INSTITUE OF AERONAUTICAL ENGINEERING

MBA DEPARTMENT

PPTs on

FINANCIAL SERVICES AND SYSTEMS

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Prepared by

Ms. Surabhi Lakshmi

UNIT-I

INTRODUCTION TO FINANCIAL SYSTEM

Meaning of financial services

- In general, all types of activities, which are of a financial nature could be brought under the term 'financial services'.
- The term financial services' in a broad, sense means "mobilizing and allocating savings".
- Thus it includes all activities involved in the transformation of savings into investment

- Financial services can also be called 'financial inter mediation'.
- Financial intermediation is a process by which funds are mobilizing from a large number of savers and make them available to all those who are in need of it and particularly to , corporate customers.
- Thus, financial services sector is a key area and it is very vital for industrial developments.

Classification of Financial Services Industry

- The financial intermediaries in India can be traditionally classified into two :

i. Capital Market intermediaries and

ii. Money market intermediaries.

- The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide lung term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate.

Scope of Financial Services

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

i. Traditional. Activities

ii. Modern activities.

Traditional Activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads, viz.

a. Fund based activities and

b. Non-fund based activities.

Fund based activities

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The traditional services which come under fund based activities are the following :

i. Underwriting or investment in shares, debentures, bonds, etc. of new issues (primary market activities).

ii. Dealing in secondary market activities.

iii. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc .

iv. Involving in equipment leasing, hire purchase, venture capital, seed capital, dealing in foreign exchange market activities. Non fund based activities

Non fund based activities

- Financial intermediaries provide services on the basis of non-fund activities also.
- This can be called 'fee based' activity. Today customers, whether individual or corporate, are not satisfied with mere provisions of finance.
- They expect more from financial services companies. Hence a wide variety of services, are being provided under this head.

i. Managing die capital issue — i.e. management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.

ii. Making arrangements for the placement of capital and debt instruments with investment institutions.

iii. Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

Modern Activities

- Beside the above traditional services, the financial intermediaries render innumerable services in recent times.
- Most of them are in the nature of non-fund based activity.
- In view of the importance, these activities have been in brief under the head 'New financial products and services'.

i. Rendering project advisory services right from the preparation of the project report rill the raising of funds for starting the project with necessary Government approvals.

ii. Planning for M&A and assisting for their smooth carry out.

iii. Guiding corporate customers in capital restructuring

iv. Acting as trustees to the debenture holders.

v. Recommending suitable changes in the management structure and management style with a view to achieving better results.

vi. Structuring the financial collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements,

vii. Rehabilitating and restructuring sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

viii. Hedging of risks due to exchange rate risk, interest rate risk, economic risk, and political risk by using swaps and other derivative products.

ix. Managing [In- portfolio of large Public Sector Corporations.

x. Undertaking risk management services like insurance services, buy-hack options etc.

xi. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

xii. Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix. Undertaking services relating to the capital market, such as

a. Clearing services

b. Registration and transfers,

c. Safe custody of securities

d. Collection of income on securities

Sources of Revenue

There arc two categories of sources of income for a financial services company, namely :

(i) Fund based and

(ii) Fee based.

Fund based income

- Fund based income comes mainly from interest spread (the difference between the interest earned and interest paid), lease rentals, income from investments in capital market and real estate.
- On the other hand, fee based income has its sources *in* merchant banking, advisory services, custodial services, loan syndication, etc.
- In fact, a major part of the income is earned through fund-based activities.
- At the same time, it involves a large share of expenditure also in the form of interest and brokerage.

- In recent times, a number of private financial companies have started accepting deposits by offering a very high rate of interest.
- When the cost *of* deposit resources goes up, tin" (ending rate should also go up.
- It means that such companies have to compromise the quality of its investments.

Fee based income

- Fee based income, on the other hand, does not involve much risk.
- But, it requires a lot of expertise on the part of a financial company *to* offer such fee-based services.

Causes For Financial services Innovation

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

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

ii. Keen competition : The entry of many FIs in the financial sector has led to severe competition among them. This keen competition has paved the way for the entry of varied nature of innovative financial products so ns to meet the varied requirements of the investors.

iii. Economic Liberalization : Reform of the Financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

iv. Improved communication technology : The communication technology has become so advanced that even the world's issuers can be linked with the investors i the global financial market without any difficulty by mean of offering so many options and opportunities.

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

vi. Global impact : Many of the providers and users of capital have changed their roles all over the world. FI have come out of their traditional approach and they arc ready to assume more credit risks.

vii. Investor Awareness: With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds, etc.

- Again, within the financial assets, they go from 'risk free bank deposits to risky investments in shares.
- To meet the growing awareness of the public, innovations has become the need of the hour.

New Financial Products and Services

- In these days of complex finances, people expect a financial service company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance.
- With the opening of the economy to multinationals, the free market concept has assumed much significance.

- As a result, the clients both corporate and individuals are exposed to the phenomena of volatility and uncertainty and hence the)' expect the financial services company to innovate new products and services so as to meet their varied requirements.
- As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened.

- Moreover, there has been a structured change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market.
- Many financial intermediaries including banks have already Started expanding [heir activities in the financial services sector by offering a variety new products. As :t result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly explained hereunder :

Merchant Banking

- A merchant hanker is a financial intermediary who helps to transfer capital from those who possess it to those who need it.
- Thus, a merchant hanker renders a host of services lo corporate, and thus promote industrial development in the country.

Loan Syndication

- This is more or less similar to consortium financing. But this work is taken up by the merchant banker as a lead manager.
- It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department.
- It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

Leasing

- A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called 'rental charges'.
- In countries like USA, the UK and Japan, equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies.
- In India also, many financial companies have started equipment leasing business.

Mutual Funds

- A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public.
- It is invested in a diversified portfolio with a view to spreading and minimizing the risk The fund provides investment avenues for small investors who cannot participate in the equities of big companies.
- It ensures low-risk, steady returns, high liquidity- and better capitalization in the long run.

Factoring

- Factoring refers to the process of managing the sales register of a client by a financial services company.
- The entire responsibility of collecting the book debts passes on to the factor.

Forfeiting

- Forfeiting is a technique by which a forfeiter (financing agency) discounts an export bill and pays ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

Venture Capital

- A venture capital is another method of financing in form of equity participation.

Custodial Services

- Under this a financial intermediary mainly provides services to clients, for a prescribed fee, like safe keeping of financial securities and collection of interest and dividends.

Corporate advisory services

- Financial intermediaries particularly hanks have setup specialized branches for this.
- As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

Securitization

- Securitization is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable.

Derivative Security

- A derivative security is a security whose value depends upon the values of other basic variable backing the security.
- In most cases, these variables are nothing but the prices of traded securities.

New products in Forex Markets

- New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them are :

a. **Forward contract:** A forward transaction is one where the delivery of foreign currency takes place at a specified future date for a specified price. It may have a fixed or flexible maturity date.

b. Options: As the very name implies, it is a contract where in the buyer of option's has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his options.

c. Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange.

