LECTURE NOTES

ON

FINANCIAL SERVICES AND SYSTEMS

II MBA III SEMESTER

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UNIT -1

Finance System

Introduction:

Financial service is part of financial system that provides different types of finance through various credit instruments, financial products and services. In financial instruments, we come across cheques, bills, promissory notes, debt instruments, letter of credit, etc.

In financial products, we come across different types of mutual funds. Extending various types of investment opportunities. In addition, there are also products such as credit cards, debit cards, etc.

In services we have leasing, factoring, hire purchase finance etc., through which various types of assets can be acquired either for ownership or on lease. There are different types of leases as well as factoring too. Thus, financial services enable the user to obtain any asset on credit, according to his convenience and at a reasonable interest rate.

Importance of Financial services

It is the presence of financial services that enables a country to improve its economic condition whereby there is more production in all the sectors leading to economic growth.

The benefit of economic growth is reflected on the people in the form of economic prosperity wherein the individual enjoys higher standard of living. It is here the financial services enable an individual to acquire or obtain various consumer products through hire purchase. In the process, there are a number of financial institutions which also earn profits. The presence of these financial institutions promote investment, production, saving etc. Hence, we can bring out the importance of financial services in the following points:

<u>Importance of Financial Services</u>

- Vibrant Capital Market.
- Expands activities of financial markets.
- Benefits of Government.
- Economic Development.
- Economic Growth.
- Ensures Greater Yield.
- Maximizes Returns.
- Minimizes Risks.
- Promotes Savings.
- Promotes Investments.
- Balanced Regional Development.
- Promotion of Domestic & Foreign Trade.

1. Promoting investment

The presence of financial services creates more demand for products and the producer, in order to meet the demand from the consumer goes for more investment. At this stage, the financial services comes to the rescue of the investor such as merchant banker through the new issue market, enabling the producer to raise capital.

The stock market helps in mobilizing more funds by the investor. Investments from abroad is attracted. Factoring and leasing companies, both domestic and foreign enable the producer not only to sell the products but also to acquire modern machinery/technology for further production.

2. Promoting savings

Financial services such as mutual funds provide ample opportunity for different types of saving. In fact, different types of investment options are made available for the convenience of pensioners as well as aged people so that they can be assured of a reasonable return on investment without much risks.

For people interested in the growth of their savings, various reinvestment opportunities are provided. The laws enacted by the government regulate the working of various financial services in such a way that the interests of the public who save through these financial institutions are highly protected.

Financial Services offered by various financial institutions

- Factoring.
- Leasing.
- Forfeiting.
- Hire Purchase Finance.
- Credit card.
- Merchant Banking.
- Book Building.
- Asset Liability Management.
- Housing Finance.
- Portfolio Finance.
- Underwriting.
- Credit Rating.
- Interest & Credit Swap.
- Mutual Fund.

3. Minimizing the risks

The risks of both financial services as well as producers are minimized by the presence of insurance companies. Various types of risks are covered which not only offer protection from the fluctuating business conditions but also from risks caused by natural calamities. Insurance is not only a source of finance but also a source of savings, besides minimizing the risks. Taking this aspect into account, the government has not only privatized the life insurance but also set up a regulatory authority for the insurance companies known as IRDA, 1999 (Insurance Regulatory and Development Authority) .

4. Maximizing the Returns

The presence of financial services enables businessmen to maximize their returns. This is possible due to the availability of credit at a reasonable rate. Producers can avail various types of credit facilities for acquiring assets. In certain cases, they can even go for leasing of certain assets of very high value.

Factoring companies enable the seller as well as producer to increase their turnover which also increases the profit. Even under stiff competition, the producers will be in a position to sell their products at a low margin. With a higher turnover of stocks, they are able to maximize their return.

5. Ensures greater Yield

As seen already, there is a subtle difference between return and yield. It is the yield which attracts more producers to enter the market and increase their production to meet the demands of the consumer. The financial services enable the producer to not only earn more profits but also maximize their wealth.

Financial services enhance their goodwill and induce them to go in for diversification. The stock market and the different types of derivative market provide ample opportunities to get a higher yield for the investor.

6. Economic growth

The development of all the sectors is essential for the development of the economy. The financial services ensure equal distribution of funds to all the three sectors namely, primary, secondary and tertiary so that activities are spread over in a balanced manner in all the three sectors. This brings in a balanced growth of the economy as a result of which employment opportunities are improved.

The tertiary or service sector not only grows and this growth is an important sign of development of any economy. In a well developed country, service sector plays a major role and it contributes more to the economy than the other two sectors.

7. Economic development Financial services enable the consumers to obtain different types of products and services by which they can improve their standard of living. Purchase of car, house and other essential as well as luxurious items is made possible through hire purchase, leasing and housing finance companies. Thus, the consumer is compelled to save while he enjoys the benefits of the assets which he has acquired with the help of financial services.

8. Benefit to Government

The presence of financial services enables the government to raise both short-term and long-term funds to meet both revenue and capital expenditure. Through the money market, government raises short term funds by the issue of Treasury Bills. These are purchased by commercial banks from out of their depositors' money.

In addition to this, the government is able to raise long-term funds by the sale of government securities in the securities market which forms apart of financial market. Even foreign exchange requirements of the government can be met in the foreign exchange market. The most important benefit for any government is the raising of finance without offering any security. In this way, the financial services are a big boon to the government.

9. Expands activities of Financial Institutions

The presence of financial services enables financial institutions to not only raise finance but also get an opportunity to disburse their funds in the most profitable manner. Mutual funds, factoring, credit cards, hire purchase finance are some of the services which get financed by financial institutions.

The financial institutions are in a position to expand their activities and thus diversify the use of their funds for various activities. This ensures economic dynamism.

10. Capital Market

One of the barometers of any economy is the presence of a vibrant capital market. If there is hectic activity in the capital market, then it is an indication of the presence of a positive economic condition. The financial services ensure that all the companies are able to acquire adequate funds to boost production and to reap more profits eventually.

In the absence of financial services, there will be paucity of funds which will adversely affect the working of companies and will only result in a negative growth of the capital market. When the capital market is more active, funds from foreign countries also flow in. Hence, the changes in capital market is mainly due to the availability of financial services.

11. Promotion of Domestic and Foreign Trade

Financial services ensure promotion of domestic as well as foreign trade. The presence of factoring and forfeiting companies ensures increasing sale of goods in the domestic market and export of goods in the foreign market. Banking and insurance services further contribute to step up such promotional activities.

12. Balanced Regional development

The government monitors the growth of economy and regions that remain backward economically are given fiscal and monetary benefits through tax and cheaper credit by which more investment is promoted. This generates more production, employment, income, demand and ultimately increase in prices. The producers will earn more profits and can expand their activities further. So, the presence of financial services helps backward regions to develop and catch up with the rest of the country that has developed already.

Scope of Financial Services:

Financial services a wide range of activities. They can be broadly classified into two.

1. Traditional activates

2. Modern activates

Traditional Activates: Financial intermediates have been rendering a wide range of services encompassing both capital and money marketing activities. They can be grouped under 2 categories.

a. Fun based activities
b. Non fun based activates

a. Fund based services

Working Capital Financing:

A firm's working capital is the money available to meet current obligations (those due in less than a year) and to acquire earning assets. Chinatrust Commercial Bank offers corporations Working Capital Finance to meet their operating expenses, purchasing inventory, receivables financing, either by direct funding or by issuing letter of credit.

