finance company whose business is receiving deposits besides engaging in any of the following activities:

- Financing by way of loans, advances etc.,
- Acquisition of shares/stocks/bonds/debentures/securities
- Hire-Purchase
- Any class of insurance, stock broking etc.
- Chit funds and
- Collection of money by way of subscription/sale of units or other instruments/any other manner and their disbursement.

### ***iii. Stock Brokers***

The role of stock brokers is very important in stock market. They act as an agent and bridge between buyer and seller of securities in a recognized stock exchange. They should have obtained certificate of registration from SEBI after satisfying all the terms and conditions. The certificate from SEBI is mandatory to act as stock brokers. They may get an individual membership or corporate (firm) membership.

### ***vi. Consultants***

Corporate sector may get expert advice or opinion for their decision making. Those experts are specialized in the field of finance and they are called as Finance experts or professionals. They give only consultancy service in all areas of functional management such as production, finance, marketing and human resources management.

### ***v. Underwriters***

Underwrites are important intermediaries in the new issue/primary market to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by themselves or others. They are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. They get commission from issuing company for the assurance of subscribing to the stocks of issuing company.

### ***vi. Market makers***

The system of market making is popular in stock exchanges like London, New York and Chicago. A market maker is a bank or brokerage

company that stands ready every second of the trading day with a firm 'ask and bid price'. They actually purchase the stock from the seller even without any offer from the buyers' side. The market maker maintains a spread on each stock to prevent the risk of fall in price of stock. The temporary disparity between the supply and demand for scrip is eliminated by them.

### **c) Specialized Institutions**

Specialized institutions are providing financial services in various forms such as Acceptance Houses, Discount houses, Factors, Depositories, Credit rating agencies, Venture capital etc. Financial market is dynamic and solves the contemporary issues of corporate sectors through these specialized service providers.

### **d) Regulatory Bodies**

Regulatory body is controlling authority of financial system. Reserve Bank of India (**RBI**) and Securities Exchange Board of India (**SEBI**) are the regulatory body of Indian monetary system. They are statutory bodies who have power of monitoring and regulating the entire financial system of India. Financial market must be closely monitored and regulated because it is highly volatile. RBI is central bank of India and it is the prime authority to monitor and control the affairs of entire banking system of our country. SEBI is the sole authority of monitoring, directing, regulating and controlling Financial Market (**stock market**). There are other regulatory bodies to regulate the corporate affairs such as company law board, Industrial board etc.

### **Factors Affecting Access to Financial Services**

A number of factors affecting the access to financial services have been identified. These are

1. Gender Issues
2. Age Factor
3. Legal Identity
4. Limited literacy
5. Place of Living

6. Psychological Barriers
7. Cultural Barriers
8. Social Barriers
9. Social Security Payments
10. Level of Income
11. Bank Charges
12. Terms and Conditions
13. Types of Occupations
14. Caste and Religion
15. Attractiveness of the product
16. Cumbersome Procedures
17. Bias of Financial Institutions
18. Prides and Prejudices of the white caller
19. Wrongful Assessment
20. Willingness to spread service
21. Employment Barriers
22. Lack of Opportunities
23. Owning assets
24. Difficulty in smoothening income to cope with shocks
25. Exclusion from mainstream society

### **Scope of Financial Services**

Financial services cover a wide range of activities. They can be broadly categorized into two parts, namely:

- (a) Traditional activities
- (b) Modern activities

#### **(a) Traditional Activities**

Conventionally the financial services are identified under two heads:

1. Fund based activities and
2. Non-fund based activities

The traditional services which come under ***Fund Based Activities*** are the following:

- Underwriting of shares, debentures etc
- Dealing in foreign exchange market activities
- Lease Financing, hire purchase, venture capital, Factoring and Forfaiting,
- Housing Finance, Insurance Services, Venture Capital financing etc.
- Dealing in secondary market activities
- Participating in money market instruments like treasury bills, discounting bills, commercial papers etc.

***Non-Fund Based Activities Include***

- The management of capital issues (pre and post issue management)
- Arrangement for the placement of capital and debt instruments with investment institutions
- Arrangement of funds from financial institutions
- Arrangement of working capital for clients
- Assisting in the process of obtaining government Clearance.

**(b) Modern Activities**

It includes

- Rendering project advisory services, right from the preparation of the project report till the raising of funds for starting the project
- Planning for mergers and acquisitions and assisting for their smooth carry out.
- Directing corporate customers in capital restructuring
- Acting as trustees to the debenture holders
- Recommending suitable changes in the management structure and management style envisaging achieving better results.
- Portfolio management of large public sector undertakings



- Capital market services such as, Clearing services, Registration and transfers, collection of income on securities etc.

Let us discuss in brief some of fund based and fee based services

### **a) Leasing**

A Lease is a contract between owner of the asset and beneficiary. Owner of the asset is called lessor and the beneficiary is called lessee. The lessee has the right to possess and to use the asset on payment of the specified rentals over a predetermined period of time.

### **Steps involved in Leasing**

A contract of lease provides a person an opportunity to use an asset which belongs to another person. The following steps are involved in a leasing transaction:

- The lessee identifies the need for the equipment and selects the supplier.
- The lessee approaches a leasing company or Lessor to lease the equipment needed.
- The lessee has to furnish the following information:
  - Name and address of lessee
  - Details about his business
  - Name and address of guarantor, if any
  - Description of the equipment
  - Name and address of the supplier and the quoted price
  - Place of installation
  - Duration of the lease.
- The Lessor examines the proposal after receiving the particulars from lessee and evaluates the credit-worthiness and rent paying capacity of the lessee.
- The Lessor and Lessee enter into lease agreement. It contains the terms and conditions of the lease such as, lease period, rental

payments, details regarding renewal of lease period, cost of repair and maintenance, insurance and any other expenses etc.,.

- After the lease agreement is signed, the Lessor requests the manufacturer to supply the asset to lessee.

## **Types of Leasing**

### **Financial Lease**

Financial lease is an alternative to borrowing money and buying the equipment. The features of financial lease are:

- The machinery is selected from the supplier by lessee based on his requirement.
- The lessee negotiates the terms of the purchase i.e., price, delivery, installation, warranties, maintenance and payments.
- The payment for purchases is made by Lessor and he is the legal owner of the machinery.
- The risk of obsolescence and responsibility for maintenance are to be borne by lessee.
- Lessee has to pay rent regularly.

### **Operating Lease**

Operating lease is a rental agreement and its features are as follows:

- The period of the operating lease is generally shorter than the economic life of the leased asset.
- The 'lessor' bears the risk of obsolescence and responsibility of maintenance of asset.

### **Sale and Lease Back**

It is an agreement between owner of the asset and leasing company. First, the firm (owner) sells the asset to the Leasing Company and leases it back simultaneously. The ownership of the asset transfers to the leasing company, the company in turn leases it to the seller and the seller becomes lessee.

## **Cross Border Lease**

The lease agreement is made between the persons of two countries. Lessor and lessee are domiciled in different countries, the lease is said to be cross-border lease.

## **Merchant Banking**

The term 'Merchant banker' was used in relation to a wealthy merchant, who developed the banking side of one's business, in England. In India, merchant banking definition is framed in **SEBI rules 1992**. It defines merchant banker as “ *any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management.*”

## **Role of Merchant Bankers in the Capital Market**

The Role of merchant banker in the process of issue management is vital and his services are broadly categorized as pre-issue management and post issue management.

### ***I. Pre-issue management involves the following:***

- Obtaining approval for the issue from SEBI
- Drafting of prospectus and getting it approved by various authorities concerned.
- Underwriting
- Drafting the documents like application forms, newspaper advertisements etc.,
- Process of advertisement
- Selection of registrar to issue, printing press, advertising agencies, brokers and bankers to issue
- Arranging press conferences for brokers and investors
- Selection and fixation of collection centre for receiving application money
- Listing of securities in stock exchange

## **II. *Post issue management includes the following:***

- Collection of application forms
- Screening the applications
- Deciding allotment procedure
- Mailing of letter of allotment
- Issue of share certificates
- Refund of application money to non-allottees.

## **III. *Advisory services relating to mergers and takeovers***

- A merchant banker acts as a 'liaisoning officer' for mergers and acquisitions.
- He helps the company in managing its portfolio.

## **IV. *Off shore financing***

Merchant bankers help their clients in off shore financing such as long term foreign currency loans, joint ventures abroad, licensing and franchising, financing exports and imports, foreign collaboration arrangements etc. In addition to this, it provides advisory services like identification of investment opportunities, selection of securities, and investment management to non-resident Indians and also they help in operational activities like purchase and sale of securities, securing necessary clearance from RBI. Issue Management activities of Merchant Bankers are discussed in detail in Unit-2.

## **Mutual Fund**

*'A mutual fund means pooling the investments of a number of investors by way of investment in units of equal size'.* They are financial intermediaries which collect funds from the public and invest them in a diversified portfolio of securities, including equity, bonds debenture and other instruments issued by business or government undertakings. The purpose of mutual fund is to help small investors participate in the securities market indirectly with reduced risk for small investors by diversifying the investment into various types of securities of different corporations and industry. Unit Trust of India is the first mutual fund in India and it was established in the year 1964. Initially, UTI launched the scheme of **Unit**

**Scheme 64** and slowly, the mutual fund growth scheme was launched in 1986. The success of this scheme encouraged other institutions such as SBI mutual funds, Canbank mutual funds, LIC of India etc to enter this field. Private sectors are also allowed to enter the mutual fund industry and at present there are 40 mutual fund companies in India.

### **Benefits of Mutual Funds**

- Small investors can get diversified portfolio of assets which reduces the risks of investment.
- Small investors are not aware of risk and return in various investments. Mutual Funds remove the effects of this ignorance as they are having expert team to manage the fund.
- Mutual Fund Units can be traded in the secondary market by the small investors or it can be repurchased by the Mutual fund itself.
- Investors can get tax-relief under section 80L of the Income Tax Act.
- Mutual funds are guided and regulated by SEBI and hence, investors are protected from risk of loss.

The detailed note about Mutual Fund is given in Unit-4.

### **Credit Rating**

Credit rating means giving an expert opinion by a rating agency on debt instruments. The agency evaluates the repaying capacity of the issuer of such instruments. Ratings are denoted by symbols e.g. AAA – highly secured, BB-Moderate, c – high risk and D-default.

It is defined as “a process by which a statistical service prepares various ratings identified by symbols which are indicators of the investment quality of the securities rate.”

### **Benefits of Credit Rating to the Investor**

- Investors get expert opinion (credit rating agency) about the quality of the debt instrument through easy and simple indicator (symbol).

- It becomes guidance to the investors regarding the commitment towards a particular debt instrument for better returns.
- The risk and return relationship is established by the rating agency.
- The scale of risk is measured and indicated by way of symbols.

### **Benefits of Credit Rating to the Issuer**

- Highly rated debt instruments get easy marketing access.
- It helps pricing of securities.

### **Credit Rating Agencies in India**

- Credit Rating and Information services of India (CRISIL)
- Investment Information and Credit Rating Agency of India Limited (IICRA)
- Credit Analysis and Research Limited (CARE)
- Onida Individual Credit Rating Agency of India Limited. (ONICRA)
- Duffs and Phelps Credit Rating India (DCRI)

It is discussed in detail in Unit-5.

### **Venture Capital**

Venture capital is a method of financing high risk projects promoted by entrepreneurs. The purpose of financing is to execute the ideas of entrepreneurs. The risk level is very high. It can be in the form of equity participation.

### **Features of Venture Capital**

- It is a form of equity financing.
- The projects which involve high risk, hi-tech and growth-oriented.
- Mostly it provides financing for small and medium scale business and it may enter into partnership with them.
- This type of financing is exclusively for commercialization of new ideas.

- After making investment, venture capitalists have permanent monitoring system and take part in the business activities.

We may discuss elaborately about Venture Capital in Unit-4

### **Factoring**

Factoring is a fund based financial service. It is defined as a relationship between the banker (factor) and a business concern (the supplier), selling goods or providing services on credit, whereby the factor purchases book debts either with or without recourse to the supplier. And also it undertakes the task of recording, collecting, controlling and protecting the book debts.

#### **Factoring Involves the Following Functions**

- a) Purchase and collection of debts
- b) Management of sales ledger
- c) Credit investigation, protection and control
- d) Financing
- e) Advisory services

The detailed notes about Factoring, Forfeiting and Housing Finance are given in Unit-3.

### **Conclusion**

The Financial services the world over has undergone a profound transformation since the early 1990s. The changed operating environment for the financial intermediaries, underpinned by globalization, deregulation, advancement in information technology, introduction of innovative instruments and management practices has resulted in intense competition pressures to provide financial services. This has exposed the financial system/financial intermediaries to newer risks and posed serious regulatory and supervisory challenges.

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## **Lesson 1.2 - Innovative Financial Instruments and New Institutions**

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### **Financial Instruments: Recent Innovation**

#### **Financial Engineering**

Financial Engineering is the life blood of any financial ability. “Financial engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance.

Wall Street has developed numerous innovative financial instruments in recent years. These new financial instruments are classified according to the following traditional categories:

1. Debt instruments,
2. Equity, and
3. Hedging instruments.

#### **1. Debt Instruments**

##### **Commercial Paper**

Unsecured short-term (up to 270 days) obligations issued through brokers or directly. The interest is usually discounted. Universal commercial paper is foreign currency denominated commercial paper that trades and settles in the United States.

##### **Convertible Bonds**

Debt securities those are convertible into stock of the issuer at a specified price at the option of the holder.



### **Carrot and Stick Bonds**

Carrots have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

### **Convertible Bonds with a Premium Put**

Convertible bonds issued at face value with a put option entitling the bondholder to redeem the bonds for more than their face value.

### **Debt with Equity Warrants**

It means bonds issued with warrants for the purchase of shares. The warrants are separately tradable.

### **Dual-Currency Bonds**

Bonds denominated in one currency, for which interest is paid in the same currency but are redeemable in another currency is known as dual-currency bonds. It allows interest rate arbitrage between two markets.

### **COPS (Covered Option Securities)**

‘Covered option securities’ is a short-term debt that gives the issuer an option to repay the principal and interest in U.S. dollars or a mutually acceptable foreign currency.

### **ECU Bonds (European Currency Unit Bonds)**

A Eurobond denominated in a basket of currencies of the 10 countries that constitute the European Community is called ECU bonds. The bonds pay interest and principal in *ECUs* or in any of the 10 currencies at the option of the holder.

**ICONS (Indexed Currency Option Notes)**

A bond denominated and paying interest and principal in dollars but with principal payments linked to the exchange rate of another currency is known as ICONs.

**PERLS (Principal Exchange-Rate-Linked Securities)**

Securities paying interest and principal in dollars but with principal payments linked to the exchange rate between the dollar and a second currency is called as PERLS.

**Flip-Flop Notes**

It is an instrument that allows investors to switch between two types of securities – for example, to switch from a long-term bond to a short-term fixed-rate note.

**FRNs (Floating Rate Notes)**

It is a Debt instrument. Its feature is periodic interest rate adjustments.

**Capped Floater**

It is an FRN with an interest rate ceiling.

**Convertible FRNs**

The feature of Convertible FRNs is that the issuer can convert the FRNs into long-term fixed rate bonds.

**Drop-Lock FRNs**

In this type of the instrument, FRNs automatically are converted to fixed-rate bonds when short-term interest rates fall below a specified level.

### **Minimax FRNs**

Minimax FRNs are those FRNs which have upper and lower interest limits.

- **Indexed debt instruments:** Instruments with guaranteed and contingent payments, the latter being linked to an index or prices of certain commodities (oil or gold, for example) are called Indexed debt instruments.

### **Bull and Bear Bonds**

Bonds linked to upward and downward movements in a designated index are called Bull and bear bonds. Bulls yield more in a rising market; bears yield more in a falling market.

### **SPINs (Standard and Poor's Indexed Notes)**

A debt instrument interest payment of which is linked to the performance of the Standard and Poor's stock indexes is called **SPINs**.

### **Put Bonds**

Bonds that the investor can put (or tender) back to issuer after a specified period are known as put bonds.

### **Stripped Government Securities**

It is a type of zero coupon bonds. These securities represent long-term Treasury bonds "stripped" of semiannual interest coupons by an investment banker who resells these coupons and an interest in the principal payments. Investment banks market these stripped securities under such registered acronyms such as

- Certificates of Accrual on Treasury certificates (**CATs**)
- Certificates of Government Receipts (**COUGRs**)
- Sterling Transferrable Accruing Government Securities (**STAGs**)

- Separate Trading of Registered Interest and Principal of Securities (STRIPs)
- Treasury Investment Growth Registered certificates (TIGRs)
- Zero Coupon Euro sterling Bearer or Registered Accruing Certificates (ZEBRAs)
- Zero-coupon bonds - A bond that's sold at a deep discount from its face value is known as Zero coupon bond. It carries no interest coupon, but investors receive the gradual appreciation to the face value.
- LYONs - Liquid Yield Option Notes
- Liquid Yield Option Notes are Zero-coupon bonds which are convertible into the issuer's common stock.

### Asset-Backed Securities

#### *CMOS: (Collateralized Mortgage Obligations)*

It is debt obligations that are backed by a pool of whole mortgages or mortgage-backed securities. They are of two types

- ***Mortgage-backed securities*** (A participation in an organized pool of residential mortgages)
- ***Securitized receivables*** (Debt securities collateralized by a pool of receivables)

## 2. Equity Instruments

### MMP – 'Money Market Preferred Stock' or 'Dutch Auction Preferred Stock'

'Dutch Auction Preferred stock' is an action in which the securities are sold at the lowest yield necessary to sell the entire issue. Several investment banks have issued these instruments under such registered names as **CAMPS- Cumulative Auction Market Preferred Stock**.

## CMPS - Capital Market Preferred Stock

It is a convertible Money Market Preferred stock that can be converted into common stock. Examples:

- **DARTS** - Dutch-Auction Rate Transferable Securities
- **FRAPS** - Fixed Rate Auction Preferred Stock
- **MAPS** - Market Auction Preferred Stock
- **STARS** - Short-Term Auction Rate Cumulative Preferred Stock
- **STRAPS** - Stated Rate Auction Preferred Stock
- **PIK (pay in kind) preferred stock** - **Dividends** are paid in additional shares of preferred stock
- **Exchangeable PIK preferred stock** - The issuer can convert the PIK stock into debt.

## 3. Hedging Instruments

A strategy employed in the futures, options and warrants markets to reduce risk by making a transaction in one market to protect against a loss in another. Traditionally a commodity producer (say, a cocoa grower) would agree to sell his goods at a stated price at a stated time in the future, and the user of the commodity (say, a chocolate manufacturer) would agree to buy them. By agreeing on a price, quantity and delivery date, they introduce certainty into their operations and reduce risk. For the producer, the risk would be that prices drop, and for the processor that they would rise. In the financial markets, options and warrants can be used to hedge a portfolio position. In the case where shares have been sold, for example, the purchase of equivalent call options (the option to buy shares) means that if the shares rise in price, a corresponding rise in the value of the option will offset the notional loss expected on the underlying shares.

The following are some of the hedging instruments:

- **Butterfly spread** - Options strategy involving two calls and two puts in the same or different markets, with several maturity dates
- **Calendar spread** - Options strategy that involves buying and selling options on the same security with different maturities.

- **Cancelable forward exchange contracts** - The holder has the unilateral right to cancel the contract at maturity.
- **CIRCUS** - Combined currency and interest rate swap.
- **Convertible Option Contracts** - A foreign currency option that converts to a forward contract if the forward exchange rate falls below a trigger price.
- **Cross-hedging** - Hedging one exposure with an instrument pegged to another market or index.
- **Cylinder options** - A combined call option and put option on currency.
- **Range Forwards** - A forward exchange contract specifying a range of exchange rates within which currencies will be exchanged at maturity.
- **ZCRO (zero cost ratio option)** - A cylinder option with a put written in an amount offsetting the call premiums.
- **OPOSSMS** - Options to purchase or sell specified mortgage-backed securities.
- **Perpendicular spread** - Options strategy using options with the same maturities but different strike prices.
- **Swaption** - An option to enter or be forced to enter a swap.
- **Synthetic instruments** - Two or more transactions that have the effect of a financial instrument. For example, a fixed-rate bond combined with an interest rate swap can result in a synthetic floating rate instrument.
- **Zero-coupon swap** - A swap of zero-coupon debt into floating rate debt.

Emergence of New Institutions/Bodies in the Indian Financial system in the recent past

### **Securities and Exchange Board of India (SEBI)**

During early 90's, there were vulnerable scams in the Indian stock market. The controlling system was emerged to control the stock market scams. Hence, the SEBI (stock exchange Board of India) was established in the year 1992 as the regulatory body of the Indian capital market. SEBI

has statutory status and governing body of Indian stock exchanges. It has entrusted powers of provisions under the Companies Act, 1956 and Securities Contract Regulation Act, 1956. The financial intermediaries who want to deal as stock brokers, share transfer agents, banker to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers in the securities market must register with SEBI.

### **National Securities Depository Limited (NSDL)**

NSDL is the first Depository in India, which was established under Depositories Act in the year 1996. The purpose of setting up of NSDL is to remove the hindrances of physical transfer of securities and convert the physical transfers of securities into the electronic form (demat).

NSDL performs their functions through depository participants. They are:

- **Dematerialisation:** Dematerialisation is the conversion of physical certificates into 'demat' holdings at the request of investors.
- **Rematerialisation:** the conversion of dematerialized holdings back into physical certificates is called rematerialisation.
  - It receives the securities of depository participants.
  - It maintains investor holdings in the electronic form
  - Effects settlement of securities traded on the exchanges
  - Transfer of securities
  - Pledging of dematerialized securities
  - Electronic credit in the public offerings of companies
  - Bonus and rights issues shares accepted in the form of electronic
  - Stock lending and borrowing.

### **Clearing Corporation of India Limited (CCIL)**

CCIL was established in April, 2001 as a Joint Stock Company with share capital contribution by major banks and financial institutions. CCIL is a platform for the payment and settlement system in the Indian financial market. It provides an electronic, efficient, transparent, risk mitigated

clearing and settlement process to its members in gilts and foreign currency markets.

### **Important Milestones**

- Date of Commencement of Securities Settlement from February 2002
- Commencement of Guaranteed Settlement April, 2002
- Settlement of Forex transactions started since November 2002
- Launching of the Collateralised Borrowing and Lending Obligation (CBLO) in January 2003
- Development of a FOREX trading platform “FX-CLEAR” since August 2003.
- Starting the settlement of cross-currency deals through the CLS Bank from April 6, 2005.
- RBI introduced the system of Negotiated Dealing System-Order Matching (NDS-OM) in August 2005. NDS-OM is an electronic, screen based, anonymous, order driven trading system for dealing in Government securities. CCIL maintains the system of NDS-OM. The Reserve Bank regulates the CCIL under the Payment and Settlement Systems Act, 2007.
- The NDS-Auction module was developed by CCIL for Treasury Bills auction by RBI.

CCIL is facilitating to constant enrichment in market transparency and efficiency in India’s Money, Debt and FOREX markets.

### **Asset Reconstruction Company India Limited (ARCIL)**

Asset Reconstruction Company India Limited is a financial institution, which was established under Reserve Bank of India (RBI) under Section 3 of the SRFAESI (Securitisation and Reconstruction of Financial Assets & Enforcement of Security Interest) Act 2002. It was formed as a Securitization and Reconstruction Company to acquire nonperforming assets (NPAs) from financial institutions and banks with the objective of focused management of these assets and maximization of recovery.



## Developments in the Sector

In the last two decades, the enormous changes have taken place in the development of financial services. Some important determinant factors are the cause of such changes in the financial sector services. These are:

- a) Financial Sector Reform
- b) Technological Developments
- c) Consolidation
- d) Globalization of Financial Services
- e) Changing Role of Financial Services Providers
- f) Competition and Outsourcing

### a) Financial Sector Reform

The noteworthy financial sector reform was made all over the world in the last two decades by way of Liberalisation, Privatisation and Globalization (LPG) for reducing or eradicating the deformations in financial markets and reinforcing financial institutions.

### b) Technological Developments

The scenario of global financial system is often changing due to the Technological developments i.e. internet.

### c) Consolidation

The enduring consolidation of financial institutions is one of the most prominent contemporary features of the financial landscape both within and across many industrial countries. The leading financial services firms are increasing in size due to merger in the conglomerate and also in financial services industry. The amalgamation/absorption process involves two facets in the financial industry namely ***same line of business and multiple lines of business***. The global financial crisis of 2007-08 had accelerated the trend towards financial industry mergers and the weakened firms had been forced to merger with stronger rivals.

#### **d) Globalization of Financial Services**

Globalization of Financial services sectors are increasing in the present scenario of financial system. The market shares of Foreign –owned banks and foreign financial services providers have increased drastically in East Asia, Eastern Europe and Latin America. Cross-border trade in financial services is also an important component of services exports worldwide.

#### **e) Changing Role of Financial Service Providers**

In the contemporary world, nationalized banks are doing fee based and fund based financial services (merchant banking, mutual funds, insurance, venture capital, etc.). Non-banking and other financial institutions are providing banking products also. The scope of financial service provider is expanded at large.

#### **f) Competition and Outsourcing**

Outsourcing is contracting with another company or person to do a particular function. The contract taking place in the cross-border is called 'off shoring'. Outsourcing is a cost reduction activity and it is essential in the competitive environment. This outsourcing/offshoring has become a significant feature of the international financial services sector.

### **Recent Developments**

- India has launched the country's first domestic payment card network, RuPay, to compete with multinational Visa Inc. and MasterCard Inc. The new development will not only help banks reduce cost of issuing a debit card but also lead to expansion of payment network in rural areas. National Payments Corp of India Ltd (NPCI), the nodal agency to manage and promote RuPay, has stated that 200,000 RuPay cards have already been issued and the target is to have 10 million debit cards under the brand by March 2013.
- Stating India as 'extraordinarily attractive investment destination', PE firm Bain Capital LLC has announced that it will infuse about

US\$ 800 million in appropriate proposals across four investment deals during 2012-16.

- L&T Finance has decided to buy Fidelity Worldwide Investment's Indian mutual fund business. The deal would boost L&T's assets to Rs 13,500 crore (US\$ 2.63 billion), making it the 13th biggest fund house and the 10th largest on the basis of equity.
- In a recent announcement, the RBI has granted FIIs to invest in primary issuances of companies' non-convertible debentures (NCDs), provided these papers are scheduled to be listed on the stock exchanges within 15 days of being issued. If the instrument, that is the NCD, does not get listed within 15 days, the foreign investor concerned would have to sell the securities to a domestic investor.

### **Government Initiatives**

In its Budget for 2012-13, the Government has earmarked a capital of Rs 15,888 crore (US\$ 3.11 billion) to be infused in public sector banks, regional rural banks and other financial institutions. Apart from this, the Government is also planning to set up a financial holding company that will raise funds for public sector banks.

Furthermore, the RBI has liberalised regulations pertaining to FCAs to provide operational flexibility to Indian entities making overseas direct investments. After satisfying stipulated requirements and conditions, Indian entities can open, hold and maintain FCAs abroad that would simplify the process of making overseas direct investments.

### **Road Ahead**

According to a report by the Boston Consulting Group (BCG) India, prepared in association with a leading industry organisation and Indian Banks Associations (IBA), Indian banking industry would be the world's third largest in asset size by 2025 and mobile banking would become the second largest banking mode after ATMs. Furthermore, owing to the positive eco-system of the industry and regulatory and Government initiatives, mobile banking is anticipated to enhance from 0.1 per cent of transactions in a 45 per cent financial inclusion base in 2010 to 34 per cent

of the transactions with 80 per cent rural inclusion base by 2020, as per the report.

While the Indian Government projects that qualified foreign investors (QFIs) would invest US\$ 50-75 billion in India's equity and bond markets, G Chokkalingam, Executive director and CIO, Centrum Wealth Management, believes that Indian markets would witness record inflows, probably to the extent of US\$ 30 billion, by FIIs in 2012.

Such positive forecasts are being made owing to monetary expansions in the West and considering that India would remain the second-fastest growing economy in the world.

### **Challenges of Financial Services Sector**

There are many challenges to the financial sector reforms such as:

#### **Lack of Qualified Personnel**

The expert knowledge is essential to provide innovative financial services successfully. The trained and qualified personnel are lacking in this sector. Lack of professional personnel is impeding the growth of financial services. It is a very big challenge for the financial intermediaries. It can be overcome by way of providing proper training to the qualified personnel.

#### **Lack of Investor Awareness**

The knowledge about the new financial products and instruments is essential to investors for the success of innovative financial ideas. Lack of investor awareness can be overcome by educating prospective investors through seminars, workshops, advertisements and even through audio-visual aids.

#### **Lack of Transparency**

The traditional financial system maintains secrecy of books of accounts. The disclosure of books of accounts is mandatory as per the international accounting standards. Financial sector should adopt the transparency system.

### **Lack of Specialization**

All financial intermediaries are providing all types of financial services and dealing in different varieties of instruments in India. Indian financial intermediaries are losing the excellence of specialization.

### **Lack of Recent Data**

Indian intermediaries are lacking in the field of research and development. Proper data base is essential to take sound financial decisions. It paves the way for growth of financial sector. Hence, the intermediaries should concentrate on it.

### **Lack of Efficient Risk Management System**

**The international transaction involves lot of risk such as exchange rate risk, interest risk and economic and political risk.** In India, the efficient risk management system is lacking. Therefore, efficient risk management system is essential to develop the growth of financial services sector.

The financial service sector is facing many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are:

1. Volatility of the market
2. Increasing customer expectations
3. Lack of technical Knowledge
4. Lack of Professionalism
5. Deficiencies in Performance appraisals
6. Concentration of wealth, on account of malpractices
7. Lack of safety
8. Deficiency in marketing process
9. Prevailing high handedness and arrogance

In the post liberalization era, the finance sector is witnessing a complete metamorphosis. Deregulation measures have included the freeing up of direct controls over ownership, liberalizing interest rates

and credit allocation, deregulating foreign exchange transaction controls, freeing up the entry of new firms, and expanding and broadening the base of banking system, both for nationals and international business ventures. At the same time, non banking financial institutions, securities markets and money markets have developed to mobilize and allocate savings. Experience suggests that financial liberalization needs to be undertaken alongside macroeconomic reforms.

## **Conclusion**

The Financial services over the years has deepened and widened. The concept of financial services continues to improve and change to keep pace with the rapid growth of the economy. Financial intermediaries are now using mobile technology in order to provide new and innovative products and services to its customers. Importantly, managing and facilitating of mobile transactions falls cheaper for banks compared to other channels, thereby allowing them to pass on the additional savings onto the customer. Thus, financial services have assumed greater importance and attract attention of the people world over.

## **Self Assessment Questions**

1. Bring out various stages of the development of financial services industry in India
2. What are the major constituents of the financial services market? And explain.
3. Write the concept of financial services and its characteristics
4. What are the funds based and fees based activities of financial services
5. Explain any five fund based services rendered by financial services institutions
6. Explain any five fee based services rendered by financial services institutions
7. What are the various kind of innovative financial instruments issued by corporate India
8. Bring out the emergence of New Institutions/Bodies in the Indian Financial system in the recent past.

9. What are the challenges faced by Indian Financial Services sector?
10. What are the modern activities of the financial services sector?
11. Trace the history and growth of financial services market in India?
12. What are the factors that affect the access of Financial services in India?
13. Define leasing? What are steps involved in it?
14. What are the different types of leasing?
15. Describe the benefits of Mutual funds?
16. What is venture capital? What are its features?

## **CASE STUDY**

### **ICICI Group**

ICICI Group offers a wide range of banking products and financial services to corporate and retail customers through a variety of delivery channels and through its specialised group companies and subsidiaries in the areas of personal banking, investment banking, life and general insurance, venture capital and asset management. With a strong customer focus, the ICICI Group Companies have maintained and enhanced their leadership positions in their respective sectors.

#### **You are required to answer the following questions**

1. Identify the funds based & fee based services provided by ICICI – Group to retail customers.
2. Identify the fee based and fund based services provided by ICICI - Group to its corporate customers.
3. What considerations are to be kept in mind which extending these services to customers?
4. Which of the risks need to be avoided while providing these services?
5. Give two examples of each financial product are offered by ICICI – Group

## CASE STUDY

TNS Link Provides the Ideal Solution for Co-Op Financial Services.

### Background

Formed in 1981, CO-OP Financial Services is the largest credit union service network in the US. As a whole, the organization generates more than 120 million transactions per month originating from approximately 3,500 credit union member sites across the country.

### Business Challenge

CO-OP was in search of a vendor that could work to test, create and implement a variety of configurations of a data communication service in order to be compatible with all of the credit unions' ATMs. This includes secure wireless as well as wired broadband solutions.

### Solution

TNSLink, offered by TNS, is an end-to-end managed data communications solution designed specifically for the ATM, Kiosk and POS terminal markets. TNSLink, in this case rebranded CO-OP Connect, allows processors and terminal estate owners to utilize the latest telecommunications technologies for high speed data delivery without the need to replace existing, legacy equipment.

TNS Link also allows CO-OP to move forward with implementing enhanced ATM feature sets such as check imaging, kiosk transaction processing and remote graphics distribution. CO-OP's member institutions can also rely on the security and performance of the TNS' global PCI DSS certified backbone network and 24x7x365 helpdesk services with live real-time support.

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## UNIT - 2

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### Merchant Banking

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#### Learning Objectives

*After studying this unit you can be able to:*

- know the functions of merchant bankers
- understand the role of intermediaries in the issue management activities
- familiarize with the SEBI norms for intermediaries in relation to the issue activities
- get knowledge of the issue procedures of issue management

#### Unit Structure

Lesson 2.1 – Issue Management Intermediaries

Lesson 2.2 – Issue Management: Activities/Procedures

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## Lesson 2.1 - Issue Management Intermediaries

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### Introduction

The origin of Merchant Banking is Italy. The Italian grain merchants provided funds for commodity traders and cargo owners. Their other activities were buying, selling and shipping of goods. The merchant Bankers were either individuals or Banking houses. Later on, the center of merchant banking operations was shifted from Italy to Amsterdam and thereafter to London.

Merchant Banking is one of the major Fee Based/Advisory Services. In 1969, the Greenlays Bank commenced merchant Banking division in India. Formal Merchant Banking service was originated. The bank started the activities relating to public issue of securities. They also undertook financial consultancy services. In the year 1973 the State Bank of India started Merchant Banking services. In 1974, the ICICI started research service. After 1975 many Merchant Banking organizations came into existence. The sponsors for these organizations were by Banks, Financial Institutions, Non-Banking Financial Institutions (NBFCs), Brokers and so on. Consequently, the scope of merchant banking activities was widened.

Initially, the new issue market was regulated under the provisions of the Capital issues (Control) Act 1947 and rules made under it. In 1992, the act was repealed. The protection of the interest of the investors was transferred to the Securities and Exchange Board of India (SEBI). Various regulatory measures covering both the intermediaries as well as the activities were introduced by SEBI for strengthening the operations of the new issues in the country. Many intermediaries who play an important role in the process of selling new issues emerged.

The major new issue Market intermediaries are:-

1. Merchant Bankers
2. Lead Managers

3. Underwriters
4. Bankers to issue
5. Brokers to an issue
6. Registrars to issue and Share transfer agent
7. Debenture trustees
8. Portfolio Managers

The legal framework prescribed by SEBI controlled the operations of these intermediaries. Rules and regulations were framed by SEBI for prohibition of fraudulent and unfair trading practices relating to the Securities Market and Prohibition on dealing/communicating/counseling on matters relating to insider trading.

The role of these intermediaries and SEBI regulations on their activities as well as issue procedure relating to issues of capital/securities are elaborately dealt in this unit.

## 1. Merchant Bankers

### Definition

*“A Merchant Banker means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant/advisors or rendering corporate advisory service in relation to such issue”.*

The word ‘**issues**’ in the definition refers to an offer for sale/purchase of securities by any Body-Corporate/other person or group of persons on its / his / their behalf to, or from the public or, from the holders of the securities through a Merchant Banker.

### Categories of Merchant Bankers

Merchant Bankers fall under four categories:-

1. **Category 1** – Merchant Bankers of this category can carry on any activity relating to issue management. The activities are as follows:
  - Preparation of Prospectus and other information relating to issue,

- Determining the financial structure,
- Tie-up of financiers,
- Final allotment of securities
- Refund of subscribes etc.,

They could also act as Advisors, Consultants, Co-Managers, Underwriters or Portfolio Managers.

2. **Category II** – Merchant Bankers of this category can act as Advisors, Consultants, Co-Managers, Underwriters and Portfolio Manager.
3. **Category III** - Merchant Bankers of this category can act as Underwriters, Advisors and Consultants to an issue.
4. **Category IV** - Merchant Bankers of this category can act only as Advisors or consultant to an issue.

All the categories below Category – 1 were abolished by SEBI on 5th September 1997. Those operating below category-1 have to apply for Category-1 status.

### **Registration of Merchant Bankers**

Registration of Merchant Bankers with the SEBI is compulsory to carry out their activities. With effect from 9/12/1997 SEBI registers only category I merchant Bankers. A separate certificate of Registration from SEBI is required to carry on activities as portfolio managers.

### **Matters considered by SEBI for grant of certificate of Registration**

1. Merchant Bankers should also be a body corporate other than non-banking financial company.
2. Merchant Bankers must have necessary infrastructure such as place, equipment and manpower to effectively discharge their activities.
3. Merchant Bankers must have employed at least 2 persons with experience to conduct merchant banking business.
4. Merchant Bankers should fulfill the capital adequacy requirement of minimum net worth (net worth means paid up capital and free Reserves) of ₹ 5 crore.

5. Any person either directly or indirectly connected with the applicant that is an associate/subsidiary/interconnected/group company cannot have a Certificate of Registration from SEBI.
6. The merchant Bankers/their partners/their directors/principal officers should not be involved in any litigation connected with the securities market, which has an adverse effect on their business.
7. The merchant Bankers should have recognized professional qualification in Finance, Law or Business Management. Their Registration should be in the interest of the investors. The applicant must be a fit and proper person as per the criteria specified in the SEBI intermediaries Regulation 2008.

### **Fees Payable**

The Merchant Bankers have to pay to the SEBI the following fees:-

1. Application fee of ₹ 25,000/-.
2. Registration fee ₹ 10 lakh (registration is valid for 3 years from the date of registration).
3. Renewal ₹ 5 Lakh.

### **Functions of Merchant Bankers**

1. Corporate Counseling
2. Project Counseling
3. Pre investment studies
4. Capital Restructuring
5. Credit Syndication and Project Finance
6. Issue Management and underwriting
7. Portfolio Management
8. Working Capital Finance
9. Acceptance of credit and bill discounting
10. Merger, Amalgamation and Takeover
11. Venture capital
12. Lease Financing

13. Foreign Currency Financing
14. Fixed Deposits Broking
15. Mutual Funds

Brief descriptions of these functions are given below:

### **Corporate Counseling**

A set of activities undertaken to ensure the efficient running of a corporate enterprise is known as corporate counseling. The merchant banker is guiding in the following activities:

- Diversification based on the Government's economic and licensing policies.
- Appraisal of product lines, analyzing their growth and profitability and forecasting future trends.
- Diagnosing sick units, assessing revival prospects for rehabilitation by way of modernization and diversification, suggesting suitable strategy for improving their production technology and financial structure.
- Arranging funds for rehabilitation through banks/financial institutions.
- Monitoring of rehabilitation schemes.
- Assisting takeover of sick units

### **Project Counseling**

Project counseling is the feasibility study of the project with reference to various aspects such as financial, economical, commercial technical etc... It includes the following activities:

- Review of project idea, conducting feasibility study and providing advice for implementation.
- Providing assistance in the preparation of project reports, conducting market surveys and obtaining government consents (approvals/licenses/permissions/grants) for implementation of the project.

- Providing guidance in making investment in Indian projects in India and abroad.
- Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.

### **Pre-Investment Studies**

It is a detailed feasibility study to evaluate alternative avenues of capital investment in terms of growth and profit prospects. Activities related to pre-investment studies are:

- Analyzing environment and regulatory factors
- Identification of raw material sources
- Estimation of demand
- Estimation of financial requirements

### **Capital Restructuring Services**

Capital restructuring aims to reduce the cost of capital and maximize the shareholders wealth. Merchant bankers provide the following services related to capital restructuring:

- Determination of optimum capital structure conforming to legal requirements.
- Getting consent of controller of Capital issues for capitalization of reserves by way of issuing bonus shares.

### **Credit Syndication**

Credit syndication refers to activities connected with credit procurement and project financing, aimed at raising Indian and foreign currency loans from banks and financial institutions, are collectively known as 'credit syndication'. The activities are:

- Estimating the total cost of the project and drawing up a financing plan for the total project cost.

- Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.
- Selecting institutions and banks for participation for financing.

### **Issue Management and Underwriting**

Issue management and underwriting is concerned with the activities of management of the public issues of corporate securities, viz. equity shares, preference shares, and debentures of bonds to procure money from the capital market. The activities and SEBI guidelines in this regard are discussed later elaborately in this unit.

### **Portfolio Management**

Portfolio management is making investment decisions in marketable securities for maximizing returns with minimum risk.

#### ***The services are***

- Providing advice on selection of investments.
- Carrying out a critical evaluation of investment portfolio.
- Collecting and remitting interest and dividend on investment.
- Undertaking investment in securities.
- Safe custody of securities in India and overseas.
- Undertaking review of Provident fund investment, Trust investment, etc.

### **Working Capital Finance**

Working Capital finance is the fund required to meet the day-to-day expenses of an enterprise. The related activities are:

- Assessment of working capital requirements.
- Facilitating sanction of credit facilities speedy disbursements.



## **Acceptance Credit and Bills Discounting**

‘Acceptance credit and bill discounting’ means activities relating to acceptance and discounting of bills of exchange and advancement of loans on the strength of such instruments.

## **Merger and Acquisition**

The merchant banker arranges for negotiating acquisitions and mergers by offering expert valuation regarding the quantum and the nature of considerations, and other related matters. The activities relating to merger and acquisition are:

- Conducting SWOT analysis in order to help formulate guidelines and directions for future growth.
- Conducting studies for locating overseas markets, foreign collaborations and prospective joint venture associates.
- Obtaining approvals from shareholders and other stakeholders
- Monitoring the implementation of merger and amalgamation schemes.