- **d. Swaps :** A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates.

Lines of Credit

- It is an innovative funding mechanism for the import of goods and services on deferred payments terms.
- LOC is an arrangement of a financing institution of one country with another to support the export of goods and services to as to enable the importer to import on deferred payment terms.

Challenges Facing the Financial Services Sector

- Though financial services sector is growing very fast, it has its own set of problems and challenges.
- The financial sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy.
- Some of the important challenges are briefly explained hereunder

I. **Lack of qualified personnel :** The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. The dearth of qualified and trained personnel is an important impediment in its growth,

II. **Lack of investor awareness :** The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments,

- **Lack of transparency :** The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner.
- **Lack of specialization:** in the Indian sense, each financial intermediary seems to deal in a different financial service lines without specializing in one or two areas. In other countries , FI specialize in one or two areas only and provide expert service.

- Lack of recent data: most of the fi do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon financial creativity.
- Lack of efficient risk management system: with the opening of the economy to multinationals and exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk.

- The above challenges are likely to increase in number with the growing requirements of the customers.
- The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

Present Scenario

- The Indian economy is in the process of rapid transformation. Reforms ate taking place in every field / part of economy.
- Hence financial services sector is also witnessing changes.
- The present scenario can be explained in following terms

Conservatism to dynamism

- The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country.
- This is very essential to raise the allocate efficiency of available savings, increase the return on investment and thus to promote (he accelerated growth of the economy as a whole.
- At present numerous new FIs have started functioning with a view to extending multifarious services to the investing public in the area of financial services

Emergence of Primary Equity Market

- The capital markets, which were very sluggish, have become a very popular source of raising finance.
- The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994.
- After the lowering of bank interest rates, capital markets have become a very popular mode of channelizing the saving of medium class people.

Concept of credit rating

- The investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision making.

Process of globalization

- The process of globalization has paved the way for the entry of innovative and sophisticated products into our country.
- Since the government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative, international financial products in India are very great.
- Moreover, our country is likely to enter the full convertibility era soon.

Process of liberalization

- Our government has initiated many steps to reform the financial services industry.
- The government has already switched over to free pricing of issues the interest have been deregulated.
- The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized.
- SEBI has liberalized many stringent conditions so as to boost the capital and money markets.

Unit -II

Concept of Leasing

Lease - definition

- A lease is an agreement whereby the lessor conveys to the lessee , in return for rent, the right to use an asset for an agreed period of time.
- A financing arrangement that provides a firm with an advantage of using an asset, without owning it, may be termed as ‘leasing’.

Characteristics of lease

- The Parties
- The Asset
- The Term
- The Lease Rentals

PURPOSE OF LEASING ?

- The purpose of choosing a lease can be many. Generally, a lease is structured for following reasons.
- **Benefits of Taxes:** Tax benefit is availed to both the parties, i.e. Lessor and Lessee.
- Lessor, being the owner of the asset, can claim depreciation as an expense in his books and therefore get the tax benefit.
- On the other hand, the lessee can claim the MLPs i.e. lease rentals as an expense and achieve tax benefit in a similar way.

Avoid Ownership and thereby Avoiding Risks of Ownership:

- Ownership is avoided to avoid the investment of money into the asset.
- It indirectly keeps the leverage low and hence opportunities of borrowing money remain open for the business.
- A Lease is an off balance sheet item.

ADVANTAGES OF LEASING

BALANCED CASH OUTFLOW

- The biggest advantage of leasing is that cash outflow or payments related to leasing are spread out over several years, hence saving the burden of one-time significant cash payment.
- This helps a business to maintain a steady cash-flow profile.

QUALITY ASSETS

- While leasing an asset, the ownership of the asset still lies with the lessor whereas the lessee just pays the rental expense.
- Given this agreement, it becomes plausible for a business to invest in good quality assets which might look unaffordable or expensive otherwise.

BETTER USAGE OF CAPITAL

- Given that a company chooses to lease over investing in an asset by purchasing, it releases capital for the business to fund its other capital needs or to save money for a better capital investment decision.

TAX BENEFIT

- Leasing expense or lease payments are considered as operating expenses, and hence, of interest, are tax deductible.

OFF-BALANCE SHEET DEBT

- Although lease expenses get the same treatment as that of interest expense, the lease itself is treated differently from debt.
- Leasing is classified as an off-balance sheet debt and doesn’t appear on company’s balance sheet.

BETTER PLANNING

- Lease expenses usually remain constant for over the asset's life or lease tenor, or grow in line with inflation.
- This helps in planning expense or cash outflow when undertaking a budgeting exercise.

NO RISK OF OBSOLESCENCE

- For businesses operating in the sector, where there is a high risk of technology becoming obsolete, leasing yields great returns and saves the business from the risk of investing in a technology that might soon become outdated.
- For example, it is ideal for the technology business

Regulatory framework of leasing

- Provisions under Contract Act relating to Bailment:
- two parties - lessor - bailor, lessee-bailee.
- Transfer of possession of goods from bailor(lessor) to bailee(lessee), for a specific purpose.
- As under bailment, on accomplishment of purpose the goods transferred from lessee to lessor.

Regulatory framework of leasing....

- Not to set up an Adverse Title: must inform the lessor of any adverse claim.
- Payment of Lease Rental:
- Insure and Repair the Goods:
- Liabilities of the Lessor(Bailor):

Theoretical Framework of Leasing

- Liabilities of Lessor (Bailor):
- Delivery of Goods:

\- Ensure delivery of goods to the lessee, along with documents for lawful use of asset. Lease commences on delivery.

- Peaceful Possession:

\- Lessor must ensure quite possession of the goods during the lease term

- Fitness of Goods
- To Disclose All Defects: all known defects to be disclosed. If not then the lessor has to compensate the losses incurred by the lessee due to such defects.

Theoretical Framework of Leasing…

Remedies for Breach;

- **Remedies to the Lessor:**

  - **Forfeiture :** forfeiture of all lease rentals paid up to the date of termination, even if it exceeds the amt. of benefit received by the lessee.

  - **Repossession :** repossession of goods on breach of lease through serving of a notice on lessee.

- For repossession of goods physical force can be used by the lessor.

- **Remedies to the lessee:** may claim damages for loss resulting from the termination.
- This includes increased lease rentals he has to pay on new lease asset obtained + damages for not allowing him to use the asset from termination date to the date of expiry of the lease term.

Theoretical Framework of Leasing…

- Insurance of the leased Asset ;
- Both lessor or lesse can obtain the insurance.
- Generally obtained by the lessee, covering loss due damage by fire, riot, faulty handling, Act of God etc.
- Claims Proceeds : in case of asset being fully destroyed, the claims received , adjusted against the lessor’s dues.
- Sub Lease by lessee : not allowed unless provided in the lease agreement. Except for assets where sub lease is apparent. Sub lease becomes the lease of the original lessor as well.