Key Benefits

- Funded facilities, i.e. the bank provides funding and assistance to actually purchase business assets or to meet business expenses.
- Non-Funded facilities, i.e. the bank can issue letters of credit or can give a guarantee on behalf of the customer to the suppliers, Government Departments for the procurement of goods and services on credit.
- Available in both Indian as well as Foreign currency.

Short Term Financing

The bank can structure low cost credit programmes and cash flow financing to meet your specific short-term cash requirements. The loans are structured to enhance your profitability by scheduling the repayment to match the cash flow available to repay the debt.

Bill Discounting

Bill discounting is a short tenure financing instrument for companies willing to discount their purchase / sales bills to get funds for the short run and as for the investors in them. These are customized to suit your requirement for short-term finance, from the date of sale to the date of receipt of payment there on. We consider two types of bills facility viz. where documents are delivered on payment, i.e. D/P Bills and where the documents are delivered against acceptance i.e. D/A Bills.

Export credit

We offer short-term working capital finance both at the pre-shipment and post-shipment stages .Pre-shipment finance facility provides liquidity for procuring raw materials, processing, packing, transporting, meant for export.

Post-shipment finance is a credit facility extended from the date of shipment of goods till the realization of the export proceeds. The different types of post-shipment advances include:

- Export bills purchased/discounted
- Export bills negotiated (against letter of credit)
- Advances against bills sent on collection basis
- Advances against exports on consignment basis
- Exporters have the option of availing Post-Shipment finance either in rupees or in foreign currency.

Structured finance

Structured Finance describes any "non-standard" way of raising money. These tailor-made securities go beyond "standard" securities like conventional loans, debentures, debt, and equity. The reason to structure a more advanced security may be that conventional securities may be unattractive, unavailable or too expensive. These products are structured for both long and short tenor with exit options at intervals for both parties.

● Term Lending

CTCB offers very competitive rates for term financing. We also provide advisory services to companies for syndication of the term loans to a wide spectrum of financial institutions.

Under Term Finance, **China trust Commercial Bank**, offers the following:

- Fund Based Finance for capital expenditure acquisition of fixed assets towards starting or expanding a business to swap with high cost existing debt from other bank / financial institution
- Non-Fund Based Finance in the form of Deferred Payment Guarantee for acquisition of fixed assets towards starting / expanding a business or industrial unit.

b. Non-Fund Based Services

Letters Of Credit

Letter of credit is a legal document issued by a buyer's bank that upon presentation of required documents payment would be made. Usually confirmed by the seller's bank, protection is given to the seller that payment will be made if the goods are shipped correctly, following the conditions laid down when the LC is opened or based on subsequent amendments and protection is given to the buyer that the goods will be shipped before payment is made.

The LC facility can be granted to the importers after assessing their requirement/ credit worthiness/ financial strength and other parameters being to the satisfaction of the Bank.

China trust Commercial Bank can extend Import financing through Letters of Credit, which are well accepted globally and are supported by a strong trade finance set-up. We are direct members of SWIFT and have correspondent banking arrangements with many banks worldwide.

Bank Guarantees

Bank Guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default. China trust Commercial Bank sanctions Bank Guarantee limit to facilitate issue of guarantees on behalf of its clients. Various types of guarantees offered are – financial, performance, bid bond, tenders, customs, etc. Our guarantees are accepted by all government agencies including Customs, Excise, Insurance Companies, Shipping Companies, all Capital Market Agencies such as NSE, BSE, ASE, CSE etc. and all major corporates.

Collection Of Documents

We have a full-fledged trade finance set-up catering to all your trade related requirements, which offers you the following advantages:

1. Better turnaround time through timely processing of your documents
2. Facilitating faster payments
3. Lower cost
4. Excellent trade support
5. Arrangement of credit reports of overseas parties

Specialized advice on international trade related issues as well as technical issues such as Exchange Control requirements, RBI reporting, latest circulars and latest international developments.

2. 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'. However, some of the modern services provided by them are given in brief hereunder.

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.

XIII. 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

XIV. Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instrument;*.

Financial engineering

Financial engineering is a multidisciplinary field involving financial theory, methods of engineering, tools of mathematics and the practice of programming. It has also been defined as the application of technical methods, especially from mathematical finance and computational finance, in the practice of finance. Despite its name, financial engineering does not belong to any of the fields in traditional professional engineering even though many financial engineers have studied engineering beforehand and many universities offering a postgraduate degree in this field require applicants to have a background in engineering as well. In the United States, the Accreditation Board for Engineering and Technology(ABET) does not accredit financial engineering degrees. In the United States, financial engineering programs are accredited by the *International Association of Quantitative Finance*.

Financial engineering draws on tools from applied mathematics, computer science, statistics and economic theory. In the broadest sense, anyone who uses technical tools in finance could be called a financial engineer, for example any computer programmer in a bank or any statistician in a government economic bureau. However, most practitioners restrict the term to someone educated in the full range of tools of modern finance and whose work is informed by financial theory. It is sometimes restricted even further, to cover only those originating new financial products and strategies. Financial engineering plays a key role in the customer-driven derivatives business which encompasses quantitative modelling and programming, trading and risk managing derivative products in compliance with the regulations and Basel capital/liquidity requirements.

Why does financial innovation occur?

Economic theory has much to say about what types of securities should exist, and why some may not exist (why some markets should be "incomplete") but little to say about why new types of securities should come into existence.

One interpretation of the Modigliani-Miller theorem is that taxes and regulation are the only reasons for investors to care what kinds of securities firms issue, whether debt, equity, or something else. The theorem states that the structure of a firm's liabilities should have no bearing on its net worth (absent taxes, etc.). The securities may trade at different prices depending on their composition, but they must ultimately add up to the same value.

Furthermore, there should be little demand for specific types of securities. The capital asset pricing model, first developed by Jack L. Treynor and William F. Sharpe, suggests that investors should fully diversify and their portfolios should be a mixture of the "market" and a risk-free investment. Investors with different risk/return goals can use leverage to increase the ratio of the market return to the risk-free return in their portfolios. However, Richard Roll argued that this model was incorrect, because investors cannot invest in the entire market. This implies there should be demand for instruments that open up new types of investment opportunities (since this gets investors closer to being able to buy the entire market), but not for instruments that merely repackage existing risks (since investors already have as much exposure to those risks in their portfolio).

If the world existed as the Arrow-Debreu model posits, then there would be no need for financial innovation. The Arrow-Debreu model assumes that investors are able to purchase securities that pay off if and only if a certain state of the world occurs. Investors can then combine these securities to create portfolios that have whatever payoff they desire. The fundamental theorem of finance states that the price of assembling such a portfolio will be equal to its expected value under the appropriate risk-neutral measure.

Historical examples of financial innovation

Examples of spanning the market

Some types of financial instrument became prominent after macroeconomic conditions forced investors to be more aware of the need to hedge certain types of risk.

- The development of interest rate swaps in the early 1980s after interest rates skyrocketed.
- The development of credit default swaps in the early 2000s after the recession beginning in 2001 led to the highest corporate-bond default rate in 2002 since the Great Depression.

Examples of mathematical innovation

- The market in options exploded after the development of the Black–Scholes model in 1973.
- The development of the CDO was heavily influenced by the popularization of the copula technique (Li 2000).
- Flash trading exists since 2000 at the Chicago Board Options Exchange and 2006 in the stock market. In July 2010, Direct Edge became a U.S. Futures Exchange. Nasdaq and Bats Exchange, Inc created their own flash market in early 2009.