## **Venture Capital Financing**

Venture capital is the seed capital in the form of equity financing for high-risk and high-reward projects. It is discussed in detail in unit 4.

## **Lease Financing**

Leasing is one of the fund based financial services of merchant banker. Leasing means ‘letting out assets on lease’ for use by the lessee for a particular period of time. Merchant banker provides the following services:

- Providing advice on the viability of leasing
- Providing advice on the choice of a favorable rental structure.

## **Foreign Currency Financing**

Foreign currency finance is the fund provided for foreign trade transactions in the form of export-import trade finance, euro currency loans. The role of merchant bankers in this regard is:

- Assisting the study of turnkey project and construction of contract projects.
- Liaison with RBI, EXIM, ECGC and other institutions.
- Providing assistance in opening and operating banks accounts abroad.
- Assisting in obtaining export credit facilities and letter of credit.
- Providing guidance on forward cover for exchange risk.
- Arranging foreign currency guarantees.
- Arranging various types of foreign currency loans such as Euro-currency Loans, Syndication of Euro loans, Bank guarantees etc.

## **Brokering Fixed Deposits**

*The merchant bankers render the following services*

- Working out the quantum of procurement of fund in the form of deposits from the public
- Drafting of advertisement for inviting deposits and filing a copy of it with the registrar of Companies for registration.
- Arranging payment of interest amounts.
- Advising on the terms and conditions of fixed deposits the company.

## **Mutual Funds**

Mutual funds are institutions that mobilize the savings of innumerable investors for the purpose of channeling them into productive investments in a wide variety of corporate and other securities. Investment of the fund is in a diversified portfolio of shares and debentures belonging to well managed and growing companies. For details refer unit 4.

## 2. Lead Managers

*“In a syndicate, an underwriting firm immediately subordinate to the managing underwriter. A syndicate is a group of underwriters responsible for placing a new issue of a security with investors. Every syndicate is a temporary arrangement. The lead manager is assigned the second-largest part of the new issue for placement. A lead manager is also called an arranger”.*

As per the SEBI regulations all issues should be managed by at least one authorized Merchant Banker functioning as Sole manager or Lead manager. As such only Category1 Merchant Bankers could act as Lead Managers to an issue.

### Number of Lead Managers

*The SEBI guidelines stipulate the following:*

1. For an issue of size less than ₹ 50 crores, the number of Lead Managers should not exceed 2.
2. For an issue of size ₹ 50 crores but less than 100 crores, the maximum number of Lead Managers should not exceed 3.
3. For an issue of size ₹ 100 crores but less than 200 crores, the maximum number of Lead Managers should not exceed 4.
4. For an issue of size 200 crores but less than 400 crores, the maximum number of Lead Managers should not exceed 5.
5. For an issue of size above ₹ 400 crore the number of Lead Managers may be 5 or more as may be agreed by SEBI.

### Conditions of Registration/Renewal Certificate of a Merchant Banker

The Registration/Renewal certificate of a Merchant Banker is subject to the following conditions:

1. Prior approval of SEBI is necessary to continue to act as a Merchant Banker after change of its status/constitution – such as amalgamation, merger, and consolidation and any other kind

of corporate restructuring/ change in its managing/whole time directors, change in control etc.

2. A Merchant Banker should enter into a legally binding contract with the issuer specifying their mutual duties and responsibilities.
3. A Merchant Banker should pay the Registration/Renewal in the prescribed manner.
4. He should take adequate steps for redressal of grievances of investors within one month of the complaint. He should inform the SEBI the details of complains and the manner of redressal.
5. He should abide by the relevant regulations under the SEBI act.

### **Restriction on Business**

The Merchant Banker other than a bank/public finance institution is not permitted to carry on business other than in the securities market i.e., he is prohibited from carrying on fund/asset based business such as leasing.

### **Responsibilities of Lead Managers**

- Every Lead Manager must sign an agreement with the issuing companies. The agreement must contain the matters regarding mutual rights, liabilities and obligations relating to issues which must necessarily include disclosures, allotment and refund.
- Merchant banker should furnish a statement specifying the details in the agreement to SEBI. Such statement should be sent at least one month before the opening of the issue for subscription. The statements should also contain the details about all lead managers and their respective responsibilities if there were more than one Lead Manager/Merchant Banker.
- There should be no association between the lead manager and the issuing company.
- There should be no association with other merchant bankers who do not hold a certificate of registration with SEBI.

- The minimum undertaking obligation to be accepted by a lead manager is 5% of the total underwriting commitment or ₹ 25 lakhs whichever is less.
- **Due diligence certificate:** The lead manager should furnish a certificate to SEBI 2 weeks before the opening of the issue for subscription stating the following:
  - The prospectus/letter of offer is in conformity with the documents/materials and papers relevant to the issue.
  - All legal requirements in connection with the issue have been complied with.
  - The disclosures are true fair and adequate to enable the investors to make a decision regarding investment.
- The merchant banker must submit to the SEBI two weeks before the date of filing with the registrar of companies/regional stock exchanges or both, the following particulars of the issue:
  - Draft prospectus/letter of offer,
  - Other literature to be circulated to the investors/shareholders.
- The merchant banker should pay to the SEBI, the following fee prescribed:-

	Issue Size	Fees
a. Public issue	upto ₹ 10 crore	Flat rate of ₹ 25,000/-
	₹ 10 to 5000 crore	0.025% of the issue size
	₹ 5000 crore to 25,000 crore	₹ 1.25 crore plus 0.00625% of the issue size in excess of 5000 crore
	More than ₹ 25,000 crore	Flat charge of ₹ 3 crore
b. Right issue	upto ₹ 10 crore	Flat rate of ₹ 25,000/-
	₹ 10 to 500crore	0.005% of the issue size
	More than ₹ 500 crore	Flat charge of ₹ 5 lakh

### 3. Underwriters

Underwriters to issue of capital are one of the important intermediaries in the new issue/primary market. They agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or themselves. After 1995, underwriting is not mandatory.

#### Appointment of Underwriters

The issuing companies, in consultation with the lead managers/merchant bankers to the issues appoint underwriters. The underwriters' assets must be adequate to meet their obligations. A statement to this effect should be incorporated in the prospectus.

#### Registration

To act as underwriters, a certificate of registration should be obtained from the SEBI. No separate registration to act as underwriter is required in the case of merchant banker registered with SEBI.

#### Matters considered by SEBI in granting certificate of Registration:

- Infrastructure adequacy (office space, equipment and manpower) to discharge the activities relating to underwriting.
- The applicant must have experience in underwriting or he must appoint at least two persons with experience in it.
- The applicant or any person directly or indirectly connected with the applicant has not been granted registration with the SEBI as underwriter (Previous application for registration should not have been rejected).
- The applicant for underwriting should not have any disciplinary action taken against him under the SEBI Act/Rules/Regulations.
- The applicant for underwriting should have net worth (capital plus free reserve) of not less than ₹ 20 lakh.
- The applicant for underwriting should not have been found guilty of any economic offence and should not have been convicted of offence involving moral turpitude.

## **Fees**

- The application fee for underwriter is ₹ 25,000/- the fee payable for registration at the time of grant of certificate is ₹ 10 lakh.
- A renewal fee of ₹ 5 lakh every two years from the fourth year from the date of initial registration is payable.

Failure to pay the fee would result in suspension of certificate of registration.

## **Conditions for Registration**

Conditions for registration applicable to merchant bankers are also applicable to underwriters.

## **Obligations and Responsibilities**

The underwriters have

- To protect the interests of its clients.
- To maintain high standards of integrity, dignity and fairness in the conduct of business.
- To render high standards of service and maintain professional ethics.
- To exercise due diligence.
- To ensure proper care and professional judgment.
- To avoid conflict of interest
- To make adequate disclosure of his interest.
- To treat equally all its clients without discrimination.
- To maintain appropriate level of knowledge and competence.
- To abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI.
- To furnish true and complete statement, material fact in any documents reports papers without suppressing any fact or making untrue statement.
- Should not have insider trading activity.
- Should not engage in unfair competition harmful to the interest of other underwriters.

## **4. Bankers to an Issue**

### **Meaning**

Bankers to an issue are engaged in the following activities:-

- Acceptance of applications from the investors in respect of issues of capital,
- Acceptance of application money and
- Refund of application money.

Issue means an offer of sale/purchase of security by anybody corporate/person/group of persons on his/its/their behalf to or from the public/holders of securities of the body corporate/person/group of persons.

### **Registration**

A person for acting as a banker to an issue must obtain a certificate of registration from the SEBI.

### **Requirements**

- The applicants must have necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his functions as a banker to an issue.
- The applicant/any of the directors of the applicant should not have been involved in any litigation connected with the securities market.
- The applicant should not have been convicted of any economic offence.
- The applicant must be a scheduled bank.
- The grant of certificate should be in the interest of the investors.
- The applicant should be a fit and proper person as per the criteria specified in the SEBI Intermediaries Regulation 2008.



## Obligations and Responsibilities of Bankers to an Issue

- ***Furnishing information to SEBI:*** The bankers to an issue must furnish the following information if required by SEBI
  - a. No. of issues for which he is a banker
  - b. No. of applications received
  - c. Details of application money received
  - d. Date of forwarding the applications to the issuing company/Registrar to the issue.
  - e. Date and amount of refund to the investors
- ***Maintenance of accounts and Documents:*** The banker must maintain records/documents/accounts for furnishing information to SEBI when they require. He must keep the records for 3 years.
- ***Entering agreement with issuing companies:*** The agreement entered into by the bankers with the issuing company must provide for the following:
  - a. No. of collection centers at which applications/application money received is forwarded to registrar.
  - b. Submission of daily statement stating the no. of applications and amount of money received by the investors.

Any disciplinary action taken by RBI against a banker to an issue regarding issue payment must be informed to the SEBI.

## 5. Brokers to the Issue

### Meaning

Brokers are the persons mainly concerned with procurement of subscription to the issue from the prospective investors.

### Appointment of Brokers

The appointment of brokers is not obligatory. There is no restriction to the number of brokers to be appointed. The leading merchant bankers acting as managers to the issue have particulars of the performance of

brokers. The company consults with the stock exchange and writes to all active brokers of all exchanges. It obtains their consent to act as brokers to the issue. The prospectus should disclose the names and addresses of the brokers to the issue and the same along with the copy of the consent letter of the broker is to be filed with the Registrar of companies.

### **Who cannot be appointed?**

The stock exchange bye laws prohibit the members from acting as

- Managers or brokers to the issue and
- Making preliminary arrangement in connection with new issue

If the stock exchange of which they are members does not give its approval. Also it would prohibit the members to act as brokers if the company does not confirm to the prescribed listing requirements and undertakes to have its securities listed on a recognized stock exchange.

The permission granted by stock exchange is further subject to other stipulations which are set out in the letter of consent.

### **Brokerage Rate**

The brokerage rate is 1.5% for all types of public issue industrial securities. It is immaterial whether the issue is underwritten or not. The stock brokers have to meet mailing cost and other out of pocket expenses for canvassing of public issues. The company will not pay these expenses. The agreement with broker and company should include a clause to this effect.

The brokerage on private placement of capital payable by the listed companies is a maximum of 0.5%. Brokerage is not allowed in respect of

- Promoters quota
- Amount taken up by the directors/their friends and employees
- Rights issue taken by or renounced by the existing shareholders
- Brokerage is not allowed when the application are made by institutions/bankers against their underwriting commitments.

The brokerage should be paid by the company within two months from the date of allotment. The particulars of the allotment made against applications bearing their stamps should be furnished to the broker. The cheques for brokerage amount on new issues should be made payable at par at all centers where the recognized stock exchanges are situated. The prospectus should disclose the rate of brokerage.

## **6. Registrar to an Issue and Share Transfer Agents**

### **Functions of Registrar to an issue**

The Registrar to an issue, in the capacity of an intermediary in the primary market carry on the following activities:-

- Collecting applications from the investors
- Keeping a proper record of applications and money received from investors.
- Keeping a proper record of amount paid to seller of securities
- Assisting company in determining the basis of allotment of securities in consultation with stock exchanges.
- Finalizing the allotment of securities
- Processing/dispatching allotment letters, refund orders, certificates and other related documents in respect of issue of capital.

### **Functions of Share Transfer Agent**

- Maintaining records of holders of securities or on behalf of companies.
- Dealing with all matters connected with the transfer/redemption of securities.

### **Registration**

The Registrars to an issue and the share transfer agents for carrying out their function must be registered with the SEBI.

**A. The Registrar and Share Transfer Agent fall into two categories**

- To carry on the functions of both Registrars to an issue and share transfer agent
- To carry on the functions of either the Registrar or share transfer agent

**B. Conditions for Registrations**

SEBI grants Registration considering besides all relevant matters, the following:-

- Necessary infrastructure
- Past experience
- Capital adequacy
- Should not have been convicted for any offence involving moral turpitude, or should not have been found guilty of any economic offence.
- The applicant must be a fit and proper person in terms of the SEBI Intermediary Regulation 2008.

**C. Capital Adequacy**

Category	Net worth (capital & free reserve)
Category – I	₹ 6,00,000/-
Category – II	₹ 3,00,000/-

**D. Fees**

Category	Registration Fees	Renewal Fees
Category - I	₹ 3,00,000/-	₹ 1,00,000/- every 3 years
Category – II	₹ 1,00,000/-	₹ 50,000/- every 3 years

The application Fee for Registration is ₹ 10,000/-

**E. Conditions of Registration**

The conditions of Registration are as applicable to merchant bankers/underwriters/ Bankers:

### ***F. Maintenance of Records: Records relating to***

- To all applications received from investors.
- To rejected application together with reasons.
- To basis of allotment
- To terms and conditions of purchase of security.
- To allotment of securities.
- To list of allottees and non-allottees.
- To refund orders
- To list of holders of securities of corporate.
- To names of transferors and transferees
- To Dates of transfer of security are to be maintained and preserved for a period of 3 years.

### ***G. Appointment of Compliance Officer***

They should appoint a compliance officer for Investors Grievances Redressal and for monitoring SEBI Act rules and regulations.

### ***H. Inspection***

SEBI is empowered to inspect books of accounts and other records of Registrar to an issue and Share Transfer Agent. SEBI is also empowered to investigate into compliance from investors and others. SEBI can also investigate on its own in the interest of investors into the affairs of Registrar to an issue and Share Transfer Agent. Based on inspection report SEBI can instruct the concerned parties to take remedial measures. It may appoint an auditor to investigate the accounts of Registrar to an issue and Share Transfer Agent. Any Registrar to an issue and Share Transfer Agent, any of the provisions of SEBI act, rules and regulations would be dealt with in accordance with the SEBI Intermediary Regulation 2008.

## **7. Debenture Trustees**

### **Definition**

“Debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private

placement of debentures by a listed/proposed to be listed company. Trust Deed means, a deed executed by the body corporate in favour of the trustees named wherein for the benefit of debenture holder”.

### **Who can be a Trustee?**

Banks, Public Finance Institutions, Insurance Companies and Body Corporate can be a trustee when they fulfilling the capital adequacy requirement of ₹ 1 crore in terms of net worth.

**Net worth = Paid-up capital + Free reserve – (accumulated losses + deferred expenditure not written off).**

The Certificate of registration from SEBI is mandatory to act as debenture trustee.

### **Who cannot act as a Debenture Trustee?**

A debenture trustee cannot act as a trustee for any issue of debenture if (a) it is an associate to the body corporate; (b) it has lent money to the body corporate; (c) if the loan is not fully repaid; (d) if it proposes to lend money to the body corporate.

### **Factors considered for Registration by SEBI**

- Infrastructure facilities like office space, equipment and manpower to discharge duties effectively.
- Past experience as a debenture trustees (or) employment of two experienced persons in the matters relating to debenture trustee.
- Should not have direct/indirect connection with the applicant.
- Engagement of minimum of one person with professional qualification in law.
- Any of its directors/principal officers should not have been convicted for any offence involving more turpitude or should not have been found guilty of any economic offence.
- Must be fit and a proper person as per the criteria specified in SEBI intermediary regulation 2008.

### Period of Registration & Registration Fee

- The Registration is valid for 3 years and can be renewed before 3 months following the expiry of the period of the certificate.
- Registration fee is ₹ 10 lakh.
- Renewal fee is ₹ 5 lakh

Conditions of Registration are the same as those applicable to merchant bankers.

### Responsibilities and Duties

Responsibilities and duties of a debenture trustee of obligation before appointment.

- Must enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures. Agreement should contain the following:-
  - a) Agreeing to act as the trustee under the trust deed for securing an issue of debentures for the body corporate.
  - b) The time limit of the security for the debenture holders.
- **Obligations:** The Debenture Trustee should accept the trust deed. The deed should contain the following matter.
  - Rights of the Debenture holders and manner in which they are vested in the trustee.
  - Purpose of raising funds through debenture issue.
  - Description of debenture like, amount, tenure, interest, periodicity of payment, period for redemption, options available terms of conversion/redemption of the debentures.
  - Nature of charge, rank of charge of assets.
  - Creation of future security for the issue of debentures – time limit within which is to be created.
  - Events under which security becomes enforceable.
  - Creation of obligation of company not to create future security.
  - Minimum security cover require
  - A clause for subsequent valuation

- Circumstances necessitating the enforceability of the security.
- Preservation methods of assets charged as security circumstances under which security may be disposed or leased out with the approval of the trustee.
- Inspection of charged.
- Steps which would be taken by the Debenture Trustee in the event of default.
- The companies' duties should be specified in the agreement.
- Other Miscellaneous provisions such as
  - Procedure for appointment
  - Removal of trustee,
  - Appointment of new trustee
  - Non-relinquishment from the assignment
  - Procedure for removal of debenture trustee by a resolution passed by at which 75% of debenture holders.
  - Provision for redressal of grievance of the debenture holders.

### **Duties of Debenture Trustee**

- To take possession of trust property to enclosing securities.
- To perform acts necessary in the event of security becoming enforceable resolving grievances of debenture holders.
- To ensure dispatch of debenture certificate.
- To ensure dispatch of interest warrants.
- To ensure repayment of maturity value of the debentures.
- To ensure availability of property charged to the debentures an adequate enough to discharge the interest and principal amount.
- To ensure that the property is free from any other encumbrance.
- To take steps to protect the interest of debenture holders in case of any breach of the trustee deed law comes to its notice.
- To ensure the conversion/redemption is done as per the provisions under which they were offered to the debenture holders.



- To nominate a director on the Board of directors of the body corporate in the event of default in payment of interest in two consecutive times, default in creation of security for debentures and default in redemption of debentures.
- To arrange for the meeting of all debenture holders in the event of
- Request from at least 10% (in value) of debenture holders.
- Happening of an event constituting a default affecting the interest of the debenture holders.
- To continue as debenture trustee until another trustee is appointed (i.e., trustee should not relinquish its assignment).
- To maintain net worth requirements
- To inspect books of accounts records registers of the body corporate and the trust property.

### **Maintenance of Books of Records**

The Records relating to the trusteeship functions must be kept and maintained for at least five financial years preceding the current financial year.

### **Appoint of Compliance officer**

A compliance officer should be appointed by the trustee to monitor the compliance of the SEBI Act/Rules & Regulations etc., and for redressal of investors' grievances. Non-compliance should be immediately and independently reported to the SEBI by the compliance.

### **Information to SEBI**

As and when required by SEBI the debenture trustee is bound to submit the following:-

- Number of grievances received from debenture holders and number resolved copies of trust deed.
- Delayed payment/Non-payment of interest to debenture holder.
- Dispatch/transfer details of debenture certificate.
- Any other detail relevant to the trustee.

### **Inspection by SEBI**

- a. SEBI is authorized to inspect books of account and other records of debenture trustees.
- b. The purpose of inspection is
  - To ensure proper maintenance and compliance with companies Act.
  - To ensure that they are maintained in the manner prescribed by SEBI.
  - To grant continuance of Registration
  - Investigation of compliance against the trustees' activities.
  - In the interest of securities/Business/investors.
- c. As an alternative the SEBI may appoint a qualified auditor for investigation into the accounts/affairs of the trustee.
- d. Based on the inspection report SEBI can direct the trustee to take measures in the interest of the security market and for due compliance with the provisions of SEBI Act.

## **8. Portfolio Managers**

### **Definition**

Portfolio means the total holdings of securities of a person. Portfolio managers are persons who in pursuance of a contract/arrangement with client, advise/direct/ undertake on behalf of the client by the discretionary portfolio manager or otherwise, the management/administration of portfolio of securities/funds of clients.

Discretionary portfolio management allows the exercise of discretion with regard to investment/Management of the portfolio of the security/funds. Non-Discretionary portfolio manager acts in accordance with the directions of the client.

### **Registration**

- A certificate of Registration from SEBI is mandatory to act as portfolio manager.

- Certificate of Registration is valid for 3 years.
- The application fee for registration is ₹ 1,00,000/-
- Registration fee is ₹ 10,00,000/- Renewal Fee is ₹ 5,00,000/-
- Renewal is also valid for 3 years.

### **Registration Procedure**

The SEBI takes into account the following matters while considering the application:-

- Matters relevant to portfolio management activities
- Employment of two persons experienced in portfolio management, stock broking, investment management.
- Persons connected with the applicant should not have been refused registration.
- Capital adequacy requirement of not less than net worth of ₹ 2 crore.
- The applicant/partner/director/principal officer should not have been convicted for any offence involving moral turpitude/guilty of any economic offence. The applicant should not have been involved in any litigation connected with the securities market.
- The principal officer of the applicant to have professional qualification in finance/law/accounting/business management or at least 10 years experience in related activities in the securities market.
- The issue of certificate should be in the interest of investors.
- The applicant should be a body corporate
- There should not have been any disciplinary action taken by SEBI against any person directly or indirectly connected with the applicant.
- The applicant must be a fit and proper person as per the criteria specified in the SEBI Intermediaries Regulation 2008.

**The Future**

For the merchant banking division, the development of new services to meet the changing market conditions is an ongoing process. Today the entire merchant banking industry in India is faced with the challenge of attracting Non Resident Indian (NRI) investment into India, particularly under the scheme for portfolio investments through stock exchange. The Merchant Banking Division is the process of introducing a comprehensive portfolio advisory service which will try to fill up the information gap, offer expert counseling on investment opportunities, undertake to buy/sell orders, periodically evaluate the portfolio and look after all the administrative formalities such as attending to tax returns, collections and remittances of dividends etc., in compliance with the Reserve Bank of India and SEBI guidelines.

**Conclusion**

Merchant banking essentially involves selling an issue for a company and handling related work. In the wake of liberalization of the financial sector, we are witnessing certain merchant banking prospects emerging be it an Indian company or foreign or a multinational, playing in the primary and secondary markets competitively. The mushroom growth of merchant banks has given rise to unethical means to sell shares. For a healthy growth of the market operation, the SEBI should enforce strict control on merchant banks and remove the weeds of manipulation and corruption in the market. Stipulation of proper checks and regulation will raise the confidence of investing public in the dynamic and vibrant market mechanism which will be in the larger interests of the society as well as of the economy.

The growth of the capital market in India in the 90s is mainly due to the key role played by the merchant banking divisions of leading development banks as well as commercial banks. In a way, the merchant banks have come to occupy an important place in the Indian financial scene with seven of the top ten merchant banking coming from the development banks and other financial institutions. They dominate the market in providing professional service to the corporate sector. The future growth of the capital market depends, to a large extent on the financial services made available by them.

In fact, merchant banks should replace brokers in trading, in course of time, so that the market operations will be beneficial both to the industrial sector and investors as well as other operators in the primary and secondary markets. And the merchant bankers should also pass on the profits to investors, depositors and shareholders equitably. By its unique features, it is playing key role in accelerating the economic growth.

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## Lesson 2.2 - Issue Management: Activities/Procedures

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### **Establishment of Disclosure and Investor Protection (DIP) guidelines**

The SEBI has issued Disclosure and Investor Protection (DIP) guidelines as ground rules relating to new issue procedure/activities. The purposes for which SEBI has framed the DIP guidelines are

- To protect the interest of investors
- For the orderly growth and development of the securities market.
- For removing inadequacies and deficiencies in the system.

These guidelines are in addition to the company law requirements in relation to issues of capital/securities.

### **Applicability**

These procedures/activities are applicable to all

- Public issues and offers for sale by listed/unlisted companies and
- Rights issue (i.e., an issue of capital under sec.81 (1) of the companies act to the existing shareholder through a letter of offer) by listed companies, except in cases where the aggregate value of securities including premium is less than ₹ 50 lakh.

### **Note**

1. Letter of offer in compliance with the disclosure requirement specified in these guidelines should be prepared by the issuing company in respect of rights issue with aggregate value less than ₹ 50 lakh. The letter of offer should be filed with the SEBI.
2. Public issue means an invitation by a company to the public to subscribe to the securities offered through a prospectus.

3. Existing share holders of a company offer securities to the public for subscription through an offer document. This is said to be offer for sale.

### **Subject Matter of DIP Guidelines**

The issue procedure, the subject matter of DIP guidelines deals with the following:-

1. Eligibility norms
2. Pricing of issues
3. Promoters contribution and lock-in requirements
4. Indian Depository Receipts (IDR)
5. Issue advertisement
6. Issue of Debt Instruments
7. Book building
8. Green shoe option
9. Initial Public offer through stock exchange online system (EIPO)
10. Preferential issues
11. Qualified Institutional Placement

### **Filing of Offer Document**

In the following cases, a draft prospectus/letter of offer should be filed with the SEBI through a merchant Banker at least 30 days prior to filing it with the Registrar of companies:-

- Public issue of securities by any company
- Any type of securities by a listed company through a rights issue in excess of ₹ 50 lakh

Before filing the draft prospectus with the Registrar of companies, the lead merchant banker/issuer should carry out any changes specified by the SEBI on the draft prospectus/letter of offer. The SEBI may specify changes only after receipt of in principle approval from the exchanges on which the proposed securities are to be listed.

## 1. Eligibility Norms

An initial public offering for sale of equity shares or any other security convertible into equity shares can be made by an unlisted company subject to fulfillment of all the following conditions:

- a. During each of the preceding 3 full years, the company should have Net tangible assets of at least ₹ 3 crore. Out of these net tangible assets 50% should be in monetary assets.
- b. The company should have made distributable profits for at least 3 out of the immediately preceding 5 years.
- c. The company must have a net worth (total of paid up equity capital and free reserves excluding revaluation reserves minus total of accumulated losses and deferred expenditure not written off) of at least ₹ 1 crore in each of the preceding 3 full years.
- d. In case of change of its name, the company should have at least 50% of the revenue from the new activity mentioned in the suggested new name in the preceding full year.
- e. Total of the proposed issue and all previous issues in the same financial year, should not exceed 5 times its pre-issue net worth.

An unlisted company which does not fulfill any of these five conditions can issue shares if it satisfies alternatively the following two conditions.

- It issues through book building process. At least 50% of the net offer is allotted to a Qualified Institutional Buyer (QIB) like a public financial institution, banks, mutual funds, FIIs, development finance institutions, VCFs, a foreign venture capital investor registered with SEBI, SIDCs, Insurance Companies.....or banks/ financial institutions participate in the project to an extent of 15% of which 10% should come from the appraises.
- The minimum post issue capital of the issuer would be ₹ 10 crores or there would be a compulsory market making for at least 2 years from the date of listing of the shares. The number of prospective allottees should not be less than 1000.



## Public Issue by Listed Companies

- All listed companies can issue shares/convertible securities provided the issue size in a financial year does not exceed 5 times their pre issue net worth as per the audited balance sheet of the last financial year.
- If the name of the issuer company is changed within the last one year, the revenue from the activity suggested by the new name should not be less than 50% of the total revenue in the preceding one full year.
- If the above two conditions are not satisfied, a listed company can make a public issue through the book building process with the same conditions as applicable to unlisted companies.
- Listed companies can also raise funds through Qualified Institutional placement.

## Exemptions

The above norms for listed and unlisted companies are not applicable in the following cases.

- Private/Public sector banks
- Infrastructure companies whose project has been appraised by a PFI/IDFC/ILFS or a bank which was earlier a PFI and also not less than 5% of the project cost has been financed by any of the appraising institutions jointly/severally.
- Rights issue by a listed company.

Issues both public and rights of a convertible debt instruments – conditions

A convertible debt instrument means an instrument/security which creates/acknowledges indebtedness. It includes debentures, bonds and other securities.

**Conditions for issue of a Debt Instrument**

The following conditions should be satisfied on the date of filing the draft offer document with SEBI and also on the date of filing the final offer document with the ROCs/designated stock exchange:

- i. The offer document should disclose credit rating obtained from at least two SEBI registered credit rating agency.
- ii. The issuer company should not be in the RBI's defaulters list.
- iii. In case of debentures, the issuer company should not be in default for more than six months in the payment of interest and repayment of principal.
- iv. The issuing company should disclose in the offer document all credit ratings obtained during the 3 years preceding the public/ rights issue for any listed security.

**2. Pricing of Public Issues**

The Initial Public Offering Price is the price at which the stock is going to be offered to the public. The determination of initial public offering price depends on several things, like market condition, growth rate of the company, profitability etc.

**Pricing**

- 1) An issuer may determine the price of specified securities in consultation with the lead merchant banker or through the book building process.
- 2) An issuer may determine the coupon rate and conversion price of convertible debt instruments in consultation with the lead merchant banker or through the book building process.
- 3) The issuer shall undertake the book building process.

The determination of pricing of issues through book building process as follows:

- a) Firstly, the company and its underwriters determine a price range (price band) within which they are going to set their stock's price.

- b) Then the underwriter puts together a prospectus which comprises the price range. That prospectus is submitted to the Securities and Exchange Commission (SEC).
- c) The next phase of pricing starts just before the day of offering. In this phase the company and its underwriter fix the final price at which the public can buy the issue.
- d) Finally the phase of observation. That is, the company will observe its value assessment by the market after the issue starts trading.

### 3. Promoter's Contribution

#### Promoter

The person who conceived the idea of starting a business and organizes the setting up of a new company is called promoter of company.

The promoters' contribution in any issue shall be as per the provisions existing on

- Date of filing of prospectus with the Registrar of Company or date of filing of letter of offer with the designated stock exchange.
- Date of filing of draft offer document with the SEBI in other cases.

The rates of promoters' contribution are as under:

Public issue by unlisted cos.	Offer for sale by unlisted cos.	Public issue by listed cos.	Composite issues by listed cos.
At least 20% of post issue capital	Promoters share holding after offer for sale should be at least 20% of post issue capital	20% of the proposed issue (or) To ensure shareholding to the extent of 20% of the post issue category.	20% of proposed public issue (or) 20% of the post issue capital excluding the rights issue component of the composite issue.

In the above cases a minimum contribution is ₹ 25,000/- per application for each individual and ₹ 1,00,000/- from firms & companies.

### **Promoters' Contribution Before Public Issue**

- The promoters should bring in their contribution (including premium) in full at least one day before the public issue opens.
- The contribution would be kept in an escrow account with a bank.
- The contribution will be released to the company along with the public issue process.
- Where the contribution has been brought prior to the public issue and has already been used, the issuer company in their offer document should disclose the use of such funds in the cash flow statement submitted along with offer document.
- The shares should be allotted to the promoters against the money received after passing a resolution by the board of directors.
- The resolution and a certificate of the chartered accountant for having brought in promoters contribution should be filed with SEBI before the issue opens.

### ***Exemption from requirement of promoter contribution is allowed in the following three cases***

- a. Where no identifiable promoter/promoter group exists.
- b. Rights issue
- c. Public issue by a company listed on a stock exchange for at least 3 years with a record of dividend payment for at least 3 immediately preceding years.

### ***Lock-in Requirement of Promoters' Contribution***

- I. Any issue of capital to the public
  - Minimum lock-in period is 3 years
  - The lock-in-period starts from the date of allotment in the proposed issue.

- The lock-in-period ends on completion of three years from the date of commencement of commercial production or date of allotment in the public issue whichever is later.
- II. Public issue by unlisted company, Excess promoter's contribution would be locked in for 1 year.
- III. Public issue by a listed company, Lock in period is 1 year
- IV. Pre-issue share capital of an unlisted company
  - The pre-issue share capital other than locked in as promoter's contribution would be locked in for one year from the date of allotment.
  - Shares held by promoters lent to stabilizing agent are exempted from the lock-in requirements.
- V. Securities issued on firm allotment basis
  - Lock in period is one year from the date of commencement of commercial production or date of allotment in public issue or whichever is later.

#### *Requirements with Respect to Lock-in*

- The locked-in securities may be pledged only with banks/financial institutions as collateral security for loans granted by them.
- The minimum promoters' contribution in public issue locked in may be pledged if the purpose of the loan is for financing the object of the issue.
- The locked in shares held by the persons other than the promoters may be transferred to any other person holding locked in shares. However, the locked in period should be continued after the transfer also for the remaining period.
- Locked in shares held by promoters may be transferred to and amongst promoter/promoters group or new promoter/persons in control of the company. However, the lock-in-period should be continued in the hands of the transferee for the remaining period.
- Securities subjected to lock-in-period should carry the inscription non-transferrable. The duration of the lock-in-period should also be specified.

#### 4. Issue of Indian Depository Receipt (IDR)

Indian Depository Receipt is an instrument in the form of a depository receipt created by a Domestic Depository in India against the underlying equity shares of the issuing company incorporated outside India.

##### Conditions to be Satisfied for the Issue of IDR

- The pre-issue paid-up capital and free reserves should be at least US \$ 50 million.
- Average turnover should be US \$500 million during the 3 preceding years.
- The company should have been making profit and declaring minimum 10% dividend for at least 3 out of 5 years preceding the issue.
- The companies pre-issue debt equity rates should not exceed 2:1
- The company should fulfill the eligibility criteria prescribed by SEBI
- Issue size: the size of an IDR issue should not be less than ₹ 50 crore
- Ceiling: In any financial year the ceiling on IDR by a company shall be 15% of paid-up capital & reserves. The denomination should be in Indian Rupees.

##### Issue Procedure of IDR

- 1) To raise funds in India by issuing IDR, prior approval from SEBI should be obtained. The company should apply for permission at least 90 days before the opening of the issue. The fee payable with application is \$10,000 US which is non-refundable.
- 2) (a) For issue size upto ₹ 100 crore - 0.5% subject to min of ₹ 10 lakh  
(b) For issue size value exceeding ₹ 100 crore - additional 0.25% of the issue value
- 3) The issuer must obtain necessary approval from the appropriate authority from the country of its incorporation.

- 4) The issuer should appoint an overseas custodian bank, a domestic depository and merchant banker for the issue of IDR.
- 5) The issuer should deliver the underlying equity shares to the overseas custodian bank.
- 6) The overseas custodian bank authorizes the domestic depository to issue IDR.
- 7) The issuer should file the following with the ROC and SEBI
  - Due diligence report
  - Prospectus certified by two authorized signatories

The above should be filed through a merchant banker or domestic depository.

### **Listing of IDR**

The IDR should be listed on a recognized stock exchange. They can be purchased/possessed/freely transferred by a person resident in India.

### **Redemption**

A holder of IDR may ask the domestic depository to redeem the IDR. The domestic depository would request the OCB to get the corresponding underlying shares in favour of the holder for the purpose of being sold.

## **5. Issue Advertisement**

The term advertisement is defined to include notices, brochures, pamphlets, circulars, show cards, catalogues, hoardings, play cards, posters, and insertions in newspapers, pictures, films, cover pages of offer documents, or any other print medium, radio, television programmes through any electronic medium.

It is the duty of the lead merchant banker to ensure that the issuing companies comply with the guidelines on issue advertisement.

### Features of Issue Advertisement

- It must be fair clear and truthful
- Information in an offer document into should be reproduced in the issue advertisement
- It must disclose all relevant facts and must not be an extract of the relevant item
- Statements regarding performance should not be misleading.
- The language of the advertisement should be clear concise and understandable use of technical and legal terminology, complex language and excessive details should be avoided.
- It should not contain any promise regarding increase in profits.
- It should not include any information not in the offer document.
- It should not be in the form of crawlers on TV. (i.e., advertisement should not run simultaneously with the programme at the bottom of the television screen)
- No issue slogans should be included
- Brand name other than commercial name should not be used.
- Should not display models, celebrates fictional characters, landmarks, carry cages, etc., on the offer document or issue advertisement.
- In the case of advertisement on television screen, the risk factors should not be scrolled on the screen. Viewers must be advised to refer prospectus/offer document for detail.
- Slogans should not appear in the issue advertisement
- Non-factual and unsubstantiated titles should not appear in the issue advertisement.
- Financial data in the advertisement should contain the particulars of sales, gross profit, net profit, share capital, reserves, Earning per share, dividend and book values for 3 years.
- Advertisement should be released with risk factors also in respect of the issue.



- All public communications must be consistent with past practices.
- The public communication should
  - display that draft offer document has been filed with the SEBI or prospectus with the Registrar or letter of offer with the stock exchange
  - contain only factual information and it should not contain projection/estimates.
  - not contain in any information erroneous to the prospectus filed.
- All material development relating to its business & securities should be disclosed.
- Announcement regarding closure of issue should be made only after 90% of the issue has been subscribed.
- The advertisement should not offer any incentive to anyone associated with marketing the issue.
- The advertisement should specify the reservation if any for NRI's
- All issue advertisements and publicity materials should have the approval of the lead merchant banker responsible for marketing the issue.

## 6. Issue of Debt Instruments

Debt instruments mean non-convertible securities which create/acknowledge indebtedness and include debentures, bonds, and other securities of a body corporate/statutory body constituted by virtue of legislation. It excludes –

- Bonds issued by Government/other bodies specified by SEBI
- Security receipts
- Securitized debt instruments

### Methods of Issue

- *Public issue*: It is a public offer by an issuer to subscribe the debt securities.

- *Private Placement:* It is an offer to less than 50 persons to subscribe to debt securities
- ***Elements o SEBI Regulations:*** The main elements of
  - Issue requirements for public issue
  - Listing of debt instruments
  - Conditions for continuous listing and trading
  - Obligations of intermediaries and issuers

### ***Issue Requirements for Public Issue***

- a) Issuer cannot make public issue of debt securities if he has been prohibited / debarred by the SEBI from dealing in securities.
- b) Application should have been made to a recognized stock exchange for their listing.
- c) Should have obtained in principal approval.
- d) Credit rating should have been obtained from a credit agency registered with SEBI, it should be disclosed in the offer document along with all the ratings including the unaccepted ratings.
- e) An agreement should be entered with a SEBI Registered Depository for their dematerialization.
- f) The issuer should appoint SEBI Registered Merchant Bankers. One of them should be the lead manager.
- g) The issuer should appoint debenture trustees
- h) Debt securities should not be issued to provide loan to any person who is part of the same group/same management
- i) As per the company act provisions, the issuer should create Debenture Redemption Reserve.

### ***Listing of Debt Securities***

The listing of debt securities is mandatory. The issuer should comply with the conditions specified in the listing agreement. Under private placement basis the issue should comply with provisions of company act/rules, credit rating should have been obtained from the SEBI Registered agency, the securities are listed demat from the required disclosures are made.

### ***Conditions for Continuous Listing or Trading***

- Under the private placement basis the conditions of listing specified in the listing agreement should be complied with
- Rating should be periodically reviewed by the rating agency.
- Any revision in the rating should be promptly disclosed the concerned stock exchange.
- Rating changes should be communicated the investors.
- The trading of debt securities issued to public are on private placement basis should be cleared/settled in recognized stock exchanges. This is subject to condition specified by SEBI.

As regards securities made over the counter, the trade should be reported on a recognized stock exchange. This stock exchange should have a nationwide trading terminal/ other platform specified by the SEBI.

### ***Obligations of Intermediary and Issuers***

- Debenture trustees: protecting the interest of the security holders for this purpose they should have the required power including the right of a nominee Board of director.
- Performing their functions as per the regulations of SEBI debenture trustee regulation/trust deed with care diligence and loyalty.
- Supervising the implementation of conditions regarding creation of security and debenture Redemption reserve.
- Ascertaining disclosure of all material events.

### ***Issuer/lead Merchant Banker***

The disclosures made by the issuer should be true fair and adequate. There should be no misleading, untrue statement/misstatement. All material facts should be disclosed by the issuer in the offer document.

The merchant banker should ensure that the disclosures are true fair and adequate. He should ensure that the issuer has complied with the required regulations. The issuer and the merchant banker must ensure the adequacy of the security created. There must be 100% asset cover for debt securities.

## 7. Book Building

### Meaning

Book Building is essentially a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

There are two alternatives in Book Building

- a. 75% Book Building process
- b. Offer to public through Book Building process.

#### ***a. 75% Book Building Process***

The option for 75% Book Building is available subject to the following conditions:

- The prospectus should indicate separately “placement portion category” i.e. issue of securities through the Book Building process.
- Securities available to the public i.e. ‘net offer to the public’ should be separately identified.
- A minimum of 25% of the securities is required to be offered to the public is also applicable.
- The net offer to the public must be mandatorily underwritten.
- The draft prospectus containing all the information should be filed with the SEBI. However price at which the securities are offered need not be furnished.
- The issuer company should nominate a book runner from among the lead merchant bankers to the issue. His name should be mentioned in the prospectus.

- The book runner should circulate the copy of the draft prospectus filed with the SEBI to
  - a. Institutional buyers who are eligible for firm allotment
  - b. Intermediaries eligible to act as underwriters, inviting offers for subscription to the securities.

### *Process*

The price band within which the securities are being offered for subscription should be indicated in the draft prospectus circulated. The book runner should maintain a record of

- The names and number of securities ordered
- The price at which the institutional buyer/underwriter is willing to subscribe to the securities under the placement portion.

The underwriters should maintain a record of the orders received by him for subscribing to the issue out of the placement portion. He should intimate the book runner the aggregate of these offers. The book runner and issuing company fix the price at which the securities would be offered to the public. The issue price for the placement portion and offer to the public should be the same. After fixation of the price, the underwriter should execute an agreement with the issuer indicating the number of securities as well as the price at which the former would subscribe to the securities. The prospectus should be filed with the ROCs within two days of the determination of the issue price.

Two different accounts for collection of application money should be opened by the issuer company, one for the private placement portion and the other for the public subscription. The application forms with application money should be collected one day prior to the opening of the issue to the public. The money should be collected from the institutional buyers and underwriters to the extent of securities proposed to be allotted to them/subscribed by them. The allotments for the private placement portion should be made on the second day from the closure of the issue. The issuer company may have one date of allotment which should be deemed as the date of allotment for the issue of securities through the book building process. This is to ensure that the securities allotted under the placement portion and public portion are at the same rate and maintain equality. The

issues under the private placement category would be eligible to be listed if the underwriters were required to pay all money required to be paid as per the commitment by the eleventh day of the closure of the issue. The securities allotments under public category are eligible to be listed and the allotment should be made as per SEBI guidelines.