Lease Documentation and Agreement

- Lease Approval Process:
- Appraisal of the Lease proposal. Sanctioning of the credit amount.
- Letter of Offer, with stipulated time for acceptance.
- Acceptance of Offer by lessee within stipulated time, with Board Resolution for acceptance of the offer.

- Documents required:
- Purchase Order, Invoice, Bill of Sale from supplier, delivery note, insurance policies, import license, copy of shops and establishments registration certificate, copies of Audited balance Sheet and P&L A/c. for 3yrs, M of A and Articles of Association, Provisional results for the first 6 months, IT returns/Salary certificate.

Lease Documentation and Agreement…..

- All these documents to be obtained by the lessor from the lessee.
- They are called "Attendant Documents" as they help in taking a decision for the lease proposal.
- Insurance Policy compulsory for the leased asset, in the name of the lessor account lessee. Policy should be in the custody of the lessor.

Lease Agreements

- It specifies the legal rights and obligations of the lessor and lessee.
- Usually a Master lease is signed containing the qualitative terms in the main part, and the equipment details, rentals, credit limits and payment duration etc in attached schedules.
- Additional lease facilities are finalized under supplemental lease agreements, with reference to the Main Master Lease Agreement.

Lease Agreements...

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- Clauses in Lease Agreement:
- Nature of the lease : financial lease, operating lease etc.
- Description : of the equipment, its actual condition, size, estimated useful life, components etc.
- Delivery and Re-delivery : when and how the equipment would be delivered to the lessee and redelivered by him.
- Lease Rentals ; procedure for payments of lease rentals with the rates. Besides, the late payment charges.
- Repairs & Maintenance : responsibility of repairs, insurance etc.
- Title : identification and ownership of equipment.
- Events of default and Remedies : consequences of default and recourse available to the lessor.

Tripartite Lease Agreement

- Three parties - Manufacturer, lessor(financier) and lessee.
- Guarantee Agreement : in addition to master lease agreement. Guarantor liable for the due amt. of lessee. He signs the guarantee agreement. If Guarantor is a company then Board Resoultion for the same is a must.
- Income and Address proof of Guarantor taken.
- Agreement on a stamp paper.

Tripartite Lease Agreement...

- Promissory Note:

  Lessee to execute an unconditional promissory note in favour of lessor for the full amount of lease rentals payable, counter guaranteed by the guarantor.

- Receipt of Goods:

  In case of tripartite lease , the manufacturer/ supplier/ lessor, delivers the goods directly to the lessee, so he has the execute the receipt for the goods.

Tripartite lease agreements...

Collateral Security/Hypothecation Agreement:

- Sometimes required if financial position of the lessee is weak.
- Collateral security may be a Promissory Note by lessee , insurance policies, shares etc.
- No Pledge Deed is required.
- A deed of Hypothecation may be executed on stamp paper of appropriate value.

Leasing -Tax Provisions

Lessor:

- The depreciation can be claimed by the lessor and not the lessee.
- Depreciation can be charged as a tax deductible expense item by lessor.

Lessee:

- The lease rentals and Insurance, repairs, maintenance charges paid by lessee are tax deductible items of expenses for the lessee

Financial evaluation of leasing

- Financial theorists and model builders have devoted a substantial amount of time and effort to developing an analytical framework within which the differential costs associated with leasing versus buying can be compared.
- In spite of this abundance of models, the perplexed financial manager can take some comfort in the fact that the practical effects resulting from the differences in the models tend to be small because few real -world decisions are changed as a result of which lease –buy model is chosen.

Example of Lease–Buy Analysis

- Consider the following example to illustrate the lease –buy analysis procedure just described.
- Suppose that the Alcoa Corporation is trying to decide whether it should purchase or lease a new heavy -duty GMC truck.
- The truck can be purchased for $50,000, including delivery. Alternatively, the truck can be leased from General Motors Acceptance Corporation for a 6-year period at a beginning -of -the -year lease payment of $10,000.

Example :

- If the truck is purchased, Alcoa estimates that it will incur $750 per year of expenses to cover insurance and a maintenance contract. These expenses would not be incurred if the truck is leased. The truck will be depreciated under MACRS guidelines as a 5-year asset. Alcoa expects the actual salvage value to be $20,000 at the end of six years. Alcoa's marginal tax rate is 40 percent, and its weighted after-tax cost of capital is 15 percent

Net present value

- *Net present value (NPV)* of a project is the potential change in an investor's wealth caused by that project while time value of money is being accounted for. It equals the present value of net cash inflows generated by a project less the initial investment on the project.
- **When cash inflows are even:**

$$NPV = R \times \frac{1 - (1 + i)^{-n}}{i} - \text{Initial Investment}$$

- In the above formula,

R is the net cash inflow expected to be received in each period;

i is the required rate of return per period;

n are the number of periods during which the project is expected to operate and generate cash inflows.

- **When cash inflows are uneven:**

$$NPV = \frac{R_1}{(1+i)^1} + \frac{R_2}{(1+i)^2} + \frac{R_3}{(1+i)^3} + \ldots - \text{Initial Investment}$$

Where,

i is the target rate of return per period;

$\mathbf{R_1}$ is the net cash inflow during the first period;

$\mathbf{R_2}$ is the net cash inflow during the second period;

$\mathbf{R_3}$ is the net cash inflow during the third period, and so on ...

- **Decision Rule**
- In case of standalone projects, accept a project only if its NPV is positive, reject it if its NPV is negative and stay indifferent between accepting or rejecting if NPV is zero.
- In case of mutually exclusive projects (i.e. competing projects), accept the project with higher NPV.

Internal rate of return

- The **internal rate of return** sometime known as **yield on project** is the rate at which an investment project promises to generate a return during its useful life.
- It is the discount rate at which the present value of a project's net cash inflows becomes equal to the present value of its net cash outflows.
- In other words, internal rate of return is the discount rate at which a project's net present value becomes equal to zero.

- **Formula of internal rate of return factor:**

$$\text{Internal rate of return factor} = \frac{\text{Net initial investment}}{\text{Annual cash inflow}}$$

Hire purchase

Meaning:

Hire purchase is a method of financing of the fixed asset to be purchased on future date. Under this method of financing, the purchase price is paid in instalments. Ownership of the asset is transferred after the payment of the last instalment.

Features of Hire Purchase:

The main features of hire purchase finance are:

1. The hire purchaser becomes the owner of the asset after paying the last instalment.

2. Every instalment is treated as hire charge for using the asset.

3. Hire purchaser can use the asset right after making the agreement with the hire vendor.

4. The hire vendor has the right to repossess the asset in case of difficulties in obtaining the payment of instalment.

Advantages of Hire Purchase:

Hire purchase as a source of finance has the advantages:

i. Financing of an asset through hire purchase is very easy.

ii. Hire purchaser becomes the owner of the asset in future.

iii. Hire purchaser gets the benefit of depreciation on asset hired by him/her.

iv. Hire purchasers also enjoy the tax benefit on the interest payable by them.