Futures, options, and many other types of derivatives have been around for centuries: the Japanese rice futures market started trading around 1730. However, recent decades have seen an explosion use of derivatives and mathematically complicated securitization techniques. MacKenzie (2006) argues from a sociological point of view that mathematical formulas actually change the way that economic agents use and price assets. Economists, rather than acting as a camera taking an objective picture of the way the world works, actively change behavior by providing formulas that let dispersed agents agree on prices for new assets.

Examples of innovation to avoid taxes and regulation

Miller (1986) places great emphasis on the role of taxes and government regulation in stimulating financial innovation. Modigliani and Miller (1958) explicitly considered taxes as a reason to prefer one type of security over another, despite that corporations and investors should be indifferent to capital structure in a fraction less world.The development of checking accounts at U.S. banks was in order to avoid punitive taxes on state bank notes that were part of the National Banking Act.

Some investors use total return swaps to convert dividends into capital gains, which are taxed at a lower rate.[1]

Many times, regulators have explicitly discouraged or outlawed trading in certain types of financial securities. In the United States, gambling is mostly illegal, and it can be difficult to tell whether financial contracts are illegal gambling instruments or legitimate tools for investment and risk-sharing. The Commodity Futures Trading Commission is in charge of making this determination. The difficulty that the Chicago Board of Trade faced in attempting to trade futures on stocks and stock indexes is described in Melamed (1996).

In the United States, Regulation Q drove several types of financial innovation to get around its interest rate ceilings, including eurodollars and NOW accounts.

The role of technology in financial innovation

Some types of financial innovation are driven by improvements in computer and telecommunication technology. For example, Paul Volcker suggested that for most people, the creation of the ATM was a greater financial innovation than asset-backed securitization.[2] Other types of financial innovation affecting the payments system include credit and debit cards and online payment systems like PayPal.

These types of innovations are notable because they reduce transaction costs. Households need to keep lower cash balances—if the economy exhibits cash-in-advance constraints then these kinds of financial innovations can contribute to greater efficiency. Alvarez and Lippi (2009), using data on Italian households' use of debit cards, find that ownership of an ATM card results in benefits worth €17 annually.

These types of innovations may also affect monetary policy by reducing real household balances. Especially with the increased popularity of online banking, households are able to keep greater percentages of their wealth in non-cash instruments. In a special edition of 'International Finance' devoted to the interaction of electronic commerce and central banking, Goodhart (2000) and Woodford (2000) express confidence in the ability of a central bank to maintain its policy goals by affecting the short-term interest rate even if electronic money has eliminated the demand for central bank liabilities, while Friedman (2000) is less sanguine.

An overview of Indian financial services sector 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 Fls 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 market.

Unit -2

Concept of Leasing

Meaning

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

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

The advantages of leasing include:

- Leasing helps to possess and use a new piece of machinery or equipment without huge investment. .
- Leasing enables businesses to preserve precious cash reserves.
- The smaller, regular payments required by a lease agreement enable businesses with limited capital to manage their cash flow more effectively and adapt quickly to changing economic conditions.
- Leasing also allows businesses to upgrade assets more frequently ensuring they have the latest equipment without having to make further capital outlays.
- It offers the flexibility of the repayment period being matched to the useful life of the equipment.
- It gives businesses certainty because asset finance agreements cannot be cancelled by the lenders and repayments are generally fixed.
- However, they can also be structured to include additional benefits such as servicing of equipment or variable monthly payments depending on a business's needs.
- It is easy to access because it is secured – largely or entirely – on the asset being financed, rather than on other personal or business assets.
- The rental, which sometimes exceeds the purchase price of the asset, can be paid from revenue generated by its use, directly impacting the lessee's liquidity.
- Lease instalments are exclusively material costs.
- Using the purchase option, the lessee can acquire the leased asset at a lower price, as they pay the residual or non-depreciated value of the asset.
- For the national economy, this way of financing allows access to state-of-the-art technology otherwise unavailable, due to high prices, and often impossible to acquire by loan arrangements.

Limitation of leasing

- It is not a suitable mode of project financing because rental is payable soon after entering into lease agreement while new project generate cash only after long gestation period.
- Certain tax benefits/ incentives/subsidies etc. May not be available to lease equipment's.
- The value of real assets (land and building) may increase during lease period. In this case lessee may lose potential capital gain.
- The cost of financing is generally higher than that of debt financing.
- A manufacturer(lessee) who want to discontinue business need to pay huge penalty to lessor for pre-closing lease agreement
- There is no exclusive law for regulating leasing transaction.

- In undeveloped legal systems, lease arrangements can result in inequality between the parties due to the lessor's economic dominance, which may lead to the lessee signing an unfavorable contract.

TYPES OF LEASE

(a) Financial lease
(b) Operating lease.
(c) Sale and lease back
(d) Leveraged leasing and
(e) Direct leasing.

1) Financial lease

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease'. In India, financial leases are very popular with high-cost and high technology equipment.

2) Operational lease

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

3) Sale and lease back

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

4) Leveraged leasing

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

5) Direct leasing

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

Other types of leasing:

- First Amendment Lease: The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.

- Full Payout Lease: A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

- Guideline Lease: A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

- Net Lease: A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.

- Open-end Lease: A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

- Sales-type Lease: A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

- Synthetic Lease: A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

- Tax Lease: A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition of this tax incentive.

- True Lease: A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

Legal aspects of leasing

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

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

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

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

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

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

Lease documentation and contract

A real estate lease is a legal and binding contract between the landlord or owner and the tenant. To be binding, it requires that the signing parties be of legal age and competent to enter into an agreement.If your tenant is a student and under the age of consent in your state, you will want to get the signature of a parent or legal guardian as well.

An Adequate Description of the Property

It might seem obvious, but you cannot over-describe the property being rented. The address, complete with a unit or apartment number may be all that you need. However, it never hurts to give the apartment project name, building number, or any other information that makes this leased property unique from all others.

Length and Time Frame of the Lease

It isn't enough to just specify a time frame, as in "six months." Have a beginning date and exact ending date. One more step is also important, and that is a time to vacate. Whether it's midnight or five in the evening, you and the tenant should know precisely when the unit is supposed to be empty of their belongings.

Renewal Terms

If you give your tenant the ability to renew, it should be stated specifically in the lease. This area might also include statements about the new rental rate for this period. Some property managers place escalation clauses for rent.

It is best if you require the tenant to give you written notice of their intent to renew and that they sign a new lease extension document. If you allow them to continue on a month-to-month basis, be clear in this area about the new rules for vacating the property when in this monthly status.

Security Deposits and Rent Payments

State laws differ about how much an owner can require in deposits by type; security, first or last month rent, or pet and damage deposits.

Your lease document should be clear as to the amounts, how the money will be held, and if interest is earned.

Important for deposits is a clear understanding as to how the money will be released at the end of the lease. How will damages be determined and valued? What time period is legal for holding the deposits at lease end?

Make sure that the tenant knows the day that rents are due, how to pay them, and what happens and when if they are late in paying.

Use, Occupancy and Sublet Agreements

Don't just assume that a residential unit will be used for residential purposes. If you allow a home office, say so, or be clear if you do not. If you do, what about business type, visiting customers or parking? How many people can occupy the unit? State a number, or you may find the local fraternity living there.

If you will allow subletting of the unit, be very clear as to the terms, whether you must approve the person, and how the responsibilities of the original tenant pass to the party subletting. Many landlords specifically rule out this practice, or they require that they approve on a case basis.

Your Rights of Entry and Inspection

The longer the lease, the greater the likelihood that you'll want to enter and inspect for property condition.