#### *Under Subscription*

In the case of net offer to the public category and under the placement portion the spill over to the extent of under subscription should be permitted from the placement portion. However, preference would be given to individual investors. In the case of placement portion, spillover would be permitted from the net offer to public.

#### *Payment of Interest on Application Money*

Interest on application money till the date of allotment or deemed date of allotment uniformly to all the applicants should be paid by the issuer company.

#### *Records of Book Building Process*

Records of the Book Building process should be maintained by the book runner and other intermediaries. The SEBI has the right to inspect those records.

#### ***b. Offer to Public Through Book Building Process***

An issuer company may make an issue of securities to the public in the following manner

- a. 100% of net offer to the public through the Book Building Process.
- b. 75% of net offer to the public through the Book Building Process and 25% at the price determined through the Book Building. Reservation to the extent of the percentage specified in the relevant SEBI guidelines can be made only to promoters, permanent employees of the issuer company, permanent employees of the promoting company, shareholders of the promoting companies, shareholders of group companies (in case of existing company).

*Conditions*

- Eligible merchant bankers should be appointed as book runners by the issuing company.
- The draft prospectus should contain the names of book runners.
- Agreement should be executed between the Issuer Company and stock exchanges. The stock exchanges should have the requisite system of online offer of securities. The agreement should specify among other things, their mutual rights, duties, responsibilities and obligations.
- The agreement should also provide for dispute resolution mechanism between them.
- The lead merchant bankers shall be the lead book runner. The other eligible merchant bankers shall be co-book runners.
- If there are more than one book runner, the names of all such book runners who have submitted the due diligence certificate to the SEBI should be mentioned on the front cover page of the prospectus.
- The prospectus should disclose that for any complaint pertaining to the issue the investor may contact any of such book runners.
- Responsibilities of lead book runner
- Building the books
- Book runners shall appoint syndicate members from among the SEBI registered intermediaries who are permitted to carry on activity as 'underwriters'.
- The book runners/syndicate members should appoint SEBI registered brokers of the stock exchange. These brokers should be financially capable of honoring their commitments arising out of defaults of their clients/investors.
- The lead merchant banker should file with the SEBI the draft prospectus containing all the disclosures as laid down by the SEBI.
- The total size of issue should be mentioned in the draft prospectus.

## **8. Green Shoe Option (G.S.O)**

### **Meaning**

Green shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post listing price stabilizing mechanism through a stabilizing agent.

For Instance if a company decides to publicly sell 10 lakh shares, the underwriters can implement their green shoe option and sell 10.15 lakh shares. When the shares are priced and can be publicly traded, the underwriters can buy back 15% of the shares. This enables underwriters to alleviate fluctuating share prices by increasing or decreasing the supply of shares according to initial public demand.

The green shoe option has the ability to diminish the risk for the company issuing the shares. It allows the underwriters to have good buying power in order to cover their deficit when a stock price falls without the risk of having to buy stock if the price rises. This in turn ensures the price stability of share prices which has greater positive impact on the investors and issuers.

### **Origin of Green Shoe Option**

The term Green Shoe Option is derived from a company named “Green Shoe Manufacturing Company established in 1919. This company is currently known as Stride Rite Corp. This Company was first to commence this option in 1960. It is mainly practiced in US and European Market

### **Why GSO?**

It is to reduce the risk of the IPO (Initial Public Offering). When the public demand for the shares exceeds expectations and the stock trades above the offering price.

### **Objectives of GSO**

- Risk diminution
- Price constancy



## Stabilizing Agent

The stabilizing agent is one of the merchant bankers/book runners. He is responsible for the price stabilization process. He is appointed by the issuing company. The stabilization agent borrows shares from the promoters/pre issue share holders. The maximum that can be borrowed is 15% of the total issue. The merchant banker in consultation with the Stabilization Agent determines the amount of shares to be allotted in excess of the public issue. The excess allotment is made out of the shares borrowed from the promoters.

## Conditions

- The issuing company should seek authorization for the possibility of allotment of further issues to the stabilizing agent together with the authorization for the public issue in the general meeting of its shareholders.
- The stabilizing agent should enter into an agreement with the issuer company, prior to the filing of the offer document with the SEBI.
- The agreement should clearly state all the items/conditions relating to Green Shoe option including fees charged/expenses to be incurred by the Stabilizing Agent for this purpose.
- The Stabilizing Agent should enter into agreement with the promoters or pre issue shareholders who would lend their shares specifying the maximum number of shares that may be borrowed from them. It should not exceed 15% of the total issue size.

## *Draft Prospectus/Final Prospectus Contents*

The draft prospectus/final Prospectus should contain

- Name of Stabilizing Agent.
- Maximum number of shares and the percentage of the proposed issue size.
- Period for which the company proposed to avail of the stabilization mechanism.

- Details of the agreement with promoters and stabilizing agent such as name of promoters, their holdings, number and % of shares to be lent by them, rights & obligations of each party etc.
- Exact number and % of over allotment to total issue size should be disclosed in the final prospectus.
- Maximum amount of securities to be received by the company in case of further allotment should be disclosed in final document to be filed with R.O.C. The use of these additional funds should also be disclosed.

#### *Other Conditions*

- In case of an IPO by an unlisted company/public issue by a listed company the promoters/pre issue shareholders holding more than 5% shares may lend their shares which are in dematerialized form only.
- The Stabilizing Agent would borrow to the extent of over allotment proposed.
- The allocation of these shares should be on pro rata basis to all the applicants.

#### *Period of Stabilization Mechanism*

The stabilization mechanism would be available for the period disclosed by the company in the prospectus up to a maximum grant of trading of 30 days from the date of permission by the stock exchange.

#### *Accounting Procedure*

The money received from the applicants against the over allotment in the G.S.O should be kept in G.S.O Bank account. It is to be used for buying shares from the market during the stabilization period. These shares should be credited to G.S.O Demat account. They should be returned to the promoters immediately within 2 working days after the close of the stabilization period.

If the stabilization agent does not buy shares to the extent of their over allotment from the market, the issuer company should allot shares to the extent of the shortfall in dematerialized form to G.S.O demat Account within 5 days of the closure of the stabilization period. These would be returned to the promoters by the stabilization agent in lien of those borrowed from them and the G.S.O demat account would be closed. Such shares would be listed in all the concerned Stock Exchanges where the shares allotted in the public issue are listed. The shares returned to promoters would be subject to the remaining lock in period.

The stabilization agent would remit the issue price to the company from the G.S.O Bank account. The remaining balance, net of expenses incurred by the Stabilization agent would be transferred to the investors' protection fund of the concerned stock exchange and the G.S.O Bank account would be closed.

During stabilization period, the Stabilization agent should submit a daily report signed by him/company to SEBI in the specified form and also submit the following:

- A depository statement for the G.S.O demats account for stabilization period.
- An undertaking by the stabilization agent and countersigned by the depositories in respect of confirmation of lock in shares returned to the promoters in lien of the shares borrowed from them for stabilization purposes.

The stabilization agent must maintain in respect of each issue with G.S.O, a register contain the following details:

- Price, date and time of each transaction
- Promoters and the number of shares borrowed from each.
- Allotments made.

The register should be maintained for at least 3 years from the date of the stabilizing period.

## 9. Initial Public Offer Through Stock Exchange Online System

An issuing company may issue securities to the public either through the existing banking channel or through the online system of the stock exchanges (E-IPO).

An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. It is when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to public. This paves way for listing and trading of the issuer's securities. The sale of securities can be either through book building or through normal public issue.

The e-IPO software smooth the progress of online bidding for Retail/HNI/QIB clients of the member in different IPO's, this software works as a distinct interface to bid for different IPO's in NSE and BSE at one go and also do activities such as viewing the details of upcoming IPO's, transferring the funds etc..

### Features of e-IPOs

- e-IPO Provides facility to create and sustain the client and assign rights to them based on the member's business modulate.
- Multiple users with enhanced user access and rights and Detailed price wise demand analysis of IPOs based on the files as received by the exchange,
- e-IPO Provides Facility to bulk upload of orders for institutional clients
- e-IPO aids generation of bulk files online, through a single platform
- e-IPO facilitates export of bid
- Multiple reports are accessible to end clients with report formation and export to excel facility
- e-IPO make possible post IPO closure activities such as allocation etc.
- e-IPO Supports both Fixed Price and Book Building methods of IPO Bidding

**Requirements**

- The company should enter into an agreement with the stock exchanges. The agreement should specify mutual right duties/responsibilities and obligations and it should provide for dispute resolution mechanism between them.
- The stock exchanges would appoint the SEBI registered stock brokers of the exchange. These brokers are to accept applications and place orders with the company.
- The brokers should collect money from the clients for orders placed. If the clients fail to pay for the shares allocated, the brokers would have to pay the amount.
- It should be ensured by the lead manager/company that the brokers are financially capable of honoring their commitments if the clients fail to pay.
- The company should pay the brokers a commission for their services. The brokers should not levy a service fee on the clients. This should be ensured by the stock exchanges.
- The company should appoint a Registrar to the issue. He should have electronic connectivity with the stock exchanges through which securities are offered under the system.
- Listing the company may list its securities on an exchange other than the one through which it offer its securities to the public via online system.

**Responsibility of Lead Manager**

- Co-ordination of all activities among the various intermediaries connected on the issue system.
- Disclosure in the prospectus and the application form of names of the appointed brokers along with other intermediaries like lead manager, Registrar to issue.

### **Mode of Operation**

The company should advertise in dailies with nationwide circulation.

- The advertisement should contain in addition to other required information, the following
  - i. The date of operating/closing of issue
  - ii. The method and process of application/allotment
  - iii. The names/addresses/telephone numbers of the brokers/centers for accepting applications.
- The applicants may contact the brokers of stock exchanges through which securities are offered through online system to place an order for subscribing to the securities.
- They may send the application forms with the cheque/DD towards application money to the Registrar to the issue or place the order to subscribe through a broker under the online system.
- The Registrar should open centers for collection of direct applications at the four metropolitan centers at Delhi, Bombay, Kolkata and Chennai (for issue of capital of ₹ 10 crores or above).
- The broker should collect the client registration form from the applicants duly filled and signed before placing the order in the system as per the 'know your client rule' as specified by the SEBI.
- The broker should thereafter enter the buy order in the system on behalf of the clients. He should enter details including name, addresses, telephone number and category of applicant, number of shares applied for, beneficiary ID etc. He should give an order number / order continuation ship to the applicant.

### **10. Preferential Issues**

Preferential issue means issue of shares/convertible debenture/ any other financial instrument to any select group of persons on a private placement basis.

Preferential issues are governed by the guidelines given below:

*a) Compliance with Conditions for Continuous Listing*

A listed company can make preferential issues only subject to compliance with the conditions for continuous listing.

*b) Pricing of the Preferential Issues*

**A. Shares**

The issue can be made at a price not less than the higher of the following:

- Average of weakly high and low of the closing prices of the related shares quoted on the stock exchange during the 6 months preceding the relevant date.
- Average of weakly high and low of the closing prices of the related shares quoted on the stock exchange during the 2 weeks preceding the relevant date.

The relevant date means 30 days prior to the date on which the meeting of the general body of shareholders is held to consider the proposed issue.

**B. Pricing of the Shares Arising out of Warrants**

In cases of issue of warrants on a preferential basis with an option to apply for shares, the price of the resultant share is determined in accordance with the provisions mentioned above (A). Here the relevant date is either the one referred to in (A) or a date 30 days prior to the date on which the holder of the warrant become entitled to apply for the said shares. It is at the option of the issuer company.

**C. Pricing of Shares on Conversion**

Where convertible instruments are issued on a preferential basis with a provision to allot share at a future rate, the issuer should determine the price of the shares to be allotted in the same manner as specified for pricing of shares in lieu of warrants.

a) *Currency of Financial Instruments*

The currency of the instruments with a provision for the allotment at a future date cannot exceed beyond 18 months from the date of issue of the relevant instruments.

b) *Non-transferability of Financial Instruments*

The instruments allotted on a preferential basis and shares allotted are subject to a lock in period as detailed below:

	<b>Nature of Allotment</b>	<b>Lock in period</b>
a	Instruments allotted on a preferential basis to the promoter /promoter groups	<ul style="list-style-type: none"> <li>➤ 3 years from the date of allotment</li> <li>➤ Not more than 20% of the total capital of the company including the one bought by way of preferential issue would be subject to a lock in period of 3 years from the date of allotment.</li> </ul>
b	Instruments allotted to any person including the promoter/promoters groups.	One year from the date of allotment
c	Shares issued on preferential basis pursuant to a scheme approved under corporate debt restructuring framework by RBI.	One year from the date of allotment
d	Entire pre-preferential allotment shareholding of a preferential allottee.	Lock in period is from the relevant date to six months from the date of preferential allotment.

Lock in shares/instruments can be transferred to, and among promoter group or to a new promoter or person in control of the company subject to continuation of the lock-in in the hands of the transferee for the remaining period.



c) *Currency of Shareholders Resolution*

The resolution passed at a meeting of shareholders of a company granting consent for preferential issues of any financial instrument is valid for a period of 15 days from the date of passing of the resolution/within 15 days from the date of approval of any Regulatory Authority/Government/within the time specified by SEBI in relaxation order.

d) *Other Requirements*

- The statutory auditors of the issue company should certify that the issue of the said instrument is being made in accordance with the requirements contained in these guidelines and Copies of the auditors' certificate should be laid before the meeting of the shareholders convened to consider the proposed issue.
- An independent qualified evaluator should value the assets in consideration for which shares are proposed to be issued in the following case:-
  - Preferential allotment of shares to promoters/relatives/associates and related entities for consideration other than cash
- The valuation report should be submitted to the stock exchange on which they are listed.
  - The following disclosures are to be made
- Details of all money utilized out of the preferential issue proceeds (to be disclosed in the balance sheet) along with purpose for which it has been used.
- Details of unutilized money and the form in which it is invested should also be disclosed.

e) *Applicability to FIIs*

The guidelines issued by Govt. of India/SEBI/RBI are applicable in the case of preferential allotment if any to be made to FIIs.

*The guidelines are not applicable in the following cases*

- Where further shares are allotted in pursuance to the merger and amalgamation scheme approved by a High court.
- Allotment made to persons in accordance with the provisions of the rehabilitation packages approved by the BIFR. If such persons are promoters/promoters group, the lock in provisions would apply unless otherwise stated in the BIFR order.
- Where further shares are allotted to All India Public financial institutions in accordance with the provisions of the loan agreements signed prior to August 4, 1994.

## **11. Qualified Institutional Placement**

Qualified Institutional placement is the placing on a private placement basis specified securities with the QIBs (Qualified Institutional Buyers) only. Specified securities mentioned above are Equity Shares and other convertible /exchangeable securities excluding warrants.

Q.I.P is subject to the following conditions

- Mutual funds should be allotted a minimum of 10% of the specified securities and the portion allotted but not subscribed can be allotted to other QIBs.
- If a QIB is a promoter or related to promoter no allotment can be made to it either directly or indirectly.
- The private placement should comply with the requirements of sec.67 (3a) of the companies act.
- Persons related to QIB means QIB having
  - a. Rights under a shareholders/voting agreement.
  - b. Veto right
  - c. Right to appoint any nominee director on the Board of the Issuer.
- The minimum number of allottees for each placement should not be less than

- a. Two, where the issue size is up to ₹ 250 crore
- b. Five, where the issue size is above ₹ 250 crore
- An allottee should not be allotted more than 50% of the issue size. (The same group/under common control QIBs would be deemed to be single allottee).
- The maximum total amount that can be raised through QIBs in a financial year is five times the net worth (as per the audited balance sheet of the previous year) of the issuer.
- The issue should be made on the basis of placement documents which should contain all material information specified in annexure 14J on the website. This is a private document to select the investors. This should be placed in the website of the concerned stock exchange. A copy should be filed with the SEBI for record within 30 days of allotment of the specified securities.

#### Other provisions relating to QIP

- QIP would be managed by SEBI registered merchant bankers. They should furnish a due diligence certificate to the stock exchange stating that the issue complies with all the relevant requirements.
- The issue price shall not be less than the higher of the average of the closing prices of the related shares quoted on the stock exchange during the (i) six months (ii) two weeks preceding the relevant date.
- The QIB can sell the allotted securities for 12 months only through a stock exchange.
- The securities should be made fully paid up at the time of allotment.
- The prices considered for determination of issue prices would be subject to appropriate adjustment if the issuer company
  - a. Makes an issue of shares by way of capitalization of profit/ reserve and on rights basis
  - b. consolidates its outstanding shares into a smaller number of shares
  - c. divides the outstanding shares including by way of stock split
  - d. reclassifies its share into other securities

- e. is involved in similar events/circumstances which in the opinion of the concerned stock exchange require adjustments.
- Securities can be converted into shares at any time within a maximum of 60 months from the date of allotment.
- The allotment of securities should be completed within 12 months from the date of passing of the shareholders resolution to allot securities to QIBs.
- A minimum of 6 months gap should be provided between two placements.

### **Obligations of Merchant Banker**

- The issue should be managed by a merchant banker registered with SEBI. He should exercise due diligence.
- The merchant banker should furnish to the concerned stock exchanges a due diligence certificate.
- Due diligence certificate to the effect that the issue complies with all the requirements along with the application for seeking in principle approval and final permission for listing.

### **Issuer Certificate**

The issuer should furnish to the concerned stock exchanges

- i. A copy of the placement document
- ii. Certificate of compliance with all the requirements and
- iii. Documents/undertakings specified in the listing agreement for seeking in principle approval/final permission for listing of the specified securities.

### **Self Assessment Questions**

1. Explain various financial activities /functions/services which come in the ambit of merchant Banking?
2. What is the code of conduct laid down by SEBI which the merchant bankers have to abide by?

3. Discuss the role of merchant banker in the pre-issue process.
4. Who are the major new issue market intermediaries? Explain briefly.
5. Explain the various methods of public issue? What is an IPO? Explain the IPO issue management activities performed by merchant banker.
6. Discuss the process of IPO through Book-building
7. Write short notes on the following:
  - a) Bankers to an issue
  - b) Brokers to an issue
  - c) Registrars to an issue
  - d) Share transfer agent
  - e) Portfolio managers
8. Explain the role of underwriters in the issuing process of IPO shares
9. Discuss the responsibilities and duties of a debenture trustee.
10. Write short notes on the following:
  - a) Green shoe option
  - b) Preferential issues
  - c) Indian Depository Receipts
  - d) Initial Public offer through stock exchange online system
  - e) Promoters' contribution
  - f) Qualified Institutional Placement
11. State the pre-issue and post issue obligations which are part of issue management of merchant bankers in India
12. What is Book Building as a method of offering securities? Narrate the procedure involved in it.
13. Explain in detail the procedures involved incase of IPO through Stock exchange online system?
14. Enumerate the SEBI's regulatory framework involved in the issue of Debt instruments?
15. Describe the procedure involved in the issue of Indian Depository Receipts (IDR)?

## CASE STUDY

Indbank Merchant Banking Services Limited (Indbank) was incorporated in the 1989 as a subsidiary of Indian Bank. Indbank is engaged in Merchant Banking, Advisory Services, Stock Broking, Depository Participant Activities, Distribution of Mutual Fund and other Investment Products and online Trading.

Indbank is a Category 1 Merchant Banker registered with Securities Exchange Board of India (SEBI) undertaking the following assignments:

- Under various capacities like Lead Manager, Co-Manager, Advisor, Arranger etc. for public issues, rights issues and private placement.
- For acquisition of shares & takeovers under SEBI.
- For Employee stock option scheme / Stock Purchase Scheme by Corporates under the SEBI, Guidelines, 1999.

Assume that you are appointed as Assistant Manager in Indbank Merchant Banking Services Limited. XYZ Company approaches Indbank Merchant banking services Ltd., to manage a new issue of shares of ₹ 100 crores. This task is entrusted to you to independently handle this new issue of shares. Handling of this type of task is new and challenge to you. You have to establish your credibility to your employer and client of XYZ Company.

1. As an Asstt. Manager, how you would proceed to manage this issue of ₹ 100 crores keeping in view the guidelines of SEBI, Registrar of companies & Stock Exchange?
2. Besides issue of shares, what other services are provided by Merchant Banks to its customers?

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## UNIT - III

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### Financial Services – I

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#### Learning Objectives

*After studying this unit you can be able to:*

- understand the concept, modus operandi, types, functions and benefits of factoring service.
- know the concept, process and benefits of forfaiting service.
- differentiate 'Factoring' with 'Bills discounting' and 'Forfaiting'
- know the reality of and recent investment in Real estate Industry in India
- accustom about the Housing Finance system in India and the functions of NHB
- familiarize the concept of Asset liability Management, securitization, Mortgage Backed Securities and Reverse Mortgage Loan.

#### Unit Structure

Lesson 3.1 – Factoring and Forfeiting services

Lesson 3.2 – Real Estate Industry and Housing Finance

Lesson 3.3 – Asset Liability Management and Securitization

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## Lesson 3.1 - Factoring and Forfeiting Services

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### Introduction

Factor is derived from the Latin word 'facere' which means 'to get things done'. Factoring is an arrangement between an agency (the factor) and a business concern. This arrangement is a financial service which is provided by an institution called factor. The factor undertakes the task of realizing debts, bills receivables on behalf of its customer and makes payment to its client's creditors. For this service the factor receives commission. The entire process is known as 'factoring'. Factoring services originated in USA, and UK. The specialized financial institutions were established to do this financial service. It helps firms to meet their working capital requirements by selling their receivables.

### Definition of Factoring

**According to Peter M. Biscose factoring is** "a continuing legal relationship between a financial institution (the factor) and a business concern (the client) selling goods or providing services to trade customers, whereby the factor purchases the clients' book debts, either with or without recourse to the client, and in relation thereto, controls the credit extended to customers, and administers the sales ledger".

**According to the report submitted to the RBI by Mr. C.S. kalyanasundaram, factoring as,** *"a continuing arrangement under which a financing institution assumes the credit and collection functions for its client, purchases receivables as they arise (with or without recourse for credit losses, i.e., the customer's financial inability to pay), maintains the sales ledger, attends to other book-keeping duties relating to such accounts and performs other auxiliary functions."*

Thus, factoring is an agreement or arrangement between two parties (a firm and a factor), in which to collect or purchase the book debts of the firm by the factor, for a commission or profit.



## Characteristics of Factoring

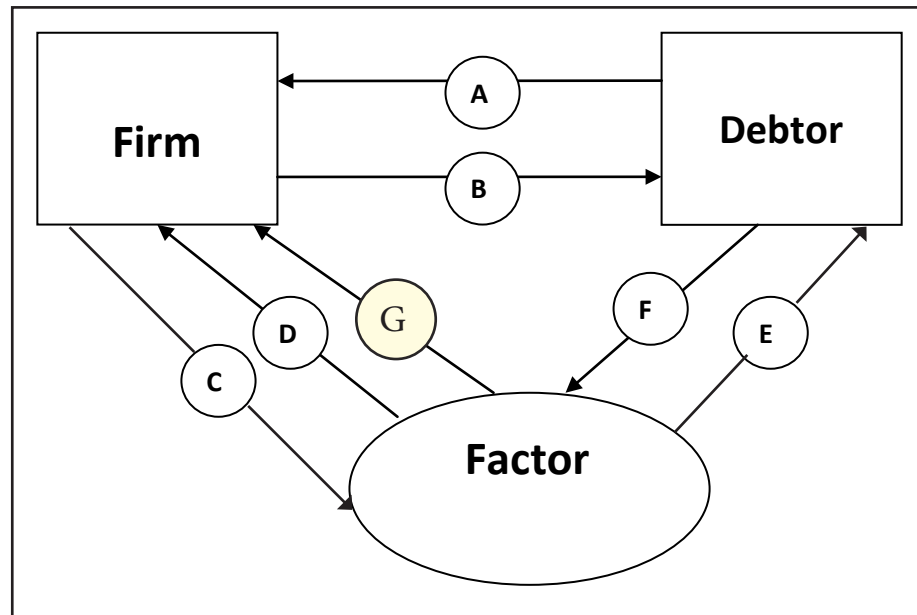
- Factoring is an arrangement between financial institution and a business concern
- It is an activity of selling the firm's receivables to a factoring organization.
- Book debts are assigned in favour of a factor.
- Factoring is not a negotiable instrument
- Factor acts as a collection agent or representative of a firm
- Factor charges commission or gets discount on the book debts
- Factor can get margin in the range of 5 percent to 20 per cent.
- The normal period of factoring is 90-150 days and rarely exceeds 150 days.
- Factoring is not possible in case of bad debts.
- Credit rating is not mandatory.
- Factoring can be with or without recourse to the seller on non-payment by the buyers.
- It is a method of 'off balance sheet' financing.
- Cost of factoring is always equal to finance cost plus operating cost.

## Modus Operandi of factoring

There are three parties to a domestic factoring arrangement. It includes a business **Firm** who is supplier or seller of goods and services, **Debtor** who is a buyer of goods and services provided by the firm, and a **Factor** who is a financial institution or intermediary between Firm and Debtor who provides the factoring services.

Generally, the firm sells the goods to the buyer or customer on credit. He sends invoices to the customer directly and also collects payment directly from the customer. The firm may also arrange factor to collect the receivables. Various processes are involved when the firm entrust the collection activities to the factor.

*Let us now study the **Modus operandi of factoring** with the help of a picture as follows:*



- A.** Firm gets an order of purchase of goods/services on credit through its customer
- B.** Firm sends goods/services and invoice to his customer (debtor) and the firm may inform or direct that the invoice is assigned to and must be paid to a factor.
- C.** Firm sends invoice to the factor, along with other valid proof of dispatch
- D.** Factor provides pre-payment to the client, it can be up to 80-90 per cent of the invoice value
- E.** Factor follows up with the customers for realisation of payment due
- F.** Debtor pays money to the factor on due date (i.e., factor collects book debts)
- G.** Factor makes the balance payment of the invoice value to the client

Through the invoices presented, the factor maintains the sales ledger for the client and statements of accounts are sent to the customer on a monthly basis. The factor takes over the collection of book debts, and reminders are sent when the invoices are overdue. The client gets information about all the factoring transactions through monthly and weekly reports provided by the factor.

## Types of Factoring

There are different forms of factoring arrangement based on the type of special features attached to them which are as follows:

1. Domestic Factoring
2. Export Factoring
3. Full servicing factoring
4. Maturity factoring
5. Advance factoring
6. Agency discounting
7. Bank participation factoring

### 1. Domestic Factoring

Domestic factoring is the transaction of sales relating to domestic, which is categorized into three forms such as:

- a. Disclosed Factoring
- b. Undisclosed Factoring
- c. Invoice Discounting

#### *a. Disclosed Factoring*

The factoring agreement is disclosed to the firm's customers. The customers will make payment directly to the factor. The arrangement for factoring may take in the form of either ***Recourse factoring*** or ***Non-recourse factoring***

- **Recourse factoring** - The factor purchases the receivables of the firm and collects the debts from the customer. The firm is responsible to the factor when the customer fails to pay the amount on maturity.
- **Non-recourse factoring** - The factor undertakes to collect the debts from the customer in case of non-recourse factoring. The factor may settle the amount to its client then and there or pay the

balance amount at the end of the credit period. The advantage of non-recourse factoring is that the firm may discontinue the service of factoring at any time.

***b. Undisclosed***

The factor realizes money from the debtors in the name of the seller because the factoring arrangement is not informed to the firm's customers. This method is popular in UK.c.

***c. Invoice Discounting***

The factor provides finance through discounting the bills. The rate of discount is based on market trends.

**2. Export Factoring**

A bank (factor) located in the exporter's country collects a guaranteed payment of export proceeds on behalf of his client (exporter) from debtor (importer). This is called 'export factoring'.

**3. Full Servicing Factoring**

It is also known as without recourse factoring service. It offers all types of services such as finance, sales ledger administration, collection, debt protection, and advisory services. Its specialty is that it gives protection to the client against bad debts.

**4. Maturity Factoring**

Under this type the payment is made only on the guaranteed payment date or on the date of collection. Financing facility is not provided to the client. All other facilities are provided by it.

**5. Advance Factoring**

The factor makes an advance payment to its client. The advance payment covers 70 to 80 percent of the receivables which are factored. The factor collects interest on the advance payments made. The balance amount is settled to his client on the date of maturity.

## 6. Agency Discounting

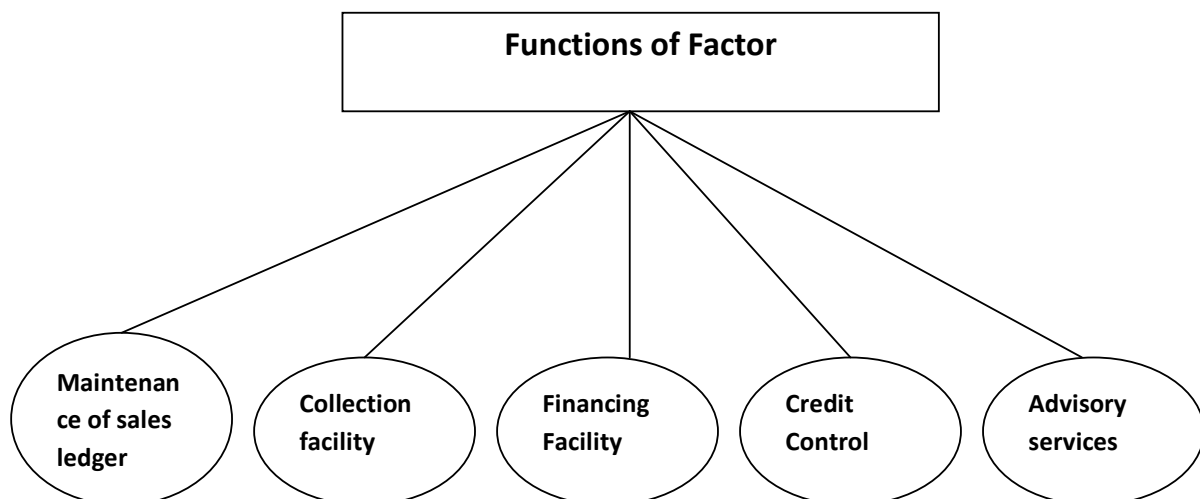
This kind of factoring, the factor provides only financing facility and protection against bad debt. The other services such as maintenance of sales ledger and carrying out the collection of book debts etc are not provided.

## 7. Bank Participation Factoring

In this system of factoring, the factor arranges an advance amount from a bank. For this service the factor pays interest to the bank and makes the advance to the client.

### Functions of a Factor

*The functions of a factor are depicted in the chart given below:*



#### a. Maintenance of Sales Ledger

- Maintenance of the clients' sales ledgers
- Sending periodical reports to the client on the current status of receivables
- Maintenance of payment schedule.

#### b. Provision of Collection Facility helps the client in the following ways

- Firm may concentrate on its other activities since it is free from collection work.

- Cost reduction, savings in manpower, time and efforts due to outsourcing of the collection activity.
- The systematic collection of receivables is possible with the help of professional manpower.
- Due to the timely demands of the factor, the prompt collection can be done.
- Factor initiates legal action on customers to secure payments.

#### **c. Financing Trade Debts**

- The factor may pay in advance up to 80% of assigned book debts.
- The factor may finance to his client through purchase of Book debts.

#### **d. Credit Control**

- The factor may fix the credit limits for accepted customers to control the credit risk.
- The factor may examine 3C's (Character, Capacity and Credit worthiness) of the client's customer.
- The factor may purchase trade debts within his approved limits.

#### **e. Advisory Services**

- Factor may give information to his client like current market trend, feedback of the client's customers etc.
- Factor may give advice to their client regarding other financial services like leasing, hire-purchase and merchant banking etc.
- Factor may assist in evaluation of the procedures of invoicing, delivery and sales returns.

#### **Factoring in India**

Factoring service is originated in India based on the proposal of the study group of Kalyanasundaram. In 1989, the study group was appointed by RBI. In 1991, SBI Factors and Commercial Ltd (SBI FACS)

was established. It is the first factoring company in India. RBI issued guidelines for factoring services based on the recommendations of the study group.

***The main recommendations of the Committee/Group are listed below:***

- Taking all the relevant facts into account, there is sufficient scope for introduction of factoring services in India which would be complementary to the services provided by banks.
- The introduction of export factoring services would provide additional facility to exporters.
- While quantification of the demand for factoring services has not been possible, it is assessed that it would grow sufficiently so as to make factoring business a commercially viable proposition within a period of two/three years.
- On the export front, there would be a fairly good availment of various services offered by export factors.
- With a view to attaining a balanced dispersal of risks, factors should offer their services to all industries and all sectors in the economy.
- The pricing of various services of by factors would essentially depend upon the cost of funds. Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible, in any case not exceeding 13.5 percent per annum, so that a reasonable spread is available.
- The RBI could consider allowing factoring organizations to raise funds from the Discount and Finance House of India Ltd, as also from other approved financial institutions, against their usance promissory notes covering receivables factored by them, on the lines of revised procedure under bills discounting scheme.
- The price for financing services would be around 16 per cent per annum and the aggregate price for all other services may not exceed 2.5 percent to 3 percent of the debts services.
- In the beginning only select promoter institutions/groups of individuals with good track record in financial services and competent management should be permitted to enter this new field.

- Initially the organizations may be promoted on a zonal basis.
- There are distinct advantages in the banks being associated with handling of factoring business. The subsidiaries or associates of banks are ideally suited for undertaking this business; initially, it would be desirable to have only four or five organizations which could be promoted either individually by the leading banks or jointly by a few major banks having a large network of branches.
- Factoring activities could perhaps be taken up by the Small Industries Development Bank of India, preferably in association with one or more commercial banks.
- The business community should first be educated through bank branches about the nature and scope of these services and the benefits accruing there from.
- Factors cannot extend their services efficiently, effectively and economically without the support of computers, as quick and dependable means of communication. Concurrent with consideration of various aspects relating to commencement of factoring operations the promoters should initiate measures for organizing network of computers /dedicated lines, the branches/ agents in different parts of the country for accounting follow up remittance and other activities involved in factoring business.
- The Central Government and RBI should initiate appropriate measures immediately for setting up specialized agencies for credit investigations; until such agencies become fully operative, factors may have to rely on such information about clients/customers as could be collected through banks or other sources.
- Since the suppliers would be able to obtain financial services from both banks and factors, it is necessary to provide for proper linkage between banks and factoring organizations.
- The factoring of Small Scale Industrial (SSI) units could be mutually beneficial to both factors and SSI units and the factors should make every effort to orient their strategy to crystallize, the potential demand for this sector.



## Benefits of Factoring

The process of factoring is very simple. It involves buying and selling firms' invoices at an agreed discount. Factoring service is different from the traditional bank financing. In traditional bank financing, finance is based on the firms' credit worthiness whereas factoring relies on the credit-worthiness of the firm's customers.

The benefits of Factoring are as follows

### 1. Improve Cash Flow Without Adding Debt

- Firm gets finance on its outstanding invoices
- It helps to meet tax requirements
- It helps to maintain sufficient working capital
- Firm can invest in additional capital equipment
- Firm can concentrate on market for additional business
- Market share may increase among with their competitor
- Firm's customers get advantage of discounts

### 2. Improve Customer Credit Services

- It helps to reduce bad debt
- New customers get advantage of rationalized credit approvals
- Administration cost may reduce due to entrusting the work
- Firm gets good Accounts Receivable Management

### 3. Take Advantage of the Flexibility

- Firm may entrust to the factor part or full book debts for collection
- There is no fixed limits of book debts for factoring
- Firm gets financial support as well as increase in the strength of its customers

## Factoring and Bills Discounting

Bills discounting is traditional method of bank financing. Bill is a promissory note and it can be negotiable. It contains the promise to pay the amount mentioned in it to the drawer/payee on the date of maturity.

## Bills Discounting

### Definition

*“When the seller (drawer) deposits genuine commercial bills and obtains financial accommodation from a bank or financial institution, it is known as “Bill Discounting”. The seller, instead of discounting the bill immediately may choose to wait till the date of maturity”.*

### Features

- **Discount charge:** The margin between advance granted by the bank and the face value of the bill is called the discount, and is calculated on the maturity value at rate a certain percentage per annum.
- **Maturity:** Maturity of a bill is defined as the date on which payment will fall due. A normal maturity period is 30, 60, 90 or 120 days.
- **Ready Finance:** Bank discount and purchase the bills of their customers so that the customers get immediate finance from bank. They need not wait till the bank collects the payment of the bill

### Advantages of Bill Discounting

- **Easy Access:** Bill discounting is beneficial because the seller has access to short term source of finance from the banker, which would help meet urgent business expenses.
- **Safety of Funds:** Bill Discounting offers advantage of safety of funds deployed by the banker.
- **Certainty of Payment:** A discounted bill of exchange being self liquidated in nature, a banker is assured of payment on the date of maturity.
- **Profitability:** Bill discounting offers the benefit of obtaining a yield much higher than other types of loans and advances.
- **Smooth liquidity:** Bill discounting allows for smooth inter-bank liquidity. Development of a healthy bill market helps achieve stability in an otherwise violently fluctuating call money market.

Bill Discounting permits banks to buy and sell bills, and eventually helps even out their liquidity investments.

- **Higher Yield:** The actual yield rate of discounted documentary bills as that are earned by the banks and financial institutions is much higher as compared to discounting of clean bills.
- **Ideal Investments:** To a banker, bill discounting and purchasing offers the advantage of ideal employment of funds for a definite period. As bills are drawn for a definite period the banker can invest surplus funds for an appropriate period.
- **Facility of Refinancing:** Discounted bills serve as the good liquid asset. Banks may always avail themselves of the refinancing facility made available by the approved financial institutions in a country for bills discounted and purchased by them.
- **Relative stability of Prices:** Bills are considered to be less volatile avenues of investments for a banker as compared to other securities. This is because bills do not fluctuate much in their value, although a banker might sometimes have to get them rediscounted at a higher rate.

### Steps in Discounting and Purchasing

- a) **Examination of Bill:** The banker verifies the nature of the bill and the transaction. The banker then ensures that the customer has supplied all required documents along with the bills.
- b) **Crediting Customer Accounts:** After examining the genuineness of the bill, the banker grants a credit limit, either on a regular or an adhoc basis. The customer account is credited with the net amount of the bill. The amount of discount is the income earned by the bank on discounting.
- c) **Control over the accounts:** To ensure that no customer borrows more than the sanctioned limit, a separate register is maintained for determining the amount availed by each customer. Separate columns are allotted to show the names of the customers, limits sanctioned, Bills discounted, Bills collected, loans granted and loans granted.

- d) Sending Bills for Collection:** The bills, together with documents duly stamped by the banker are sent to the banker's branch for presenting the bill for acceptance or payment, in accordance with the instructions accompanying the bill.
- e) Action by the Branch:** On receipt of payment, the collecting banker remits the payment to the banker which has sent the bill for collection.
- f) Dishonor:** In the event of dishonor, the dishonor advice is sent to the drawer of the bill. It would be appropriate for the collecting banker to get the bill protested for dishonor. The banker debits the customer account with the amount of the bill and also all charges incurred due to the dishonor of the bill. Such a bill should not be purchased in the event of its being presented again. However, the banker may agree to accept it for collection.

*Let us see the resemblances and contrast between factoring services and bills discounting.*

### Resemblances

- Both provide short-term finance
- Accounts Receivables are discounted in both

### Contrast

Bills Discounting	Factoring service
1. It involves a single and individual transaction.	1. It involves entire book debts.
2. Every bill requires individual acceptance of the drawee and it may take long time.	2. Firm's customers are informed once at the time of undertaking by the factor.
3. It is very expensive; however the stamp duty is levied on certain usance bills.	3. Only discount/commission is charged by the factor and no other duty is charged on accounts receivables.
4. It involves cumbersome formalities.	4. It involves no such formalities.

<b>Bills Discounting</b>	<b>Factoring service</b>
5. Only 3 days are allowed as grace period for payment after the maturity date of invoice.	5. It is very liberal and there is no such rigid condition.
6. Original documents like MTR, RR, and Bill of Lading are to be submitted.	6. Only copies of such documents are necessary.
7. Charges are normally upfront.	7. Finance charges are levied only on the amount of money withdrawn.

### **Future Prospects of factoring**

In the advent of globalization and opening up of an Indian economy, financial sector is to play a pivotal role in the overall economic development of the country. Mergers and acquisitions are the need of the hour and the corporate giants are taking birth to derive the maximum advantage of optimum size and economies of scale of production. Syndication of loans are to replace the consortium advances. Securitization of assets is the new mantra heard about recently. Factoring is going to play an important role in filling the gap and the SSI sector to become profitable and competitive. A factoring law which would address the present inadequacies and impediments stalling the growth of factoring business is also likely to be passed shortly.

### **Conclusion**

Factoring is likely to help in systematizing trade credit in India. The factoring institution takes over the responsibility and computerizes the operations to generate enough data on the payment's behavior of a large number of firms and companies in the country. Factoring would relieve the businesses, particularly the small industry and trade, of the burden of collecting their dues from their trade debtors. An efficient financial system like factoring can sustain itself on a viable basis only if a conducive environment is created and fostered.

### **Forfaiting**

‘Forfaiting’ is a French term “forfeit” which means to surrender

(forfeit) ones' rights on something to someone else. It is a form or mechanism of financing of receivables arising from international trade by discounting export receivables evidenced by bills of exchanges or promissory notes without recourse to the exporter carrying medium to long-term maturities on a fixed rate basis up to 100% of the contract value.

'Forfaiting' is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. There are four parties in a transaction of forfaiting. They are Exporter, Importer, Importer's bank (the guarantor) and the discounting bank (the forfeiter).

Forfaiting mechanism solves the problem of importer and exporter in the following way:

- The importer is purchasing machinery for which he is unwilling or unable to pay cash until the machinery begins to generate income.
- The exporter wants immediate payment in full in order to meet his ongoing business commitments.