Disadvantages of Hire Purchase:

Hire purchase financing suffers from following disadvantages:

- i. Ownership of asset is transferred only after the payment of the last instalment.
- ii. The magnitude of funds involved in hire purchase are very small and only small types of assets like office equipment's, automobiles, etc., are purchased through it.
- iii. The cost of financing through hire purchase is very high.

Legal Framework

- There is no exclusive legislation dealing with hire purchase transaction in India. The Hire purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far.

1. The format / contents of the hire-purchase agreement
2. Warrants and the conditions underlying the hire-purchase agreement,
3. Ceiling on hire-purchase charges,
4. Rights and obligations of the hirer and the owner.

- In absence of any specific law, the hire purchase transactions are governed the provisions of the Indian Contract Act and the
- Sale of Goods Act. In chapter relating to leasing we have discussed the provisions related to Indian Contract Act, here we will discuss the provisions of Sale of Goods Act.

TAXATION ASPECTS

- There are three aspects of taxation of hire-purchase deals:

(i) income-tax,

(ii) sales tax and,

(iii) interest tax.

The hire-purchase transaction can be used as a tax planning device in two ways:

(i) by inflating the net income (finance income — interest on borrowings by the finance company) at the rear-end of the deal

(ii) by using hire-purchase as a bridge between the lessor and the lessee, that is, introduction of an sales, are liable to sales tax.

Financial Evaluation of hire purchasing

From the Point of View of the Hirer (Purchaser):

The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire instalment.

- **Decision criterion:** The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.
- **Cost of hire purchase:** The cost of hire purchase to the hirer consists of the following:
  - Down payment and Service Charges
  - Present value of hire purchase payments discounted by the cost of debt.
  - Present value of depreciation tax shield discounted by cot of capital.
  - Present value of net salvage value discounted by cost of capital.

From the View Point of Vendor / Financer

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

- NPV of Hire purchase Plan: The NPV of HPP consist of

1. PV of hire purchase instalments
2. + Documentation and service fee.
3. + PV of tax shield on initial direct cost
4. – Loan amount
5. – Initial cost.
6. – PV of interest tax on finance income (interest)
7. – PV of income tax on finance income meted for interest tax
8. – PV of income tax on documentation and service fee.

Hire purchase mathematics

Under a HIRE PURCHASE contract, a purchaser pays an initial deposit and takes the item away. He or she then makes regular repayments (instalments). The instalments include both repayment of the debt and the interest being charged by the vendor.

HIRE PURCHASE FORMULAS

TOTAL AMOUNT PAID = DEPOSIT + INSTALMENTS

TOTAL INTEREST PAID = TOTAL AMOUNT PAID – ORIGINAL PRICE OF ITEM

The interest rate being charged under a Hire Purchase Agreement is calculated using the SIMPLE INTEREST formula and is called the ANNUAL FLAT RATE of interest:

$$r_f = 100\,I / P_t$$

Where:

- I = total interest paid under agreement
- P = amount owed (after deposit is deducted from original price)
- *t = the number of years over which agreement runs*

Unit- III

Factoring

Meaning and Definition of Factoring

- The word factor is derived from the Latin word *facere*. It means to make or do or to get things done.
- Factoring simply refers to selling the receivables by a firm to another party.
- The buyer of the receivables is called the factor. Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary).

Objectives of Factoring

Factoring is a method of converting receivables into cash. There are certain objectives of factoring.

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

Types of Factoring

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There are different types of factoring.

- Recourse Factoring
- Non-Recourse Factoring
- Maturity Factoring
- Advance Factoring
- Invoice Discounting
- Undisclosed Factoring

Advantages of Factoring

- Improves efficiency
- Higher credit standing
- Reduces cost
- Additional source
- Advisory service
- Acceleration of production cycle
- Adequate credit period for customers
- Competitive terms to offer

Limitations of Factoring

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.

Legal aspects of factoring

1. The sale is taking place on a credit basis and the factor takes the responsibility for collecting payment from the buyer.
2. The seller should give due authority to the factor for collecting money from the buyer.
3. Legally, the claim on the buyer is assigned by the seller to the factor. For this, a letter of authority is given by the seller to the factor.
4. The buyer is also informed by the seller that he should make payment only to the factor.

6. In case of default by the buyer, it is the factor who will take action against the buyer in his capacity as an assignee.
7. No other creditor can have any claim settled with the buyer towards the sale of goods except the factor.
8. The banker will be informed that he should not finance the seller for any post sales requirements or accounts receivable discount, as it is the factor who has been assigned with the bills.
9. Disputes arising between the seller and buyer should be settled by the parties concerned and they should not affect the factor.

Factoring scenario in India

- Factoring service in India is of recent origin. It owes its genesis to the recommendations of the Kalyanasundaram Study Group appointed by the RBI in 1989.
- Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990.
- The first factoring company – SBI Factors and Commercial Ltd (SBI FACS) started operation in April 1991. This article highlights the important aspects of the factoring services in India.

The main recommendations of the Committee/Group are listed as follows:

- Taking all the relevant facts into account, there is sufficient scope for introduction factoring services in India which would be complementary to the services provide 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.

- The pricing of various services 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.

Kalyanasundaram Standing Committee Report Summary

- The Regulation of Factor (Assignment of Receivables) Bill, 2011
- The Standing Committee on Finance submitted its 39thReport on 'The Regulation of Factor (Assignment of Receivables) Bill, 2011' on August 30, 2011. The Chairperson was Shri Yashwant Sinha.
- The Bill seeks to provide for and regulate the assignment of receivables by making provisions for registration of factoring organisations and their regulation by the Reserve Bank of India (RBI). In addition, the Bill provides for the rights and obligations of parties to contract for the assignment of re.ceivables from one to another

- The Committee opined that there is a lack of clarity in the definitions and title of the Bill, which gives the impression that a law to regulate factors already exists. In addition, the Committee noted that the Hindi version of the Bill translates ‘factor’ to ‘adhatia’.
- The Report noted that the Ministry, in response to the Committee’s concerns, has stated its intention to replace the word ‘adhatia’ in the Hindi version with the word ‘factor’ and to specifically exclude agents of agricultural produce from the definition of ‘factor’ in the Bill.

- The Committee noted that the 1988 report of an Expert Group headed by C.S. Kalyansundaram, former chairman of State Bank of India, recommended that assignment of receivables in favour of a factor be exempt from stamp duty. The Committee stated that although it is in agreement with the recommendation of the Expert Group, no such provision is included in the Bill.
- The Report of the Committee states that the Ministry, in response to the Committee's concerns, has agreed with its view and will bring an amendment to the Indian Stamp Act, 1889 through a schedule to the Bill. The Committee found this appropriate.