State your rights in the lease, including the notice you will give, usually a legal requirement. When repairs must be made, be clear as to how repair persons will gain entry and who is authorized. Remember that this is your tenant's home, and their privacy is important to them.

Acceleration of Rents

If legal in your state, you and the tenant should agree in the lease document as to your ability to accelerate the payment of rents if they violate rules, become an annoyance to others, or fail repeatedly to pay rents on time.

If Possible, A Waiver of Notices

Again, depending on your state of residence, you may want to include a waiver of notices. This simply states that it is the tenant's responsibility to know when their lease expires, rents are due, or any other deadlines or due dates. This waives you of the responsibility of notification in each instance.

It's All About Clear Language and State Law

Most real estate investors, owners and landlords get an attorney to draft their lease documents, or purchase a standard form and get their attorney to modify and bless it. This is a good practice, as you do not want to be in violation of your tenant's rights or state laws.

Whether you do-it-yourself or get an attorney, knowing the elements of a good lease document will help you to avoid many negative aspects of landlord-tenant relations. Protecting your rights is as important as doing the same for your tenants.

Tax and Accounting Aspects of Leases

Leasing assets involves a number of tax and accounting considerations, which are examined in this section.

Tax Status of True Leases

Annual lease payments are tax deductible for the lessee if one crucial criterion is met: The IRS must agree that a contract truly is a lease and not just an installment loan called a lease. Before embarking on a lease transaction, all involved parties should obtain an opinion from the IRS regarding the tax status of the proposed lease. The opinion of the IRS normally revolves primarily around the following general rules:

The remaining useful life of the equipment at the end of the lease term must be the greater of 1 year or 20 percent of its originally estimated useful life. Leases in excess of 30 years are not considered to be leases for tax purposes. The lease payments must provide the lessor with a fair market rate return on the investment. This profit potential must exist apart from the transaction's tax benefits. Renewal options must be reasonable, that is, the renewal rate must be closely related to the economic value of the asset for the renewal period. If the lease agreement specifies a purchase option at the end of the lease period, the purchase price must be based on the asset's fair market value at that time. The schedule of lease payments should not be very high early in the lease and very low thereafter. Such a payment schedule suggests that the lease structure is being used merely to avoid taxes In the case of a leveraged lease, the lessor must provide a minimum of 20 percent equity. Limited-use property (valuable only to the lessee) may not be leased.

If the IRS does not agree that a contract is truly a lease, taxes are applied as if the property had been sold to the lessee and pledged to the lessor as security for a loan. The reason for the IRS restrictions previously cited is that the IRS wants to prohibit lease transactions set up purely to speed up tax deductions. For example, a building would normally be depreciated over 39 years under MACRS depreciation rules.

It would be possible to set up a lease over a 3-year period that allowed the lessee to effectively write off the cost of the building for tax purposes over 3 years. This would increase tax deductions for the lessee at the expense of tax receipts to the U.S. Treasury. These IRS guidelines are designed to prevent this type of abuse.

Determining Lease Payments: The Lessor's Perspective

Suppose that the Dole Company (lessee) desires to lease a piece of farm equipment valued at $100,000 from Deere & Company (lessor) for a period of five years. Under the terms of the lease, payments are to be made at the beginning of each of the five years. Deere expects to depreciate the asset on a straight-line basis of $20,000 per year down to a book salvage value of $0. Actual salvage value is expected to be $10,000 at the end of five years.

This sal-vage value will be treated as a recapture of depreciation and taxed at Deere's marginal tax rate of 40 percent. Thus, the after-tax salvage value will be $6,000 ($10,000 actual salvage less $4,000 tax on depreciation recapture). If Deere requires an 11 percent after-tax rate of return on the lease, what will be the annual lease payments?

Step 1: Compute the lessor's amount to be amortized. In this case, it is the $100,000 initial outlay minus the present value of the after-tax salvage at the end of year 5 minus the present value of the after-tax depreciation tax shield for each year. (Recall that depreciation reduces taxable income by the amount of the depreciation and thus reduces a firm's cash outflow for tax payments by an amount equal to the depreciation times the company's marginal ordinary tax rate.)

(If an accelerated depreciation method, such as MACRS, was used by the lessor, the present value of the annual depreciation tax shield would have to be done using a series of Table PVIF factors, because the annual depreciation tax shield normally will change most years under accelerated depreciation methods.)

Step 2: Compute the annual after-tax lease income. This is the income that the lessor must receive in order to earn the needed 11 percent return Remember that lease payments received by a lessor are treated as taxable, ordinary income. These payments can be computed using the appropriate interest factor for the present value of an annuity (PVIFA from Table). Because lease payments are normally made at the beginning of each year,they constitute an annuity due.

Thus, the last four payments, which occur at the ends of years 1 through 4, are discounted, whereas the present value of the first payment, made at the beginning of year 1, is not discounted. Recall from Chapter 5 that taking the PVIFA for 11 percent and five years and multiplying by (1 + 0.11) gives the required PVIFA for an annuity due. If PMT is the annual after-tax lease income to the lessor, the present value of the lease income may be set equal to the amount to be amortized to determine th required PMT, as follows:

Amount to be amortized = PMT (PVIFA0.11, 5) (1 + 0.11)

$66,874 = PMT (3.696) (1.11)

$66,874 = PMT (4.103)PMT = $16,299

Therefore, Deere & Company needs to receive five beginning-of-the-year, after-tax lease income amounts of $16,301 (calculator accuracy) in order to earn an 11 percent after-tax return on the lease.

Step 3:Convert the lease income requirement of the lessor to a lease payment requirement of the lessee. Recalling that lease payments received by the lessor from the lessee are taxed as ordinary income, we can convert the after-tax lease income requirement of the lessor into a lease payment requirement for the lessee as follows:

Therefore, the Dole Company will have to make an annual lease payment of $27,168 to Deere & Company at the beginning of each year.

Lease–Buy Analysis: The Lessee's Perspective

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. At least 15 different approaches to the problem have been suggested, and there is considerable disagreement as to which one is the best.

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. One of the most commonly used approaches to the analysis of a lease versus purchase decision assumes that the appropriate comparison should be between leasing and borrowing to buy. Advocates of this approach argue that a financial lease is much like a loan in that it requires a series of fixed payments. Failure to make lease payments, like failure to make loan payments, may result in bankruptcy.

The basic approach of the lease–buy analysis model is to compute the net advantage to leasing (NAL). The net advantage to leasing compares the present value cost of leasing with the present value cost of owning the asset. If the cost of owning the asset is greater than the cost of leasing the asset, the NAL is positive and the model indicates that the asset should be leased.

The net advantage to leasing calculation is as follows:

Installed cost of the asset Less Present value of the after-tax lease payments Less Present value of depreciation tax shield Plus Present value of after-tax operating costs incurred if owned but not if leased Less Present value of the after-tax salvage value Equals Net advantage to leasing

The installed cost of the asset equals the purchase price plus installation and shipping charges. The installed cost forms the basis on which depreciation is computed.

The present value of the after -tax lease payments that are made if the asset is leased reduces the NAL; hence, they are subtracted when computing the NAL. These lease payments are discounted at the firm's after-tax marginal cost of borrowing to reflect the fact that lease payments are contractually known in advance and thus are not subject to much uncertainty.

The present value of the depreciation tax shield is equal to the depreciation claimed each year if the asset is owned times the firm's marginal tax rate. The depreciation tax shield reduces the cost of ownership and hence is subtracted when computing the NAL. Because the depreciation amounts are also known with relative certainty, they are also discounted at the firm's after -tax marginal cost of borrowing.