### **Role of EXIM Bank in Forfeiting Transactions**

The role of EXIM Bank will be that of an intermediary between the Indian exporter and overseas forfeiting agency. On a request from an exporter, for an export transaction which is eligible to be forfeited, the EXIM bank will obtain indicative and firm forfeiting quotes- discount rate, commitment and other fees- from overseas agencies. EXIM bank will also receive avulsed bills of exchange or promissory notes, as the case may be and send them to the forfeiter for discounting and will arrange for the discounted proceeds to be remitted to the Indian exporter. EXIM bank will issue appropriate certificates to enable Indian exporters to remit commitment fees and other charges.

### **Process of Forfaiting Mechanism**

1. The proposed export sales contract is a negotiation made between the two parties (exporter and importer).
2. The importer approaches his local bank to issue Letter of Credit

(guarantee) in support of promissory notes or bills of exchange drawn in favour of the exporter.

3. The exporter approaches the forfeiter to establish the terms of forfeiting.
4. The forfeiter quotes the discount rate after estimating the risk involved in it.
5. The exporter sells and delivers the goods.
6. The importer draws a promissory note in favour of the exporter.
7. The exporter draws bill and gets acceptance of the importer.
8. The exporter enters into a forfeiting agreement with a forfeiter.
9. The exporter sells the bills/notes to the forfeiter at a discount without recourse after quoting the contract price to the overseas buyer including discount rate and commitment fee on the sales price of the goods to be exported.
10. The forfeiter presents the bill to the importer for payment on the due date if he holds the bill till the date of maturity or he may sell the bills in the capital market (short term security) before the maturity period.

The forfaiting typically involves the following cost elements

- Commitment fee, payable by the exporter to the forfeiter 'for latter's' commitment to execute a specific forfaiting transaction at a firm discount rate within a specified time.
- Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfeiter from the amount paid to the exporter against the promissory notes or bills of exchange.

## **Benefits to Exporter**

### **1. 100 Per Cent Financing**

The exporter is able to get 100% finance through a forfeiter. The exporter receives payment in full immediately after shipping (i.e. submission of documents to the forfeiter).

## **2. Improved Cash Flow**

100% financing through forfeiter is enabling the exporter to convert his deferred transaction into cash transaction. The exporter's cash inflow may increase. This helps to improve financial status and fund raising capability of the exporter.

## **3. Reduced Administration Cost**

The exporter is free from the management of the receivables by using forfaiting.

## **4. Advance Tax Refund**

The exporter can get tax refund in advance.

## **5. Risk Reduction**

The risk arising from deferred payments such as interest rate risk, currency risk, credit risk, and political risk are transferred from exporter to the forfeiting bank.

## **6. Increased Trade Opportunity**

The exporter can enlarge his business in the world market due to extending the credit limit. Forfeiting encourages more credit transactions.

## **Difference between Factoring and Forfeiting**

Both the services 'factoring' and 'forfeiting' are providing finance to the seller. Their main objective is to provide smooth cash flow to the sellers. The basic difference between the forfeiting and factoring is that forfeiting is a long term receivables (over 90 days up to 5 years) while factoring is short term receivables (within 90 days) and is more related to receivables against commodity sales. Let us see the other differences between factoring and forfeiting:-



Factoring	Forfaiting
<ol style="list-style-type: none"> <li>1. It is employed to finance both domestic and export business.</li> <li>2. It involves the purchase of the invoice of the client.</li> <li>3. Suitable for ongoing open account sales.</li> <li>4. It provides short-term financing for a credit period up to 180 days.</li> <li>5. It is a continuous arrangement between factor and client.</li> <li>6. The administrative cost on management of receivables may reduce because the collection responsibility is entrusted with the factor.</li> <li>7. Separate charges are applied for financing, collection, administration, credit protection and provision of information.</li> <li>8. Financing can be with or without recourse; the credit protection collection and administration services may also be provided without financing.</li> <li>9. Factoring can be covered any amount of transaction. There is no restriction of minimum size.</li> <li>10. The factor has to wait till the due date for getting payment.</li> </ol>	<ol style="list-style-type: none"> <li>1. It is used to finance only export business.</li> <li>2. It involves the purchase of the export bill.</li> <li>3. Oriented towards single transactions backed by LC or bank guarantee.</li> <li>4. It is medium and long-term financing for a credit period from 180 days to 7 years.</li> <li>5. It is a single transaction arrangement between exporter and forfaiter. Each transaction is treated as individual.</li> <li>6. The exporter must manage the receivables account because the forfaiter's responsibility extends to collection of forfeited debt only.</li> <li>7. Single discount charges is applied which depend on guaranteeing bank and country risk, credit period involved and currency of debt. Only additional charges are commitment fee if firm commitment is required prior to drawdown during delivery period.</li> <li>8. It is always 'without recourse' and essentially a financing product.</li> <li>9. Transactions should be of a minimum value of USD 250,000.</li> <li>10. Forfeiter may hold the bill either till the due date or realize in the securities market before the due date.</li> </ol>

### **The Growth of forfeiting Business**

With the increased volume of trade between the developed and developing countries, exporters in developed countries were in search of some alternative mode of trade finance as the buyers of the developing countries required credit that could not be offered through the traditional means of finance. Forfeiting originated in West Germany and Switzerland in 1960 and extended to all countries later. London soon became the most vibrant market. Some of the international operators are Chase Manhattan, Citibank and Security Pacific.

### **The Problem Areas in forfeiting services**

The absence of legal framework for settling disputes between exporter, importer and forfeiter are major hindrances to these services. Lack of an accurate database on importers and their status in their countries is another problem. The risks-commercial, political and sovereign may sometimes be high. Absence of developed secondary market may also pose difficulties for the success of these services.

### **Conclusion**

Forfeiting has been increasingly in popularity because of the limitations of the traditional sources of export finance. With the decline in the attractiveness of the traditional modes of export financing, the benefits of forfeiting become quite self evident. With a view to boost the exports, financial institutions and banks could indeed take a hard look at forfeiting at least to put the Indian exporter on par with his competitors from other countries. Over a period of time, forfeiting is likely to emerge as an alternate source of trade finance especially for deferred exports.

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## Lesson 3.2 - Real Estate Industry and Housing Finance

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### Real Estate Industry

#### Introduction

Indian economy is growing rapidly in recent years. It will be one of the fastest growing economies in the next decade. Real estate industry plays a vital role in the India's economic growth. The contribution of Real estate industry in India is about 5% to Gross Domestic Product (GDP).

The growth rate of demand on real estate industry in recent years is abruptly amplified in Tier 1 metropolitan cities. The real estate industry has wider scope in the sectors like education, healthcare and tourism. In the last decade, the investment of FDI was more than US \$ 9billion in the real estate. In 2010, over 11 per cent of total FDI in India was in the real estate sector. There have been 110 deals in this sector during the period 2001 to the first half of 2011. Due to the economic growth, the rural population migrates towards urban for employment opportunity. Urban population has started increasing. Due to this urbanization, the demand for residential real estate is significantly increased.

Real estate investment is a long term investment and also it is a durable asset. The life of the building is much longer than any other asset. The realization of land and building takes much longer time because it involves complicated legal procedures and high transaction cost.

Real estate assets are classified based on use into the following:-

- a) Purchaser occupied property
- b) Income producing property
- c) Property developed for sale

a) **Purchaser occupied property:** The person who purchases the property for his own use either for his residence or for his business premises is called purchaser occupied property.

- b) **Income producing property:** The property purchased for the purposes of leasing or renting is called income generating property.
- c) **Property developed for sale:** If the purpose of purchasing the property is to sell to others for profit, it is called property developed for sale.

### **Factors that make Real Estate Attractive**

The real estate industry is attractive because:

- The demand of this industry is based on need
- It generates two types of income such as capital gain and rental income.
- It paves the way for regular income through lease/rent.
- The revolution in the real estate industry is due to arrival of MNCs especially in the IT sector.

Therefore, the housing sector in India has witnessed strong development in the last few years.

### **Benefits of Real Estate Investment**

- There is tax exemption subject to certain conditions on profit (capital gain) arising from sale of land/buildings. This encourages investors to invest in real estate sector.
- Housing Loans are available at the lower rate of interest. Hence, middle-class people can easily purchase own house.
- Investment in commercial premises generates more rental income besides incredible increase in the value of the investment in premises.
- Yield of Investment in real estate is exorbitant whereas stock market investment is highly volatile. Hence, investors are more interested to invest in real estate.

## Investments

Due to arrival of MNCs, real estate emerged as popular sector for private equity fund. Some of the recent investments in this sector are discussed below:

- Sahara India has joined hands with the US-based Turner Construction Company. The Joint venture of Sahara Turner Construction, will build integrated townships called Sahara City Homes and other Sahara India projects in India worth US\$ 25 billion over the next 20 years
- DLF acquired the additional 26 per cent stake in its joint venture company—DLF Hotels & Hospitality Ltd (DHHL)—from Aro Participation Ltd and Splendid Property Company Ltd, affiliates of Hilton International. At present, the company holds 74 per cent equity in DHHL
- Pride Group of Hotels, which owns a chain of upscale mid-market and business hotels is planning to set up a series of new properties and this will involve an investment of Rs 1,000 crore (US\$ 203.18 million) over the next few years. The company plans to have a mix of owned and managed properties having 3,500 rooms by 2015-16.

## Government Initiatives

- 100% FDI investment is permitted by the government of India for the development of townships.
- Government of India grants interest subsidy on loans up to ₹ 1.5 millions for 'New Home Loan borrowers' subject to the condition that the cost of the house must not exceed ₹ 2.5 million.
- 100% FDI investment is allowed in the development of Special Economic Zones (SEZ) under the automatic route subject to the provisions of Special Economic Zones Act 2005 and the SEZ Policy of the Department of Commerce.

In the Union Budget 2011-12, the Government provided various initiatives for the real estate sector, especially focusing on affordable housing. Some of these initiatives are listed below:

- Increasing the limit on housing loans eligible for a 1 per cent subsidy in interest rates
- Widening the scope for housing under “priority-sector lending” for banks, making interest rates cheaper on them
- Allocating substantial amount to the Urban Development Ministry for spending on extension of Metro networks in Delhi, Bengaluru and Chennai
- Earmarking US\$ 20.03 million for the urban infrastructure development project. The Urban Development Ministry received US\$ 1.5 billion, an increase of US\$ 68.53 million from the last fiscal 2010-11

The role of real estate sector in the Indian economy is extraordinary. It gives larger employment opportunity next to the agricultural sector. This sector will grow rapidly in the next decade. The market share of this sector is expected to touch US\$ 180 billion by 2020 in India. The contribution of housing sector alone is 5-6% of the India's GDP. In India, the construction industry is ranked 3rd out of 14 major sectors as per the study conducted by ICRA. Therefore, real estate acts as a means for adding impetus to growth of the Indian economy.

## **Housing Finance**

### **Introduction**

Urbanization becomes a popular trend in developing countries in recent decades. This trend is both a source of development opportunities and challenges for the housing sector. Many developing countries are facing the problem of poor housing conditions on one hand and witnessing a large and growing market for housing on the other hand. This is because of inadequate housing policies, improper property registration and limits to access to housing finance. Therefore in recent years, developing countries are giving more importance to promote housing finance.

Housing finance is a fund based financial service. In India, Housing finance was largely provided by Government till the mid-eighties. In 1988, RBI established a fully owned subsidiary bank namely National Housing Bank (NHB) exclusively for housing finance. The role of NHB is discussed later. Let us see various types of housing loans and lending practices in India.

## Types of Housing Loans

- **Home Equity Loans:** Loan is provided to customer by mortgaging the existing house property at the market value for any purpose.
- **Home Purchase Loans:** The Loan is provided exclusively for the purchase of Apartments or individual building both new and old.
- **Land Purchase Loans:** Loan is provided for the purchase of land and construction of residential houses.
- **Home Extension Loans:** This loan is provided for construction of additional rooms or other facilities.
- **Home improvement Loans:** It is provided for renovation of old house.

## Lending Practices of Housing Finance

### Interest Rates

There are two types of interest rate system namely fixed and floating interest rate system. Under fixed Interest rate system, interest is fixed for a particular period of time. Beyond such period interest rate may fluctuate based on RBI directions. (E.g. Mr. X takes housing loan for a repayment period of 20 years under the fixed rate system. There is no change in the interest rate for the first 5 years and it fluctuates thereafter based on the directions of RBI.) Under floating rate system, the interest rate fluctuates frequently based on bank rate. The rate of interest differs under different slab system based on amount and repayment period.

### Security

The title deeds must be mortgaged with the lender for the security purpose.

### Processing Fee

To meet the operational expenses, lender charges 0.50 % of loan amount for processing housing loan.

### **Equated Monthly Installment (EMI)**

It is a fixed monthly repayment of housing loan. Borrower of the housing loan repays to his lender in the form of EMI over a period of time. The EMI amount depends on the rate of interest, the loan amount and the repayment period. The tenure of the loan can be reduced increasing the EMI amount. EMI covers both principal and interest component.

### **Pre Close of Housing Loan Account**

Normally, the repayment period of housing loan may be 5,10,15,20 or any number of years at the option of the borrower. The borrower can pre-close the housing loan at any time paying the balance amount in full. The lender charges 0.50% or 1% on outstanding loan amount on the date of pre-closure for premature closure of loan account. The borrower is free from his liability towards repayment of principal amount and payment of interest amount for the remaining period.

### **Advantages of Housing Finance**

- Even lower middle class people can become the owner of the property
- Easy and convenient method of repayment (EMI) with lower interest rate is possible for borrower.
- The borrower can get bulk finance at the time of purchase of house and the same can be mortgaged as security.
- It creates greater employment opportunity both directly and indirectly.
- The demand for construction materials like cement, brick, sanitary products, electrical fittings and glass industries is rising day by day due to construction of building.
- Housing finance paves the way for infrastructure development.
- The borrower can avail income tax exemption under the Income Tax Act for the repayment of loan (both principal and interest) subject to certain limits.



## **Housing Finance in India**

In India, for a long time there was no proper financial institution for providing housing finance. During 1960's, the central and state governments brought various housing programmes in order to relieve the congestion of population in cities and urban areas. In this direction, the Housing and Urban Development Corporation (HUDCO) was established in April 1970, to finance various housing and urban infrastructure activities. Total shares of HUDCO were subscribed by Government of India.

### **Assistance of HUDCO**

It provides mass housing schemes such as:

- Rural housing schemes
- Co-operative house construction
- Urban housing schemes
- Cyclone shelters
- Land acquisition
- Sanitation and slum improvement
- Promoting building technology

HUDCO provides the following Housing Refinancing facility to state governments:

- State Housing Boards
- Rural Housing Boards
- Slum clearance Boards
- Development Authorities
- City Improvement Trusts
- Municipal corporations
- Town Panchayats
- Primary Co-operative Societies.

### **Housing Development Finance Corporation Ltd. (HDFC)**

Later on, private sector Housing finance company came into existence in 1977, which is known as Housing Development Finance Corporation (HDFC) Ltd. It is the first private sector housing finance

company in India. It is one of the leaders in the Indian housing finance market. The special features of HDFC are providing finance in the form of:

- Home Extension Loan
- Home improvement Loan
- Short-term building Loan
- Home Equity Loan
- Land Purchase Loan

HDFC has promoted subsidiaries such as HDFC Bank, HDFC Mutual fund, HDFC Standard Life Insurance Company Ltd., HDFC Securities, Internet Global services Ltd., Credit Information bureau India Ltd.

The List of other leading Housing Finance Companies in India are:

- State Bank of India Home Finance (SBI)
- LIC Housing Finance Limited
- ICICI Home Finance Company Limited
- IDBI Home finance Limited (IHFL)
- PNB Housing Finance Limited
- Dewan Housing Finance Corporation Limited (DHFL)
- GIC Housing Finance Limited
- Can Fin Homes Limited (CFHL)

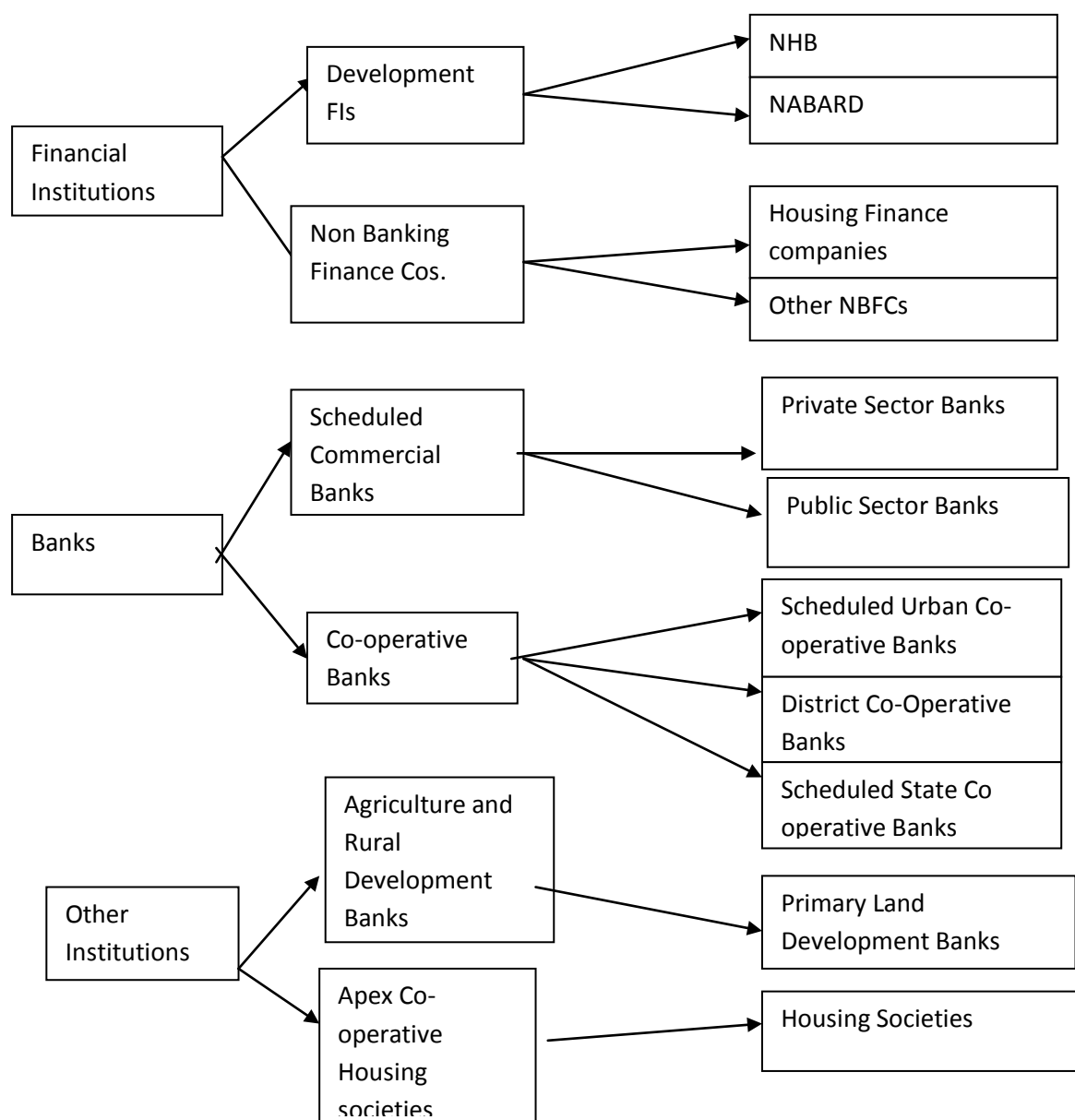
The ***National Housing and the Habitat Policy (NHHP)*** was formulated in 1998 based on the estimation of housing shortage in the country in 1997. The policy stressed on the following aspects:

- Easy access for housing loan, finance and technology by removing the hindrances of legal, financial and administrative controls.
- Housing and allied services must be treated as a priority sector like infrastructure sector.
- Increase in creation of surpluses in housing stock
- The poor and lower middle class people must get quality and cost-effective shelters.

The National Urban Housing and Habitat Policy (NUHHP) was formulated in 2005. The policy focused on urban shelters and emphasized on the promotion of larger flow of funds to meet the revenue requirements of urban housing and infrastructure using innovative tools.

The Working Group on Rural Housing for the 12th five year plan estimated the total housing shortage in rural areas at 48.81 million for the plan period (2012-17). Of these, about 43.93 million units pertain to the below poverty line population.

### Housing Finance System in India



## National Housing Bank

### Introduction

National Housing Bank was established on July 9, 1988 under the National Housing Bank Act, 1987. It is a wholly owned and apex bank of RBI (Reserve Bank of India). The Head Office of NHB is located at New Delhi.

The Preamble of the National Housing Bank Act, 1987 describes the basic functions of the NHB as –

*“... to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto...”*

### Objectives

- To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
- To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
- To enlarge resources for the sector and channelise them for housing.
- To make housing credit more affordable.
- To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
- To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
- To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

### Organization

It has the following Departments for handling the activities –

- Regulation & Supervision
- Refinancing Operations

- Direct Finance Operations
- Enabling Processes
- Information Technology
- Resource Mobilization and Management
- Development and Risk Management
- Board and CMD Secretariat
- Legal Department

## Milestones

1988-89 Financial Year	<ol style="list-style-type: none"> <li>1. Refinance Schemes for housing loans</li> <li>2. Schemes for Land Development &amp; Shelter Projects</li> <li>3. Scheme for Equity Participation in Housing Finance Companies (HFCs)/ Building Materials Companies</li> </ol>
1989-90	<ol style="list-style-type: none"> <li>1. Home Loan Account Scheme</li> <li>2. Housing Finance Companies (NHB) Directions, 1989</li> <li>3. Raised Loan of US\$25m (first tranche) under USAID Govt. Housing Guaranty Program</li> </ol>
1990-91	<ol style="list-style-type: none"> <li>1. Notified as a Public Financial Institution</li> </ol>
1991-92	<ol style="list-style-type: none"> <li>1. Received a Loan Assistance of Yen 2,970 billion from OECF (now JBIC)</li> <li>2. Scheme for Financing Housing Infrastructure</li> </ol>
1992-93	<ol style="list-style-type: none"> <li>1. Refinance Schemes for Slum Redevelopment Projects</li> </ol>
1994-95	<ol style="list-style-type: none"> <li>1. Launched the issue of Unsecured Bonds</li> <li>2. Guidelines for Prudential Norms for HFCs</li> </ol>
1997-98	<ol style="list-style-type: none"> <li>1. Golden Jubilee Rural Housing Finance Scheme (GJRHFS)</li> <li>2. Issued Tax Free Bonds to finance GJRHFS</li> <li>3. Drawn from ADB US\$20m in 1997-98 and US\$30m in 1998-99</li> </ol>

1999-2000	Agreement for Cooperation with Canada Mortgage and Housing Corporation for introducing Mortgage Insurance and New Products in the Country
2000-01	<ol style="list-style-type: none"> <li>1. First Residential Mortgaged Backed Securitization Issue in the Country</li> <li>2. Guidelines for Entry of HFCs into Insurance Business</li> <li>3. Refinance Scheme for reconstruction of dwelling units in the earthquake affected areas in Gujarat</li> </ol>
2001-02	<ol style="list-style-type: none"> <li>1. Credit Enhancement of Bonds floated by HFCs</li> </ol>
2002-03	<ol style="list-style-type: none"> <li>1. Liberalized Refinance Scheme for Housing Loans</li> </ol>
2004-05	<ol style="list-style-type: none"> <li>1. First time provided Corporate Guarantee for RMBS</li> <li>2. New Window of lending to Micro Finance Institutions</li> </ol>
2005-06	<ol style="list-style-type: none"> <li>1. Fraud Management Cell set up to disseminate information on frauds committed on housing loans</li> </ol>
2006-07	<ol style="list-style-type: none"> <li>1. NHB RESIDEX was launched (first official residential housing price index).</li> <li>2. New Products Developed for unserved and underserved segments of Society <ul style="list-style-type: none"> <li>➤ Reverse Mortgage Loan for Senior Citizens</li> <li>➤ Productive Housing in Rural Areas (PHIRA) i.e. Scheme for composite loans (housing and production) to rural families</li> <li>➤ Refinance for Top-up loan for Indira Awas Yojana Beneficiaries</li> <li>➤ Equity Participation in New Rural Housing Finance Companies</li> <li>➤ Occasional Papers &amp; Discussion Papers Series launched</li> </ul> </li> </ol>

2007-08	<ol style="list-style-type: none"> <li>1. Rural Housing Fund was created with ` 1,000 crores allocation</li> <li>2. Rural Housing Microfinance was launched</li> <li>3. NHB-UNESCAP Study on pro-poor housing finance: 7 Asian Countries initiated</li> <li>4. MOC with UNHABITAT signed for water and sanitation projects for housing</li> <li>5. Home Loan Counselling: Diploma programme put in place (IIBF)</li> </ol>
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### Finance Functions of NHB

NHB supports housing finance sector by:

- Extending refinance to different primary lenders in respect of
- Eligible housing loans extended by them to individual beneficiaries,
- Project loans extended by them to various implementing agencies.
- Lending directly in respect of projects undertaken by public housing agencies for house construction and development of housing related infrastructure.
- Guaranteeing the repayment of principal and payment of interest on bonds issued by Housing Finance Companies.
- Acting as Special Purpose Vehicle for securitizing the housing loan receivables.

### Refinance Assistance of NHB

In India, a large number of Primary Lending Institutions are providing housing finance to individual borrowers, builders, corporate houses etc. for purchase/construction of houses and for repair / up gradation of existing house. NHB extends refinance to the following categories of institutions in respect of the housing loans provided by them.

- Housing Finance Company
- Scheduled Commercial Banks

- Scheduled Urban Cooperative Banks
- Regional Rural Banks
- State Level Apex Co-operative Housing Finance Companies
- Agriculture and Rural Development Banks

### **Promotion Functions of NHB**

- Promoting, establishing and supporting housing finance institutions.
- Granting loans and advances
- Purchasing Housing finance companies shares and bonds
- Guaranteeing the loan taken by housing finance companies from the open market
- Underwriting the issue of securities of Housing finance companies
- Discounting and rediscounting the bills of exchange of housing finance
- Dealing with the Mortgage of Immovable properties belonging to housing finance institutions
- Promoting mutual funds of housing finance
- Conducting research and undertaking survey on construction activities.
- Initiating various schemes for the extension of housing unit
- Coordinating with LIC, UTI, GIC and other financial institutions

### **Regulatory Functions of NHB**

National Housing Bank is the regulatory authority of Indian housing finance system as per the act of National Housing Bank Act, 1987. The purpose of holding the controlling power is to regulate the housing finance institutions in the interest of the depositors and borrowers. In addition to this provision, NHB issues directions and guidelines to HFCs for its financial assistance, prudential norms for income recognition, asset classification and Asset Liability Management System etc.

### **The main businesses and finance products of NHB**

- ***Raising Resources*** by issuing bonds or debentures, borrowing from reserve bank of India and other financial institutions



- NHB launched “**Swarna Jayanti Rural Housing Finance Scheme**” to make housing loans accessible to housing development works in rural India on the occasion of the golden jubilee of India’s Independence
- **Mortgage Backed Securitisation** and development of secondary mortgage market in India
- **Mortgage Credit Guarantee** scheme for protection of lenders against any default.
- Providing **Refinance** to Housing Finance Institutions
- National Housing Bank is engaged in **Project Finance** for large-scale housing projects also.
- The finance products by NHB include **Equity Support** and **Reverse Mortgage** loans along with the above listed services

### **Refinance Scheme for HFC**

NHB currently has the following refinance schemes in operation for HFCs:

#### **1. Liberalized Refinance Scheme (LRS)**

- **Scheme Code** - RH1
- **Purpose** - To provide refinance assistance in respect of housing loans extended by HFCs for:
  - Construction / purchase of dwelling units
  - Repairs / renovation / upgradation of dwelling units
- **Eligible Loans**
  - Loan size - Any – (Interest rates concession is provided upto lakhs)
  - Location - Rural or urban
  - Tenure - 1 year to 15 years
  - Ultimate borrowers - Any

#### **2. Golden Jubilee Rural Housing Refinance Scheme (GJRHRS)**

- **Scheme Code** - RH2

- **Purpose** - To provide refinance assistance in respect of housing loans extended by HFCs for:

- Construction / purchase of dwelling units in rural areas
- Repairs / renovation / upgradation of dwelling units in rural areas

- **Eligible Loans**

- Loan size - upto 15 lakhs
- Location - Rural

‘Rural area’ is defined as the area comprised in any village, including the area comprised in any town, the population of which did not exceed 50,000 as per the 1991 Census.

- Tenure - 1 year to 15 years
- Ultimate borrowers - Any

### 3. Rural Housing Fund (RHF)

- **Scheme Code** - RH3

- **Purpose** - To provide refinance assistance in respect of housing loans extended by HFCs to borrowers belonging to ‘weaker sections’ for:

- Construction / purchase of dwelling units in rural areas
- Repairs / renovation / upgradation of dwelling units in rural areas

- **Eligible Loans**

- Loan size - upto 15 lakhs
- Location – Rural

‘Rural area’ is defined as the area comprised in any village, including the area comprised in any town, the population of which did not exceed 50,000 as per the 1991 Census.

- Tenure - 3 years to 7 years
- Ultimate borrowers - Persons belonging to weaker sections

**“Weaker section” means and includes:**

- (a) Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers;
- (b) Women
- (c) All individuals eligible for loans under Swarnjayanti Gram Swarozgar Yojana (SGSY) and Differential Rate of Interest (DRI) i.e. classified as BPL or marginally above the poverty line.
- (d) Scheduled Castes, Scheduled Tribes and
- (e) Persons from minority communities as may be notified by Government of India from time to time. In States, where one of the minority communities notified is, in fact, in majority, item (e) will cover only other notified minorities. These States/ Union Territories are Jammu & Kashmir, Punjab, Sikkim, Mizoram, Nagaland and Lakshadweep.
- (f) rural population with income upto 2 lakhs
  - **Type of Interest Rate** - Refinance under RHF will be extended at interest rates which shall remain fixed for the entire tenure without reset.

#### 4. **Energy Efficient Housing Refinance Scheme (EEHRS)**

- **Scheme Code** - RH4
- **Purpose** - To provide refinance assistance in respect of housing loans extended by HFCs for construction / purchase of new energy efficient housing units in urban areas
- **Validity of Scheme** - This Scheme shall remain valid till 31-12-2013 or such further time as decided by NHB.
- **Eligible Loans**
  - Type of housing unit - Having energy efficiency (EE) certificate recognized by National Housing Bank in consultation with KfW, based on TERI calculations
  - Loan size – any
  - Location - Urban
  - Date of origination of loan - Loans sanctioned and disbursed on or after 01-01-2011

- Tenure - 1 year to 15 years
- Ultimate borrowers - Any

## 5. Special Refinance for Urban Low Income Housing

- **Scheme Code** - RH5
- **Purpose** - To provide refinance assistance in respect of housing loans extended by HFCs in urban areas for construction / purchase of new dwelling units, purchase of existing dwelling units and extension / up gradation / repairs of existing dwelling units
- **Eligible Loans**
  - Loan size - upto 10 lakhs
  - Location - Urban
  - Date of origination of loan - Loans sanctioned and disbursed on or after 01-01-2012
  - Tenure - The tenure of refinance for a particular disbursement shall be co-terminus with the average residual tenure of the pool of housing loans included in that claim for disbursement, subject to minimum tenure of 5 years and maximum tenure of 15 years
  - Ultimate borrowers - Persons having annual household income not exceeding 2 lakhs

**Note:** Household income for the purpose of this Scheme shall mean the income of all the co-borrowers taken together. Income shall be assessed / verified by the HFCs to their satisfaction and recorded as such in their credit notes / loan files covering parameters like IIR, LTV, etc. assessing credit worthiness and affordability of the borrowers.

- I. Security for loan - The housing loan shall be secured by mortgagable title over the land / property. Loans given to urban slum dwellers having mortgagable land title in the form of 'patta' allotted by state governments would be eligible for refinance under the Scheme. There shall not be any requirement for seeking collateral security or guarantee from any third party as additional security.
- II. Type of Interest Rate - Refinance under the Scheme will be extended at rates of interest which shall remain fixed for the entire tenure.

- III. Conversion from Fixed Rate to Floating Rate - Conversion from fixed rate of interest to floating rate of interest shall be permitted without payment of any conversion fee after three years from the date of disbursement.

### **On-Lending Cap**

- With a view to ensuring delivery of credit at affordable rates to the target segments, an interest rate cap on on-lending is envisaged under the Scheme.
- The interest rates on individual loans covered under refinance under the Scheme should not be more than 275 basis points over and above the interest rate payable by the HFC to NHB on that tranche of refinance.
- Loans carrying guarantee cover under the Credit Risk Guarantee Fund Trust for Low Income Housing will have on-lending cap of 250 bps over and above the refinance interest rate on that tranche.

### **6. Refinance Scheme for Installation of Solar Water Heating and Solar Lighting Equipments in Homes**

- **Scheme Code** - RH6
- **Purpose** - To provide refinance assistance in respect of loans extended by HFCs for purchase and installation of solar water heating systems and purchase and installation of solar lighting systems

**Note:** The loan for solar equipments could be extended by the HFCs either as a stand-alone loan for solar equipment only, or as part of composite housing loan. Loans extended by the HFCs in the form of project loans for installation of solar equipment in existing or new buildings would also be eligible for refinance under the Scheme.

### **Eligible Loans**

- Loan size - upto 50,000
- Location - Rural / Urban
- Date of origination of loan - Loans disbursed on or after 01-07-2012
- Tenure - 3 years to 7 years

**Type of Interest Rate** - Refinance under the Scheme will be extended at rates of interest which shall remain fixed for the entire tenure.

### **Conclusion**

Real estate finance has received a boost through combination of growing demand and rising affordability. While the demand for housing has always been there and will be for a long run to come, its increased affordability has been the key to growth. Enhanced affordability has spurred an increase in the demand for real estate loans. The key to high growth rates in the housing finance business will continue to be affordability.

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## Lesson 3.3 - Asset Liability Management and Securitization

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### Asset Liability Management Services

#### Introduction

Asset Liability Management is a technique of managing the maturities, rate structure, and risk in the asset and liability portfolios in accordance with interest rate changes. This service is concerned with the banks and financial institutions. Management of Asset is concerned to trade off between profitability and liquidity. To trade off between risk and return is called Liability management. Interest rate sensitivity is highly influenced in the bank funds and its impact reflects on the profitability & liquidity and risk & returns of the bank funds. Hence, the handling of fund should be with efficiency and effectiveness.

#### *The main objectives of 'Asset-Liability Management Service' are*

- To coordinate the bank's portfolios
- To manage the risk of Interest Rate Risk and Currency Risks
- To facilitate bank in maximizing profitability
- To increase the stockholders' returns in the long run i.e. wealth maximization of shareholders
- To maintain the liquidity of the bank fund Asset-Liability Management Service provides proper planning to meet liquidity needs and to reduce interest rate risk on the maturities of assets and liabilities.

**Definition of Asset Liability Management** *"Asset Liability Management is the ongoing process of formulating, implementing, monitoring, and revising strategies related to assets and liabilities to achieve financial objectives, for a given set of risk tolerances and constraints".*

*"ALM is critical for the sound financial management of any entity that invests to meet future cash flow needs within constraints. ALM is*

*broader than risk mitigation and is inextricably linked to the liability and investment management functions”.*

Normally, it is covered under the framework of Risk Management of an enterprise and it is managed by the fund manager of the company itself. Asset Liability management services are offered by outsiders and the services are used by some companies to optimize their risk/reward profile. The circumstances and preferences are different from entity to entity. Hence, the application of ALM process is different for each entity. The service of ALM is very important to an entity because it focuses on managing risks for maximizing profit.

### **Functions of Asset Liability Management**

- To evaluate the interest rate structure and compare it with the interest/product pricing of assets and liabilities
- To scrutinize the loan and investment portfolios which may involve foreign exchange risk and liquidity risk
- To examine the credit risk and contingency risk which may be created due to interest/exchange rate fluctuations, the quality of assets and others
- To assess and compare the actual performance with their estimations and to analyze the reasons for its effect if any on spreads
- To maintain the stability of the short-term profits, long-term earnings and long-term substance of the bank

The parameters that are selected for the purpose of stabilizing asset liability management of banks are:-

- Net Interest Income (NII)
- Net Interest Margin (NIM)
- Economic Equity Ratio

### **Applicability of ALM Principles**

The ALM principles are applicable to the following institutions and funds:



- Insurance companies, banks, investment firms, and other financial services companies
- Pension and trust funds (e.g., endowments and foundations) of Governments
- Commercial entities
- Non-profit enterprises
- Individual investors

### **Fundamental Steps of an ALM Process**

The process consists of five fundamental steps:

- 1) **Assess the entity's risk/reward objectives:** The nature of risk is different for different companies. The determined financial objectives and risk bearings are to be reorganized.
- 2) **Identify risks:** Identification of risk on each and every asset and liability is the prime function. ALM has to evaluate various types of risks. It has to find the causes of each type and establish the relationship of internal and external sources of risk.
- 3) **Quantify the level of risk exposure:** Risk exposure can be quantified in the following ways:
  - relatively to changes in the risk component,
  - at the maximum expected loss for a certain confidence interval in a specified set of circumstances, or
  - by the allocation of outcomes for agreed set of pretentious circumstances for the risk component over a period of time
 Regular measurement and monitoring of the risk exposure is mandatory.
- 4) **Formulate and implement strategies to modify existing risk:** ALM has to formulate and implement some strategies like diversification, hedging, portfolio management etc., to reduce the risk and optimize the risk/reward tradeoff after measuring the risk. Professional judgement is an important part of the process.
- 5) **Monitor risk exposures and revise ALM strategies as appropriate:** ALM has to monitor and report to the top management from time

to time about all identified and quantified risk exposures. The corrective measures must be taken whenever the risk exposure exceeds the limit.

The following ALM statements are to be submitted to RBI

- Statement of Structural Liquidity - Rupee
- Statement of Interest Rate Sensitivity - Rupee
- Statement of Dynamic Liquidity - Rupee
- Statement of Maturity and Position (MAP) - Forex
- Statement of Sensitivity to Interest Rate - Forex

## **Securitisation**

### **The Concept**

Security means a financial claim in the form of document which is marketable. Securitization is an array of conversion of non marketable assets into marketable securities. Non marketable assets may be in the form of existing assets or future cash flows which are translated into marketable securities. The conversion of existing assets into marketable securities is known as asset-backed securitisation and the conversion of future cash flows into marketable securities is known as future-flows securitization.

### **Example**

- Car loans, Housing loans etc. –Asset Backed Securities
- Ticket sales, Credit card payments, Car rentals etc. - Future-Flows Securitization

Accordingly, securitization is a process by which financial institutions create additional liquidity on the backing of their existing assets through the sale of financial instruments.

### **Origin**

During 1970, securitization technique was originated in the US. Initially, the market for securitisation was dominated by home mortgages only. Subsequently, credit cards, home equity loans, student loans and small business loans also came into picture.

The second largest market for securitisation is in UK and it is dominated by residential mortgages, credit cards, consumer loans, commercial real estate and student loan. The Bank of England has played a leading role in evolving guidelines for banking and other authorised institutions in loan transfers and securitisation. Now, the Financial Services Authority (FSA) sets out the policy on securitization and loan transfers.

### **The Process and Participants**

Banks and financial institutions are allowed to securitize their financial assets as per section 5 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Traditionally, Banks provide loans to borrowers based on the borrowers' creditworthiness. The repayment of principal and interest is based on the tenure of the loan such as short term (within 1 year) or Long term (above 1 year). The loan is to be treated as an asset and the outstanding portion of the loan is shown in the balance sheet of the bank. The bank has to raise additional funds from the market to meet its requirement since huge funds are blocked in loans. Securitization is a way of unlocking these blocked funds. The following steps are involved in the process of securitization:

#### ***Step -1 - Originator***

In the first step, the banker or financial institution is called originator. The originator segregates loans/lease/receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk.

#### ***Step -2 – Special Purpose Vehicle***

The pools of assets are transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. It may be floated either as a subsidiary in the form of a limited company or jointly by the originator / individuals / banks / institutions (merchant bankers) who are interested in the securitisation deal.

### ***Step-3 – Splitting of Securities***

The SPV splits various assets and issues asset backed securities (pass through certificate or pay through certificate) in the form of debt, certificates of beneficiary ownership and other instruments with or without recourse according to their maturity date and interest rate.

### ***Step-4- Payment for Securities***

Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors.

### ***Step-5- Credit Rating***

A pass through certificates or pay through certificates are to be rated by credit rating agency when issued to the public. It is mandatory in some countries. This debt instruments can also be traded in the secondary market particularly for interest swap.

## **Participants Involved in a Securitisation Transaction**

Primarily, three parties are involved in the process of securitization transaction namely originator, SPV and investor.