BILL DISCOUNTING

- When the seller (drawer) deposits genuine commercial bills and obtains financial accommodation from a bank or financial instit instead of discounting the bill immediately may choose to wait till the date of maturity.
- 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.

Salient features

1. Discount charge:

The margin between advance granted by the bank and face value of the bill is called the discount, and is calculated on the maturity value at rate a certain percentage per annum.

2. Maturity:

Maturity date of a bill is defined as the date on which payment will fall due. Normal maturity periods are 30, 60, 90 or 120 days. However, bills maturing within 90 days are the most popular.

3. Ready finance:

Banks discount and purchase the bills of their customers so that the customers get immediate finance from the bank.

4. Discounting and purchasing:

The term discounting of bills is used for demand bills, where the term purchasing of bills is used for usance bills. In both cases, the bank immediately credits the account of the customer with the amount of the bill, less its charges. Charges are less in case of purchasing of bill because the bank can collect the payment immediately by presenting the bill to the drawee for payment. Charges are, however, higher in the case of discounting of bill because the bank charges include not only the charges for service rendered, but also the interest for the period from the date of discounting the bill to the date of its maturity.

Parties involved in Bills of Exchange

Bills of exchange is used primarily in International trade, and is a written order by one person to pay another a specific sum on a specific date sometime in the future. It is known as "**Draft**" in the United States. If the bill of exchange is drawn on a bank, it is called a **bank draft**. A bill of exchange may involve the following parties

1. **Drawer** This is the person who writes and signs the bill.
2. **Drawee** This is the person on whom the bill is drawn.
3. **Acceptor** This is the person who accepts the bill. In practice, the drawee is the acceptor but a third person may accept a bill on behalf of the drawee.
4. **Payee** This is the person to whom the money stated in the bill is payable. He may be the drawer or any other person to whom the bill has been endorsed.

5. **Holder** This is the person who is in the possession of the bill, after being drawn. 6. **Endorser** The person, either the drawer or holder, who endorses the bill to any one by signing on the back of it is called an endorser.

7. **Endorsee** He/ She is the person in whose favour the bill is endorsed.

8. **Drawee in case of need** This is a person who is introduced at the option of the drawer.

9. **Acceptor for honour** The person who may voluntarily become a party to a bill as acceptor in the event of the refusal by original drawee to accept the bill if demanded by the notary.

BILL DISCOUNTING PROCESS

The process of bill discounting is simple and logical.

- The seller sells the goods on credit and raises invoice on the buyer.
- The buyer accepts the invoice. By accepting, the buyer acknowledges paying on the due date.
- Seller approaches the financing company to discount it.
- The financing company assures itself of the legitimacy of the bill and creditworthiness of the buyer.
- The financing company avails the fund to the seller after deducting appropriate margin, discount and fee as per the norms.

- The seller gets the funds and uses it for further business.
- On the due date of payment, the financial intermediary or the seller collects the money from the buyer. ‘Who will collect the money’ depends on the agreement between the seller and financing company.

ADVANTAGES OF BILL DISCOUNTING

- The business gets the cash instantaneously giving business cycle a better momentum. It allows an entrepreneur to do business without funds.
- This works like a bank overdraft, the borrower pays the interest only on the amount of money utilized.
- There is a tough competition in the market to extend such credit and hence there are a plenty of different products to suit the needs of the client.
- There are borrowers who even cover the risk of bad debt along with the service. Obviously, the charge may be little more.

DISADVANTAGES OF BILL DISCOUNTING

- It can be an expensive form of financing compared to other modes of financing such as bank overdraft etc. In many countries like India, where the central bank encouraged the scheme of bill discounting and allowed a lower percentage of interest. But, it was not successful due to various misuses by financing brokers, banks etc.
- Note: Situation of invoice discounting is different in different countries. The norms of financing differ in different countries and they are different with different borrowers of the same countries as well. This depends on the business policies of the banks and financial institutions engaging in the discounting business.

Unit - IV

Venture Capital Financing

Meaning

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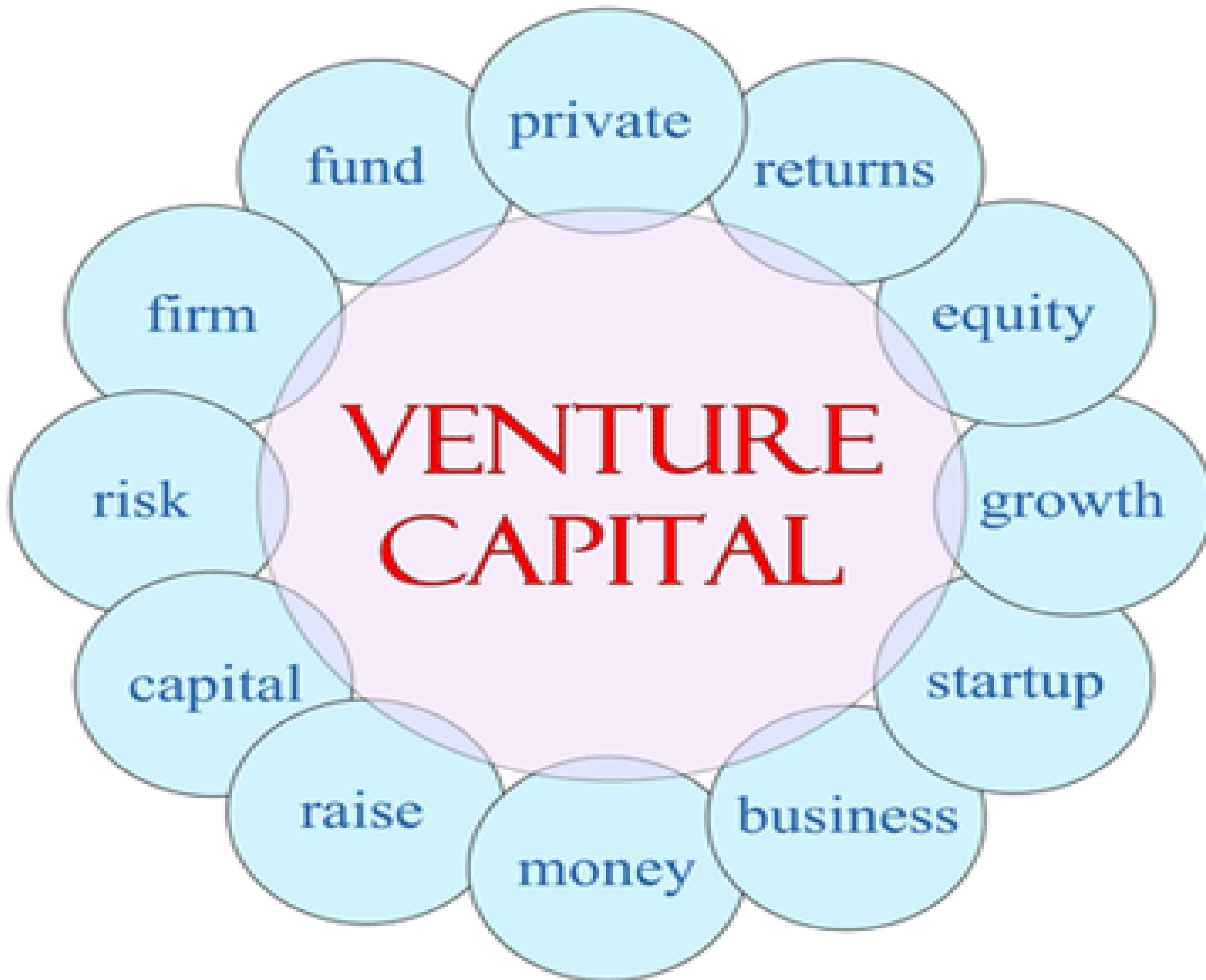
- It is a private or institutional investment made into early-stage / start-up companies (new ventures).
- As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain.
- Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs).
- The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.