Sometimes operating costs are incurred if the asset is owned but not if it is leased. These may include property tax payments, insurance, or some maintenance expenses. If these do exist, they represent a benefit of leasing and increase the NAL. Hence, the after -tax amount of these costs is added in the NAL calculation. These operating cost savings are also discounted at the after-tax marginal cost of borrowing, reflecting their relative certainty.

Finally, if the asset is owned, the owner will receive the after-tax salvage value. This is lost if the asset is leased. Hence the after-tax salvage reduces the NAL and must be subtracted when calculating the NAL. Because asset salvage values are generally subject to substantial uncertainty, they are normally discounted at a rate equal to the firm's weighted (marginal) cost of capital.

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 firm has already computed the net present value of this proposed asset acquisition and found the project to be acceptable.) 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. If purchased, Alcoa could borrow the needed funds from Mellon Bank at an annual interest rate of 10 percent.

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. Which alternative —leasing or buying —should be chosen? In order to answer this question, we need to compute the NAL. This is shown in Table.

The calculation in Table indicates a net advantage to leasing of -$1,296. Because the NAL is negative, the asset should be owned rather than leased.

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. It is one of the most reliable measures used in capital budgeting because it accounts for time value of money by using discounted cash flows in the calculation.

Net present value calculations take the following two inputs:

- Projected net cash flows in successive periods from the project.
- A target rate of return i.e. the hurdle rate.

Where,

Net cash flow equals total cash inflow during a period, including salvage value if any, less cash outflows from the project during the period. Hurdle rate is the rate used to discount the net cash inflows. Weighted average cost of capital (WACC)is the most commonly used hurdle rate.

Calculation Methods and Formulas

The first step involved in the calculation of NPV is the estimation of net cash flows from the project over its life. The second step is to discount those cash flows at the hurdle rate.

The net cash flows may be even (i.e. equal cash flows in different periods) or uneven (i.e. different cash flows in different periods). When they are even, present value can be easily calculated by using the formula for present value of annuity. However, if they are uneven, we need to calculate the present value of each individual net cash inflow separately.

Once we have the total present value of all project cash flows, we subtract the initial investment on the project from the total present value of inflows to arrive at net present value.

Thus we have the following two formulas for the calculation of NPV:

When cash inflows are even:

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

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:

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

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.

The **minimum required rate of return** is set by management. Most of the time, it is the cost of capital of the company.

Under this method, If the internal rate of return promised by the investment project is greater than or equal to the minimum required rate of return, the project is considered acceptable otherwise the project is rejected. Internal rate of return method is also known as *time-adjusted rate of return method*.

To understand how computations are made and how a proposed investment is accepted or rejected under this method, consider the following example:

Example:

The management of VGA Textile Company is considering to replace an old machine with a new one. The new machine will be capable of performing some tasks much faster than the old one. The installation of machine will cost $8,475 and will reduce the annual labor cost by $1,500. The useful life of the machine will be 10 years with no salvage value. The minimum required rate of return is 15%.

Required: Should VGA Textile Company purchase the machine? Use internal rate of return (IRR) method for your conclusion.

Solution:

To conclude whether the proposal should be accepted or not, the internal rate of return promised by machine would be found out first and then compared to the company's minimum required rate of return.

The first step in finding out the internal rate of return is to compute a discount factor called *internal rate of return factor*. It is computed by dividing the *investment required for the project* by *net annual cash inflow* to be generated by the project. The formula is given below:

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 installment.

2. Every installment 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 installment.

Advantages of Hire Purchase:
Hire purchase as a source of finance has the following 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:

- Ownership of asset is transferred only after the payment of the last installment.

- 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.

- 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. The provisions of are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

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 bthe 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.

Though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price.

He can also claim deduction on account of consideration for hire, that is, finance charge.

The amount of finance charge to be deducted each year is to be spread evenly over the term of the agreement on the basis of a method chosen from amongst the alternatives: SOYD, ERI, SLM.

The consideration is viewed as a rental charge rather than interest and no deduction of tax at source is made.

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 and (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.

However, hire-purchase transaction structured by finance companies (which are not hire-vendors), being essentially a financing arrangement, do not attract sales tax.

An interest tax has to be paid on the interest earned less bad debts. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income under the Income-Tax Act..

Financial Evaluation

Now let us discuss the framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's viewpoint.

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. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative.

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:

1. Down payment
2. + Service Charges
3. + Present value of hire purchase payments discounted by the cost of debt.
4. – Present value of depreciation tax shield discounted by cost of capital.
5. – Present value of net salvage value discounted by cost of capital.

Cost of leasing: The cost of leasing consists of the following elements:

1. Lease management fee
2. + PV of lease payments discounted by cost of debt.
3. – PV of tax shield on lease payments and lease management fee discounted by cost of capital.
4. + PV of interest tax shield on hire purchase 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.

NPV of Leas Plan: The NPV of LP consists of the following elements:

1. PV of lease rentals.
2. + Leas management fee
3. + PV of tax shield on initial direct costs and depreciation.
4. + PV of Net salvage value.
5. – Initial investment
6. – Initial direct costs.
7. – PV of tax liability on lease rentals and lease management 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. At the end of the period of the agreement, the purchaser owns the item.

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

EFFECTIVE INTEREST IN HIRE PURCHASE
The effective rate of interest in a hire purchase agreement is the interest rate that would be charged in an equivalent *reducing balance* loan. The effective rate of interest is always higher than the flat rate of interest because the effective interest rate takes into account the fact that the amount owed is being progressively reduced by the regular instalment payments, while simple interest does not take this into account.

EFFECTIVE RATE OF INTEREST FORMULA

$\mathbf{r_{eff} = 2n / n+1 * r_{flat}}$

where n = no. of instalments over the life of the contract
r_{flat}= annual flat rate of interest charged in contract
The effective rate of interest is roughly about twice the flat rate of interest. The more repayments there are, the closer it is to double the flat rate.

Unit-3
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). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e. credit control, sales accounting etc. Thus factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.). The balance is the profit of the factor for the factoring services.

Objectives of Factoring

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:
1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realization of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

Types of Factoring

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

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

Process of Factoring (Factoring Mechanism)

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

Functions of a Factor

A factor performs some important functions. These may be discussed as follows:

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

Advantages of Factoring

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

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

Limitations of Factoring

The main limitations of factoring are outlined as below:

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

Legal aspects of factoring

The growth of a company depends largely on its liquidity. Many business projects, sales and credit expansion are hindered by lack of immediate cash. Today, the companies which are increasingly exporting face the risk of insolvency of its customers in addition to affecting the margin of the company. This weakens the results and becomes a permanent menace in achieving financial balance. So finding different financial variants is necessary which includes factoring.

Factoring in its traditional conception includes the management and collection of loans granted by the client and accepted by the factor, which assumes according to the contract the risk of insolvency of debtors. However there are certain legal aspects of factoring which you need to be aware of before you consider it as another financial variant.

The following are the legal aspects of factoring:

- The sale is taking place on a credit basis and the factor takes the responsibility for collecting payment from the buyer. For this purpose, the agreement between the seller and the factor should clearly state the role of each party involved in the sale.
- The seller should give due authority to the factor for collecting money from the buyer.
- 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.
- The buyer is also informed by the seller that he should make payment only to the factor.
- All the rights of the seller on the buyer now get transferred to the factor in his capacity as an assignee.
- In case of default by the buyer, it is the factor who will take action against the buyer in his capacity as an assignee.
- No other creditor can have any claim settled with the buyer towards the sale of goods except the factor.
- 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.
- Disputes arising between the seller and buyer should be settled by the parties concerned and they should not affect the factor.
- The factor must have the right to take legal action against the buyer in the case of default.