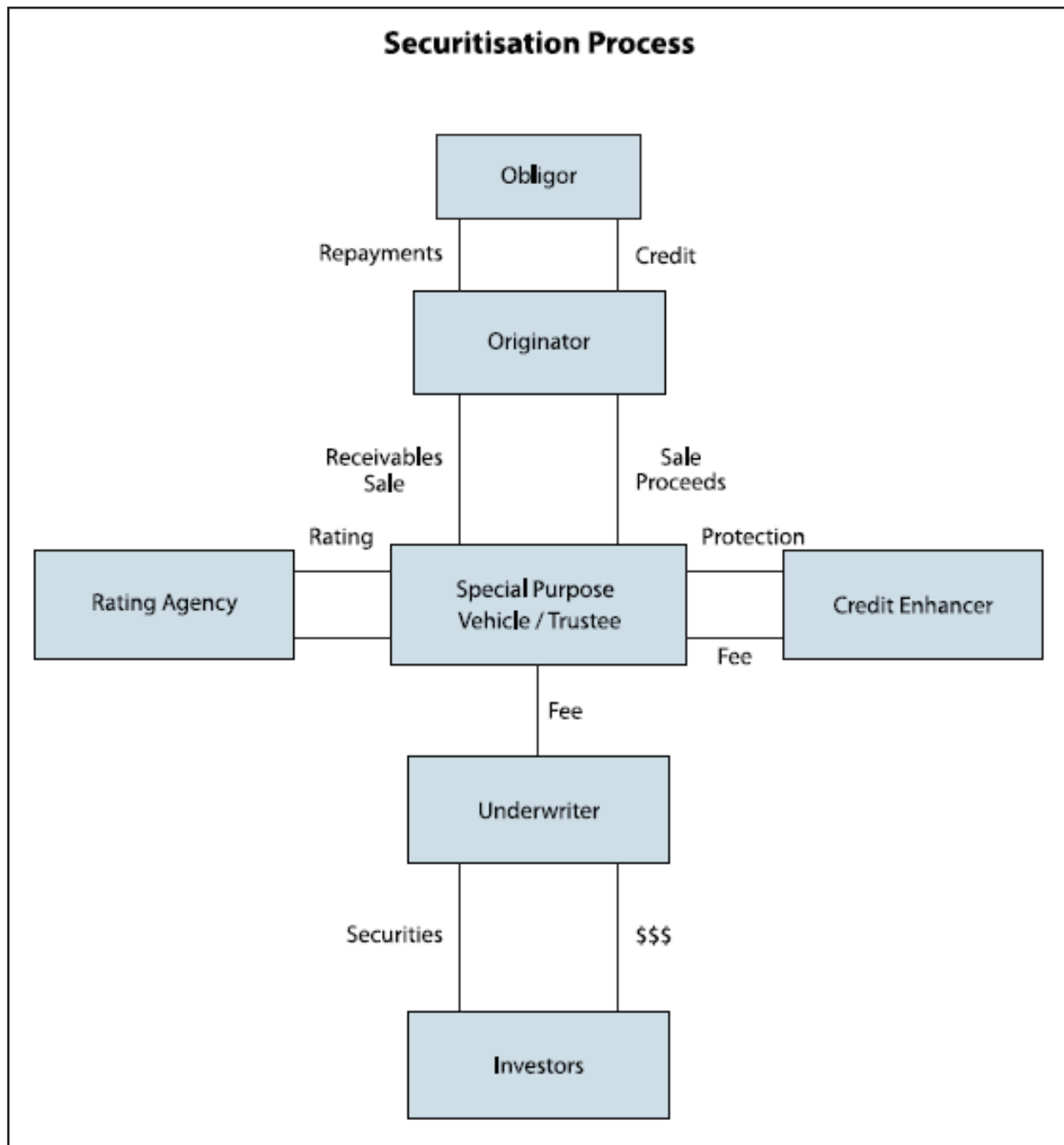
- ***The Originator*** - This is the entity on whose books the assets to be securitised exist and is the prime mover of the deal. The entity designs the necessary structures to execute the deal. In a true sale of the assets, the Originator transfers both the legal and the beneficial interest in the assets to the SPV.
- ***The SPV*** - This entity is the issuer of the bond/security paper and is typically a low-capitalised entity with narrowly defined purposes and activities. It usually has independent trustees / directors. The SPV buys the assets to be securitised from the Originator, holds the assets in its books and makes upfront payment to the Originator.
- ***The Investors*** - The investors could be either individuals or institutions like financial institutions (FIs), mutual funds, pension funds, insurance companies, etc. The investors buy a participating

interest in the total pool of assets and receive their payments in the form of interest and principal as per an agreed pattern.

Apart from these three primary players, others involved in a securitisation transaction include:

- **The Obligor(s)** - The obligor is the Originator's debtor or the borrower of the original loan. The credit standing of the Obligor is very important in a securitisation transaction, as the amount outstanding from the Obligor is the asset that is transferred to the SPV.
- **The Rating Agency** - The rating process assesses the strength of the cash flows and the mechanism designed to ensure full and timely payment. In this regard the rating agency plays an important role as it assesses the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.
- **Administrator or Servicer** - Also called as the receiving and paying agent, it collects the payment due from the Obligor(s) and passes it to the SPV. It also follows up with delinquent borrowers and pursues legal remedies available against defaulting borrowers.
- **Agent and Trustee** - It oversees that all the parties involved in the securitisation transaction perform in accordance with the securitisation trust agreement. Its principal role is to look after the interests of the investors.
- **External Credit Enhancements** - Underwriters sometime resort to external credit enhancements to improve the credit profile of the instruments. There are various types of external credit enhancements such as surety bonds, third-party guarantees, letters of credit (LC) etc.
- **Structurer** - Normally, an investment banker is responsible for bringing together the Originator, credit enhancer, the investors and other partners to a securitisation deal. He also helps in structuring the deals along with the Originator.

The following picture depicts the process of securitization:



### Types of Securitisation Instruments

- a) **‘Pass Through Securities’**: Also known as participation certificates, it represents direct ownership interest in the underlying asset pool. All the periodic payments of principal and interest are collected by the servicer and passed on to the investors. In this structure there is no modification of the cash flow as it is received from the obligor(s).

- b) **Tranched Securities:** In this type of security, the cash flows from the obligors are prioritised into tranches. The first tranche receives the first priority of payment followed by subsequent tranches.
- c) **Planned Amortisation (PAC) Tranches:** A principal sinking fund is created that takes care of prepayments beyond a certain band. This ensures stability of cash flows and hence offers lower yields compared to similar tranches without a sinking fund.
- d) **Z-Tranches or Accretion Bonds:** No interest is paid during a certain period (lock out period) during which the face value of the bond increases due to accrued interest. After the lock out period, the tranche holders start receiving interest and principal payments.
- e) **Principal Only (PO) Securities:** The PO investors receive only the principal component of the underlying loans. These bonds are usually issued at a deep discount to their face value and redeemed at face value.
- f) **Interest Only (IO) Securities:** The IO investors receive only the interest component of the underlying loans. These securities have no face or par value and its cash flow diminishes as the principal is repaid or prepaid.
- g) **Floater and Inverse Floater Securities:** The floater and inverse floaters are instruments that pay a variable interest rate linked to an index such as LIBOR. The Floater pays an interest rate in the same direction of interest rate movements while a reverse floater pays an interest rate in the opposite direction of the interest rate movements.
- h) **Amortizing and Non-amortizing Securities:** The principal repayment for instruments issued could be done either by a) repaying total amount at maturity, or b) throughout the life of the security. The latter refers to a schedule of payments called amortisation schedule and securities issued under this are called amortizing securities. Loans having this feature include car & home loans.

Let us take an example to understand the process of securitization. Consider a bank, ABC Bank. The loans given out by this bank are its assets. Thus, the bank has a pool of these assets on its balance sheet and so the

funds of the bank are locked up in these loans. The bank gives loans to its customers. The customers who have taken a loan from the ABC bank are known as obligors.

To free these blocked funds the assets are transferred by the **originator** (the person who holds the assets, ABC Bank in this case) to a **special purpose vehicle** (SPV).

The SPV is a separate entity formed exclusively for the facilitation of the securitisation process and providing funds to the originator. The assets being transferred to the SPV need to be homogenous in terms of the underlying asset, maturity and risk profile.

What this means is that only one type of asset (e.g. auto loans) of similar maturity (e.g. 20 to 24 months) will be bundled together for creating the securitised instrument. The SPV will act as an intermediary which divides the assets of the originator into marketable securities.

These securities issued by the SPV to the investors and are known as **pass-through-certificates (PTCs)**. The cash flows (which will include principal repayment, interest and prepayments received ) received from the obligors are passed onto the investors (investors who have invested in the PTCs) on a pro rata basis once the service fees has been deducted.

The difference between rate of interest payable by the obligor and return promised to the investor investing in PTCs is the servicing fee for the SPV. The way the PTCs are structured the cash flows are unpredictable as there will always be a certain percentage of obligors who won't pay up and this cannot be known in advance. Though various steps are taken to take care of this, some amount of risk still remains.

The investors can be banks, mutual funds, other financial institutions, government etc. In India only qualified institutional buyers (QIBs) who possess the expertise and the financial muscle to invest in securities market are allowed to invest in PTCs.

Mutual funds, financial institutions (FIs), scheduled commercial banks, insurance companies, provident funds, pension funds, state industrial development corporations, et cetera fall under the definition of



being a QIB. The reason for the same being that since PTCs are new to the Indian market only informed big players are capable of taking on the risk that comes with this type of investment.

In order to facilitate a wide distribution of securitised instruments, evaluation of their quality is of utmost importance. This is carried on by rating the securitised instrument which will acquaint the investor with the degree of risk involved.

The rating agency rates the securitised instruments on the basis of asset quality, and not on the basis of rating of the originator. So particular transaction of securitisation can enjoy a credit rating, which is much better than that of the originator.

High rated securitised instruments can offer low risk and higher yields to investors. The low risk of securitised instruments is attributable to their backing by financial assets and some credit enhancement measures like insurance/underwriting, guarantee, etc used by the originator.

The administrator or the servicer is appointed to collect the payments from the obligors. The servicer follows up with the defaulters and uses legal remedies against them. In the case of ABC bank, the SPV can have a servicer to collect the loan repayment installments from the people who have taken loan from the bank. Normally the originator carries out this activity. Once assets are securitised, these assets are removed from the bank's books and the money generated through securitisation can be used for other profitable uses, like for giving new loans.

For an originator (ABC bank in the example), securitisation is an alternative to corporate debt or equity for meeting its funding requirements. As the securitized instruments can have a better credit rating than the company, the originator can get funds from new investors and additional funds from existing investors at a lower cost than debt.

### **Benefits to the Originators**

- Lower cost of borrowing
- A source of liquidity
- Improved financial indicators

- Asset-Liability Management
- Diversified fund sources
- Positive signals to the Capital Markets
- An avenue for divestiture (sale of more stock holdings)

### **Benefits to the Investors**

Investors purchase risk-adjusted securities based on its level of maturity. For instance, an auto loan or credit card receivables backed paper carries regular monthly cash flows, which can match the requirements of investors like mutual funds.

- New Asset Class
- Risk Diversification
- Customisation
- Decoupling with Originator

### **Securitisation in India**

In India during 1990-91, the first securitisation deal was undertaken by Citibank. They securitized auto loans and placed a paper with GIC mutual fund. Later on, a variety of deals had been undertaken. Almost 35 per cent of all securitisation deals undertaken between 1992 and 1998 related to hire purchase receivables of trucks and the rest towards other auto/ transport segment receivables.

During 1994-95, SBI Cap structured an innovative deal where a pool of future cash flows of high value customers of Rajasthan State Industrial and Development Corporation was securitised. ICICI had securitised assets to the tune of ₹ 2,750 crore in its books as at the end of March 1999. Real estate developers have securitised receivables arising out of installment sales. The recent securitisation deal of Larsen & Toubro has opened a new vista for financing power projects. The First Mortgage backed Securities in India were issued by National Housing Bank and Housing Development Finance Corporations in 2001. NHB has made efforts to structure the pilot issue of mortgage backed securities (MBS) within the existing legal, fiscal and regulatory framework.

## Asset Classes

Typically, any asset that produces a predictable stream of cash flows can be securitized. The types of assets that are securitized today include:

➤ ***Mortgage-backed***

- Residential mortgage-backed securities (RMBS)
- Commercial mortgage-backed securities (CMBS)

➤ ***Retail Loan Pools***

- Credit card receivables
- Auto loan receivables
- Student loan receivables
- Equipment lease / loan receivables
- Trade receivables
- Toll receipts

➤ ***Risk Transfers***

- Insurance risk
- Weather risk
- Credit risk

Mortgage Backed Securities (RMBS and CMBS) form the largest two segments of the securitization market in the world.

## Mortgage Backed Securities

An individual borrows loan from a bank or other lender for purchase of property (house). The borrower mortgages the property title deeds as collateral with the banker for getting the loan and he has to pay monthly installment (EMI) for the repayment of the loan in the agreed period (5years, 10 years, 20 years etc., as the case may be).

These originated mortgages are sold off by the lender in a secondary market. Investment bankers or a federal agency known as the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) are the buyers of these mortgages. By grouping together numerous mortgages, the investment banker or FHLMC will issue securities known as **mortgage**

**backed securities.** Mortgage backed securities are sold as bonds. Their coupon payments and par value are derived from the original mortgages from which they are created.

*For example*, Mr. X takes housing loan from a local bank for the amount ₹ 10, 00,000 by mortgaging his house. His bank sells his mortgage in the navigate market to an investment banking firm that groups together mortgages in order to sell mortgage backed securities to buyers such as a pension fund. In return X's bank receives the value of the mortgage, ₹ 10,00,000, which it can again lend out to a different borrower although he still make his monthly payment to the bank that originated mortgage, the interest and principal payment is passed-through to the buyer of the mortgage backed security. X's bank will receive a small processing fee, the investment banker takes a cut by offering a coupon on the bonds that is slightly less than the interest payments on the mortgage, and the buyer gains a slightly higher return than a corresponding 10-year Treasury note. The risk of default is in actual fact zero because home mortgages are guaranteed by the Federal Housing Administration (FHA), Mortgage backed securities are a class of derivatives since the owner of these bonds derives the return from the payments on mortgages, but does not actually own the mortgage itself.

### **Reverse Mortgage Loan**

A reverse mortgage is a loan that enables senior home owners, aged 62 and above, to convert part of their home equity into tax-free\* income-without having to sell their home, give up title to it, or make monthly mortgage payments. The loan only becomes due when the last borrower(s) permanently leaves the home.

Reverse Mortgage Loan is a scheme for senior citizens. It was introduced by National Housing Bank. The announcement of this scheme was made by Govt. in the Union Budget of 2007-08.

### **Salient Features**

- Reverse Mortgage Loan (RML) enables a Senior Citizen i.e. to avail of periodical payments from a lender against the mortgage of his/her house while retaining the ownership and occupation of the house.

- The Senior Citizen borrower is not required to service the loan during his/her lifetime and therefore does not make monthly repayments of principal and interest to the lender.
- RMLs are extended by Primary Lending Institutions (PLIs) viz. Scheduled Banks and Housing Finance Companies (HFCs) registered with NHB.
- The loan amount is dependent on the value of house property as assessed by the lender, age of the borrower(s) and prevalent interest rate.
- The loan can be provided through monthly/quarterly/half-yearly/annual disbursements or a lump-sum or as a committed line of credit or as a combination of the three.
- The maximum period of the loan is 20 years.
- The loan amount may be used by the Senior Citizen borrower for varied purposes including up-gradation/ renovation of residential property, medical exigencies, etc. However, use of RML for speculative, trading and business purposes is not permissible.
- Valuation of the residential property would be done at such frequency and intervals as decided by the reverse mortgage lender, which in any case shall be at least once in every five years.
- The quantum of loan may undergo revisions based on such re-evaluation of property at the discretion of the lender.
- The borrower(s) will continue to use the residential property as his/her/their primary residence till he/she/they is/are alive, or permanently move out of the property, or cease to use the property as permanent primary residence.
- The lender will have limited recourse i.e. only to the mortgaged property in respect of the RML extended to the borrower.
- All reverse mortgage loan products are expected to carry a clear and transparent 'no negative equity' or 'non-recourse' guarantee. That is, the Borrower(s) will never owe more than the net realizable value of their property, provided the terms and conditions of the loan have been met.

- On the borrower's death or on the borrower leaving the house property permanently, the loan is repaid along with accumulated interest, through sale of the house property.
- The borrower(s)/heir(s) can also repay the loan with accumulated interest and have the mortgage released without resorting to sale of the property.
- The borrower(s) or his/her heirs also have the option of prepaying the loan at any time during the loan tenure or later, without any prepayment levy.

### **Benefits**

- Pay off existing liens or mortgages - eliminate monthly obligations
- Provide additional monthly income for medical expenses and home repair
- Create a cash reserve for emergencies or special needs
- Can be used for estate planning and wealth management

### **Vulture Funds**

Vulture funds are forms of financial services in the corporate debt markets. It is a fund that buys securities in distressed investments, such as high yield bonds in or near default, or equities that are in or near bankruptcy. Every highly leveraged firm may be targeted if there is a chance that the owners will not be able to make all required debt payment. As the name implies, these funds are like circling vultures patiently waiting to pick over the remains of a rapidly weakening company. The Goal is high returns at bargain prices. Some people looked down upon hedge funds that operate like vulture funds which have preyed on the cheap debt of struggling companies and forced these companies to pay it back, plus interest.

### **Illustrations**

These funds often operate in secret through shell companies based in tax havens. Large US based financial institutions such as hedge funds own some. It has been shown that these companies are often set up simply to pursue on debt and then shut down again.

## Potential

There is huge potential for Securitization in India especially in respect of infrastructure projects. Securitization will be of great help to tide over the financial constraints. Further, it is considering the present state of capital market. Securitization offers a very good source of funding for corporate sectors. It has been seen that companies hold large quantum of securities in their investment portfolio and may not be inclined to sell them in times of liquidity crunch for various reasons. An opportunity also exists to use these securities as collateral by pledging them with a custodian and issuing bonds backed by such security. The collateral can serve as a credit enhancement and would enable issuers to obtain a higher credit rating. The shift in the method of bank finance from the traditional cash credit to a loan based system offers opportunity to securities some of the blue chip company loans to start with. This could provide the much needed relief to banks hard pressed to improve their capital adequacy.

## Conclusion

Securisation is a right hand side of the Balance sheet approach of raising funds based on the cash flows and values of the specific pool of assets. Intense competitions, balance sheet management and high funding cost make exclusive relief on the left and side funding strategies both risky and costly. Firms can improve their liquidity position and improve certain key ratios like ROE and ROA through securisation. Securitization also enables banks and institutions to borrow at a lower cost. An improvement in the liquidity position will lower working capital requirements and thus reduce the interest burden. The proceeds from securitization can also be invested in projects which give a higher rate of return, thus improving the overall performance of the institutions.

The securitization market in India, though in infancy stage holds good promise especially in the Mortgaged Based Securities (MBS) area. While more complex securitization transactions and public issuances of securitized paper are still distant possibilities, appropriate legislation and investors' education could give the securitization market in India a much needed thrust.

### Self Assessment Questions

1. Explain the mechanism of factoring and forfaiting
2. What are the benefits of factoring
3. Differentiate between:
  - a) Factoring and Bills Discounting
  - b) Factoring and Forfaiting
4. What is the significance of housing finance? Explain the various institutions that are providing housing finance in India.
5. Describe the structure of the Housing Finance Industry in India. Emphasize the role of the National Housing Bank in housing finance.
6. Emphasize the role of the National Housing Bank as the apex bank in the field of housing finance. Give details of the directions issued by it for housing finance companies.
7. Write short notes on:
  - a) Asset Liability management
  - b) Securitisation
  - c) Mortgage – based securitization
  - d) Reverse Mortgage Loan
8. Discuss about the various steps involved in the process of securitization.
9. Explain the various types of securitization Instruments
10. Discuss the fundamental steps involved in the process of Asset Liability Management (ALM)
11. Explain the modus operandi involved in forfeiting
12. Discuss the major issues confronting real estate financing in India
13. Give an account of the genesis and objective of major real estate finance institutions in India
14. How does competition shape the growth of institutions pursuing real estate finance schemes in India?



## CASE STUDY

### 1. Factoring Problem

In 2008, a lighting manufacture named Lighting Plus began designing and manufacturing its own line of flashlights and solar products decided to start selling in the market U.S. Their plan was to sell to wholesalers and directly to major retailers. Besides sound management and execution, they needed two main items ... *Sales and Working Capital*.

### Opportunities

Initial opportunities to expand presented themselves, and they landed their first major catalog company. This catalog company was their main client for the first 6 months while they located new clients and new sales reps to sell and promote their goods. In 2009, the lighting company's orders started to pickup and they realized that their suppliers need advances for manufacturing some of their popular products that they did not make in house. They began wiring 30 to 50% advances but this quickly became impractical because the deposit amounts were large and this process was locking-up their valuable working capital. They also realized that their targeted client base all required 30 to 90 terms on their invoices before making payment.

### Current Working Capital Situation

Lighting Plus had \$200,000 in working capital at the start, but the funds were initially deployed as shown below which prevented further grow:

### Lighting Plus

Working Capital WITHOUT new financing as follows:

Office setup	\$ 20,000
Monthly Payroll	\$ 20,000
Factory Deposits	\$ 60,000
*Receivables Outstanding	\$ 130,000

\* Note that a 30% gross profit has been built into the receivables

As you can see, with only modest sales, all of Lighting Plus's working capital was used.

### **Choosing Equity or Debt to Raise Capital**

Lighting Plus needed more capital and there was a choice...to raise more equity for the company (the price being less control and % ownership in the company) or finding lenders that could provide the needed working capital.

### **The Decision**

Lighting Plus management decided to find a lender that could provide a combination of lending and factoring. Traditionally, a company would like to get a simple line of credit based on its assets from a bank and be done; however, Lighting Plus was a new company without 3 years of profitable tax returns. Even if a line of credit at a bank was established, it would be limited based on current equity to debt ratio which would greatly limit the line of credit. Lighting Plus needed a line of credit that could grow with their fast growing sales.

### **Solution of the Problem**

**Lighting Plus established a line of credit with 1st PMF Bancorp** that provided a solution for their fast growth through two key financial products. First, a PMF Bancorp established a line for a Letter of Credit up to \$400,000. Second, PMF also established a factoring line to convert all outstanding receivables to liquid cash (i.e. the \$130,000 in outstanding receivables above would be converted to approximately \$104,000 or 80%). Lighting Plus no longer had to make deposits to suppliers for 30% to 50%. Instead, Lighting Plus used its new Letter of Credit line to purchase \$400,000 in new inventory and generate \$520,000 in new sales from that inventory. Additionally, the \$520,000 in new sales/invoices was converted into \$416,000 in instant cash by using PMF's factoring line facility.

### **Lighting Plus**

Working Capital WITH new financing from PMF Bancorp's LC & Factoring Line as follows:

Office setup	\$ 20,000
Monthly Payroll	\$ 20,000
Factory Deposits	\$ 400,000
*Receivables Outstanding	\$ 520,000

CASH converted from receivables \$416,000 (new cash from PMF line)

With PMF Bancorp's financing, the direct financial benefits were that Lighting Plus was able to increase its sales by 400%, and its cash position from \$0 to \$416,000. The more subtle and indirect benefits were that Lighting Plus able to transition to a more sophisticated and safer way to conduct business. By using Letters of Credit (LC), Lighting Plus no longer had to worry about their supplier being paid before goods were delivered. There were also inspections and certifications built into the LC process that insured paid goods were delivered according to their specifications. The factoring/receivable financing also made the collection process more efficient and safer because customers paid more timely as they were afraid to have PMF report them as late payers. Factoring also allowed Lighting Plus to credit insure various clients as they saw fit.

In 2010, Lighting Plus is set to do approximately \$10,000,000 million in sales. Their model has been a typical model at PMF Bancorp for approximately 30 years.

## CASE STUDY

**Progress Payment to Builder:** Mr and Mrs T engaged a building firm to construct their home. They entered into a loan contract with the bank to finance the construction whereby progress payments to the builder were made at five defined stages. Mid-way through the construction the builders went into liquidation. Mr and Mrs T disputed the payment made by the bank to the provisional liquidators at the "lock-up" stage because they said the construction was not at that stage and in fact, the house had to be demolished due to defective workmanship. Mr and Mrs T acknowledged signing the authorization to pay the provisional liquidators at "lock-up" stage but argued that the bank owed a duty to them and should not have paid the invoice without inspecting the property.

**Business Challenge** - The case manager issued a Finding on the merits of the dispute after considering the bank's policy for progress payment inspections, the bank's building payment practice and the Ombudsman's legal counsel's review of the relevant terms and conditions of the loan contract.

The Finding concluded that the bank's policy did not require it to make inspections of the building of a residential home where the contract price was less than \$1 million and that it was not the bank's practice to inspect constructions prior to releasing a payment authorized by the owner. In this case the first two progress payments had been released without a bank inspection of the construction.

**Solution** - There had been no allegation that the bank represented to the disputants that it would inspect the property at each of the stages before releasing the payment to the builder. Furthermore, the loan contract specifically absolved the bank for any contractual liability to the borrowers to inspect before releasing a payment. The case manager also considered that Mr and Mrs T's written authorization meant that the bank was entitled to release the payment and was a representation to the bank that they were satisfied that the payment could be made. Taking all these factors into consideration, the case was closed after the Finding confirmed that the bank had acted appropriately in releasing the payment to the provisional liquidators.

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## UNIT - IV

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### Financial Services – II

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#### Learning Objectives

*After studying this unit you will be able to:*

- know the concept, origin, types importance of Mutual Funds
- understand the constitution and management of mutual fund
- familiarize with the SEBI directive for Mutual Funds
- understand the role Unit Trust of India
- get the knowledge about Money Market Mutual Funds
- acquaint about Venture capital

#### Unit Structure

Lesson 4.1 – Mutual Funds

Lesson 4.2 – Unit Trust of India and Money Market Mutual Funds

Lesson 4.3 – Venture Capital

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## Lesson 4.1 - Mutual Funds

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### Mutual Fund

According to Association of Mutual Funds in India (AMFI), “A *Mutual fund is a trust that pools number of savings investors, who shares common financial goal*’. From the aforesaid definition, we can understand the concept of Mutual fund and the key points as mentioned hereunder:-

- Mutual fund is a trust
- Mutual fund pools money from a group of investors called **Unit Holders**
- The investors share common financial goals
- Invest the money, collected from small investors into securities (shares, bonds etc.,). It is called as **diversified investment**.
- Mutual Fund use professional expertise (investment management skills) on investments made.
- Asset classes of investments match the stated investment objectives of the scheme
- Incomes and Gains from the investments are passed on to the unit holders based on the proportion of the number of units they own.

### Origin

Even though Historians are uncertain of the origin of investment funds, some say that the closed-end investment companies launched at Netherlands in the year 1822 by the King William-I is the first mutual funds, whereas some others say that Dutch merchant named Adriaan van Ketwich, whose investment trust was created in the year 1774 might have given the idea to the king. Ketwich probably theorized that diversification would increase the appeal for investments to smaller investors with the minimal capital. The name of Ketwich’s fund, *Eendragt Maakt Magt*, means “unity creates strength”.

A further development of mutual funds was made in Switzerland in the year 1849, and subsequently it was followed in Scotland in the 1880s in the similar fashion. Consequent to the evolution of mutual fund rooted in Great Britain and France, the idea of pooling resources and spreading risk using closed-end investments, came to the United States in the year 1890s.

The first closed-end fund “Boston Personal Property Trust” was formed in U.S in the year 1893. The modern mutual fund evolution developed in the year 1970 in Philadelphia under the name Alexander Fund had special features of semi-annual issues and facility for investors to withdraw their investments on demand.

### **The Launching of the Modern Fund**

In the year 1924, the modern mutual fund was created in pursuance of the formulation of the Massachusetts Investors’ Trust in Boston. Generation of the mutual fund firm namely “MFS Investment Management” went public in the year 1928”. The custodian of the Massachusetts Investors’ Trust was State Street Investors. However, State Street Investors started generating their own fund at the helm in the year 1924 with Richard Paine, Richard Saltonstall and Paul Cabot. It is also pertinent to note that Saltonstall was also associated with Scudder, Stevens and Clark. In view of the said setup the first no-load fund was launched in the year 1928. Instantaneously, the first new launch of Wellington Mutual Fund emerged to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.

### **Regulation and Development of Mutual Funds**

19 open-ended mutual funds and nearly 700 closed-end funds existed before the stock market crash of 1929. Due to that crash, closed-end funds were wiped out. Small open-end funds managed to survive. To protect the investors, Government regulators created the **Securities and Exchange Commission (SEC)**. It paved way to enact the **Securities Exchange Act of 1934**. As a result, mutual funds must register with the SEC and to reveal it in its prospectus.

The mutual fund industry grew-up gradually during 1950s with 100 top open-end funds. And in addition to that, 50 new funds emerged during

the decade. Hundreds of new funds were launched during the decade of 1960s, which had aggressive growth till the bear market condition of 1969. The first index fund concept was established in the year 1971 by William Fouse and John McQuown of Wells Fargo Bank. The mutual fund industry further flourished due to the impact of Low-cost index fund and the rise of no-load fund.

The assets and household ownership of mutual funds experienced rapid growth simultaneously in United States also. On account of increasing globalization of finance, expanding presence of large multinational financial groups and strong performance of equity and bond markets, the global growth of mutual funds boosted during 1990s.

### **Types of Mutual Fund**

There are various tools for investing money such as bank deposits, metals, real estates, and stock market instruments. The scale of risk and return is based on the type of investments. Investors should tradeoff between risk and return. If they invest in bank deposits, the risk is very lower and at the same time the return is also very lower than that of any other means of investment. The metals and real estate assets are not sold easily.

The expectation of investors is higher return with lower risk or Lower risk with optimum return within short period of time. It is possible only in stock market investments. But it is not possible to the common investor because he is not technically competent to understand the stock market operations. A common man can invest his money safely in stock market through the rescuer, Mutual funds.

Mutual funds are dynamic financial institutions which play a crucial role in an economy by mobilizing savings and investing them in the capital market. Savings pooled from small investors are invested through a fund manager to purchase a diversified portfolio of stocks or bonds. An investor can invest in mutual fund at lower cost with the advantage of diversification. Diversification means “spreading out money across many different types of investments”. When one investment involves high risk, another might be lower. Diversification of investment holdings reduces the risk tremendously.



On the basis of their structure and objective, mutual funds can be classified into various types. Generally, there are two major types of Mutual Funds:-

- Open-end Mutual Funds
- Closed-end Mutual Funds

### **Open End Mutual Funds**

An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at **Net Asset Value** (NAV) related prices, which are notified daily. The key feature of open-end schemes is their liquidity.

### **Closed End Mutual Funds**

A close-ended fund or scheme has a stipulated maturity period say for e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of launching of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme through the stock exchanges, where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. Stock Exchange Board of India (**SEBI**) Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis. They are traded more like the general stocks.

The reasons to invest in this category are:

- Prices are determined by market demands and thus, closed end funds trade at lower than the offer price more often.
- The open end funds provide wide options for investors to choose from (a) stock funds and balanced funds which give full asset allocation benefit and (b) bond funds.

After the closure of the offer, buying and redemption of units by the investors directly from the Funds are not allowed. However, to protect the interests of the investors, SEBI provides investors with two avenues to liquidate their positions:

1. Closed-end Funds are listed on the stock exchanges where investors can buy/sell units from/to each other. The trading is generally done based on NAV at a discounted rate. The NAV of a closed-end fund is computed on a weekly basis (updated every Thursday).
2. Closed-end Funds may also offer “buy-back of units” to the unit holders. In this case, the corpus of the Fund and its outstanding units do get changed.

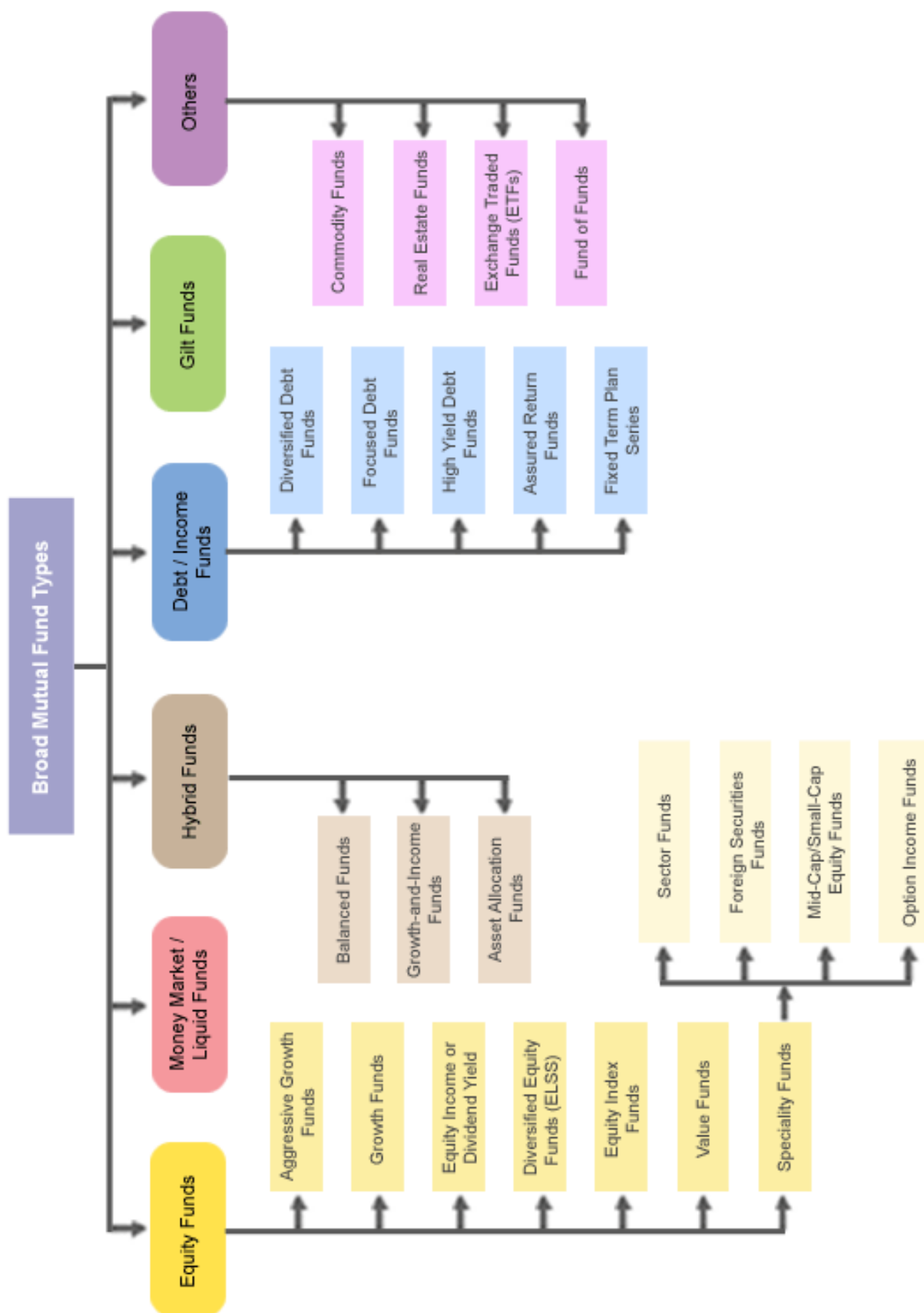
### **Mutual Fund Classifications**

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes. *Such schemes may be classified mainly as follows:* (See Figure on the next page).

### **Equity Funds**

Equity funds provide higher returns and at the same time it is more risky while compared to any other fund. For long term investment purpose, an investor is advised to invest in equity. There are different types of equity funds under different level of risk as follows:

- a. **Aggressive Growth Funds** – The maximization of capital appreciation is the mantra for fund managers. So they invest in highly grown-up companies’ equities and less in speculative investments. Investment in speculative nature of equities may lead to higher risk.
- b. **Growth Funds** – Here, the objective is to achieve an increase in value of investment through capital appreciation and not in the regular income. Fund manager selects the companies which are expected to earn above average in future for the investment of growth funds.



- c. **Equity Income or Dividend Yield Funds** – These are for investors who are more concerned about regular returns from investments. Fund manager invests in those companies which declare high rate of dividends. Capital appreciation and risk level are less while compared to other equity funds.
- d. **Diversified Equity Funds** – Fund manager invests this type of funds in the equities of all the companies and industries without any specified industry or sector. Due to this diversification of investment, the market risk is also diversified. Example **Equity Linked Savings Schemes** (ELSS). (ELSS investors can claim deduction from taxable income (up to Rs 1 lakh) at the time of filing the income tax return).
- e. **Equity Index Funds** – It is based on the performance of a specific stock market index. **Equity index funds are two types namely broad indices** (like **S&P CNX Nifty, Sensex**) and narrow indices (like **BSEBANKEX or CNX Bank Index** etc). Investments in Narrow indices index funds are less diversifiable; therefore it is more risky than that of broad indices index funds.
- f. **Value Funds** – Fund manager invests in shares of companies which have strong financial performance but whose price-earnings ratio is low. Price-earnings ratio is the relationship between the Market Price per share and Earnings per share. These companies' book value of the shares is higher than the market price. The market price of these shares may rise in future. With this assumption the fund manager invests huge fund for long term time horizon. The cyclical industries like cement, steel, sugar etc., are the examples of value stocks.
- g. **Specialty Funds** - Specialty funds are concentrated on particular industry or companies. Concentration is based on certain criteria for investments and those criteria must match with their portfolio. It is much riskier than other funds.
  - i. **Sector Funds:** The portfolio of sector funds comprises of only those companies that meet their criteria.
  - ii. **Foreign Securities Funds:** Fund manager invests in securities of one or more foreign companies. This fund gets the advantage of international diversification, but it has to face the foreign exchange rate risk and country risk.

- iii. **Mid-Cap or Small-Cap Funds:** The Mutual Fund invests in securities of those companies whose market capitalization is lower. The market capitalization of Mid-Cap companies is between ₹ 500 crore and ₹ 2500. In case of Small-Cap companies' market capitalization is lower than ₹ 500 crore. The market capitalization is the market price of the share multiplied by the number of outstanding shares of the company. The volatility of this type of companies' securities is very high but the liquidity is very low. Due to this high volatility and low liquidity the risk of this kind of companies' securities will be very high.
- iv. **Option Income Funds:** Option income funds are those funds invested in high yielding companies. The options are used for hedging activity i.e., to reduce the risk or volatility. The risk can be controlled by way of proper utilization of options. It generates stable income for investors.

### **Money Market / Liquid Funds**

Money market instruments are short-term interest bearing debt securities i.e., Treasury bills issued by Governments, (30 days, 60 days, 90 days etc., but maturing within one year), certificate of deposits issued by banks, commercial papers issued by companies etc.,. These securities are having high liquidity and safety. The investments in these funds are called money market/liquid funds. The risk of these funds is due to interest rate fluctuation.

### **Hybrid Funds**

Hybrid funds comprise the portfolio of equities, debts and money market securities. The debt and equity are equal in proportion for the investment.

The types of hybrid funds in India are as follows:

#### **a. *Balanced Funds***

The equal proportion of debt, equity, preference and convertible securities is the portfolio of balanced funds. It gives regular income and

moderates capital appreciation to investors. The risk of capital is at the minimum level. This fund is suitable for traditional investors of those who prefer long term investment.

***b. Growth-and-Income Funds***

The combination of the features of growth funds and income funds is referred as Growth-and Income Funds. The capital appreciation as well as declaration of high dividend companies' securities is comprised in the portfolio of this fund.

***c. Asset Allocation Funds***

There are two types of investment avenues namely financial assets (equity, debt, money market instruments) and non-financial assets (real estate, gold, commodities). The fund manager may adopt the strategy of variable asset allocation. It allows change over from one asset to another at any time depending upon the market trends.

**Debt / Income Funds**

The investment of debt or income funds is purely only on the debt instruments issued by private companies, banks, financial institutions, governments and other entities. These funds are suitable to those investors who expect regular income and low risk. Debt instruments are graded by credit rating agencies. Grading indicates the risk of the debt securities. There are different types of debt funds based on investment objectives, which are as follows:-

***a. Diversified Debt Funds***

The portfolio of the fund comprises the debt securities of all companies belonging to all industries. The result of diversified investments in all sectors is risk reduction.

***b. Focused Debt Funds***

Debt funds that invest in debt securities issued by entities belonging to a particular sector or companies of the market are known as focused debt funds.

### ***c. High Yield Debt funds***

Generally, all debt funds have default risk. By and large, investors would like to invest in “**high investment grade**” securities which protect the risk of default. High yield debt funds invested in “below investment grade” securities provides high returns but the existence of default risk is higher due to more volatility.

### ***d. Assured Return Funds***

The investors of this fund will get assured returns with a low-risk investment opportunity. But there may be a shortfall in returns which is borne by Asset Management Company or sponsor. The security of investments depends upon the net worth of the guarantor, whose name is specified in the offer document. To safeguard the interest of investors, the sponsors must have adequate net worth to guarantee returns as per the norms of SEBI to offer assured return schemes. Unit trust of India had offered ‘Monthly Income Plans’ under the scheme of assured return schemes. But the UTI had failed to fulfill its promises due to heavy shortfall in returns. The UTI’s payment obligations were taken over by the Government. Now-a-days no assured return schemes are offered in India.

### ***e. Fixed Term Plan Series***

The funds’ attracts the short-term investors and invests in short term debt securities. It is a closed-end scheme that offers a series of plans and issues units to investors at regular intervals. But these plans are not listed on the stock exchanges.

## **Gilt Funds**

The portfolio of Gilt fund’ is only the government securities of medium and long term matured bonds. It provides much safety to the investors with no credit risk. But it is exposed to interest rate risk.

## **Commodity Funds**

The focus of investment of this fund is on different commodities, such as metals (like gold, silver, copper etc.), food grains, oils, etc., or

options and futures, contracts of commodities, commodity producing companies etc. The concentration of investment may be made on a specialized commodity or on a diversified commodity fund. Specialized commodity fund bears more risk than that of diversified commodity fund.

### ***Real Estate Funds***

Real estate investment provides higher capital appreciation and generates regular and higher income to the investors. Real estate investment includes not only in direct investment in real estate but also investments in securities of housing finance companies or lending to real estate developers.

### ***Exchange Traded Funds (ETF)***

Exchange Traded Funds are traded on stock exchanges like a single stock at index linked prices and it follows stock market indices. Investors of this fund get benefits of both closed-end fund and open-end mutual fund. It is very popular in London and New York stock exchanges. In India, it is introduced recently. This fund is more diversified and flexible of holding like a single share.

### ***Fund of Funds***

It means funds of a mutual fund invested in units of mutual fund schemes offered by other Asset Management Companies. No investments are made on financial (shares, bonds) or physical assets of the Fund of Funds. The investors of this fund get benefit of diversifying into different mutual fund schemes with a small amount of investment. And also, it facilitates diversification of risks.

## **Importance / Benefits of Mutual Funds**

### **Mobilizing Small Savings**

Funds are mobilized by way of selling units. A unit is a proportional share of securities in the portfolio of a mutual fund. Small fund investors get benefits of portfolio investment with the small amount of their savings.



**Investment Avenue**

Mobilized funds are invested in various types of investment avenues. Investment avenues are Shares and Bonds of various Companies and Industries, Gold, Deposits, Govt. bonds, Money Market Instruments etc., Investors can get opportunity on the portfolio of assets proportionately. Individual investors may not invest in all these investment avenues.

**Professional Management**

‘Mutual Funds’ utilizes professional experts and the experts manage the investment portfolios efficiently and profitably. Investors are free from taking risk of buying and selling shares.

**Diversified Investment**

Small investors can enjoy the benefit of portfolio investment through mutual funds. Mutual funds have the advantage of diversified investment in various industry segments.