private
fund
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VENTURE
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growth
capital
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Features of Venture Capital investments

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

Methods of Venture capital financing

- Equity
- participating debentures
- conditional loan

FUNDING PROCESS

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

Step 1: Idea generation and submission of the Business Plan

- The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:
- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company
- There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

Types of Venture Capital funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- Seed money: Low level financing for proving and fructifying a new idea
- Start-up: New firms needing funds for expenses related with marketingand product development
- First-Round: Manufacturing and early sales funding
- Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit
- Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company

Advantages of Venture Capital

- They bring wealth and expertise to the company
- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful.

Disadvantages of Venture Capital

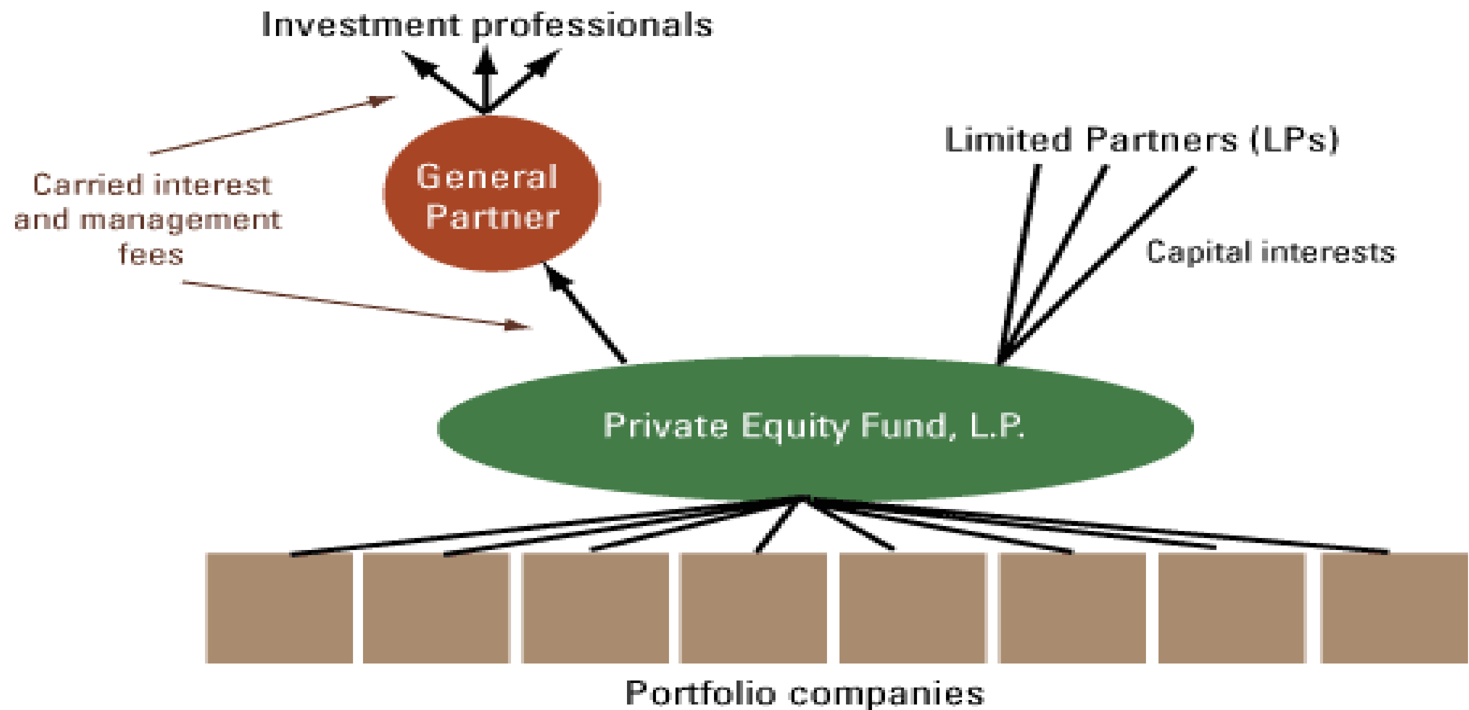
- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

Exit route

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

Venture Fund Structure



First Chicago method

This method is different from the previous conventional method of evaluation, as it gives some discount to the starting point and the exit point. There is more consideration given for the earnings during the entire period. This scheme has the following aspects.

1. Three alternative positions are taken which are

- Success
- Sideways survival
- failure.

A **probability rating** is given to the three positions.

1.Through the discounted cash flow, the **discounted present value is assessed** by giving a high discount rate to accommodate the risk factor.

2. The discounted value is multiplied by probability ratings which will provide **expected present value**.

3. If the expected present value is Rs. 10 lakhs, and the fund required is Rs. 5 lakhs, then the borrowing concern must have a **minimum net worth** of 50%.

Revenue Multiplier method

In this method, the **value of the borrowing concern is based on an estimated value**. The estimated value is calculated on the basis of

1. Present value of the borrowing concern
2. Annual revenue
3. Expected rate of growth of revenue per year
4. Expected holding period (number of years for the repayment)

5. Profit margin after tax

6. Expected P/E ratio at the time of quitting the borrowing concern.

This method will be useful for such concerns which have started earning and where in the course of years their revenue will be increasing. But this system is based on more data which may not be available, especially in underdeveloped countries.

Regulatory frame work of venture capital financing

Venture Capital Fund: means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which-

- has a dedicated pool of capital,
- raised in a manner specified in the regulations, and
- invests in accordance with the regulations.

Venture Capital Undertaking; means a domestic company

- whose shares are not listed on a recognized stock exchange in India;
- which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf.

Negative List

- Non-banking financial services excluding those Non-Banking Financial companies which are registered with Reserve Bank of India and have been categorized as Equipment Leasing or Hire Purchase companies
- Gold Financing excluding those companies which are engaged in gold financing for jewellery
- Activities not permitted under industrial policy of Government of India.
- Any other activity which may be specified by the Board in consultation with Government of India from time to time."