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.
- 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 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 liens 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 meter into 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 ad 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 to 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.

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 receivables 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'. This may give the impression that factors are to serve as intermediaries between enterprises and buyers of products, which is prohibited by the Bill.

- 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. In addition, the Ministry has stated its intention to change the name of the Bill to 'The Factoring Regulation Bill, 2011'. The Committee recommends that the Ministry incorporate these modifications in to 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.
- The Report notes that the Bill does not include any provision on the amount of commission or discount charged by factors. The Committee stated its concern that unregulated pricing will lead to exploitative practices, and recommends that guidelines on factor pricing be issued by the RBI.
- The Committee opined in its Report that clauses 8 and 18 of the Bill are inconsistent. Clause 8 provides that the debtor is responsible to make payment to the assignee (factor) only after notice of assignment is served upon him by the assignor. Clause 18 provides that in case the assignor commits a breach of contract against the debtor, the debtor is not entitled to recover payments already made to the assignor or assignee (factor). The Committee felt that clause 18 does not mention the rights of the debtor and is thus inconsistent with clause 8, which determines the responsibilities of all parties.
- The Report notes that the Ministry, in response to the concerns of the Committee, submitted that clause 18 does not preclude the right of the debtor to claim any losses on account of defective goods or short supply from the assignor, and that an explanation to this effect may be added to clause 18. The Committee recommends that such amendment be made to the Bill.
- Clause 32 of the Bill states that the government may make rules in respect to the "form and manner in which transactions of assignments of receivables in favour of a non-banking financial company shall be filed." The Committee recommends that the phrase 'non-banking financial company' be changed to 'factor', since the definition of 'factor' includes other statutory companies as well. The Report notes that the government has agreed to this change.

RBI Guidelines

The move comes close on the heels of the RBI receiving five applications for licence from international companies who want to set up factoring business.

Factoring is selling of a company's accounts receivables at a discount to an entity which assumes the credit risk. This entity makes upfront payment to the exporter, freeing it from the job of getting payments from the buyer. The recovery of payment for bills becomes a lookout of the factor.

The proposed regulation by the central bank for standalone factoring companies is expected to cover the minimum capital requirement for setting up a factoring business, direction, end use, due diligence, foreign exchange dealers' approval, prudential norms, regulatory reporting requirements, inspection by regulatory bodies, classification of loans which remain unpaid for a certain period and whether public deposits should be accepted or not, said an industry source.

Bibby Financial Services is one of the licence seekers. The Australian company has business interests ranging from shipping and logistics to distribution of financial services such as factoring, invoice discounting, recruitment finance, asset finance, construction finance and trade services.

The second application is from UAE Exchange, an exchange house in the Middle East catering to the remittances by Non-Resident Indians (NRIs) in partnership with Dr B R Shetty. Other applications are from US firms.

Currently, schedule banks can do factoring without an RBI licence. However, non-banking finance companies need an authorised dealers licence from the RBI for getting into export and import factoring. On the other hand, no licenses is required for domestic factoring and NBFCs registered with the RBI can enter into the filed.

"Though the RBI in last December had introduced guidelines for NBFCs which are non-deposit taking and having assets of more than Rs 100 crore (now categorised as systemically important NBFCs). The RBI is considering whether activity wise, there should be additional guidelines from a regulatory point of view," said an official.

So far, the country has seven factoring companies which are into international factoring business. These are: SBI Factors and Commercial Services, CanBank Factors, Foremost Factors, Global Trade Finance, CitiBank NA, HSBC, and the government-owned Export Credit Guarantee Corporation.

BILL DISCOUNTING

1 INTRODUCTION:

Bills of exchange that are used in the course of normal trade and commercial activities are called commercial bills_. Bill financing, is an ideal mode of short-term financing available to business concerns. It imparts flexibility to the money market, besides providing liquidity within the banking system. It also contributes towards the effectiveness of the monetary policy of the central bank of a country.
According to the Indian Negotiable Instruments Act 1881, ―Bill of Exchange is an instrument in writing containing an unconditional order, signed by the marker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument. The bill of exchange is essentially a trade-related instrument, and is used for financing genuine transactions. Bill financing, is an ideal mode of short term financing available to business concerns. It imparts flexibility to the money market, besides providing liquidity within the banking system. It also contributes towards the effectiveness of the monetary policy of the central bank of a country.

2 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. Commercial, the option of discounting will be advantageous because the seller obtains ready cash, which can be used for meeting immediate business requirements. However, in the process, the seller may lose a little by way of discount charged by the discounting banker.

3 Following are the salient features of bill discounting financing:

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. They need not wait till the bank collects the payment of the bill.

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. In addition, there are also charges when bills are dishonoured. In such circumstances, the bank will debit the account of the customer with the amount of the bill along with interest and other charges. Since the bank is granting advance to the customers in both the discounting and purchasing of bills, bills discounted and purchased are shown as advances (Schedule 9) by a bank in its balance sheet.

4 Steps In Discounting And Purchasing Following steps are involved in the discounting and purchas8isng of commercial bills of exchange:

1. **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 bill.

2. **Crediting Customer Account** after examining the genuineness of the bill, the banker grants a credit limit, either on a regular or on an ad net amount of the bill i.e. value of bill minus discount charges. The amount of discount is the income earned by the bank on discounting / purchasing. The amount of the bill is taken as advance by the bank.
3. **Control over 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 customers, limits sanctioned, bills discounted, bills collected, loans granted and loans repaid. Thus, at any given point in time the extent of limit utilized by the customer can be readily known.

4. **Sending Bill for collection:** The bill, together with documents duly stamped by the banker, is sent to the banker's branch (or some other banks branch if the banker does not have a branch of its own) for presenting the bill for acceptance or payment, in accordance with the instructions accompanying the bill.

5. **Action by the Branch:** On receipt of payment, the collecting bank remits the payment to the banker which has sent the bill for collection.

6. **Dishonour:** In the event of dishonour, the dishonour advice is sent to the drawer of the bill. It would be appropriate for the collecting banker to get the protested for dishonour. For this purpose, the collecting banker or branch of the bank maintains a separate register in which details such as date on which the bills are to be presented, the party to whom it is to be presented, etc. are recorded. The banker then presents them for acceptance or payment, as required. The banker debits the customers' (drawer / borrower) account with the amount of the bill and also all charges incurred due to dishonour 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.

5 BILL SYSTEMS There are essentially two systems of bills, the drawer bill system and the drawee bill system, which are explained blow:

Drawer Bills System 'Drawer Bills System's characterize sellers of goods on the buyer of the goods 2. Bills being discounted or purchased at the instance of the drawer of the bills 3. The banker primarily taking into consideration the credit of the drawer of bill, while discounting or purchasing these bills this system of financing goods is quite popular in our country.