**Liquidity**

Mutual fund investors can buy and sell their units in the secondary market in case of close - ended mutual funds. In case of open-ended mutual funds, the investors can withdraw holdings any time at the Net Asset Value.

**Less Risk**

Mutual fund investment involves very less risk. Because, the fund is managed with the professional expertise, portfolio investment, diversification and the economies of scale in transaction cost.

**Legal Protection**

Securities Exchange Board of India (SEBI) is the regulatory body of securities market in India; it provides the regulations and guidelines for Mutual funds.

### Tax Benefits

Under the provisions of Income Tax Act, the investors of mutual fund can get tax shelter on the their investment in Mutual fund.

### Minimum Transaction Costs

The transaction cost of buying and selling of mutual fund units is very less. This facilitates the investors to switch over from one scheme to another and they get benefit of flexible investment opportunities.

### Economic Development

Mobilization of savings leads to investment. Mutual fund money is utilized for the investment in various industrial sectors. Industrial sector development leads to enhance the countries' economy.

### Mutual Fund vs Insurance

Mutual Fund	Insurance
Returns are higher	Lower returns, but risk too is low
Fund management is active	Ideal for long term investors
Lower distribution fees	Offer switching between asset classes without any load
Tax liabilities in some schemes	No Tax liability
Offers a range of products in debt and equity	Security is a big trigger for investing

### Mutual Funds Industry in India

Mutual Fund in India was first started by **Unit Trust of India (UTI)** in the year 1964 in the form of investment trust. UTI initially started with open-ended mutual fund; the first unit scheme offered was the “US-64” and the face value of a single unit was ₹ 10, to attract the medium and low

income group people. UTI enjoyed the monopoly of Mutual fund till 1987 and later the Government of India by amending the Banking Regulation Act, permitted commercial banks in the public sector to set up subsidiaries operating as trusts to perform the functions of mutual funds.

Before, the monopoly of the market had seen an ending phase; the Assets under Management (AUM) were ₹ 67 billion. The private sector entry to the fund family raised the AUM to ₹ 470 billion in March 1993 and at the end of April 2004; it reached the height of 1,540 billion.

Putting the AUM of the Indian Mutual Funds Industry into comparison, the total of it is less than the deposits of SBI alone and less than 11% of the total deposits held by the Indian banking industry. The main reason for its poor growth is that the mutual fund industry in India is new to the country. Hence, it is the prime responsibility of all mutual fund companies, to market correctly the product besides selling.

The growth of mutual fund industry in India is broadly put into four phases. The description of each phase is as under:

#### **First Phase - 1964-87**

In 1963, Unit Trust of India (UTI) was established by an Act of Parliament. It functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978, the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control from RBI. The first scheme launched by UTI was Unit Scheme 1964. The detailed notes about UTI are given separately in this unit.

#### **Second Phase - 1987-1993 (Entry of Public Sector Funds)**

##### ***Entry of Non-UTI Mutual Funds***

SBI Mutual Fund was the first public sector mutual funds followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92), LIC (1989) and GIC (1990). The end of 1993 marked ₹ 47, 004 crores as assets under management.

### **Third Phase - 1993-2003 (Entry of Private Sector Funds)**

During 1993, a new era started in the Indian mutual fund industry due to the entry of private sector funds. The Mutual Fund Regulations came into existence under which all mutual funds were to be registered and governed except UTI. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. In 1996, SEBI (Mutual Fund) Regulations were framed. During this phase, many foreign mutual funds were set up in India and the industry witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of ₹ 1, 21,805 crores out of which the assets of UTI alone were ₹ 44,541 crores.

### **Fourth Phase - since February 2003**

In February 2003, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with AUM (Asset Under Management) of ₹ 29,835 crores (as on January 2003). The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India does not come under the purview of the Mutual Fund Regulations. The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It was registered under SEBI Mutual Fund Regulations Act 1996.

### **Major Mutual Fund Companies in India**

#### **ABN AMRO Mutual Fund**

ABN AMRO Mutual Fund was setup on April 15, 2004 with ABN AMRO Trustee (India) Pvt. Ltd. as the Trustee Company. The AMC, ABN AMRO Asset Management (India) Ltd. was incorporated on November 4, 2003. Deutsche Bank AG is the custodian of ABN AMRO Mutual Fund

#### **Birla Sun Life Mutual Fund**

Birla Sun Life Mutual Fund is the joint venture of Aditya Birla Group and Sun Life Financial. Sun Life Financial is a global organisation evolved in 1871 and is being represented in Canada, the US, the Philippines, Japan, Indonesia and Bermuda apart from India. Birla Sun Life Mutual

Fund follows a conservative long-term approach to investment. Recently it crossed AUM of ₹ 10,000 crores.

### **Bank of Baroda Mutual Fund (BOB Mutual Fund)**

Bank of Baroda Mutual Fund or BOB Mutual Fund was setup on October 30, 1992 under the sponsorship of Bank of Baroda. BOB Asset Management Company Limited is the AMC of BOB Mutual Fund and was incorporated on November 5, 1992. Deutsche Bank AG is the custodian.

### **HDFC Mutual Fund**

HDFC Mutual Fund was setup on June 30, 2000 with two sponsorers namely Housing Development Finance Corporation Limited and Standard Life Investments Limited.

### **HSBC Mutual Fund**

HSBC Mutual Fund was setup on May 27, 2002 with HSBC Securities and Capital Markets (India) Private Limited as the sponsor and Board of Trustees.

### **ING Vysya Mutual Fund**

ING Vysya Mutual Fund was setup on February 11, 1999 with the same named Trustee Company. It is a joint venture of Vysya and ING. The AMC, ING Investment Management (India) Pvt. Ltd. was incorporated on April 6, 1998.

### **Prudential ICICI Mutual Fund**

The mutual fund of ICICI is a joint venture with Prudential Plc. of America, one of the largest life insurance companies in the US of A. Prudential ICICI Mutual Fund was setup on 13th of October, 1993 with two sponsorers, Prudential Plc. and ICICI Ltd. The Trustee Company formed is Prudential ICICI Trust Ltd. and the AMC is Prudential ICICI Asset Management Company Limited incorporated on 22nd of June, 1993.

### **Sahara Mutual Fund**

Sahara Mutual Fund was set up on July 18, 1996 with Sahara India Financial Corporation Ltd. as the sponsor. Sahara Asset Management Company Private Limited incorporated on August 31, 1995 works as the AMC of Sahara Mutual Fund. The paid-up capital of the AMC stands at ₹ 25.8 crore.

### **State Bank of India Mutual Fund**

State Bank of India Mutual Fund is the first Bank sponsored Mutual Fund to launch offshore fund, the India Magnum Fund with a corpus of ₹ 225 cr. approximately. Today it is the largest Bank sponsored Mutual Fund in India. They have already launched 35 Schemes out of which 15 have already yielded handsome returns to investors. State Bank of India Mutual Fund has more than ₹ 5,500 Crores as AUM. Now it has an investor base of over 8 Lakhs spread over 18 schemes.

### **Tata Mutual Fund**

Tata Mutual Fund (TMF) is a Trust under the Indian Trust Act, 1882. The sponsorers for Tata Mutual Fund are Tata Sons Ltd., and Tata Investment Corporation Ltd. The investment manager is Tata Asset Management Limited and its Tata Trustee Company Pvt. Limited. Tata Asset Management Limited's is one of the fastest in the country with more than ₹ 7,703 crores (as on April 30, 2005) of AUM.

### **Kotak Mahindra Mutual Fund**

Kotak Mahindra Asset Management Company (KMAMC) is a subsidiary of KMBL. It is presently having more than 1,99,818 investors in its various schemes. KMAMC started its operations in December 1998. Kotak Mahindra Mutual Fund offers schemes catering to investors with varying risk - return profiles. It was the first company to launch dedicated gilt scheme investing only in government securities.

### **Unit Trust of India Mutual Fund**

UTI Asset Management Company Private Limited, established in Jan 14, 2003, manages the UTI Mutual Fund with the support of UTI

Trustee Company Private Limited. UTI Asset Management Company presently manages a corpus of over ₹ 20000 Crore. The sponsors of UTI Mutual Fund are Bank of Baroda (BOB), Punjab National Bank (PNB), State Bank of India (SBI), and Life Insurance Corporation of India (LIC). The schemes of UTI Mutual Fund are Liquid Funds, Income Funds, Asset Management Funds, Index Funds, Equity Funds and Balance Funds.

### **Reliance Mutual Fund**

Reliance Mutual Fund (RMF) was established as trust under Indian Trusts Act, 1882. The sponsor of RMF is Reliance Capital Limited and Reliance Capital Trustee Co. Limited is the Trustee. It was registered on June 30, 1995 as Reliance Capital Mutual Fund which was changed on March 11, 2004. Reliance Mutual Fund was formed for launching of various schemes under which units are issued to the Public with a view to contribute to the capital market and to provide investors the opportunities to make investments in diversified securities.

### **Standard Chartered Mutual Fund**

Standard Chartered Mutual Fund was set up on March 13, 2000 sponsored by Standard Chartered Bank. The Trustee is Standard Chartered Trustee Company Pvt. Ltd. Standard Chartered Asset Management Company Pvt. Ltd. is the AMC which was incorporated with SEBI on December 20, 1999.

### **Franklin Templeton India Mutual Fund**

The group, Franklin Templeton Investments is a California (USA) based company with a global AUM of US\$ 409.2 bn. (as of April 30, 2005). It is one of the largest financial services groups in the world. Investors can buy or sell the Mutual Fund through their financial advisor or through mail or through their website. They have Open end Diversified Equity schemes, Open end Sector Equity schemes, Open end Hybrid schemes, Open end Tax Saving schemes, Open end Income and Liquid schemes, Closed end Income schemes and Open end Fund of Funds schemes to offer.

### **Morgan Stanley Mutual Fund India**

Morgan Stanley is a worldwide financial services company and its leading in the market in securities, investment management and credit services. Morgan Stanley Investment Management (MISM) was established in the year 1975. It provides customized asset management services and products to governments, corporations, pension funds and non-profit organisations. Its services are also extended to high net worth individuals and retail investors. In India it is known as Morgan Stanley Investment Management Private Limited (MSIM India) and its AMC is Morgan Stanley Mutual Fund (MSMF). This is the first close end diversified equity scheme serving the needs of Indian retail investors focussing on a long-term capital appreciation.

### **Escorts Mutual Fund**

Escorts Mutual Fund was setup on April 15, 1996 with Escorts Finance Limited as its sponsor. The Trustee Company is Escorts Investment Trust Limited. Its AMC was incorporated on December 1, 1995 with the name Escorts Asset Management Limited.

### **Alliance Capital Mutual Fund**

Alliance Capital Mutual Fund was setup on December 30, 1994 with Alliance Capital Management Corp. of Delaware (USA) as sponsorer. The Trustee is ACAM Trust Company Pvt. Ltd. and AMC, the Alliance Capital Asset Management India (Pvt) Ltd. with the corporate office in Mumbai.

### **Benchmark Mutual Fund**

Benchmark Mutual Fund was setup on June 12, 2001 with Niche Financial Services Pvt. Ltd. as the sponsorer and Benchmark Trustee Company Pvt. Ltd. as the Trustee Company. Incorporated on October 16, 2000 and headquartered in Mumbai, Benchmark Asset Management Company Pvt. Ltd. is the AMC.



### **Canbank Mutual Fund**

Canbank Mutual Fund was setup on December 19, 1987 with Canara Bank acting as the sponsor. Canbank Investment Management Services Ltd. incorporated on March 2, 1993 is the AMC. The Corporate Office of the AMC is in Mumbai.

### **Chola Mutual Fund**

Chola Mutual Fund under the sponsorship of Cholamandalam Investment & Finance Company Ltd. was setup on January 3, 1997. Cholamandalam Trustee Co. Ltd. is the Trustee Company and AMC is Cholamandalam AMC Limited.

### **LIC Mutual Fund**

Life Insurance Corporation of India set up LIC Mutual Fund on 19th June 1989. It contributed ₹ 2 Crores towards the corpus of the Fund. LIC Mutual Fund was constituted as a Trust in accordance with the provisions of the Indian Trust Act, 1882.. The Company started its business on 29th April 1994. The Trustees of LIC Mutual Fund have appointed Jeevan Bima Sahayog Asset Management Company Ltd as the Investment Managers for LIC Mutual Fund.

### **GIC Mutual Fund**

GIC Mutual Fund, sponsored by General Insurance Corporation of India (GIC), a Government of India undertaking and the four Public Sector General Insurance Companies, viz. National Insurance Co. Ltd (NIC), The New India Assurance Co. Ltd. (NIA), The Oriental Insurance Co. Ltd (OIC) and United India Insurance Co. Ltd. (UII) and is constituted as a Trust in accordance with the provisions of the Indian Trusts Act, 1882. The mutual funds are listed as follows:

#### ***A. Bank Sponsored***

##### **1. Joint Ventures – Predominantly Indian**

- Canara Robeco Asset Management Company Limited
- SBI Funds Management Private Limited

## **2. Joint Ventures – Predominantly Foreign**

- Baroda Pioneer Asset Management Company Limited

## **3. Others**

- UTI Asset Management Company Ltd

## ***B. Institutions***

- LIC Mutual Fund Asset Management Company Limited

## ***C. Private Sector***

### **1. Indian**

- Axis Asset Management Company Ltd.
- Benchmark Asset Management Company Pvt. Ltd.
- DBS Cholamandalam Asset Management Ltd.
- Deutsche Asset Management (India) Pvt. Ltd.
- Edelweiss Asset Management Limited
- Escorts Asset Management Limited
- IDFC Asset Management Company Private Limited
- JM Financial Asset Management Private Limited
- Kotak Mahindra Asset Management Company Limited (KMAMCL)
- Quantum Asset Management Co. Private Ltd.
- Reliance Capital Asset Management Ltd.
- Religare Asset Management Company Ltd.
- Sahara Asset Management Company Private Limited
- Tata Asset Management Limited
- Taurus Asset Management Company Limited

### **2. Foreign**

- AIG Global Asset Management Company (India) Pvt. Ltd.
- FIL Fund Management Private Limited
- Fortis Investment Management (India) Pvt. Ltd.
- Franklin Templeton Asset Management (India) Private Limited
- Goldman Sachs Asset Management (India) Private Limited
- Mirae Asset Global Investments (India) Pvt. Ltd.

### 3. Joint Ventures – Predominantly Indian

- Birla Sun Life Asset Management Company Limited
- DSP Black Rock Investment Managers Private Limited
- HDFC Asset Management Company Limited
- ICICI Prudential Asset Mgmt. Company Limited
- Religare AEGON Asset Management Company Pvt. Ltd.
- Sundaram BNP Paribas Asset Management Company Limited

### 4. Joint Ventures – Predominantly Foreign

- Bharti AXA Investment Managers Private Limited
- HSBC Asset Management (India) Private Ltd.
- ING Investment Management (India) Pvt. Ltd.
- JPMorgan Asset Management India Pvt. Ltd.
- Morgan Stanley Investment Management Pvt.Ltd.
- Principal Pnb Asset Management Co. Pvt. Ltd.
- Shinsei Asset Management (India) Pvt. Ltd.

## Constitution and Management of Mutual Fund

A Mutual fund is formed as trust, which has sponsor, trustees, Asset Management Company (AMC) and custodian. Sponsor is like the promoters of a company. More than one sponsor establishes the trust. They take initiative for promoting the Mutual Fund. Trustee is the person/firm/company/institutions who look after the assets of the mutual fund for the benefit of the unit holders. Normally, bankers, insurance companies are appointed as trustees, who supervise the assets of the mutual fund. Asset Liability Management Company (ALM) manages the 'funds' which is mobilized by mutual fund. ALM is expertise in the field of investment portfolio and approved by SEBI. They take care of Mutual funds' investments in various types of securities in a diversified manner. Custodian is the person/company who/which holds the securities of various schemes of the fund in his/its custody and who/which is registered with SEBI.

The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund. SEBI Regulations require that at

least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. The registration of mutual funds under SEBI is mandatory.

### **Sponsor**

The sponsor is a body corporate which initiates the launching of a mutual fund. As per SEBI norms, it should have minimum 5 years of experience in the relevant field of financial services with good track record and its' contribution of capital must be 40% of the net worth of the Asset Management Company. It appoints trustees, an asset management company and custodians.

### **Trustees**

Trustee is a manager of another's property. In mutual fund he holds the assets of mutual fund for the benefit of unit holders. The trust should be constituted under the provisions of Indian Trust Act.

### **Contents of Trust Deed**

- The trust deed shall contain such clauses as are mentioned in the third Schedule to the Indian trust Act and such other clauses which are necessary for safeguarding the interests of the unit holders.
- No trust deed shall contain a clause which has the effect of-
  1. limiting or extinguishing the obligations and liabilities of the trust in relation to any mutual fund or the unit holders; or
  2. Indemnifying the trustees or the asset management company for loss or damage caused to the unit holders by their acts of negligence or acts of commissions or omissions.

### **Approval of the Board for Appointment of Trustee**

- No trustee shall initially or any time thereafter be appointed without prior approval of the Board.
- The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the Board.

**Functions of the Trustees**

- All assets of Mutual fund should be kept under the custody of trustee.
- It should provide information about the schemes to SEBI and Unit Holders.
- It can appoint an asset management company for floating of mutual fund schemes.
- It has rights to dismiss the AMC appointed by it.
- It has power to monitor and supervise the activities of AMC

**Rights and Obligations of the Trustees**

- The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement.
- The trustees shall have a right to obtain from the asset management company such information as is considered necessary by the trustees.
- The trustees shall ensure that an asset management company has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.
- The trustees shall ensure that the transactions entered into by the asset management company are in accordance with these regulations and the scheme.
- The trustees shall be accountable for, and shall be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with these regulations and the provisions of trust deed.
- The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.
- The trustees shall be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the units of any scheme in accordance with these regulations and the trust deed.

- The trustees shall quarterly review all transactions carried out between the mutual funds, Asset Management Company and its associates.
- The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy it that such contracts are executed in the interest of the unit holders.

### **Asset Management Company (AMC)**

Asset Management company acts as investment manager and manages the affairs of Mutual Fund. It is appointed by the sponsor or the trustees. It should have a sound track record with a net worth of at least ₹ 100 crores. All schemes of the fund are operated by AMC and it is responsible for it. It may also operate as an underwriter with the approval of SEBI.

### **SEBI Regulations**

The following rules and regulations of Securities Exchange of Board of India (SEBI) are related to the establishment and issue of schemes of Mutual Fund.

- Mutual fund shall be established in the form of trusts under the Indian Trust Act and managed by separately formed Asset Management Company.
- In the Board of directors of AMC must be 50% members are independent without the influence of sponsoring organization and they should have at least 10 years experience in the field of portfolio management.
- A minimum of ₹ 10 crores must have AMC as net worth
- An AMC can function for only one mutual fund and it is prohibited to work for another.
- AMCs are also allowed to do other fund based businesses such as providing investment management services to offshore funds, venture capital funds and insurance companies.
- Minimum issue of fund for closed-end scheme and open end scheme should be ₹ 20 crores and ₹ 50 crores respectively.

- The maximum period for subscription is 45 days in case of close-end schemes, but no such limitation in case of open – end scheme.
- The entire subscription has to be returned to the investors when the minimum amount or 60% of the target amount is not raised.
- There should be a separate and responsible fund manager for each scheme.
- To protect the small investors, SEBI restrict the portfolio investment of Mutual Fund in a single company by 10% of Net Assets Value of a scheme.
- The issue expenses are restricted to 6% of raising funds under each scheme.
- A minimum of 90% of the profits must distribute to the unit holders in any given year.
- Accounting and Auditing of Mutual funds are mandatory and furnish the audited Annual statements to SEBI.
- SEBI has power to impose penalty on mutual funds for violation of SEBI guidelines.

### **New SEBI Guidelines for Mutual Funds**

The Securities and Exchange Board of India (SEBI) has brought in sweeping changes for the mutual fund industry, the impact of which will be felt on the investor in more ways than one.

#### **First, for New Fund Offers (NFOs)**

They will ***only be open for 15 days***. (ELSS funds though will continue to stay open for up to 90 days) It will save investors from a prolonged NFO period and being harangued by advisors and advertisements. The motivation behind the rule seems to be simple; investor can invest anytime, no need to wait for NFO period.

#### **NFOs can only be Invested at the Close of the NFO Period**

Earlier, Mutual funds would keep an NFO open for 30 days, and the minute they received their first cheque, the money would be directly

invested in the market; creating a skewed accounting for those that entered later since they get a fixed NFO price.

### **Dividends can now only be Paid out of Actually Realized Gains**

**Impact:** it will reduce both the quantum of dividends announced, and the measures used by MFs to gather investor money using dividend as an incentive to attract new investors.

- Equity Mutual funds have been asked to play a **more active role in corporate governance** of the companies they invest in. This will help mutual funds become more active and not just that, they must reveal, in their annual reports from next year, what they did in each “vote”. SEBI has now made it mandatory for funds to disclose whether they voted for or against moves (suggested by companies in which they have invested) such as mergers, demergers, corporate governance issues, appointment and removal of directors. MFs have to disclose it on their website as well as annual reports.
- Equity Funds were allowed to charge 1% more as management fees if the funds were “no-load”; but since SEBI has banned entry loads, **this extra 1% has also been removed.**
- SEBI has also asked Mutual Funds to **reveal all commission paid to its sponsor or associate companies, employees and their relatives.**
- **Regarding the Fund-of-Fund (FOF)** – The market regulator has stated that information documents that Asset Management Companies (AMCs) have been entering into revenue sharing arrangements with offshore funds in respect of investments made on behalf of Fund of Fund schemes create conflict of interest. Henceforth, AMCs shall not enter into any revenue sharing arrangement with the underlying funds in any manner and shall not receive any revenue by whatever means/head from the underlying fund.

These guidelines set by the SEBI will lead to greater transparency for the common investor. SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. With these guide-



lines falling in place, it would create better trust and transparency and investable environment that would attract investors with greater faith and confidence.

## **Conclusion**

Mutual funds have become a major vehicle for mobilization of saving particularly from the small and household sectors for investment in the stock market. Mutual funds have responded to this challenge by diversifying through organic growth, innovative new products and building trust with the investors. With greater flexibility in operation, the mutual fund industry is expected to play its desired role to harness savings for economic development, inculcate equity culture, strengthening the capital market.

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## **Lesson 4.2 - Unit Trust of India and Money Market Mutual Funds**

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### **Unit Trust of India**

#### **Establishment**

The Unit Trust of India (UTI) was established by the government of India on 1st February, 1964 under the Unit Trust of India Act, 1963 (the bill was introduced by the then Finance Minister Sri.T.T.Krishnamachari).

#### **Structure**

The initial capital of UTI was ₹ 5 crores which was contributed by Reserve Bank of India (RBI), State Bank of India (SBI), Life Insurance Corporation of India (LIC), Scheduled banks and foreign banks. The management was entrusted to an independent Board of Trustees appointed by the Government.

#### **Objectives**

The basic objective of the UTI is to offer both small and large investors the means of acquiring shares in the widening prosperity resulting from the steady, industrial growth of the country.

There are two primary objectives of UTI,

- To promote and pool the small savings from the lower and middle income people who cannot have direct access to the stock exchange, and
- To give them an opportunity to share the benefits and fruits of prosperity resulting from rapid industrialization in India.

## Functions

The main functions of UTI are as follows:

- To encourage savings of lower and middle-class people.
- To sell units to investors in different parts of the country.
- To convert the small savings into industrial finance.
- To give them an opportunity to share the benefits of industrialization in the country.
- To provide liquidity to units.

## Recent Developments and Investment Policies of UTI

UTI Mutual Fund is managed by UTI Asset Management Company Private Limited (Estb: on Jan 14, 2003) appointed by the UTI Trustee Company Private Limited for managing the schemes of UTI Mutual Fund and the schemes transferred / migrated from UTI Mutual Fund. UTI Mutual Fund has come into existence with effect from 1st February 2003. UTI Asset Management Company presently manages a corpus fund of over ₹ 34,500 Crores. UTI Mutual Fund has a track record of managing a variety of schemes catering to the needs of every class of citizenry. It has a nationwide network consisting 70 UTI Financial Centers (UFCs) and UTI International offices in London, Dubai and Bahrain.

## Types of Funds

UTI funds are classified based on the following two aspects:-

- I. Maturity period
- II. Investment objective

### I. Based on Maturity

#### a. *Open-Ended Fund/Scheme*

An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices, which are declared on a daily basis. The key feature of open-ended schemes is its liquidity.

### ***b. Close-Ended Fund/Scheme***

A close-ended fund or scheme has a stipulated maturity period, say for example 5-7 years. The fund is open for subscription only during a specified period at the time of launching of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme through the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

## **II. Investment Objective**

### ***a. Liquid Funds Category***

- UTI - Money Market Fund - It is an open-ended pure debt liquid plan, seeking to provide highest possible current income, by investing in a diversified portfolio of short-term money market securities.
- UTI - Floating Rate Fund - It is to generate regular income through investment in a portfolio comprising substantially of floating rate debt / money market instruments and fixed rate debt / money market instruments.
- UTI - Liquid Fund Cash Plan - The scheme seeks to generate steady & reasonable income with low risk & high level of liquidity from a portfolio of money market securities & high quality debt.

### ***b. Income Funds Category***

- UTI - G-Sec Fund - Investment Plan - It is an open-end Gilt-Fund with the objective to invest only in Central Government securities including call money, treasury bills and repos of varying maturities with a view to generate credit risk free return.
- UTI - G-Sec Fund - Short Term Plan - It is an open-end Gilt-Fund with the objective to invest only in Central Government securities

including call money, treasury bills and repos of varying maturities with a view to generate credit risk free return.

- UTI - GILT Advantage Fund -LTP - It is to generate credit risk-free return through investments in sovereign securities issued by the Central and / or a State Government LTP.
- UTI - Variable Investment Scheme - It is an open ended debt oriented fund with 100% investment in Debt/G-sec. Investment can be made in the name of the children upto the age of 15 years.
- UTI - Bond Advantage Fund - LTP - It aims to generate attractive returns consistent with capital preservation and liquidity.
- UTI - Monthly Income Scheme – It is an open-ended debt oriented fund investing a minimum of 90% in Debt and G-Sec and a maximum of 10% in equity instruments. The fund aims to distribute income periodically and it is best suited to the investors.
- UTI - Liquid Fund - Short Term Plan - The scheme seeks to generate steady & reasonable income with low risk & high level of liquidity from a portfolio of money market securities & high quality debt.
- UTI - MIS - Advantage Plan – It is to generate regular income through investments in fixed income securities and capital appreciation / dividend income through investment of a portion of net assets of the scheme in equity and equity related instruments so as to endeavor to make periodic income distribution to Unit holders.
- UTI - Bond Fund – It is an open-end 100% pure debt fund, which invests in rated corporate debt papers and government securities with relatively low risk and easy liquidity.
- UTI - Capital Protection Oriented Scheme - The scheme will invest in a portfolio predominantly of fixed income securities that are maturing in line with duration of the respective plans. Each Plan will have a separate portfolio. The debt component of the portfolio structure shall have the highest investment grade rating. The equity components of the scheme will mainly focus on those companies / stocks that have potential to appreciate in the medium to long run.

**c. Asset Allocation Funds Category**

- UTI - Variable Investment Scheme - The UTI Variable Investment Scheme is an open-ended scheme with dynamic allocation between equity and debt classes.

**d. Index Funds Category**

- UTI - Master Index Fund - UTI MIF is an open-ended passive fund with the primary investment objective to invest in securities of companies comprising the BSE sensex in the same weightage as these companies have in BSE sensex.
- UTI - Nifty Index Fund - UTI NIF is an open-ended passive fund with the objective to invest in securities of companies comprising of the S&P CNX Nifty in the same weightage as they have in S&P CNX Nifty.
- UTI - Gold Exchange Traded Fund – Its objective is to endeavor to provide returns that, before expenses, closely track the performance and yield of Gold.

**e. Equity Funds Category**

- UTI - Equity Tax Saving Plan - It is an open-ended equity fund investing a minimum of 80% in equity and equity related instruments. It aims at enabling members to avail tax rebate under Section 88 of the IT Act and provide them with the benefits of growth.
- UTI - Master share unit Scheme – It is an open-end equity fund aiming to provide benefit of capital appreciation and income distribution through investment in equity.
- UTI – Master gain Unit Scheme - Master Gain is open-ended equity scheme with an objective of investing at least 80% of its funds in equity and equity related instrument with medium to high risk profile and up to 20% in debt and money market instruments with low to medium risk profile.
- UTI - Opportunities Fund - This scheme seeks to generate capital appreciation and/or income distribution by investing the funds of the scheme in equity shares and equity-related instruments.

- UTI - Software Fund – It is an open-ended fund which invests exclusively in the equities of the Software Sector companies. One of the growth sectors funds aiming to invest in equity shares of companies belonging to information technology sector to provide returns to investors through capital growth as well as through regular income distribution.
- UTI - Banking Sector Fund - It is an open-ended equity fund with the objective to provide capital appreciation through investments in the stocks of the companies/institutions engaged in the banking and financial services activities.
- UTI - Master Value Fund - It is an open-ended equity fund investing in stocks which are currently under valued to their future earning potential and carry medium risk profile to provide 'Capital Appreciation'.
- UTI - MNC Fund – It is an open-ended equity fund with the objective to invest predominantly in the equity shares of multinational companies in diverse sectors such as FMCG, Pharmaceutical, Engineering etc.
- UTI - Mid Cap Fund – It is an open-ended equity fund with the objective to provide 'Capital appreciation' by investing primarily in mid cap stocks.
- UTI - Infrastructure Fund – It is an open-ended equity fund with the objective to provide Capital appreciation through investing in the stocks of the companies engaged in the sectors like Metals, Building materials, oil and gas, power, chemicals, engineering etc. The fund will invest in the stocks of the companies which form part of Basic Industries.
- UTI - Leadership Equity Fund - This scheme seeks to generate capital appreciation and/or income distribution by investing the funds of the scheme in stocks that are "Leaders" in their respective industries/sectors/sub-sector.
- UTI - Contra Fund - The fund aims to provide long-term capital gain/dividend distribution through investments in listed equities and equity-related instruments. The Fund's investment policies are based on insights from behavioral finance.

- UTI - Wealth Builder Fund - The objective of the scheme is to achieve long term capital appreciation by investing predominantly in a diversified portfolio of equity and equity related instruments.
- UTI - Long-Term Advantage Fund - The investment objective of the scheme is to provide medium to long term capital appreciation along with income tax benefit.
- UTI - India Lifestyle Fund – Its aim is to provide long term capital gain and/or income distribution from a diversified portfolio of equity and equity related instruments of companies that are expected to benefit from changing Indian demographics, Indian lifestyles and rising consumption pattern.

***f. Balanced Funds Category***

- I. UTI - Balanced Fund – It is an open-ended balance fund investing between 40% to 60% in equality related securities and the balance in debt (fixed income securities) with a view to generate regular income together with capital appreciation.
- II. UTI - US 2002 – It is an Open-ended balance fund scheme aims at providing income distribution/ cumulation of income and capital appreciation over a long term from a prudent portfolio mix of equity and fixed income securities.
- III. UTI - Mahila Unit Scheme – It is an open-ended scheme is designed with a minimum 70% investment in Debt/G-Securities and a maximum 30% investment in equity. The fund is designed to provide an enabler to adult female persons in pooling their own savings and/ or gifts into an investment vehicle so as to get periodic cash flow near to the time of any chosen festival/ occasion or to allow income/ gains redeployed in the scheme and repurchase units partially or fully as and when desired.
- IV. UTI – Children’s Career Plan (Balanced) - It is an open-ended debt oriented fund with investment in Debt/G-Securities of minimum 60% and a maximum of 40% in Equity. Investment can be made in the name of the children up to the age of 15 years so as to provide them, after they attain the age of 18 years, to receive scholarship to meet the cost of higher education and/or to help them in setting up a profession, practice or business or enabling them to set up a home or finance the cost of other social obligation.



- V. UTI - CRTS - This is an open-end income oriented scheme. The scheme aims at catering to the investment needs of charitable, religious, educational trusts and similar institutions to provide them an investment vehicle to avail of tax exemption and also to have regular income.
- VI. UTI - ULIP - This is an open-ended balanced fund with an objective of investing not more than 40% of the funds in equity and equity related instruments and balance in debt and money market instruments with low to medium risk profile. Investment by an individual in the scheme is eligible for exemption under section 88 of the IT Act 1961. In addition the scheme also offers Life Insurance and Accident Insurance cover.
- VII. UTI - Retirement Benefit Pension Fund - It is an open-ended balanced fund with a maximum equity allocation of 40% and the balance in debt. This ensures to provide pension to investors particularly self-employed persons after they attain age of 58 years, in the form of periodical cash flow up to the extent of repurchase value of their holding through systematic withdrawal plan.

## **Evaluation of Performance of Mutual Funds**

### **Performance Measures of Mutual Funds**

Mutual Fund industry today, with about 34 players and more than five hundred schemes, is one of the most preferred investment avenues in India. However, with such a huge number of schemes to choose from, the retail investor faces problems in selecting funds. Factors such as investment strategy and management style are qualitative, but the 'funds performance record' is an important indicator too. Though past performance alone cannot be indicative of future performance, it is, frankly, the only quantitative way to judge how good a fund is at present. Therefore, there is a need to correctly assess the past performance of different mutual funds.

Worldwide, good mutual fund companies are known by their AMCs and this fame is directly linked to their superior stock selection skills. For mutual funds to grow, AMCs must be held accountable for their selection of stocks. In other words, there must be some performance indicator that will reveal the quality of stock selection of various AMCs.

Return alone should not be considered as the basis of measurement of the performance of a mutual fund scheme. It should also include the risk taken by the fund manager because different funds will have different levels of risk attached to them. Risk associated with a fund, in general, can be defined as variability or fluctuations in the returns generated by it. The higher the fluctuations in the returns of a fund are during a given period, the higher is the risk associated with it.

These fluctuations in the returns generated by a fund are resultant of two guiding forces. The first one is general market fluctuations, which affect all the securities, present in the market, called market risk or systematic risk and second is fluctuations due to specific securities present in the portfolio of the fund, called unsystematic risk. The **total risk** of a given fund is the sum of these two and is measured in terms of **standard deviation** of returns of the fund. Systematic risk, on the other hand, is measured in terms of **Beta**, which represents fluctuations in the NAV of the fund as against market. The more responsive the NAV of a mutual fund is to the changes in the market; higher will be its beta. Beta is calculated by relating the returns on a mutual fund with the returns in the market. While unsystematic risk can be diversified through investments in a number of instruments, systematic risk cannot be.

In order to determine the risk-adjusted returns of investment portfolios, several eminent authors have worked since 1960s to develop composite performance indices to evaluate a portfolio by comparing alternative portfolios within a particular risk class. The most important and widely used measures of performance are:

- The Treynor Measure
- The Sharpe Measure
- Jenson Model
- Fama Model

### Money Market Mutual Funds

In April 1991, Money Market Mutual Funds (MMMFs) were introduced in India. They provide an additional short term investment avenue to investors and bring money market instruments within the reach of individuals.

A money market mutual fund is a fund that invests solely in money market instruments. Money market instruments are forms of debt that mature in less than one year and have high liquidity. Treasury bills make up the bulk of the money market instruments. Securities in the money market are relatively risk-free and most secure mutual fund investments. Its aim is to preserve principal while yielding a modest return. It is similar to a high-yield bank account but is not entirely risk free. Investor should concentrate on the rate of interest.

### **Types of Money Market Mutual Funds**

#### **a) Institutional Money Market Mutual Funds**

These funds are held by governments, institutional investors and businesses etc. Huge sum of money is parked in institutional money funds.

#### **b) Retail Money Market Mutual Funds**

Retail money market funds are used for parking money temporarily. The investment portfolio of money market funds comprises of treasury bills, short term debts, tax free bonds etc.

### **Special Features of Money Market Mutual Funds**

- Money market mutual funds are one of the safest instruments of investment for the retail low income investors. The assets in a money market fund are invested in safe and stable instruments of investment issued by governments, banks, corporations etc.
- Generally, money market instruments require huge amount of investments and it is beyond the capacity of an ordinary retail investor to invest such large sums. Money market funds allow retail investors the opportunity of investing in money market instrument and benefit from the price advantage.
- Money market mutual funds are usually rated by the rating agencies.

## **RBI Guidelines**

### **RBI Guidelines on MMMFs**

The setting up of MMMFs would require the prior authorization of the Reserve Bank. Furthermore, the MMMFs to be set up by banks, their subsidiaries and public financial institutions would be required to comply with the guidelines and directives that may be issued by the RBI from time to time. Although the guidelines were issued in 1992-93, yet no institutions has so far come forward to establish a MMMF. The major hurdle has been the stringent limits for investments prescribed by the RBI. Moreover, the relative quietness on the money market front led to the absence of the “necessity” factor to establish MMMFs.

In November 1995, the RBI permitted the private sector mutual funds to set up MMMFs, with a view to provide greater liquidity and depth to the money market. While allowing the private sector MFs, the RBI also relaxed some of the earlier guidelines. The important relaxations were

1. Ceiling for raising resources and minimum size of ₹ 500 million withdrawn.
2. Minimum limit 25% while investing in T-bills and the Government of India papers of residual maturity upto 1 year withdrawn
3. Maximum limit of 30% while investing in call/notice money withdrawn
4. Maximum limit of 15% while investing in CPs withdrawn
5. Maximum limit of 20% while investing in Commercial bills withdrawn
6. Dividend / income on subscriptions by individual NRI in MMMFs can be repatriated, but not principal
7. Private sector MMMF should need the RBI and SEBI approval

In April 1992, the Reserve Bank announced the guidelines for Money Market Mutual Funds. The Reserve Bank had made several modifications in the scheme to make it more flexible and attractive to banks and financial institutions. These guidelines were subsequently incorporated into the revised SEBI regulations. In October 1997, MMMFs were permitted to

invest in rated corporate bonds and debentures with a residual maturity of up to one year, within the ceiling existing for Commercial Paper (CPs). The minimum lock-in period was also reduced gradually to 15 days, making the scheme more attractive to investors. MMMFs would come under the purview of SEBI regulations. Banks and Financial Institutions desirous of setting up MMMFs would however have to seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

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## Lesson 4.3 - Venture Capital

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### Introduction

Venture Capital is a form of “risk capital” which is invested in a project or a business where there is a substantial element of risk relating to the future creation of profits and cash flows. Risk capital is invested as shares (equity) rather than as a loan and the investor requires a higher “rate of return” to compensate him for his risk.

### Concept

Venture capital provides seed capital or funding for expansion of companies in the form of share capital, to help unquoted companies grow and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalize a company etc., venture capital could help do this. Obtaining venture capital is substantially different from raising a debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business.

Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalists’ return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist “exits” by selling its shareholding when the business is sold.

### Origin

Venture capital funding is first originated in the UK in the late 18th century, when European entrepreneurs and merchant bankers were helping the growth of industry in USA, South Africa and India. This informal method of financing became an industry in the late 1970s and early 1980s when a number of venture capital firms were founded. There are now over 100 active venture capital firms in the UK, which provide

several billion pounds each year to unquoted companies mostly located in the UK. The venture capital funds are active in UK in the form of

- Clearing bank captive funds,
- Funds sponsored by savings and investment institutions and merchant bankers
- Business expansion scheme funds
- Corporate, academic and other private sector funds
- Semi-State bodies (both Central and Local Government).

### **Venture Capital and Development Capital**

Venture capital is advanced for ventures using a new technology or new innovation. The venture capital company remains interested in the overall management of the project due to the high risk involved in the venture. Funds are made available throughout the project, commencing from commercial production to the successful marketing of products, to ensure continuous revenue earnings, enhanced worth of the investments and finally making available a proper exit route for liquating the investments.

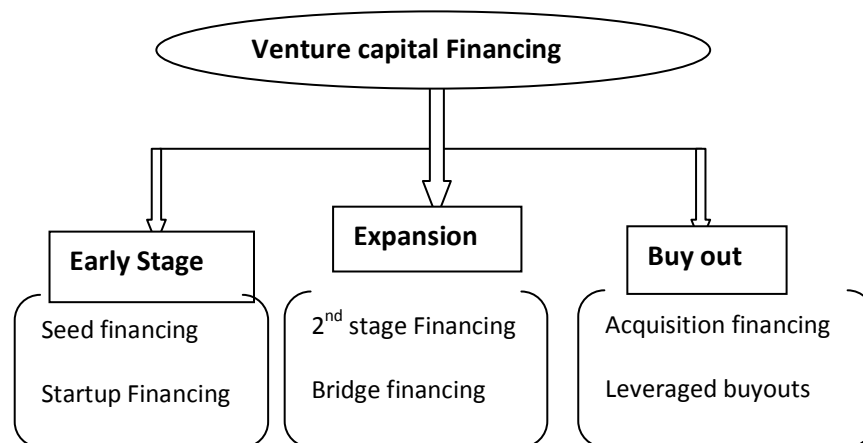
Development capital is generally granted in the form of loans for setting up industrial units, and also for expansion and modernization. The lender takes special care in ensuring the end use of the credit and requires prompt payment of interest and repayment of the loan amount.

### **Types of Venture Capital Financing**

There are three main groups into which venture capital investment can be divided. They are early stage, expansion, and buyout. Each of these groups is further divided into subgroups, as illustrated in the chart on the next page:

#### **Early Stage**

Early stage investing is divided into three subgroups: seed financing, startup financing, and 1st stage financing.



### ***Seed Financing***

This type of financing will be very early in the life of the business, usually pre-revenue and sometimes even before the product or service is created. It will also make it easier for the entrepreneur to get loans after being financed this way. The entrepreneur will use seed money for market research and early product or service development.

### ***Startup Financing***

Startup financing is used by businesses to finish the development of their products and services. In some cases, it will also be used for marketing the products and services. This helps the company launch their operations.

### ***1st Stage Financing***

This is the last subgroup of financing in the early stage category, and would be used to continue operations of the company at a higher scale. Products (or services) would start to be produced in a large scale, and the initial funding would have been used by this time.

### ***Expansion***

Expansion investing is also broken up into three subgroups: 2nd stage financing, bridge financing, and 3rd stage financing.



## ***2nd Stage Financing***

This stage of financing is used by a business for initial expansion plans whether that involves products or services. The company usually will not be profitable even after receiving this type of financing.