Associate Company: means a company in which a director or trustee or sponsor or settlor of the venture capital fund or asset management company holds either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of venture capital undertaking".

Equity Linked Instruments: includes instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.

Investible Funds: means corpus of the fund net of expenditure for administration and management of the fund.

Unit : means beneficial interest of the investors in the scheme or fund floated by trust or shares issued by a company including a body corporate

Unit -V

Merchant banking

Meaning

- Merchant Banking is a combination of banking, and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee. It helps a businessman to start a business. It helps to raise (collect) finance. It helps to expand and modernize the business. It helps in restructuring of a business. It helps to revive sick business units. It also helps companies to register, buy and sell shares at the stock exchange.

Functions of Merchant Banking

The functions of merchant banking are listed as follows:

- Raising Finance for Clients
- Broker in Stock Exchange
- Project management
- Advice on Expansion and Modernization
- Managing Public Issue of Companies
- Handling Government Consent for Industrial Projects
- Special Assistance to Small Companies and Entrepreneurs
- Services to Public Sector Units
- Revival of Sick Industrial Units

- Portfolio management
- Corporate Restructuring
- Money Market Operation
- Leasing Services
- Management of Interest and Dividend

Registration and Regulation of Working of Intermediaries

SEBI regulates various intermediaries in the primary and secondary markets through its Regulations for these intermediaries. These Regulations allow SEBI to inspect the functioning of these intermediaries and to collect to fees from them. Details of the registration and regulation of the working of intermediaries are given in the following sub-sections.

Primary Market Intermediaries

- Merchant bankers
- Registrars to an issue and share transfer agents
- Bankers to an issue
- Debenture trustees
- Underwriters
- Portfolio managers

Secondary Market Intermediaries

- Stock brokers
- Sub-brokers

Eligibility norms on Merchant Banking

Reforms for the merchant bankers

SEBI has made the following reforms for the merchant banker

1. Multiple categories of merchant banker will be abolished and there will be only one equity merchant banker.
2. The merchant banker is allowed to perform underwriting activity. For performing portfolio manager, the merchant banker has to seek separate registration from SEBI.
3. A merchant banker cannot undertake the function of a non banking financial company, such as accepting deposits, financing others' business, etc.
4. A merchant banker has to confine himself only to capital market activities

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Recognition by SEBI on merchant bankers

SEBI will grant recognition a merchant banker after taking into account the following aspects

1.Considering how much the merchant are professionally competent.

2. Whether they have adequate capital

3.Track record, experience and general reputation of merchant bankers.

4.Quality of staff employed by merchant bankers, their adequacy and available infrastructure are taken into account. After considering the above aspects, SEBI will grant permission for the merchant banker to start functioning.

Conditions by SEBI for merchant bankers

SEBI has laid the following conditions on the merchant bankers, for conducting their operations. They are

1. SEBI will give authorization for a merchant banker to operate for 3 years only. Without SEBI's authorization, merchant bankers cannot operate.
2. The minimum net worth of merchant banker should be Rs. 1 crore.
3. Merchant banker has to pay authorization fee, annual fee and renewal fee.
4. All issue of shares must be managed by one authorized merchant banker. It should be the lead manager.
5. The responsibility of the lead manager will be clearly indicated by SEBI.

Lead Manager

The commercial or investment bank which has primary responsibility for organizing a given credit or bond issuance. This bank will find other lending organizations or underwriters to create the syndicate, negotiate terms with the issuer, and assess conditions , also called syndicate manager, managing underwriter or lead underwriter.

Responsibilities of Lead Managers

Every lead managers has to enter into an agreement with the issuing companies setting out their mutual rights, liabilities and obligation relating to such issues and in particular to disclosures, allotment and refund. A statement specifying these is furnished to the SEBI at least one month before the opening of the issue for subscription. In case of more than one lead manager, the statement has to provide details about their respective responsibilities. A lead merchant banker cannot manage an issue if the issuing company is his associate. He can also not associate with a merchant banker who does not hold a certificate of registration with the SEBI.

- Due Diligence Certificate
- Submission of Documents
- Acquisition of Shares
- Disclosure to SEBI

UNDERWRITER

"Underwriter" has the meaning assigned to it in clause (f) of rule 2 of the Securities and Exchange Board of India (Underwriters) Rules, 1993. According to SEBI Rules/Regulations on underwriters, underwriter means a person who engages in the business of underwriting of an issue of securities of a body corporate.

Registration : To act as underwriter, a certificate of registration must be obtained from SEBI. On application registration is granted to eligible body corporate with adequate infrastructure to support the business and with net worth not less than Rs. 20 lakhs.

Fee : Underwriters had to pay Rs. 5 lakh as registration fee and Rs. 2 lakh as renewal fee every three years from the fourth year from the date of initial registration. Failure to pay renewal fee leads to cancellation of certificate of registration.

General Obligations and responsibilities

- **Code of conduct :**Every underwriter has at all times to abide by the code of conduct; he has to maintain a high standard of integrity, dignity and fairness in all his dealings.
- He must not make any written or oral statement to misrepresent (a) the services that he is capable of performing for the issuer or has rendered to other issues or (b) his underwriting commitment.
- **Agreement with clients :**Every underwriter has to enter into an agreement with the issuing company.
- The agreement, among others, provides for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by/on behalf of the issuer, the amount of Commission / brokerage, and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations.

General responsibilities

- An underwriter cannot derive any direct or indirect benefit from underwriting the issue other thanby the underwriting commission. The maximum obligation under all underwriting agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

Brokers and bankers to issue

Bankers to an Issue

The bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investor in respect of capital and refund of application money.

Registration : To carry on activity as a banker to issue, a person must obtain a certificate of registration from the SEBI. The applicant should be a scheduled bank. Every banker to an issue had to pay to the SEBI an annual free for Rs. 5 lakh and renewal fee or Rs. 2.5 lakh every three years from the fourth year from the date of initial registration. Non-payment of the prescribed fee may lead to the suspension of the registration certificate.

Brokers to the Issue

- Brokers are persons mainly concerned with the procurement of subscription to the issue from the prospective investors.
- The appointment of brokers is not compulsory and the companies are free to appoint any number of brokers.
- The managers to the issue and the official brokers organize the preliminary distribution of securities and procure direct subscription from as large or as wide a circle of investors as possible.
- A copy of the consent letter from all the brokers to the issue, should be filed with the prospectus to the ROC.
- The brokerage applicable to all types of public issue of industrial securities is fixed at 1.5%, whether the issue is underwritten or not.

- The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5%.
- Brokerage is not allowed in respect of promoters' quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders.
- Brokerage is not payable when the applications are made by the institutions/ bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the under subscription of the issues.