Drawee Bills System „Drawee Bills System's characterized by: a. The banker accepting the bill drawn by the seller at the instance of the buyer (the drawee) b. The banker providing assistance, primarily on the strength of the creditworthiness of the buyer the two types of the drawee bills system are as follows:

1. **Acceptance credit system:** Under this system, the buyers banker accepts the bill of exchange for the goods purchased by the drawee. Such a bill may either be drawn on the buyer or the banker. The banker also requires the borrower to show separately, the goods purchased under acceptance credit in periodical stock statements submitted to the banker.
2. **Bills discounting system:** Under this system, the seller directly draws the bill on the buyer's bank discounts the bill and sends the proceeds to the seller. The buyer's banker will show the bill as bill discounted. Under both the systems, the banker keeps a record of the bills, both accepted and still outstanding. This is to ensure that the advance sanctioned does not exceed the credit limit. The main advantages of the Drawee bill scheme are as follows:

a. **Assured payment:** Since the banker has accepted the bill, the seller is assured of payment. Moreover, if the seller decides to get it discounted, the discount rate will be lower because the drawee is the banker itself.

b. **Buying advantage:** Due to the surety and standing of the banker, it is possible for the buyer to obtain goods at competitive rates.

3. **Safety of funds:** There is hardly any risk for the buyers bank because the bill is accepted or discounted against the security of the goods purchased by the buyer. Moreover, the goods are under the control of the banker. It is equally advantageous for the seller's bank, since the discounted bill may be rediscounted with any other financial institution. This is because; a banker has accepted the bill.

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. He /She may be the original payee, endorsee and bearer in case of a bearer bill.
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. Any endorser may insert the name of such person, and the effect of it is that a resort may be had to him in case the bill is dishonoured for non-acceptance or non-payment or in any other need.
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. The acceptor for honour offers to accept the bill *supra protest** with a view to safeguard the honour or prestige of the original drawer or any other endorser, as the case may be. This happens when the bill gets dishonoured and a formal certificate of dishonour, known as protest, is issued by the Notary Public to the holder of a bill in question. Hence the term supra protest.

* This happens when the bill gets dishonoured and a formal certificate of dishonour, known as protest, is issued by the Notary Public to the holder of a bill in question. Hence the term supra protest.

It is not necessary that all the above mentioned parties are involved in one bill of exchange. Usually there are three parties to a bill of exchange. They are

- Drawer,
- Drawee, and

- Payee.

It is also not necessary that three separate persons should answer to the description of drawer, drawee, and payee. Depending upon the situation one person may fill any two of three positions. Accordingly, drawer and payee may be the same person. For instance, when the bill is drawn as '***pay to me or my order***', drawer and drawee may be the same person. Similarly, when a principal draws a bill on his agent or upon himself, drawee and payee may be the same person.

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.

Suppose there are two sister companies A & B, A draws bill on B without any judicious transaction. B accepts it and A discounts it with the bank and utilizes the credit illegitimately. If the intentions are bad, A & B may default on payment and the banks will have to suffer.

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 -4
Venture Capital Financing

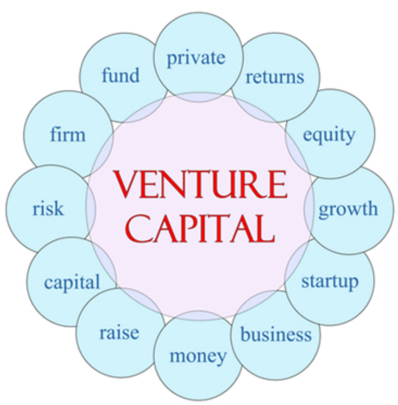
It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but 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.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives .*Software and other intellectual property* are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.



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

THE FUNDING PROCESS: ***Approaching a Venture Capital for funding as a Company***

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. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

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*
- *Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process*

A) Early Stage Financing:

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

B) Expansion Financing:

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

C) Acquisition or Buyout Financing:

Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another 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

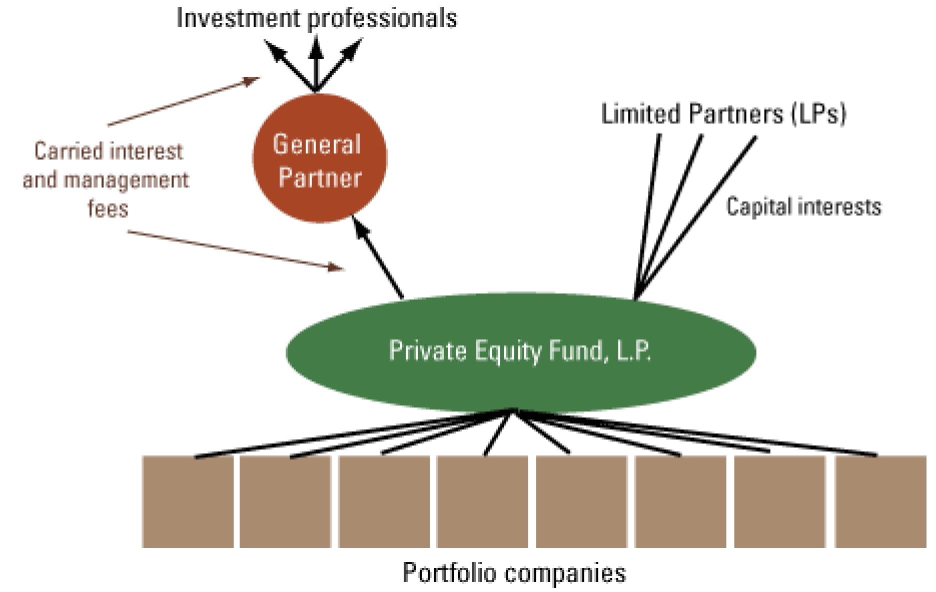
Examples of venture capital funding

Kohlberg Kravis & Roberts (KKR), one of the top-tier alternative investment asset managers in the world, has entered into a definitive agreement to invest USD150 million (Rs 962crore) in Mumbai-based listed polyester maker JBF Industries Ltd. The firm will acquire 20% stake in JBF Industries and will also invest in zero-coupon compulsorily convertible preference shares with 14.5% voting rights in its Singapore-based wholly owned subsidiary JBF Global Pte Ltd. The funding provided by KKR will help JBF complete the ongoing projects.

Pepperfry.com, India's largest furniture e-marketplace, has raised USD100 million in a fresh round of funding led by Goldman Sachs and Zodius Technology Fund. Pepper fry will use the funds to expand its footprint in Tier III and Tier IV cities by adding to its growing fleet of delivery vehicles. It will also open new distribution centres and expand its carpenter and assembly service network. This is the largest quantum of investment raised by a sector focused e-commerce player in India.

The Venture Fund Structure

Figure 1. Fund Structure



Source: Adapted by author from Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, NYU Law Review (forthcoming, 2008).

Venture Fund is the main investment vehicle used for venture investing. Each is structured as a limited partnership governed by partnership agreement covenants, of finite life (usually 7–10 years). It pays out profit sharing through carried interest (about 20% of the fund's .

Management Company is the business of the fund. The management company receives the management fee from the fund (about 2%) and uses it to pay the overhead related to operating the venture firm, such as rent, salaries of employees, etc. It makes carried interest only after the Limited Partners have been repaid.

Limited Partners (LPs) is someone who commits capital to the venture fund. LPs are mostly institutional investors, such as pension funds, insurance companies, endowments, foundations, family offices, and high net worth individuals.

General Partner (GP) is the venture capital partner of the management company. GPs raise and manage venture funds, set and make investment decisions, and help their portfolio companies exit, because they have a fiduciary responsibility to their Limited Partners.

Portfolio Companies (Start ups) receive financing from the venture fund in exchange for shares of *preferred equity*. The fund can only realize gains if there is a liquidity event (such as mergers and acquisitions or IPOs) and these shares can be converted to cash.