## ***Bridge Financing***

Bridge financing is used as a short term investment that will maintain liquidity, especially if an inflow of cash is going to be received. One example could be if the company plans to have an IPO, bridge financing can be used to sustain the company for a short period of time that is till it receives money from the allottees.

## ***3rd Stage Financing***

This type of financing is also called mezzanine financing, and is invested into a company that has achieved its breakeven point, and in some cases is achieving profitability. This type of financing will be used by a company for marketing, plant expansion, and new products or services.

## ***Buyout***

The buyout stage of investing can be broken down into two subgroups: acquisition financing and leveraged buyouts (LBO).

## ***Acquisition Financing***

This type of financing is used to acquire either part of a company or the entire company. The original business making the acquisition would have expanded to the point where this strategy is feasible.

## ***Leveraged Buyout (LBO)***

This type of financing is otherwise known as a management buyout. The management group of the company will acquire an equity stake in a company and potentially buyout certain assets of the company. The company acquisition will be primarily financed through debt. Management teams or companies themselves use this strategy when they do not want to commit capital to the deal.

## **Venture Capital Firms - Fund Sources**

There are several sources for raising funds by Venture capital firms. To obtain their funds, venture capital firms have to reveal a good track record and the prospect of producing returns greater than can be achieved through fixed interest or quoted equity investments. Most UK venture capital firms raise their funds for investment from external sources, mainly institutional investors, such as pension funds and insurance companies.

Venture capital firms' investment preferences may be affected by the source of their funds. Many funds raised from external sources are structured as Limited Partnerships and usually have a fixed life of 10 years. Within this period the funds invest the money committed to them and by the end of the 10th year they will have to return the investors' original money, plus any additional returns made. This generally requires the investments to be sold, or to be in the form of quoted shares, before the end of the fund.

## **Venture Capital - Investment Process**

The investment process, from reviewing the business plan to actually investing in a proposition, can take a venture capitalist any period from one month to one year but typically it takes between 3 and 6 months. There are always exceptions to the rule and deals can be done in extremely short time frames. Much depends on the quality of information provided and made available.

The key stage of the investment process is the initial evaluation of a business plan. Most approaches to venture capitalists are rejected at this stage. In considering the business plan, the venture capitalist will consider several principal aspects such as:

- Is the product or service commercially viable?
- Does the company have potential for sustained growth?
- Does the management have the ability to exploit this potential and control the company through the growth phases?
- Does the possible reward justify the risk?
- Does the potential financial return on the investment meet their investment criteria?

In structuring its investment, the venture capitalist may use one or more of the following types of share capital:

### ***Ordinary Shares***

These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Ordinary shares holders have voting rights. In a venture capital deal these are the shares typically held by the management and family shareholders rather than the venture capital firm.

### ***Preferred Ordinary Shares***

These are equity shares with special rights. For example, they may be entitled to a fixed dividend or share of the profits. Preferred ordinary shares holders have voting rights.

### ***Preference Shares***

These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually entitled to a fixed dividend. The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (eg. at 120% of cost). They may be convertible into a class of ordinary shares.

### ***Loan Capital***

Venture capital loans typically are entitled to interest and are usually, though not necessarily, repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached which gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Venture capital investments are often accompanied by additional financing at the point of investment. This is nearly always the case where the business in which the investment is being made is relatively mature or well-established. In this case, it is appropriate for a business to have a financing structure that includes both equity and debt.

Other forms of finance provided in addition to venture capitalist equity include:

- **Clearing banks** – They principally provide overdrafts and short to medium-term loans at fixed or, more usually, variable rates of interest.
- **Merchant banks** – They organize the provision of medium to longer-term loans, usually for larger amounts than clearing banks. Later they can play an important role in the process of “going public” by advising on the terms and price of public issues and by arranging underwriting when necessary.
- **Finance houses** - They provide various forms of installment credit, ranging from hire purchase to leasing; often asset based and usually for a fixed term and at fixed interest rates.
- **Factoring companies** - They provide finance by buying trade debts at a discount, either on a recourse basis (you retain the credit risk on the debts) or on a non-recourse basis (the factoring company takes over the credit risk).
- **Government and European Commission sources** - They provide financial aid to UK companies, ranging from project grants (related to jobs created and safeguarded) to enterprise loans in selective areas.
- **Mezzanine firms** – They provide loan finance that is halfway between equity and secured debt. These facilities require either a second charge on the company’s assets or are unsecured. Because the risk is consequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that by the principal lenders and sometimes a modest equity “up-side” will be required through options or warrants. It is generally most appropriate for larger transactions.

## Venture Capital in India

Venture capital was originated in India very late. Bhatt Committee (Committee on Development of Small and Medium Entrepreneurs) in the year 1972 recommended the creation of venture capital. The committee urged the need for providing such capital to help new entrepreneurs and technologists in setting up industries.

Brief description of some of the venture capital funds of India is as follows:

- **Risk capital foundation:** The Industrial Finance Corporation of India (IFCI) launched the first venture capital fund in the year 1975. The fund, 'Risk Capital Foundation' (RCF) aimed at supplementing promoters' equity with a view to encourage technologies and professionals to promote new industries.
- **Seed capital scheme:** This venture capital fund was launched by IDBI in 1976, with the same objective in mind.
- **Venture capital schemes:** Venture capital funding obtained official sponsorship with the announcement by the Central Government of the "Technology Policy Statement" in 1983. It prescribed guidelines for achieving technological self reliance through commercialization and exploitation of technologies. The ICICI, an all-India financial institution in the private sector set up a Venture Capital Scheme in 1986, to encourage new technocrats in the private sector to enter new fields of high technology with inherent high risk. The scheme aimed at allocating funds for providing assistance in the form of venture capital to economic activities having risk, but also high profit potential.
- **PACT:** The ICICI undertook the administration of *Program for Application of Commercial Technology* (PACT) aided by USAID with an initial grant of US\$ 10 million. The program aims at financing specific needs of the corporate sector industrial units along the lines of venture capital funding.
- **Government fund:** IDBI, as nodal agency, administers the venture capital fund created on April 1, 1986, by the Central Government. The government started imposing a Research and Development (R

& D) under the R & D Cess Act, 1986, levy on all payments made for the purchase of technology from abroad, including royalty payments, lump sum payments for foreign collaboration and payment for designs and drawings.

- **TDICI:** In 1988, an ICICI sponsored company, viz, *Technology Development and Information Company of India Ltd.* (TDICI) was founded, and venture capital operations of ICICI were taken over by it with effect from July 1, 1988.
- **RCTFC:** The Risk Capital Foundation (RCF) sponsored by IFCI was converted into *Risk Capital and Technology Finance Corporation Ltd.* (RCTFC) in the year 1988. It took over the activities of RCF in addition to the management of other financing technology development schemes and venture capital fund.
- **VECAUS:** VECAUS-I, the UTI sponsored “*Venture Capital Unit Scheme*” was launched in the year 1989. Technology Development and Information Company of India Ltd. (TDICI) was appointed as its manager. In the year 1990, the corporation was also entrusted with the responsibility of managing another UTI sponsored venture fund named “VECAUS-II”. In 1991, UTI launched VECAUS -III and RCTC was appointed as fund manager.

**Other funds:** The liberalized guidelines introduced by the government, in 1988 gave rise to the setting up of a number of venture capital funds, especially in the private sector.

### Venture Leasing

A leasing arrangement in which the ‘lessor’ provides both the assets and the equity capital to the lessee is called venture leasing

#### Advantages

- Minimizes initial investments by startups
- Rentals can be tailored to the cash flow profile
- Equity participation can lower lease rentals
- Asset risk transferred to lessor

## Disadvantages

- May be difficult to offload equity stake
- Depreciation tax shield transferred to the lessor
- High agency costs to prevent misuse of asset
- Lower debt capacity for lessee.

## Conclusion

In the US and UK, the venture capitalists are playing a strategic role in the promotion and development of industries in partnership with the entrepreneurs. Its phenomenal contribution to the harnessing of technical innovation to successful commercial exploitation is there as standing testimony. In the radically changing economic environment, now further accelerated by the high technology explosion both the entrepreneurs and the venture capitalists are equally important to the well being of any country. Venture capital promotes entrepreneurship, accelerates the process of industrialization, promotes new products and services and generates employment opportunities and brings a new boost to the economy.

## Self Assessment Questions

- 1) Explain the concept of Mutual Funds and various types of Mutual fund products offered in India.
- 2) Explain the classification of Mutual funds what factors should be considered before selecting a mutual fund.
- 3) Discuss the role of SEBI in the regulation of mutual funds
- 4) Discuss some of the major mutual funds in INDIA
- 5) Discuss the general constitution and management of mutual funds
- 6) Explain the role of Unit Trust of India (UTI) in mutual fund industry
- 7) Give the special features of money market mutual funds and its types.
- 8) Explain the stages in venture capital financing
- 9) What are the distinguishing characteristics of venture capital? Describe the different modes which are used for providing venture capital finance.

- 10) Discuss Venture capital financing in India.
- 11) What are the broad parameters of operational efficiency for mutual fund?
- 12) How will we evaluate the performance of mutual funds?
- 13) Enumerate the causes for the slow growth of mutual funds in India? Highlight the suggestions to overcome these challenges?
- 14) Explain the working mechanism of AMC?
- 15) Narrate the SEBI Regulatory Framework on AMC and Mutual Funds?
- 16) How does a venture capitalist evaluate prospective investee firm? Discuss with reference to the methods involved.
- 17) What is the rationale for venture capital financing?
- 18) Trace the origin and growth of venture capital financing?
- 19) Distinguish between venture capital and development capital?

## **CASE STUDY**

### **SBI Mutual Fund Deployed Speech-Enabled Interactive Voice Response (IVR) Solution**

SBI Mutual Fund wanted to use speech recognition to provide Net Asset Values (NAV) of its Mutual fund schemes to their customers via touch tone customer services. The clients has a long list of funds, which cannot be serviced by dual tone multi frequency (DTMF) IVR. It required speech system as a self service platform and for future flexibility. SBI Mutual Fund is one of the largest mutual funds in the country with an investor base of over 5.4 million. SBI Mutual is the first bank sponsored fund to launch an offshore fund- Resurgent India Opportunities Fund.

#### **Business Challenge**

The Profound competition in India's financial services sector and high level of expectation from customers in terms of service and user experience are some of the business challenges. SBI Mutual decided on the deployment of speech- enabled IVR service. The Dimension Data



team had to listen to hundreds of customer interactions to find the trends in speaker dialects and requests for NAV of the mutual funds. The NAV requests were unique as customers would use the full name, short form or abbreviation for the fund name. Before the solution goes live, the team had conducted test trials for over 2000 calls so as to fine tune the application for different dialects and accuracy.

**Solution:** The Interactive Voice Response with Speech engine will prompt the caller for the fund name. The system will recognize the fund retrieve the latest NAV value from the back end database system and play the NAV values to the caller. The system allows callers to request for the NAV information of up to five funds. Dimension Data Team conceptualized designed and successfully implemented the complex speech recognition. The project was completed in a record time of 90 days. The solution was complex for various factors. First, the recognition had to be developed for more than 150 mutual funds with dividend and growth options. Second mutual fund names are not standard names and require a great deal of customization. Third, the customer base of SBI MF speaks in different dialects. Dimension Data team will be observing the application for about a month after its launch and will further fine tune the application for accuracy close to 80%.

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## UNIT - V

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### Financial Services – III

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#### Learning Objectives

*After studying this unit you will be able to:*

- Understand the role of Insurance sector in India
- Familiarize the different types of credit cards
- Know the concept and importance of credit rating
- understand the process and mechanism of credit rating agency
- get knowledge about Credit rating agency in India and its regulations govern by SEBI
- know various types of pension plan and New Pension Scheme for Non-Government employees

#### Unit Structure

Lesson 5.1 – Insurance

Lesson 5.2 – Credit Cards

Lesson 5.3 – Credit Rating

Lesson 5.4 – Pension Plan

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## Lesson 5.1 - Insurance

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### Introduction

Insurance is a contract whereby the insurer undertakes to compensate the insured for any loss suffered by the later in consideration of premium paid for certain period. There are different insurance companies such as LIC, GIC, United India, New India assurance etc., offering wide range of insurance options. They provide comprehensive coverage with affordable premium. An insured can choose the policy according to his needs and ability to pay periodical premium to cover the risk of insurance for the stipulated period. The periodical insurance premiums are calculated according to the total insurance amount specified or estimated value of the property/things insured.

Thus, Insurance provides financial protection against a loss arising out of happening of an uncertain event. Hence, insurance is used as an effective tool for *risk management*.

### Definition

Insurance is a contract between two parties, whereby one party agrees to undertake the risk of another, in exchange for consideration known as *premium* and promises to pay a fixed sum of money to the other party on happening of an uncertain event (death) or after the expiry of a certain period/maturity period in case of life insurance or to indemnify the loss to the other party on happening of an uncertain event in case of general insurance. The party bearing the risk is known as the '*insurer*' or '*assurer*' and the party whose risk is covered is known as the '*insured*' or '*assured*'.

## Types of Insurance

Various types of insurances are as mentioned hereunder:

- **Life insurance:** Descendant's family receives insured amount in the case of death of the insured. In other case the insured himself gets the insured amount
- **Automobile/Motor insurance:** Usually automobile insurances cover damages to the automobile and legal financial expenditure of the automobile driver/cleaner.
- **Workmen Compensation Insurance:** It covers the employee for the loss of life or total/partial permanent disablement (loss of limb) or for occupational disease arising out of his employment during and in the course of his employment.
- **Health insurance:** Health insurance covers the expenditure associated with treatment and medical expenditure including medicine.
- **Credit insurance:** Borrowers often fail to repay the debts, loans and mortgages, due to certain unavoidable circumstances. Credit insurance can be of great help to the lenders during such crisis.
- **Property insurance:** Property protection insurance provides protection from risks associated to theft, fire, floods etc. This type of insurance can be further classified into specialized forms as follows: -
  - Fire insurance
  - Earthquake insurance
  - Flood insurance
  - Home insurance
  - Boiler insurance

At present insurance market is much vibrant than before and this has an impact on the rates of insurance premium.

## Types of Insurance Companies

Insurance companies can be categorized into two main divisions which are classified as follows:

- **General Insurance Companies:** They provide all types of insurance apart from life insurance i.e., fire insurance, marine insurance, vehicle insurance etc.,
- **Life Insurance Companies:** The companies, dealing with life insurance, pension products and annuities are life insurance companies.

## Types of Insurance Policies

Insurance provides compensation to a person for an anticipated loss to his life, business or an asset. Insurance is broadly classified into two parts covering different types of risks:

- I. Life Insurance (Long-term)
- II. General Insurance (Non-life Insurance)

### I. Life Insurance

*“A contract in which the insurer undertakes to pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured, in consideration of payment of ‘premium’ for a certain period of time, is known as ‘life insurance’.”*

It is otherwise called as **‘Life Assurance’**. Generally, the tenure of Life insurance policy is long-term in nature; it may either be for a certain period or whole life period of the insured. Insurance against risk to one’s life is covered under ordinary life assurance. Ordinary life assurance can be further classified into several types:

### Types of Ordinary Life Assurance

#### 1. Whole Life Assurance

In whole life assurance, insurance company collects premium from the insured for whole life or till the time of his retirement and pays claim to the family of the insured only after his death.

## 2. Endowment Assurance

In case of endowment assurance, the term of policy is defined for a specified period say about 15, 20, 25 or 30 years. The insurance company pays the claim to the family of the assured in the event of his death, within the policy's period or in an event of the assured surviving the policy's period. In the event of the insured surviving beyond the coverage/specified period, the maturity value/sum assured along with bonus will be paid to the insured himself.

## 3. Assurances for Children

### *Child's Deferred Assurance*

Under this policy, the insurance company pays the claim to the insured on the maturity date of the policy, which is calculated to coincide either with the date of child's eighteenth or twenty first birthday or attaining majority. The policy holder may either claim the payment on the date of maturity period or continue the insurance coverage. If the parent dies before the option date, the policy remains continued until the option date without paying premium for the remaining period. Suppose, the child dies before the option date, the parent gets back the premium plus bonus.

### *School fee policy*

School fee policy can be availed by affecting an endowment policy on the life of the parent with the sum assured, payable in installments over the schooling period of their children.

## 4. Term Assurance

Term assurance is life insurance which provides coverage at a fixed rate of payments for a limited period of time in respect of the term offered by the assured. In case, the insured dies during the term, the death benefit will be paid to the beneficiary. If the insured survives after that period expires, either he has to pay additional premium for obtaining further coverage or he has to forgo coverage. It is the least expensive way to purchase a substantial death benefit on a coverage amount over a specific period of time.

## 5. Annuities

Annuity is a contract under which the insurer (insurance company) promises to pay the insured a series of payments until the insured's death. The insured make the premium payment in the mode of either lump sum or installments to the insurer. Generally, life annuity is chosen by a person having surplus wealth and wants to use this money after his retirement. ***The annuities can be further classified into two types, which are as follows: -***

- a. **Immediate Annuity:** It means that the insured pays a lump sum amount (**purchase price**) to the insurer and in turn the insurer promises to pay him a specified sum on a monthly/quarterly/half-yearly/yearly basis.
- b. **Deferred Annuity:** A deferred annuity can be purchased either by way of installments or by paying a single premium. The insured receives the annuity after the deferment period.

## 6) Money Back Policy

A money back policy is issued for a particular period, and the sum assured is paid through periodical payments to the insured, spread over this time period. In case of death of the insured within the term of the policy, full sum assured along with bonus accruing on it, is payable by the insurance company to the nominee of the deceased. Generally, Money back policy is preferred by the person, who requires periodical receipts.

## II. General Insurance

General insurance is also known as non-life insurance. It is normally meant for a short-term period of twelve months or less. In recent years, insurance companies are entering the long-term insurance agreements also and the period would not exceed five years. General insurance can be classified into the following categories:

### ***Fire Insurance***

Fire insurance provides protection against damage to property caused by accidents due to fire, lightening or explosion. Fire insurance also includes damage caused due to other perils like storm, tempest or

flood, burst of pipes, earthquake, riot, civil commotion, malicious damage, explosion, impact (e.g. - aircraft).

### ***Marine Insurance***

Hull, cargo and freight are the three basic risk covering area for Marine insurance. Those risks areas are exposed to are collectively known as “Perils of the Sea”. These perils include theft, fire, collision etc.

- **Marine Cargo:** Marine cargo policy provides protection to the goods loaded in a ship against all perils between the departure and arrival to warehouse. Therefore, marine cargo covers carriage of goods by sea as well as transportation of goods by land.
- **Marine Hull:** Marine hull policy provides protection against damage to ship caused due to the perils of the sea. In the event of any loss sustained due to collisions at sea, Marine hull policy covers only 3/4th liability of the hull owner (ship-owner) and the remaining 1/4th of the liability is looked after by associations formed by ship owners for the purpose.

### ***Miscellaneous***

Miscellaneous insurance covers all types of general insurance, except the fire and marine insurances. Some of the examples of general insurance are motor insurance, theft insurance, health insurance, personal accident insurance, money insurance, engineering insurance etc.

### **Insurance Industry in India**

India has a deep-rooted history in the field of Insurance. In fact, the principles of insurance finds place, even in Manu (Manusmrithi), Yagnavalkya (Dharmasastra) and Kautilya (Arthasastra). Those writings talk in terms of pooling of resources that could be re-distributed in times of calamities such as fire, floods, epidemics and famine. This was probably a pioneer to modern day insurance. Ancient Indian history has preserved the earliest traces of insurance in the form of marine trade loans and carriers’ contracts.



In 1818, the Oriental Life Insurance Company was established in Kolkata. It failed in the year 1834 due to the business of the Madras Equitable life insurance which was started in Madras from the year 1829. The Triton Insurance Company Ltd was formed in 1850 and it was the first general insurance sector in India. The British Insurance Act was enacted in 1870. The Bombay Mutual (1871), Oriental (1874) and Empire of India (1897) insurance companies were started. In 1907, Indian Mercantile Insurance Limited was started, which was the first company to handle all forms of Indian insurance.

A new era began in the Indian insurance sector, by passing of the Life Insurance Act, 1912. The Indian Insurance Companies Act was passed in 1928. This Act empowered the Government of India to gather necessary information about the life insurance and non-life insurance organizations operating in the Indian financial markets. This Act was amended in 1938 with comprehensive provisions for effective control over the activities of insurers to protecting the interest of public. The Principal Agencies system was abolished in the Amendment Act of 1950. On 19th January, 1956 an ordinance was passed for nationalizing the Life Insurance Sector and the Life Insurance Corporation came into existence.

In 1972, with the passing of the General Insurance Business (Nationalization) Act, general insurance business was nationalized with effect from 1st January, 1973. 107 insurers were amalgamated and grouped into four companies, namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd and the United India Insurance Company Ltd. The General Insurance Corporation of India was incorporated as a company in 1971 and it commenced business on January 1st 1973.

### **Reforms in Indian Insurance Sector**

In 1993, the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective was to complement the reforms initiated in the financial sector. Following the recommendations of the Malhotra Committee Report, in the year 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance

industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premium, ensuring the financial security of the insurance market, to safeguard the interests of insurance policy holders and to initiate different policy measures to help sustain growth in the Indian insurance sector.

**IRDA** has notified 27 Regulations on various issues such as Registration of Insurers, Regulation on insurance agents, Solvency Margin, Re-insurance, Obligation of Insurers to Rural and Social sector, Investment and Accounting Procedure, Protection of policy holders' interest etc. IRDA brought out guidelines on *Initial Public Offers* (IPOs).

At present, the number of Insurance companies operating in India is 24 General insurance companies and 23 Life insurance companies. The growth rate of insurance sector is enormously increasing day-by-day. The contribution of Insurance services sector in the country's GDP is 7%. Insurance sector is strengthening the risk taking ability of the country and promoting for economic development by providing long- term funds for infrastructure development.

## Conclusion

Thus, Insurance protects the interest and secure fair treatment to policyholders. Insurance promotes, monitors and enforce high standards of integrity, financial soundness, and provides speedy settlement of genuine claims and prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery. Insurance builds a reliable management information system to enforce high standards of financial soundness amongst market players.

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## Lesson 5.2 - Credit Cards

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### Credit Cards Origin

Credit is a method of selling goods or services without the buyer having cash in hand. The concept of the credit card is “*buy now, pay later*” and it is a way of offering credit to a consumer. Credit card carries an identifying number that speeds shopping transactions.

According to Encyclopedia Britannica, “the use of credit cards originated in the United States during the 1920s, when individual firms, such as oil companies and hotel chains, began issuing them to customers.” In olden days, Credit cards were issued by merchants to their customers on credit sales. These cards were accepted only by the issuer himself not by any other person and the seller would not accept the others’ card. Around 1938, companies started to accept each other’s cards. Today, credit cards allow making purchases with countless third parties.

### The Shape of Credit Cards

Long ago, credit cards were made from metal coins, metal plates, celluloid, metal, fiber, and paper. Now-a-days, credit cards are mostly made of plastic.

### First Bank Credit Card

The Flatbush National Bank of Brooklyn, New York was the first bank started issuing credit cards in 1946. The card was invented by John Biggins in the program namely “Charge-It” conducted between bank customers and local merchants. Merchants deposited sales slips into the bank and the bank billed the customer who used the card.

### Diners Club Credit Card

In 1950, the Diners Club issued their credit card in the United States. Diners’ Club founder Frank McNamara invented the Diners Club

credit card and introduced to his customers intended to pay restaurant bills. The card holder of diners club could eat without money at any restaurant which would collect money from Diners' Club. Diners' Club would settle the restaurants' bill first and later they collect the bill amount along with some charges from the customer (card holder). So, the Diners Club card was called as **charge card**. In 1958, the first credit card was issued by American Express. Later bank of America also issued America bank credit card which is popularly known as **Visa card**.

### **The Popularity of Credit Cards**

During 1960s, more companies offered credit cards, advertising them as a time-saving device rather than a form of credit. American Express and Master Card became popular overnight.

### **Standard Credit Cards**

Standard credit cards are otherwise called as “plain-vanilla” credit cards which offer no additions or rewards. This is a common kind of credit cards which allows the card holder to have a revolving balance up to a certain credit limit. Card holders can use the card according to his needs and they have to settle their account before the due date. If he fails to pay before the due date interest is charged on outstanding balances at the end of each month.

### **Premium Credit Cards**

Many incentives and benefits are offered by premium credit cards e.g. Gold and Platinum cards which offer cash back, reward points, travel upgrades, and other rewards to cardholders. The card holder of premium cards are charged higher fees and the card is issued to the person who has prescribed higher income and credit score requirements.

### **Charge Cards**

Charge card is a type of credit card that requires the cardholders to pay their balance in full at the end of each billing cycle instead of making payments on the balance over several months. Charge cards do not have

spending limit and finance (interest rate) charge. Late payments are subject to a fee, charge restrictions, or card cancellation depending on the card agreement.

### **Limited Purpose Cards**

Limited purpose credit cards can only be used at specific locations. Limited purpose cards are used like credit cards with a minimum payment and finance charge. Store credit cards and gas credit cards, petro card are examples of limited purpose credit cards.

### **Secured Credit Cards**

Instead of assessing credit worthiness, some money is to be deposited to get a secured credit card. The credit limit on a secured credit card is limited up to the amount deposited. The credit limit may be extended in some cases. Cardholder must make monthly payments on their secured credit card balance.

### **Prepaid Cards**

Prepaid cards are similar to debit cards. The cardholder can use the card after payment of some money in advance. The spending limit is limited up to the amount paid in advance by the cardholder. If the cardholder wants more credit limit, he has to load more money into the card. Prepaid cards do not have finance charges or minimum payments since the balance is withdrawn from the deposit.

### **Business Credit Cards**

A card which is designed specifically for business use is called as business credit card. It is an easy method for business people to maintain business and personal cash transactions separately. There are 12 major types of credit cards provided by banks and financial institutions in India. These cards provide a wide variety of financial benefits to holders.

## Major India Credit Card Types

Following are various types of credit cards available in India:

- Premium Credit Cards
- Cash Back Credit Cards
- Gold Credit Cards
- Airline Credit Cards
- Silver Credit Cards
- Business Credit Cards
- Balance Transfer Credit Cards
- Co-branded Credit Cards
- Low Interest Credit Cards
- Lifetime Free Credit Cards
- Rewards

There are some additional credit cards that are available in India as well. Rewards credit cards available in India can be subdivided into six categories – Points, Hotels and Travels, Retail, Auto and Fuel.

## Premium Credit Cards

There are 33 various premium credit cards available in India:

- ABN AMRO Make My Trip Go Credit Card
- ABN AMRO Platinum Credit Card
- ABN AMRO Titanium One Credit Card
- American Express Kingfisher First Credit Card
- American Express Platinum Credit Card
- Axis Bank Visa Platinum Credit Card
- Bajaj Allianz Super Value Titanium Credit Card
- Citibank Platinum Credit Card
- Deutsche Bank Landmark Platinum Credit Card
- Deutsche Bank Miles & More Platinum Credit Card
- Deutsche Bank Miles & More Signature Credit Card
- Deutsche Bank Platinum Credit Card

- HDFC Bank Platinum Plus Credit Card
- HDFC Bank Platinum Plus Credit Card
- HDFC Bank Titanium Credit Card
- HDFC Bank Visa Signature Credit Card
- HSBC Platinum Credit Card
- ICICI Bank Ascent American Express Credit Card
- ICICI Bank Platinum Credit Card
- ICICI Bank Platinum Identity Credit Card
- ICICI Bank Platinum Premiere Credit Card
- ICICI Bank Thomas Cook Titanium Credit Card
- ICICI Bank Titanium Credit Card
- ICICI Signature Credit Card
- Jet Airways Citibank Platinum Credit Card
- Kotak Mahindra League Platinum Credit Card
- Kotak Mahindra Royal Signature Credit Card
- SBI (State Bank of India) Platinum Credit Card
- Standard Chartered Emirates Platinum Credit Card
- Standard Chartered Emirates Titanium Credit Card
- Standard Chartered Platinum Credit Card
- Standard Chartered Super Value Titanium Credit Card
- Yare Barclaycard Platinum Credit Card

## **Features of Credit Card**

### **Interest Rate**

Interest rate is the prime feature of any credit card. Interest rate is directly influencing the payment for borrowing money on the credit card. In general, the interest rate is expressed as the annual percentage rate (APR).

### **Grace Period**

The card issuers may provide a grace period to pay off the balance. The grace period is the amount of time given to the cardholder for the payment of his credit card balance in full to avoid interest charges. Credit card grace periods range is subject to the conditions of the card issuers.

## Fees

Annual fee is normally charged by the card issuer. Over-limit fee is charged on the amount exceeding the credit limit of the card holder. Cash advance fee is charged when the card holder makes a cash advance on his credit card. Balance transfer fees are added when a cardholder transfers a balance to his credit card.

## Credit Limits

Credit limit is the maximum spending amount of the cardholder by using his card. The cardholder may exceed his credit limit if he has opted 'over-the-limit' option. He is charged with the fee for over-the-limit when a transaction goes over the credit limit.

## Debit Cards vs Credit Cards

Debit card	Credit card
The spending power depends on the drawing capacity which in the case of Debit Card is your own assets with the bank.	It allows a borrowing power on the bank, for which you have to pay some charge or fees.
Debit card is as good as money in the accounts with the bank	Credit card has the additional advantage of your overdrawing if necessary, payments are made by the bank to the extent of the purchases and if they exceed the limit, Interest has to be paid to the excess amount spend.
There is no risk of overspending, and it does not involve interest payment	Borrowing is possible and interest to be paid on the overdrawn amount.

Both Credit Cards and Debit cards complement each other and are precursors to the electronic card which consolidates all the cash account in various branches of a bank, connected through the Bank Internet and allows managing the payments most economically in tune with the receipts and promotes efficient cash management.



**Travelers' Cheques Vs Credit Cards**

	<b>Travelers' Cheque</b>	<b>Credit Cards</b>
What is it?	A Travelers Cheque is bearer cheque in foreign currency for a predetermined value.	A Credit card enables one to make an immediate "cashless purchase" and pay later.
Issued by?	Authorized dealers in foreign currency	Banks
Eligibility	In order to procure travelers cheque we have to furnish your passport and a confirmed ticket	In order to procure a credit card, we are assessed by the bank in terms of the income and credit worthiness.
Revolving Credit Facility	A Travelers cheque when procured, involves an upfront payment or an immediate debit the bank account.	Credit cards allow carrying forward the outstanding due on a month to month basis while paying only the minimum balance. This is called revolving credit facility. Banks charge interest on the outstanding for the period of time it is due.
Pre determined spending limit	The travelers cheque is already drawn for particular amount, it cannot be exceeded	Credit cards have a predetermined spending limit based on the bank's assessment of the credit worthiness. We can spend within this limit and carry forward the outstanding if we cannot pay it at the month end.

## **Pros and Cons of Using Credit Card**

### **Pros**

#### ***Instant Cash***

**Credit card holders can get cash instantly whenever and wherever they need.**

#### ***Convenience***

**Credit cards are convenient and time saving for cardholders from searching for an ATM or keeping cash on-hand.**

#### ***Purchase Power and Ease of Purchase***

The purchasing power of the credit card holder can increase due to allowing credit purchase by using credit cards. It makes easier to buy things. There is no need to carry bulk amount of cash with the card holder for purchase of goods. It is very useful and easy for e-ticket booking (Train, Air, bus, hotels, Theater, pilgrim dharsan etc.).

#### ***Protection of Purchases***

The credit card statement can be a voucher for the purchase when the original receipt is lost. Some credit card company may offer insurance coverage on large purchases.

#### ***Create a Good Credit Worthiness***

The credit worthiness of the cardholders is proved through making prompt payment. The creation of good credit worthiness is useful to the cardholder in certain circumstances like applying for loans, jobs etc.

#### ***Emergencies***

Credit card helps to make some emergency payment for certain dues like motor vehicle installment due, rent, Hospital bill etc., and also it will be very helpful in emergency situations like car breaking down, flood, fire etc.

### ***Credit Card Benefits***

Credit cards offer some additional benefits like discounts from particular stores or companies, bonus such as free airline miles or travel discounts, and special insurances (like travel or life insurance.).

### **Cons**

#### ***High Interest Rates***

Charging high cost of loan is the biggest drawback of credit cards. The interest rate for purchase, balance transfer, cash advance etc. is very high. These interest rates make the actual cost of any purchase higher because of the higher interest rate component. Getting money is easier by using credit card with high rate of interest.

#### ***Lavish Spending***

Normally, the human tendency is to spend lavishly when they have more liquid cash. Credit cardholders are easily influenced to spend more money through some offers like lucrative discounts, cash back etc. which drive cardholders to increase their debt.

#### ***Heavy Penalty***

Issuers of credit cards are charging heavy penalty for late payments made by the card holders. The issuer can take very serious action against the cardholders for default in repayment of debt with penalty.

### **Conclusion**

Credit cards are a new innovation in financial services introduced by the financial institutions in extending easy availability of money. Credit cards have been transforming the Indian economy in a big way. Credit card is fast catching the imagination of the people, in particular, the younger generation in a great manner. Credit cards are more convenient to people who can avail of varied services without paying in money at the cash counter.

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## Lesson 5.3 - Credit Rating

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### Meaning

Credit rating is an opinion of rating agency about a debt instrument. The opinion is expressed through symbols which indicate the degree of risk associated with repayment of principal and payment of interest on debt instrument. Credit rating agency gets fee for their services from corporate entities which approach for rating of their instruments. Credit rating is not mandatory to all corporate sectors except for certain instruments. The financial position of the corporations is reviewed frequently and the ratings are revised by the credit rating agency.

### Origin

In 1841, the first mercantile credit agency was set up in New York to rate the ability of merchants to pay their financial obligations. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with first agency to form Dun & Bradstreet in 1933. It became the owner of Moody's Investor's Service in 1962. Since 1970's, a number of credit rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan, Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency.

### Rating Indications

*Rating symbols assigned to a security issue is an indicator of the following:*

- the nature and terms of the particular security being issued;
- the ability and the creditworthiness of the issuer of a security to make payments in time;
- the probability that the issuer will make a default in payments.

## **Factors influencing Assigned Ratings**

The ratings are assigned by the credit rating agency based on the following factors:

- The issuer's ability to meet the obligations of debt.
- The volume and composition of outstanding debt.
- The earning capacity of the company and its stability of 'future cash flows'.
- The interest coverage ratio i.e. it is the relationship between fixed interest and profit of the company (EBIT) whose ability to meet its fixed interest obligations.
- Current Ratio which is calculated to assess the liquidity position of the issuing firm.
- The value of assets pledged as collateral security
- Market demand for the products, competitors' market share, and distribution channels etc.
- Operational efficiency is judged by capacity utilization, prospects of expansion, modernisation and diversification, availability of raw material etc.
- Track record of promoters, directors and expertise of staff.

## **Benefits of Credit Rating**

*The beneficiaries of Credit rating are investors, companies and intermediaries benefited in the following ways:-*

### **Benefits to Investors**

#### ***Safety***

Investors get an idea about the degree of financial strength of the issuer company through credit rating.

#### ***Risk and Returns***

Credit rating indicates the degree of risk and possibility of returns on debt instruments. The indication (symbol) helps the investor to take decision for making investment on such instruments.

***Investment Decisions***

Credit rating symbol expresses the creditworthiness of the instruments as a layman can easily understand about the risk & return status of such instruments. Hence, he can take his own decision instead of seeking any advice from the stock brokers.

***Investment Choice***

Commonly, there are two different types of investors i.e., risk taker and risk averter. The level of risk taking is different for different investors. Hence, the investor can choose the securities for his investment based on his risk bearing capacity.

***Easy Perception***

All debt instruments are rated mandatorily. No analytical knowledge is required to make investment on debt instruments. Therefore, investors can make investment easily and quickly.

***No Need of Issuing Company Details***

Credit rating agencies conduct detailed investigation about the issuing companies' details like nature of business, financial position, liquidity and profitability position before evaluating the instruments issued by them. Therefore, investors need not bother about the company.

***Monitoring System***

The constant monitoring system is followed by credit rating agencies after grading the instruments.

***Benefits to the Company******Quick Mobility of Fund***

Highly rated instruments indicate the ability of the yield of the instruments. Normally, investors are interested to invest in this kind of instruments. Hence, the issuing company can mobilize fund quickly through the issue of such type of securities.

### ***Lower Cost of Debt***

The highly rated instruments are quoted with lower rate of interest. So, the company can get cheaper source of debt fund.

### ***Reducing Issue Expenses***

The rating itself is an advertisement for highly rated instruments. Hence, the issuing company has no need to spend for publicity of such instruments. Therefore, the issuing cost can be reduced to the issuing company.

### ***Increasing Goodwill***

The goodwill of the company would increase when their instruments get high rate. The high rated instruments build good image of the company in the eyes of stakeholders.

### ***Motivation for Growth***

The promoters of the company with highly rated instruments are motivated to expand their operations and move towards the growth path of the company.

### ***Recognition***

Credit rating is a way for getting opportunity to recognize the new companies or unknown companies.

### ***Benefits to Intermediaries***

The less effort is sufficient to approach the investors for the selection of instruments by the intermediaries in case of highly rated instruments.

### ***Limitations of Credit Rating***

Credit rating suffers from the following limitations:

### ***Hidden Information***

Investors can get loss when the company does not disclose the important information to the investigation team of credit rating agency.

***Non-Consideration of External Factors***

The external factors like economic, political, environment and government policies which may affect the creditworthiness of the firm are not considered while evaluating the instruments. Generally, the rating is based on historic data which may mislead the investors.

***No Guarantee***

Rating is simply an opinion about the capability of the company but it is not a certificate or guarantee of the credit rating agency.

***Biased***

The quality of the rating may be affected due to the personal bias of the investigating team.

***Difference in Rating Grades***

Investors get confused due to different rating scale for the same instrument given by different rating agencies.

**The Regulatory Framework for Credit Rating Agencies****SEBI Regulations**

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for CRAs.

SEBI regulation for CRAs has been designed to ensure the following:

- Credible players enter this business (through stringent entry norms and eligibility criteria)
- CRAs operate in a manner that enables them to issue objective and fair opinions (through well-defined general obligations for CRAs)
- There is widespread investor access to ratings (through a clearly articulated rating dissemination process).



- The applicant should be registered as a company under the Companies Act, 1956 and possess a minimum network of ₹ 5 crore.

The following are some of the General Obligations specified in the CRA regulations. CRAs are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations.

- Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of Rating Definitions and Rationale by the CRA
- Submission of information to the Board
- Compliance with circulars etc., issued by the Board
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

These regulations cover issues with respect to confidentiality of information and disclosure with respect to the rationale of the rating being assigned. Several other provisions exist, like the regulator's right to inspect a CRA. An important feature of the regulation is that CRAs are prohibited from rating their promoters and associates.

### **SEBI Code of Conduct**

SEBI's code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs. Some of the salient provisions of the Code of Conduct are:

- A CRA shall make all efforts to protect the interests of investors.
- A CRA shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.

- A CRA shall have in place a rating process that reflects consistent and international rating standards.
- A CRA shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings.
- A CRA shall disclose its rating methodology to clients, users and the public.

### Regulating Authority

In India, the regulating authority of Credit Rating Agencies and financial instruments are SEBI, RBI and IRDA. *The list of various financial instruments, and the relevant regulators, are given below:*

### Products / Instruments requiring mandatory rating before issuance

Sl. No	Instrument	Regulator
1	Public / Rights/ Listed issue of bonds	SEBI
2	IPO Grading	SEBI
3	Capital protection oriented funds	SEBI
4	Collective Investment Schemes of plantation companies	SEBI
5	Commercial Paper	RBI
6	Bank loans	RBI (Basel II capital computation for banks)
7	Security Receipts	RBI (For NAV declaration)
8	Securitised instruments (Pass Through Certificates)	RBI ((Basel II capital computation for banks)
9	Fixed Deposits by NBFCs & HFCs	RBI
10	LPG/SKO Rating	Ministry of Petroleum and Natural Gas
11	Maritime Grading	Directorate General of Shipping (for some courses)

### Regulatory prescription of use of ratings for investment purposes

S. No	Product	Regulator
1	Banks' investments in unrated non-SLR portfolio	RBI
2	Investments by Insurance companies	IRDA
3	Provident Fund investments	Government of India

### International Regulations

The International Organization of Securities Commission (IOSCO) has formulated a Code of Conduct Fundamentals for the working of CRAs. The IOSCO Code of Conduct broadly covers the following areas:

- **Quality and integrity of the rating process** – This includes the measures to ensure quality of the rating process and monitoring and updating by the CRAs.
- **CRA's independence and avoidance of conflicts of interest** – The procedures and policies to ensure the same.
- **CRA's responsibilities to the investing public and issuers** – These address issues such as transparency and timeliness of ratings disclosure and the treatment of confidential information.
- **Disclosure of the code of conduct and communication with market participants** – This requires CRAs to disclose to the public in accordance with the IOSCO Principles regarding the activities of Credit Rating Agencies

### Credit Rating Agencies in India

The Indian credit rating agency has evolved over a period of time. Indian credit rating agencies include mainly CRISIL, ICRA, CARE, FITCH and Brickworks. CRISIL is the largest credit rating agency in India, with a market share of greater than 60%.

**CRAAs registered with SEBI**

<b>Name of the CRAAs</b>	<b>Year of commencement of Operations</b>
CRISIL	1988
ICRA	1991
CARE	1993
Fitch India	1996
Brickworks	2008

**A. Credit Rating Information Services of India (CRISIL Ltd.)**

CRISIL is the first rating agency in India. It was set-up in 1987 jointly by the erstwhile ICICI Ltd. and UTI. The other shareholders are Asian Development Bank (ADB), LIC, State Bank of India, HDFC etc. The head office of the company is located at Mumbai and it has established offices outside India also. The CRISIL Ltd. is the world's fourth largest rating agency. 'CRISIL' has rated over 4700 debt instruments issued by 2200 companies.

***The activities of CRISIL Ltd. are as under***

- To provide credit rating service in respect of Ratings of corporate debt issuances, Ratings of banks, non-banking finance companies, Ratings of borrowing programmes of governments and government bodies, Ratings of structured finance instruments and Ratings of micro-finance institutions
- To provide analytical tools for management of risk such as market risk, credit and operational risk and valuation services
- To undertake research on economy, industry and company performance and publish such reports
- To provide corporate as well as market advisory services to corporate and non-corporate clients.