Registrars to an Issue and Share Transfer Agents

To carry on their business, the registrars must be registered with the SEBI. They are divided into two categories:

(a) Category I, to carry on the activities as registrar to an issue and share transfer Agent;

(b) Category II, to carry on the activity either as registrar or as a share transfer agent. Category I registrars mush have minimum net worth of Rs. 6 lakhs and Category II, Rs. 3. Category I is required to pay a initial registration fee of Rs.50,000 and renewal fee of Rs.40,000 every three years, whereas Category II is required to pay Rs.30,000 and Rs. 25,000 respectively

PORTFOLIO MANAGER

- Portfolio manager are defined as persons who in pursuance of a contract with clients, advise, direct, undertake on their behalf the management/ administration of portfolio of securities/ funds of clients.
- The term portfolio means the total holdings of securities belonging to any person.
- The portfolio management can be (i) Discretionary or (ii) Non-discretionary.
- The first type of portfolio management permits the exercise of discretion in regard to investment / management of the portfolio of the securities / funds.
- In order to carry on portfolio services, a certificate of registration from SEBI is mandatory.

Issue Management Process

- **Issues Management** is the process of identifying and resolving issues in a project or organization.
- Using this *Issue Management Process*, you can identify and resolve issues quickly, before they have an undesirable impact.
- Whether you experience staffing, supplier, equipment or other issues, this process will guide you through the steps towards their speedy resolution.

This Issue Management Process **will help you to:**

- Identify and record issues clearly
- Use Issue Forms to document issues properly
- Determine the impact of each issue
- Prioritize issues and report on their status
- Review all issues and decide on a course of action
- Take the steps needed to resolve issues quickly

BOOK BUILDING

- Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time.
- When shares are being offered for sale in an IPO, it can either be done at a fixed price.
- However, if the company is not sure about the exact price at which to market its shares, it can decide a price range instead of an exact figure.
- This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process.

Book Building Process

- Appointment of Investment Banker
- Collecting Bids
- Price Discovery
- Publicizing
- Settlement

GREEN SHOE OPTION INITIAL PUBLIC OFFERING PROMOTERS CONTRIBUTION

Green shoe option allows companies to intervene in the market to stabilize share prices during the 30-day stabilization period immediately after listing Most of us who invest in stocks of a company know what is an IPO(initial public offering). An IPO is the first sale of a stock or share by a company to the public. Companies offering an IPO are sometimes new, young companies, or companies which have been around for many years and have finally decided to go public.

Let try to understand what does green shoe option mean.

Over-allotment option

- The green shoe option allows companies to intervene in the market to stabilise share prices during the 30-day stabilization period immediately after listing. This involves purchase of equity shares from the market by the company-appointed agent in case the shares fall below issue price.

- The green shoe option is exercised by a company making a public issue. The issuer company uses green shoe option during IPO to ensure that the shares price on the stock exchanges does not fall below the issue price after issue of shares.
- Green shoe is a kind of option which is primarily used at the time of IPO or listing of any stock to ensure a successful opening price. Any company when decides to go public generally prefers the IPO route, which it does with the help of big investment bankers also called underwriters. These underwriters are responsible for making the public issue successful and find the buyers for company's shares. They are paid a certain amount of commission to do this work.

Origin of the Green shoe

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- The term "green shoe" came from the Green Shoe Manufacturing Company (now called Stride Rite Corporation), founded in 1919. It was the first company to implement the greenshoe clause into their underwriting agreement.
- In a company prospectus, the legal term for the green shoe is "over-allotment option", because in addition to the shares originally offered, shares are set aside for underwriters. This type of option is the only means permitted by the US Securities and Exchange Commission (SEC) for an underwriter to legally stabilize the price of a new issue after the offering price has been determined. The SEC introduced this option to enhance the efficiency and competitiveness of the fund raising process for IPOs.

SEBI GUIDELINES RELATING TO NEW ISSUES OF SECURITIES

SEBI advises certain guidelines in issue of fresh share capital, first issue by new companies in Primary Market and functioning of secondary markets in order to maintain quality standards. A few such guidelines and objectives of the Securities and Exchange Board of India (SEBI) are discussed here. SEBI Guidelines for issue of fresh share capital

- 1. All applications should be submitted to SEBI in the prescribed form.
- 2. Applications should be accompanied by true copies of industrial license.
- 3. Cost of the project should be furnished with scheme of finance.
- 4. Company should have the shares issued to the public and listed in one or more recognized stock exchanges.

5. Where the issue of equity share capital involves offer for subscription by the public for the first time, the value of equity capital, subscribed capital privately held by promoters, and their friends shall be not less than 15% of the total issued equity capital.

6. An equity-preference ratio of 3:1 is allowed.

7. Capital cost_of the projects should be as per the standard set with a reasonable debt-equity ratio.

8. New company cannot issue shares at a premium. The dividend on preference shares should be within the prescribed list.

9. All the details of the underwriting agreement.

10. Allotment of shares to NRIs is not allowed without the approval of RBI.

11. Details of any firm allotment in favor of any financial institutions.

CREDIT RATING

Credit rating is a mechanism by which the reliability and viability of a credit instrument is brought out. When a company borrows or when a businessman raises loan, the lenders are interested in knowing the credit worthiness of the borrower not only in the present condition but also in future. Hence, credit rating reveals the soundness of any credit instruments issued by various business concerns for the purpose of financing their business,. In credit rating, the investor is not only able to know the soundness of the credit instrument, but be is also able to analyze between different credit instruments and he can make a trade off between risk and return.

Credit Rating Companies in India

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Credit rating companies were started in India during the late 1980s.

- Credit Rating Information Services of India Ltd (CRISIL) was started in 1988 as a subsidiary of ICICI.
- Information and Credit Rating Services Ltd., (ICRA) was started in 1990, which is a subsidiary of IDBI.
- In1993, Credit Analysis and Research Ltd. (CARE) was started

Grading System

Each of the rating agencies has different codes for expressing rating for different instruments; however, the number of grades and sub-grades is similar eg for long term debentures/bonds and fixed deposits, CRISIL has 4 main grades and a host of sub-grades. In decreasing order of quality, these are AAA,AA+, AA, AA-, A+, A, A-, BBB-, BBB, BBB+, BB+, BB, BB-,B+, B, B-, C and D. ICRA, CARE and Duff and Phelps have similar grading systems. The following table contains a key to the codes used by CRISIL and ICRA.

Types of Credit Rating

1.Equity Rating
2. Bond Rating
3. Promissory Note Rating
4. Commercial Papers
5. Sovereign Rating

Advantages of Credit Rating

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Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

- Safety of investments
- Recognition of risk and returns
- Freedom of investment decisions
- Wider choice of investments
- Dependable credibility of issuer
- Relief from botheration to know company

Benefits to Intermediaries

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Stock brokers have to make less efforts in persuading their clients to select an investment proposal of making investment in highly rated instruments. Thus rating enables brokers and other financial intermediaries to save time, energy costs and manpower in convincing their clients.

Thank you