## **B. Investment Information and Credit Rating Agency of India Ltd. (ICRA)**

ICRA was established in the year 1991 by the collaboration of financial institutions, investment companies, and banks. The company has formed the ICRA group together with its subsidiaries. The company offers products like short-term debt schemes, Issue-specific long-term rating and offers fund based as well as non-fund based facilities to its clients.

The objectives of the ICRA Ltd. are as follows:

- To rate rupee denominated debt instruments issued inter alia, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and local bodies, etc.
- To take-up assignments for credit assessment of companies/undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, non-bank financial services companies.
- It provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. It does not assign any specific symbols in respect of such general assessments. It provides a report on various aspects of the functioning of companies such as operations, quality of management etc.
- To undertake research based study reports to address the unique needs and requirements of an individual client. The assignments include due diligence studies, equity assessment/valuation, industry analysis, and market study etc.
- To offer advisory services to banks, finance companies, manufacturing companies, government, regulatory authorities and local bodies in the following areas of strategic consulting, risk management and inputs for policy formulation

## **C. Credit Analysis and Research Limited (CARE)**

CARE was incorporated in 1993. It was promoted by Industrial

Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other financial and lending institutions. CARE has completed over 7,564 rating assignments since its inception in 1993.

***The functions of CAREL are as under***

- To undertake credit rating of all types of debt instruments, both short term and long term.
- To make available information on any company, industry or sector required by a business enterprise.
- To undertake equity research study of listed or to be listed companies on the major stock exchanges

**D. FITCH Ratings**

Fitch Ratings is a global rating agency committed to provide the world's credit markets with independent and prospective credit opinions, research, and data. The headquarters of Fitch Ratings is in New York and London and it is a part of the Fitch Group.

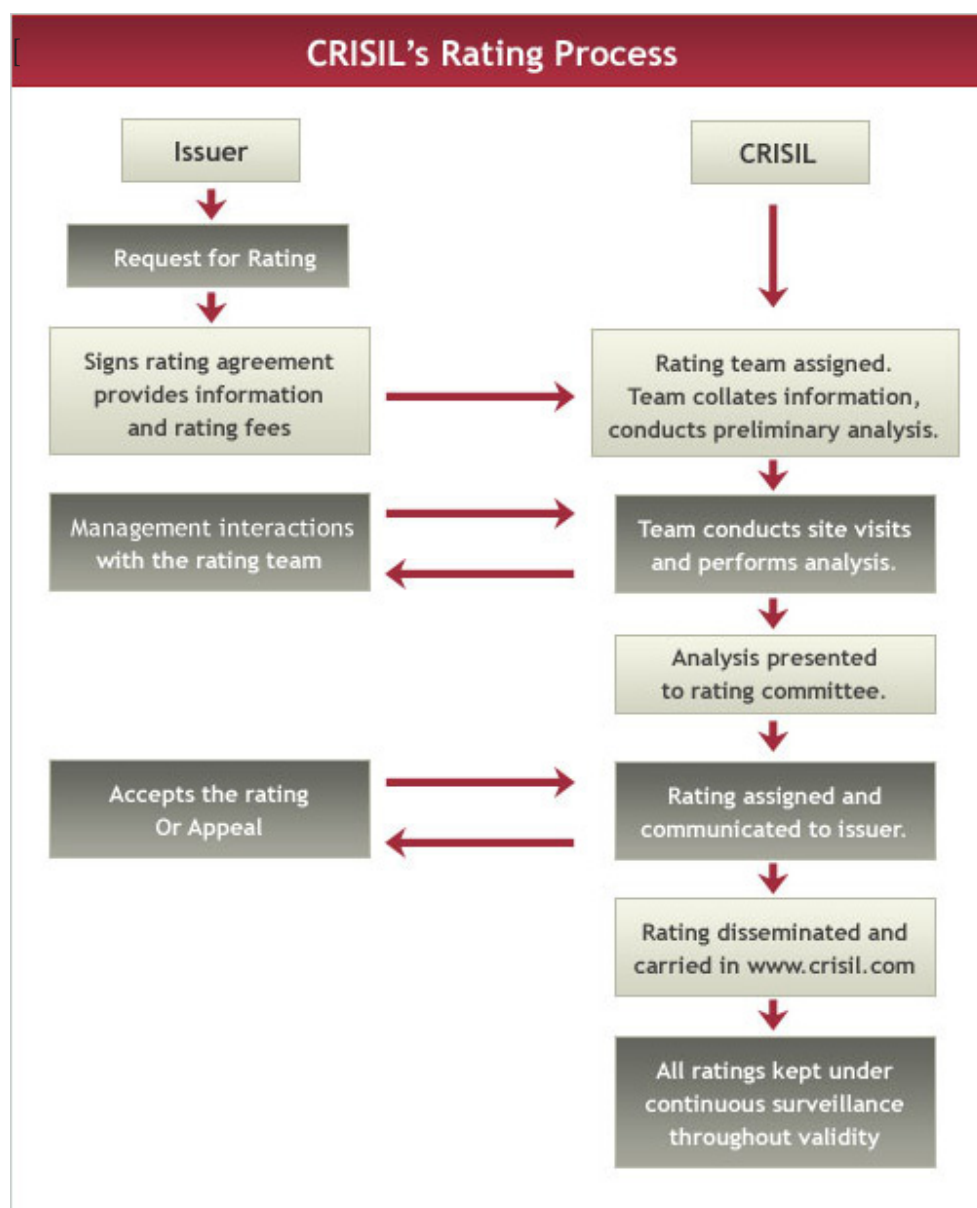
**E. BRICKWORK Ratings**

Brickwork Ratings is a private credit rating agency. It was registered under SEBI in the year 2008. It was founded by bankers, credit rating professionals, former regulators as well as professors, was committed to promoting Financial Literacy.

**Credit Rating Process**

The rating process is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour. From the initial meeting with the management to the assignment of the rating, the rating process normally takes three to four weeks. However, the rating agency has sometimes arrived at rating decisions in shorter time frames, to meet urgent requirements. The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. Credit rating agency employs a multi-layered, decision-making process in assigning a rating.

*The following picture depicts the CRISIL's Credit rating process:*



Source: <http://crisil.com/ratings/rating-process.html>

The process/ procedure followed by all the major credit rating agencies in the country are almost similar and usually comprises of the following steps.

### 1) Receipt of the Request

The issuing company approaches the credit rating agency to rate their instruments which are issued to the public. It is the starting point in the process of rating. The rating agency and Issuer Company enter into

an agreement. The general terms and conditions of the agreement are as follows:

- To Keep confidential information about the issuing company
- Acceptance of the rating is in the hands of issuing company
- Providing all information is essential on the part of issuing company

## **2) Assignment to Analytical Team**

Credit rating agency entrusts the job to its expertise team for investigating the issuing company after entering into the agreement with them. Normally, the team consists of two members and it may vary depending upon jobs.

## **3) Obtaining Information**

The issuing company must provide all the requisite information to the analytical team. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

## **4) Team Visits and Interacts with Management**

The analytical team must visit the issuing company for better understanding of the client's operations and interact with the company's executives.

## **5) Presentation of Findings**

The analytical team presents the report on the issuing company to the internal committee of the credit rating agency.

## **6) Rating Committee Meeting**

The rating committee conducts meeting with the analytical team to discuss about the assessment of all factors concerned to the issuer. After a deep discussion, the rating committee evaluates the issuing company and rates their instruments. The decision of the rating committee is final. The issuing company cannot be involved directly in the process of rating.



## **7) Communication of Decision**

The issuing company gets the information from CRA about the rating grade assigned by them. The supported documents or explanations would be furnished to the issuing company. The issuing company may accept or reject the ratings. The rejected ratings are not disclosed by the Credit rating agency.

## **8) Broadcasting to the Public**

The credit rating agency can broadcast the rating information through printed reports to the public after the acceptance of the issuer.

## **9) Continuous Surveillance**

The Credit Rating Agency is continuously monitoring the issuing company till the validity period of the ratings.

## **Rating Methodology**

The rating methodology is a detailed analysis of all the factors affecting the creditworthiness of an issuer company. The important factors are business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issue, commitment to new projects etc.

The credit rating agency analyses the following factors for evaluating the instruments such as:

- I.** Business Risk Analysis
- II.** Financial Analysis
- III.** Management Risk Analysis
- IV.** Project Risk Analysis
- V.** External support

These are explained as under:

### I. Business Risk Analysis

Business risk analysis involves the analysis of the industry risk, market position and operating efficiency of the company which has various factors that depicts in the following chart:

Business Risk Analysis		
Industry Risk	Market Position	Operating Efficiency
<ul style="list-style-type: none"> <li>➤ Macro Economic Factor</li> <li>➤ Industry Structure</li> <li>➤ Industry Demand Supply Scenario</li> <li>➤ Industry Growth Prospectus</li> <li>➤ Industry Profitability</li> <li>➤ Market Size</li> <li>➤ Extent of Competition</li> <li>➤ Extent of Cyclicalilty</li> <li>➤ Regulatory Environment</li> </ul>	<ul style="list-style-type: none"> <li>➤ Key Competitive Advantages</li> <li>➤ Market Share Movements</li> <li>➤ SWOT Analysis</li> <li>➤ Brand Strength</li> <li>➤ Product Profile</li> <li>➤ Trend Analysis</li> <li>➤ Pricing Power</li> <li>➤ Distribution Network</li> </ul>	<ul style="list-style-type: none"> <li>➤ Cost Structure</li> <li>➤ Technological Factors</li> <li>➤ Access to Resource</li> <li>➤ Labour Relations</li> <li>➤ Capacity Utilisation</li> <li>➤ Integration (forward &amp; Backward)</li> <li>➤ Flexible Production Capacities</li> <li>➤ R &amp; D Capabilities</li> </ul>

#### A. Industry risk

The rating agency evaluates the industry risk by considering the following factors:

- a. Strength of the industry prospect,
- b. Nature and basis of competition,
- c. Demand and supply position,
- d. Structure of industry,
- e. Pattern of business cycle etc.

### ***B. Market Position***

The credit rating agency determines the market position of the issuing company with reference to the following parameters:

- i. *Revenue Generation Addressed*
  - a. Market Size and Segments
  - b. Market Share and Trends
  - c. Entry Barriers and Capacity
  - d. Product Range and Customer Diversity
- ii. *Competitive Advantages*
  - a. Brands, Product Quality
  - b. Strength of Distribution network and geographical Reach
  - c. Long Term contracts for Product off take / marketing arrangement
  - d. Ability to pass on Input Cost Increase

### ***C. Operating Efficiency***

Operating Efficiency can be measured by using the following aspects:

- i. *Cost Structure*
  - a. Technology used
  - b. Capacity Utilization
  - c. Regular up keep / modernization of facilities
- ii. *Input Structure*
  - a. Access to resource, cost of key inputs
  - b. Level of Integration
  - c. Assured, Quality supply of Critical Utilises
  - d. Labour Relations – Union

## II. Financial Analysis

Financial risk analysis aims at determining the financial strength of the issuer company. The credit rating agency can use some accounting tools & techniques to analyze the financial risk which are depicted in the following picture.

Financial Risk Analysis			
Accounting Quality	Financial Position	Cash Flow Adequacy	Financial Flexibility
<ul style="list-style-type: none"> <li>➤ Accounting Policies</li> <li>➤ Reporting Disclosures</li> <li>➤ Analytical adjustments</li> </ul>	<ul style="list-style-type: none"> <li>➤ Capital Structure</li> <li>➤ Profitability Analysis</li> <li>➤ Debt Protection Ratios</li> <li>➤ Off-Balance Sheet Obligations</li> <li>➤ Sensitivity Analysis</li> <li>➤ Liquidity Short Term Factors</li> <li>➤ Working Capital Management</li> </ul>	<ul style="list-style-type: none"> <li>➤ Sources of uses of Funds</li> <li>➤ Cash accruals in relation to debt repayments</li> <li>➤ Capital Expenditure Plans, funding profile</li> </ul>	<ul style="list-style-type: none"> <li>➤ Bank Limits</li> <li>➤ Cash and marketable securities</li> <li>➤ Access to Capital markets</li> <li>➤ Relationship with bankers</li> <li>➤ Contingency Plans</li> <li>➤ Ability to Defer Capital Expenditure</li> </ul>

### A. Accounting Quality

- Qualification of Auditors
- Inventory Valuation Policies.
- Income recognition method
- Off Balance Sheet Items

**B. Past and Future Financial Record**

- Past performance
- Capital Structure (Debt – Equity)
- Debt Protection measure (Interest Coverage & Cash DSCR) & Liquidity
- Profitability Trends in Operating / Net Margins (indicating asset side Performance) – provide a tool to measure cash generation.
- Trends in Company's Funding mix Philosophy – Phasing of Capex Programmes.
- Future Performance Based on Industry Trends, Company's own operations and future plans.

**C. Cash Flow Adequacy and Financial Flexibility**

- Assess the adequacy and stability of cash Flow in relation to debt, working capital needs and capital expenditure requirement.
- Comparison of sources and uses of funds
- Ability to raise alternative financing eg. Equity, Quasi Equity, Loans from Promoters
- Financial support from group / promoters and its past track record
- Availability of un encumbered liquid assets

**III. Management Risk Analysis**

Rating of a debt instrument requires evaluation of the management strengths and weaknesses because company's performance is highly influenced by the management goals, plans, strategies etc., which can be analyzed through the following aspects:

Management Risk Analysis			
Integrity	Risk Appetite	Competence	Governance Practices
➤ Adherence to Laws & Regulations	➤ Financial Policy	➤ Track Record	➤ Equitable treatment of Share-holders

<b>Integrity</b>	<b>Risk Appetite</b>	<b>Competence</b>	<b>Governance Practices</b>
<ul style="list-style-type: none"> <li>➤ Track Record of debt repayments</li> <li>➤ Intra-group transactions</li> <li>➤ Reputation in financial markets</li> </ul>	<ul style="list-style-type: none"> <li>➤ Growth Plans funding profile</li> <li>➤ Unrelated diversification</li> <li>➤ Attitude to Business risk</li> <li>➤ Risk Management practices</li> </ul>	<ul style="list-style-type: none"> <li>➤ Consistency of performance</li> <li>➤ Success of past strategies</li> <li>➤ Succession plans</li> <li>➤ Quality of Senior Management</li> <li>➤ Experience in managing downturns</li> <li>➤ Ability to attract/retain talent</li> </ul>	<ul style="list-style-type: none"> <li>➤ Transparency &amp; Disclosure</li> <li>➤ Value creation to stakeholder</li> <li>➤ Board Composition</li> </ul>

#### IV. Project Risk Analysis

The instrument issuing company's project should be evaluated to measure the risk of the project. It is very important for rating debt instrument. The following factors are considered to evaluate the project by the credit rating agency.

- Project Size
- Implementation risk
- Funding Risk
- Technology Risk
- Track Record in timely implementation
- Cost Overruns, contingency

#### V. External Factors

The credit rating agency has to analyse the external factors and its supports also. They are as follows:

External Factors		
Government Support	Group Support	Parent Support
<b>Policy Role</b> <ul style="list-style-type: none"> <li>➤ Strategic importance to the Government</li> <li>➤ Critically of sector to economy</li> </ul> <b>Implication of default / moral obligations</b> <ul style="list-style-type: none"> <li>➤ Political implications of default</li> <li>➤ Domino effect</li> <li>➤ Public perception of sovereign backing</li> <li>➤ Stated posture of the government</li> </ul>	<b>Economic rationale</b> <ul style="list-style-type: none"> <li>➤ Relevance of the entity to the group</li> <li>➤ Percentage ownership by the group/promoters</li> <li>➤ Economic incentive to the group</li> </ul> <b>Moral Obligations</b> <ul style="list-style-type: none"> <li>➤ Extent of management control</li> <li>➤ Shared name / common logo for the group of companies</li> <li>➤ Commonality of resources</li> <li>➤ Management's Stated Posture</li> </ul>	<b>Economic Rationale</b> <ul style="list-style-type: none"> <li>➤ Strategic importance of the parent</li> <li>➤ Extent of parent holding</li> <li>➤ Economic incentive to parent</li> </ul> <b>Moral Obligations</b> <ul style="list-style-type: none"> <li>➤ Strategic importance of the parent</li> <li>➤ Shared Name</li> <li>➤ Domiciliary Status</li> <li>➤ Management's stated posture</li> </ul>

### Rating Symbols and Definitions

Rating symbols are used in terms of alphabets.

### Instruments for Rating

*CRA's in India rate a large number of financial products:*

1. Bonds/ debentures- [the main product]
2. Commercial paper
3. Structured finance products

4. Bank loans
5. Fixed deposits and bank certificate of deposits
6. Mutual fund debt schemes
7. Initial Public Offers (IPOs)

CRISIL has revised the symbols and definitions of its long-term and short-term credit ratings on debt instruments, structured finance instruments, and debt mutual fund schemes. This is in compliance with a June 15, 2011, Securities and Exchange Board of India (SEBI) circular, “Standardisation of Rating Symbols and Definitions,” which mandates the use of common rating symbols and rating definitions by all credit rating agencies (CRAs). As per the circular, all CRAs are required to revise their rating symbols and definitions as recommended by SEBI. Accordingly, CRISIL has effected changes in rating symbols and definitions with effect from July 11, 2011. The rating symbols and definitions of the following class of instruments have been revised:

- Long-term debt instruments;
- Short-term debt instruments;
- Long-term structured finance instruments;
- Short-term structured finance instruments;
- Long-term mutual fund schemes; and
- Short-term mutual fund schemes.

**CRISIL Long Term Debt Instruments Symbols and Definitions  
(Period  $\geq$  365 Days)**

<b>Long Term Rating Symbols</b>	<b>Rating Definitions under Basel II</b>	<b>Risk Weight age under Basel II</b>
<b>CRISIL AAA</b>	Highest Safety	20 %
<b>CRISIL AA</b>	High Safety	30%
<b>CRISIL A</b>	Adequate Safety	50 %
<b>CRISIL BBB</b>	Moderate Safety	100%
<b>CRISIL BB</b>	Moderate Risk	150%
<b>CRISIL B</b>	High Risk	150%
<b>CRISIL C</b>	Very High Risk	150%
<b>CRISIL D</b>	Default	



<b>Long-Term Debt Instruments</b>	
<b>Revised Rating symbol</b>	<b>Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011</b>
<b>CRISIL AAA (Highest Safety)</b>	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
<b>CRISIL AA (High Safety)</b>	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
<b>CRISIL A (Adequate Safety)</b>	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
<b>CRISIL BBB (Moderate Safety)</b>	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
<b>CRISIL BB (Moderate Risk)</b>	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
<b>CRISIL B (High Risk)</b>	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
<b>CRISIL C Very High Risk</b>	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
<b>CRISIL D (Default)</b>	Instruments with this rating are in default or are expected to be in default soon.

**CRISIL Short Term Debt instruments Symbols (Period < 365 Days)**

<b>Rating Short Term Rating Symbol</b>	<b>Rating Definitions under Basel II</b>
<b>CRISIL A1</b>	Very Strong Degree of Safety
<b>CRISIL A2</b>	Strong degree of safety
<b>CRISIL A3</b>	Moderate Degree of Safety
<b>CRISIL A4</b>	Minimum Degree of safety
<b>CRISIL D</b>	Default

<b>Short-Term Debt Instruments</b>	
<b>Revised Rating symbol</b>	<b>Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011</b>
<b>CRISIL A1</b>	Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.
<b>CRISIL A2</b>	Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
<b>CRISIL A3</b>	Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
<b>CRISIL A4</b>	Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.
<b>CRISIL D</b>	Instruments with this rating are in default or expected to be in default on maturity.

<b>Long-Term Debt Mutual Fund Schemes</b>	
<b>Revised Rating symbol</b>	<b>Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011</b>
<b>CRISIL AAAmfs</b>	Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL AAmfs</b>	Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL Amfs</b>	Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL BBBmfs</b>	Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL BBmfs</b>	Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.
<b>CRISIL Bmfs</b>	Schemes with this rating are considered to have high risk of default regarding timely receipt of payments from the investments that they have made.
<b>CRISIL Cmfs</b>	Schemes with this rating are considered to have very high risk of default regarding timely receipt of payments from the investments that they have made.
<b>Short-Term Debt Mutual Fund Schemes</b>	
<b>Revised Rating symbol</b>	<b>Revised rating definition as stipulated by SEBI in its Circular No. CIR/MIRSD/4/2011 dated June 15, 2011</b>
<b>CRISIL A1mfs</b>	Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.

<b>CRISIL A2mfs</b>	Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL A3mfs</b>	Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.
<b>CRISIL A4mfs</b>	Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

**ICRA (Investment Information and Credit Rating Agency of India Limited)**

### **ICRA's Long-Term Rating Scale**

**Long-Term Rating Scale:** All Bonds, NCDs, and other debt instruments (excluding Public Deposits) with original maturity exceeding one year.

<b>Symbols</b>	<b>Indicator</b>	<b>Profile</b>
<b>LAAA</b>	Highest Safety	The rated instrument carries the lowest credit risk
<b>LAA</b>	High Safety	The rated instrument carries low credit risk.
<b>LA</b>	Adequate Safety	The rated instrument carries average credit risk.
<b>LBBB</b>	Moderate Safety	The rated instrument carries higher than average credit risk.
<b>LBB</b>	Moderate Risk	The rated instrument carries high credit risk.
<b>LB</b>	High Risk	The rated instrument carries very high credit risk.
<b>LC</b>	Very High Risk	The rated instrument has limited prospects of recovery
<b>LD</b>	Default	The rated instrument has very low prospects of recovery.

**ICRA's Medium-Term Rating Scale (only for Public Deposits)****ICRA's Medium-Term Rating Scale**

<b>Symbols</b>	<b>Indicator</b>	<b>Profile</b>
<b>MAAA</b>	Highest Safety	The rated deposits programme carries the lowest credit risk
<b>MAA</b>	High Safety	The rated deposits programme carries low credit risk
<b>MA</b>	Adequate Safety	The rated deposits programme carries average credit risk.
<b>MB</b>	Inadequate Safety	The rated deposits programme carries high credit risk
<b>MC</b>	Risk Prone	The rated deposits programme carries very high credit risk.
<b>MD</b>	Default	The rated instrument has very low prospects of recovery.

**ICRA's Short-Term Rating Scale**

(All instruments with original maturity within one year)

**Icra's Short-Term Rating Scale**

<b>Symbols</b>	<b>Indicator</b>	<b>Profile</b>
<b>A1</b>	Highest Safety	Instruments rated in this category carry the lowest credit risk in the short term. Within this category, certain instruments are assigned the rating of A1+ to reflect their relatively stronger credit quality.
<b>A2</b>	High Safety	Instruments rated in this category carry higher credit risk than instruments rated A1.

Symbols	Indicator	Profile
A3	Adequate Safety	Instruments rated in this category carry higher credit risk than instruments rated A2 and A1.
A4	Risk Prone	Instruments rated in this category carry high credit risk.
A5	Default	Instruments rated in this category have very low prospect of recovery.

### International Credit Rating Agencies

Credit ratings are in use in the financial markets of most developed economies and several emerging market economies as well.

*The principal characteristics of the major internationally known rating agencies are as follows:*

Name of the agency	Home country	Ownership	Principle
Moody's Investors Service	U.S.A	Dun and Bradstreet	Full Service
Fitch Investors Service	U.S.A	Independent	Full Service
Standard and Poor's Corporation	U.S.A	Mcgraw Hill	Full Service
Canadian Bond Rating Service	Canada	Independent	Full Service (Canada)
Thomson Bank Rating	U.S.A	Thomson Company	Financial Institutions
Japan Bond Rating Institute	Japan	Japan Electronic Journal	Full Service (Japan)
Duff and Phelps Credit Rating	U.S.A	Duff and Phelps Corporation	Full Service

Name of the agency	Home country	Ownership	Principle
Japanese Credit Rating Agency	Japan	Financial Institution	Full Service (Japan)
IBCA Ltd.	U K	Independent	Financial Institutions

### Rating by Two Pioneer Agencies

Moody's Investor Services and Standard and Poor (S&P) of the USA

#### Moody's Investor Service Rating (MIS)

Aaa	-	Best Quality
Aa	-	High quality
A	-	Higher Medium Grade
Baa	-	Possesses safety
B	-	Generally lack characteristics of desirable investment
Caa	-	Poor standing may be in default
Ca	-	Speculative to a high degree often in default

#### Standard & Poor's Rating (S&P)

AAA	-	Highest grade
AA	-	Higher grade
A	-	Upper medium grade
BBB	-	Medium grade
BB	-	Lower medium
B	-	Speculative elements
CCC-CC	-	Outright speculation
DDD-D	-	Default with rating indicating relative salvage value.

### The Rating Challenge

Borrowers, be it an individual or a corporate entity are rated for their creditworthiness. And why not, the banks themselves are now entering the capital market to raise funds. It has become all the more important in the

context of the new code of greater transparency and prudential norms. While ratings act as a guide to the average investor, it also enhances the credibility of the rated organizations.

Presently, credit rating is mandatory in India for debt instruments with conversion/redemption exceeding 18 months for fixed deposit programmes of all non-banking finance companies. It is optional for PSU bonds and privately placed non convertible debentures.

Are the Indian rating agencies able to meet evaluation standards and eliminate influence of vested interests? For this, it is imperative that they are independent. In the Indian case, the existing three rating agencies, viz CRISIL, ICRA, and CARE are promoted by financial institutions. They may well serve as in-house rating agents to assess credit risk of their customers. But what would be the yardsticks and whether they would remain impartial when their promoters themselves would be the clients? We may think of other independent rating agencies in the field but there is every likelihood that industrial groups may start their own rating agencies, on the patterns of their own financial agencies. In such an eventuality, there is every danger of such agencies becoming an in-house sort of entity thereby compromising on objectivity in rating standards.

Multiple agencies may increase competition in rating but it may also land up in indifferent rating standards and there is also the risk of succumbing to pressures for attracting business. There have been criticisms of Indian credit rating agencies. First, that they assign ratings which are not comparable against international standards, Secondly the rating symbols they assign are internally inconsistent, and thirdly agencies are not kept at arm's length from their sponsors.

## **Conclusion**

The primary benefit of credit rating has been to enable the investor to identify the risks associated with various debt obligations. The other benefits include decreasing the potential conflict between the underwriters and the investors, providing greater liquidity in secondary markets, encouraging increased disclosure on the part of the companies, better accounting standards and improved financial information for the promotion of individual and institutional investor protection.



With the eruption of new financial instruments and the realization on the part of the investor of the invaluable service that credit rating agencies provide, credit rating is bound to find its niche in the investment decision making process and act as a positive step in the direction of increasing investor protection. Thus credit rating has firmly docked itself on the shores of the Indian capital market. The Credit rating agencies have ample opportunities to play a unique role in strengthening the capital market and building investor's confidence in the Indian Financial System.

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## Lesson 5.4 - Pension Plan

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Retired persons require reasonable money continuously to lead a comfortable life till their death. A Retirement Plan provides financial assurance for the payment of certain sum of money periodically to the retired persons. In India, the government servants are receiving pension after retirement. There is no such pension to the private employees. Instead, there are various retirement plans available to private employees. Hence, the private employees can take private Retirement Plans to secure their future in terms of finance. The trend of opting for Retirement Plans is becoming increasingly popular in India.

### Definition

*According to the Supreme Court of India (1982), "Pension is a term applied to periodic money payments to a person, who retires at a certain age, considered age of disability; payments usually continue for the rest of the natural life of the recipient."*

### Is Retirement Plan Essential?

*There are several reasons for the popularity of Retirement Plans in India, these are as follows:-*

#### Socio - Cultural Change

The trend of joint family system is slowly deteriorating and the nuclear family system is being followed especially in urban areas in India due to various reasons like employment, income, independency and reluctance etc. Due to socio-cultural changes, the retired persons are increasingly under pressure to arrange their own income after retirement. Now-a-days, the retired/old age persons also like to be more financially independent.

### **Increase in Cost of Living**

At present, the cost of living is very high due to various economic reasons like inflation, food scarcity, population etc. The medical service is very expensive and causes heavy financial burden to the old age persons as the coverage of medical insurance is limited besides, the process of medical insurance claim being cumbersome. Therefore, the old age persons are increasingly looking at creating a sufficient and reasonable post-retirement income for the bare survival after retirement.

### **Longer span of life**

The life span of human being has increased due to advanced medical facilities. Hence, a strong financial support is required to the retired persons due to the longevity.

### **Types of Retirement Plans**

There are various retirement plans and schemes in India, both in the private and public sectors such as:-

#### **Life Annuity Plan**

Life annuity plan guarantees a person a specific amount of income until he survives. After the person's death, the originally invested amount is refunded to his nominee or legal heirs, in the absence of any nominee.

#### **Guaranteed Period Annuity**

In this plan, the person is guaranteed a specific income for a minimum number of years. If the person dies before that period, the nominees will continue to receive that income till the period is completed. If the person outlives that period, he or she can continue to receive the income till his death.

#### **Annuity Certain**

Under this retirement plan, a fixed amount of income is paid for a fixed number of years. The payments will stop at the end of the fixed period, even if the retiree lives beyond this fixed period.

**Deferred Annuity**

Under this plan, the person first saves from his income to create a corpus fund for a number of years. Thereafter, that fund is used for investing in a specific retirement plan that gives him an assured income till his life time.

**Defined Benefit Pension Plan**

Under this plan, the pension amount is known and assured, but it is not dependent on any external factor. The investor must contribute some amount periodically either by himself or through his employer or both. This amount is invested which earns some returns. But the investor can get assured sum irrespective of the kind of returns generated by the investment. Their pension amounts were linked to their grade and last drawn salary.

***Pros of Defined Benefit Plan***

- Investor can get peace of mind because they know they will get assured and defined pension amount.
- Investors need not worry about monitoring the investments periodically.

***Cons of Defined Benefit Pension Plans***

- There is no disadvantage to the employees whereas this plan is disadvantageous to the employee because they have to ensure that the funds contributed for the pension are invested in such a way that they generate adequate returns to cover future pension of the employee.
- If the returns are not enough to pay the pension, the employer has to provide the deficiency either from other sources or contributions of serving employees. (e.g., Government)

**Defined Contribution Pension Plan**

The amount of contribution towards pension is fixed but the benefit amount is undetermined. This type of plan is called defined contribution pension scheme or plan. Here pension depends on the returns made on

the investments. There are multiple options of investments such as equity (high risk and high returns), debt (low risk and moderate returns) or govt. securities (no risk and low returns). The Fund would grow into a large amount at the time of retirement through the investment (of both contribution and returns) over the years. Investors are permitted to withdraw only a part of pension fund as lump-sum. Remaining portion of fund would be invested in annuity and that would provide fixed amount every month.

### **Advantages of Defined Contribution Pension Plans**

- The main advantage to the employees is that *the pension fund investment is market-linked*. They can make excellent returns on the investments through proper selection of portfolio of investments.
- The advantage for the employer is that it doesn't have to worry about the management of the pension funds and the returns generated by them.

### **Disadvantages of Defined Contribution Pension Plans**

- The disadvantage to the employees is that there is a chance of getting lower amount of pension due to improper selection of investment.
- Continuous monitoring is a burden to the employees.

### **New Pension System (Nps) for Non-Government Employees**

*The Structure of the scheme and entities involved are as follows:*

- a. The New Pension System is administered by the *Pension Fund Regulatory Development Authority* (PFRDA).
- b. A *Central Recordkeeping Agency (CRA)* maintains all the records (like account balances) related to the NPS. National Security Depository Limited (NSDL) has been selected as the nationwide CRA for the New Pension System.
- c. There are six *Pension Fund Managers (PFMs)*. The PFM are responsible for investing funds and generating returns from them.

- d. There are also entities called ***Points of Presence (PoPs)***. The PoPs are responsible for the sales and marketing of the NPS. (These are similar to the distributors of mutual funds).

### List of Pension Fund Managers (PFMs)

1. ICICI Prudential Life Insurance Company Limited
2. IDFC Asset Management Asset Management Company Limited
3. Kotak Mahindra Asset Management Company Limited
4. Reliance Capital Asset Management Company Limited
5. SBI Pension Funds Limited
6. UTI Retirement Solutions Limited

### Features and Options of the Scheme

#### I. Permanent Retirement Account Number (PRAN)

Each investor in the New Pension Scheme (NPS) would be allotted a Permanent Retirement Account Number (PRAN). This would be a unique identification number that would be used to identify an investor irrespective of his PFM.

#### II. Investment Options Available to an Investor

Investors would get multiple options for investing their funds in the NPS. These options span the entire risk spectrum from risky to risk-free. There are three investment options

1. **Growth option:** A growth option would be an ***equity based option***, wherein the investments would be primarily done in equities. This option has the potential to give the highest returns but it carries a higher risk. The ***investment would be passive***. There wouldn't be any active buying and selling of stocks based on the fund manager's analysis. Instead, funds would be invested only in the 50 stocks comprising the NSE's NIFTY stock index. This option is most suitable for young people who are just starting their careers. This would also be suitable for middle-aged people who do not have many dependents.

2. **Moderate option:** The funds would be invested in *corporate debt and other fixed income instruments*. This option has the potential to give moderate returns but it carries a moderate risk. This option is most suitable for risk-averse young people and for mid-career people. This would also be suitable for some of the more adventurous (risk taking) people nearing retirement.
3. **Cautious option:** The most cautious option would be *government security based*. Here, investors' money would be invested in government securities. These securities are risk free and hence this option would give risk free returns. The returns are expected to be the lowest among all three options. This option is most suitable for employees approaching their retirement and risk-averse mid-career employees.

Investors would get an option to allocate their funds between these three options in any proportion they prefer. Thus, they can create a balance between the risky and risk-free options based on their own risk profile. If they do not want to allocate their funds, there is an *auto choice* feature. Here, investments would be allocated among the three options *depending on their age*. Thus, when they are young, more investment would be made in the equity based fund, and when they are old, more and more funds would be invested in the low risk government securities based fund.

- **Switching Options:** Investors could *periodically reallocate* their funds among the three options once in a year. Also, they could *switch the fund managers (PFMs) periodically*. That is, they would be able to move the management of their funds from one PFM to another. This process is expected to be simple, as all the records are centrally kept by the CRA and the Permanent Retirement Account Number (PRAN) would be investors' identification number across all Pension Fund Managers (PFM).
- **Costs and Fees involved in the scheme**
  - The management fee for NPS is less than 0.01% per annum.
  - The annual record keeping fee for NPS would be just ₹ 280.
  - Transaction fee is 6 for each transaction.
- **Defined Contribution system:** The periodical payment is fixed, but the pension amount is not fixed. It totally depends on the

returns on investment. This scheme is a defined contribution scheme, without the benefit not being defined.

- **Maturity withdrawals:** Investor can get money only at the age of 60 years. Early withdrawals are not allowed except for marriage of sons/daughters and purchase of house. Investor can get only 60% of the corpus as lump sum and remaining 40% should be invested in an annuity (accumulated corpus), which is used to provide a fixed monthly amount.
- **Coexist with other schemes (EPF / EPS):** New Pension System (NPS) would not replace any existing scheme like the Employee Provident Fund scheme or the Employee Pension Scheme.
- **Income tax exemption:** The amount of contribution to NPS is exempted from income tax under section 80C and also the interest or profit earned on the investment in NPS would not be taxed in the year in which it is earned; but, the amount would be taxed at the time of withdrawal.

### Self Assessment Questions

1. Define Insurance and explain different types of Insurance and Insurance companies.
2. Discuss various types of Insurance policies.
3. Briefly explain the Insurance Industry in India.
4. What are the facilities offered to credit card holders? Discuss the features, benefits and disadvantages of credit card to its holder.
5. What are the functions of Credit rating? Explain the benefits of credit rating to rated companies and investors.
6. Discuss the regulatory framework for credit rating agencies as per SEBI (Credit Rating Agencies) Regulations act 1999.
7. Explain the credit rating process followed by any credit rating agency for a long term instruments.
8. Discuss the Credit Rating Agencies in India.
9. Discuss the rating methodology of credit rating adopted by credit rating agency



10. Explain various types of Retirement plans and discuss briefly about the features of New Pension scheme for Non-Government employees.
11. What are the major factors governing the rating framework of credit rating agencies around the world?
12. Discuss the major issues of credit rating in the context of the rapid growth witnessed in the global financial markets?
13. Trace the origin of credit rating in the international context?
14. Distinguish Debit cards and Credit cards
15. Differentiate Travellers Cheque and Credit Cards

### **CASE STUDY**

An employee of a branch of Bank X is familiar with entire debit card application process. He is witness of entire process from accepting the application from customer to verification and final submission to card issuing agency. This insider is also having access to Core Banking application and has full knowledge of some of the saving bank accounts where large sum of money is parked without any regular transaction. He prepares a fake debit card application of a similar account in which he had noticed that ₹ 2 million was kept for many months without any regular transactions. He places his application in between the bunch of applications kept on Debit Card officer's table. Debit Card officer verifies the application and sends to Chief Manager for approval. The Chief Manager gave final approval for all the application in one go and the bunch was finally dispatched to the address of card issuing agency.

This application was having genuine customer's bank account number mentioned along with his name. But the address mentioned on the application was fake one and it was not matching with the record of core banking system. As a dispatch policy decided by the management of Bank X, the card issuing agency was instructed to dispatch debit cards to customer's address and the PINs of the debit card at branch's address.

The sequence of events is given under to understand the modus operandi of this fraud.

1. Card issuing agency dispatches debit card to customer's address but Courier Company returns undelivered card because the address was not correct.
2. As per returned card policy, this card was then dispatched to the branch for onward delivery to the customer.
3. As a policy matter, PINs of all the debit cards are regularly dispatched to branches for onward delivery to customers. Customer can collect PIN after showing the receipt of debit card and ID.
4. While at branch, the fraudster was keeping a close watch on card and PIN deliveries at the branch. He checks all inwards and as soon as he receives card and PIN, he collects the same or takes the possession of card while handling inwards.
5. The insider with the help of his accomplice activates the card by first time using the PIN and then continues to withdraw cash from ATM.
6. The fraud comes to the notice of the bank when the customer approaches bank for unauthorized withdrawal from his account.

You are required to analyse the case to find the fraud

## **Solution**

### **Fraud Analysis**

A close look on the sequence of events reveals various lacunas in the system involving cards application processing and delivery.

1. A very casual approach was adopted by the branch to accept the card application from customer followed by verification and dispatch. All the particulars of the card application should be checked and verified as per the details of the customer available in bank's record. This includes address, mobile number, and signature.
2. No final checking of application form was done before dispatch to card issuing agency. Final completion of application form must be checked by a responsible senior officer of the branch and he should put his/her signature and branch stamp to confirm the source of application from the branch.

3. It was found that any staff of the branch was receiving cards and PIN from courier boy. System should be such that only authorized person of the branch should accept delivery of debit card and PIN and he should put his name, signature and branch stamp on delivery memo to confirm the receipt.
4. Handling of debit card and PIN was not assigned to two different officers. After receiving Debit card and PIN at the branch, two separate designated officers should be assigned to handle the task of maintaining the records of these secured items.
5. Customer's application was incomplete. Every application must be checked for entries of mobile number, alternative number and email Id. In case of any withdrawal, SMS alert should be delivered to customers followed by email.

## **CASE STUDY**

### **Financial Planning and the Aged Pension**

Mr and Mrs A had financial assets comprising a term deposit held with the bank for a number of years and Mr A's company superannuation fund. Their other assets comprised their family home, contents and a car. Mr A was employed on a wage of \$35,000 per annum but was due to retire in the following year. Mrs A earned income only from the term deposit investment which was held in her name and was shortly to qualify for the aged pension.

#### **Business Challenge**

Mr and Mrs A approached their bank to seek the advice of a financial planner about how they could arrange their financial arrangements to allow Mrs A to qualify for the maximum aged pension and maximise their income. After a meeting with the bank's planner, he provided advice that Mrs A would qualify for the full pension if her term deposit monies were invested in a superannuation fund in her name and recommended investment in a bank balanced superannuation fund.

Mr and Mrs A accepted the advice and transferred the funds to the recommended fund. Mrs A subsequently reached retirement age and

applied for the aged pension. However, she was subsequently advised by Centrelink that her pension entitlement was approximately half the full pension. A review of the financial planner's advice showed he had erred in his calculation. The lower pension entitlement therefore meant Mr and Mrs A's overall already modest income fell after implementing the planner's recommendation.

The value of Mrs A's superannuation investment subsequently fell significantly.

### **Solution**

Following an investigation, the Financial Ombudsman Service reached the view that it was reasonable to conclude that the error in the planner's calculations had significantly impacted both the recommendations he had made and Mr and Mrs A's acceptance of the advice. The Financial Ombudsman Service's view was that the error made by the planner was not so obvious as to have been detectable by Mr and Mrs A and they therefore reasonably relied on the information supplied.

Furthermore, the Financial Ombudsman Service's view was that the recommendation made by the planner was inappropriate given Mr and Mrs A's financial position, their historical investment profile and the resultant reduction in their income. Had the correct pension information been stated, and the appropriate recommendation supplied, it was more likely than not, in the circumstances of this case, that Mr and Mrs A would have retained their existing investment arrangements together with a part pension.

On that basis, the Financial Ombudsman Service determined that the disputants were entitled to be put back in the position they would have been had the term deposit remained in place and the bank was liable to compensate them on that basis.

## **CASE STUDY**

### **Inadequate Insurance Policy**

Mr and Mrs C had operated a home loan with the bank for many years. The bank suggested to them that they should change the loan to a

newer product that offered more benefits. Mr and Mrs C agreed to change the loan over provided that the same death and disability insurance was available with the new product. The bank officer indicated that this could be arranged and accordingly, Mr and Mrs C entered into a new loan contract.

**Business Challenge** When the new loan was drawn down Mr and Mrs C received a refund for an insurance premium. When they questioned this they were advised that their old insurance policy could not be transferred to the new loan because it was no longer offered by the bank. The new insurance policy did not offer cover for temporary disability.

Mr and Mrs C wrote to the Financial Ombudsman Service stating that they would never have taken out the new loan if they had known that their insurance policy could not be transferred.

### **Solution**

After discussions were held between the parties, the bank agreed to establish an insurance policy under the same terms as the original policy. The bank agreed to underwrite the insurance policy itself, as the insurance arm of the bank no longer offered the product. The bank also refunded the \$600 application fee.

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