Methods in evaluation of projects by Venture Capital Institutions

The venture capital institutions invariably finance industries either on the basis of idea or on the basis of growth. It is here they are different from other financial institutions which are *assets-based*. We can now see different approaches in the evaluation of projects by venture capital institutions.

Methods of evaluation of projects by VCI

There are basically three methods adopted by venture capital institutions (VCI) while financing projects. These are –

- Conventional venture capitalist evaluation method.
- The First Chicago method.
- The revenue multiplier method.

1. Conventional venture capitalist evaluation method

ln this method, VCIs give importance to two aspects, which are

- the **time of starting the investment** and
- the **time of quitting the investment**.

The institution will judge the borrowing concern in the following manner—

1. **Annual revenue** of the borrowing concern over a **period of 7 years** and whether these revenues are on the upward trend.
2. The borrowing concerns' **expected earnings** (after deducting tax liability) at the initial stage and also at the time of quitting the borrowing concern will be taken into consideration.
3. **Market evaluation** of the borrowing concern on the basis of P/E ratio (P = price of the security and E= earnings of the security). The evaluation of this ratio is the lesser the ratio, better will be the condition of the borrowing company.
4. Finding out the **net present value (NPV)** of the borrowing concern, based on suitable discount factor.
5. The borrowing concern must have net worth equivalent to the borrowing amount.

Example: If the value of enterprise is Rs. 10 crores, and the borrower wants Rs. 4 crores, then he must have a net worth of 40 percent of the total value.

The above method may not be practically feasible as most of the borrowing firms will not be in a position to provide regular stream of income and in the case of firms incurring losses, this method cannot be worked out.

2. The 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.

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

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

4. 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%.

3. 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.

Exit Strategies for Venture Capital Funds

An important aspect of venture capital investing is the exit strategies. Venture capital funds primarily invest with an exit in mind after a few years. After successfully funding at seed, pre-production, production and expansion stages, a venture capitalist will start assessing exit strategies. The exit in the form of disinvestment or liquidation is the last and final stage of the venture capital funding. The key types of liquidation/disinvestment are trade sales, sale of quoted equity post initial public offering (IPO), and write-offs. Let's look at each of these in detail:

Trade Sales: In this type of strategy the private company is sold or merged with an acquirer for stocks, cash, or a combination of both.

IPO: If the company has done well, the venture capital investors will take the IPO route, by issuing shares registered for public offering. An example is the upcoming Facebook IPO, which is expecting to raise about $15 billion through IPO and is valued at approx. 100 billion. The venture capital investors and other private investors will get their portion of shares who can put them in the open marketplace for trading after an initial lock-in period.

Write-offs: These are voluntary liquidations that may or may not result in any proceeds.

Apart from the above three types of disinvestment, there are a few other options:

Bankruptcy: The company may just go bankrupt.

Buy-back: In this method the entrepreneur buys-back the investment share from the venture capitalists and takes it back to being a privately held company.

Investors who invest in a venture capital fund get distributions of public stock or cash from realized venture capital investments. Sometimes the fund may require further investments from limited partners. At other times, they may make cash or share distributions at random times during the lifetime of the fund. Investors can sell their interests to another buyer if they find one.

In a bad case scenario, some funds find themselves with highly illiquid, barely there companies. In a good scenario, they have good investments, which they disinvest from at a stage and find new investments to fund.

Current Scenario of Venture Capital Financing In India

For Beginners, a venture is a business or any other project that has risk associated with it. Venture capital is a type of private equity financing option that is invested in high-potential startups and venture capital firms are the organizations run by venture capitalists who take the risk of investing in startups that show huge market potential. Venture capital is not only beneficial for entrepreneurs but even the investors and the economy too benefits hugely from type of financing.

Now let's move on to the current scenario of venture capital financing in India. India is definitely one of the most powerful countries in Asia with a fast-developing economy owing to the presence of huge talents and people to boost those talents. Although venture capital financing in India has already started spreading its roots, the industry is still in its nascent stage.

However, the present stage of the industry in India is a clear indication that there’s a lot to happen in the VC industry of India. The biggest per-requisite for the establishment of an active venture capital industry is the presence of wide varieties of financial instruments to take care of the investors’ high-risk investments. The easy availability of these instruments reduces the risks and ensure a greater return for the venture capitalists.

Over the last few years, venture capital financing in India has witnessed a significant expansion with the entry of large numbers of local and international venture capital firms. These firms have already raised billions of dollars to invest in the local start ups. The huge amount of talent, dynamic business policies and a favorable business environment are together luring the global investors too to spread their base in India and boost the entrepreneurial industry.

The investors offering venture capital financing in India are mainly targeting sectors like technology, software, enterprise software, consumer internet, online retail, healthcare, energy, advertising, real estate, infrastructure, private equity, etc. With the surge of activity in the VC industry of India, there is definitely a lot of scope for new start ups; all this while the private equity capital was solely meant for the growing and established companies and there was very less scope for the newbie’s to materialize their potential ideas.

But today, the scenario is quite different. Venture capital financing in India is open to all provided they find a unique business idea with a growing market, an efficient management team, an innovative business model and home-run potential. Once they find a start up with all the necessary items that make it ideal for an investment, the VCs waste no time to back it with an aim to gain huge profits. The success of Flipkart is no more new story and is largely because of venture capital that the firm has managed to raise. In less than 7 years, the firm has earned revenue of over $1 billion.

Venture capital financing in India not only comes with capital but also with guidance and mentor ship and of course, the strong network that is a must for every business to reach the ultimate point of success. The investors are, usually, actively involved in the invested company’s managerial affairs and also keep an eye on where the capital is being invested so as to ensure that everything goes into profit making both for the company and the VC firm.

The venture capital funds in India are of different varieties; some are backed by the central government, some by state government, some by public banks, and some by public sector organizations while some by the overseas venture capital companies. Depending on the suitability of sector, stage of development and location, the investors choose their portfolio companies in India.

If you are one of those investors looking to raise venture capital financing in India, all you need is a unique product or service, a great management team, an innovative business model, a strong value proposition to gain the confidence of the investors and a reliable referral. With all these things in the right place, it won’t be difficult for you to raise venture capital in India.

To make your search for the right investor faster, you can also consider becoming a member of an intelligent network, like Merger Alpha, that offers a common platform to entrepreneurs, buyers, sellers, financial and strategic investors and financial advisers.

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-

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

Venture Capital Undertaking; means a domestic company :-

i. whose shares are not listed on a recognized stock exchange in India;
ii. 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

i. 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
ii. Gold Financing excluding those companies which are engaged in gold financing for jewellery
iii. Activities not permitted under industrial policy of Government of India.
iv. 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

Incorporation & Registration of a VCF

Application for Grant of Certificate: Any company or trust or body corporate proposing to carry on any activity as a venture capital fund must apply to SEBI for grant of a certificate of carrying out venture capital activity in India. An application for grant of certificate must be made in Form A and must be accompanied by a non-refundable application fee of Rs 25,000/- payable by bank draft in favor of the Securities and Exchange Board of India at Mumbai. Registration fee for grant of certificate is Rs 500,000.

Eligibility Criteria

For the purpose of grant of certificate by SEBI, the following conditions must be satisfied :-

A. If the application is made by a company

The main object of the company as per its Memorandum of Association must be the carrying on of the activity of venture capital fund.

i. It is prohibited by its Memorandum and Articles of Association from making an invitation to the public subscribe to its securities.
ii. None of its directors or its principal officer or employee is involved in any litigation concerned with the securities market which may have an adverse bearing on the business of the applicant. The directors or the principal officer or employee must not have been at anytime convicted for an offense involving moral turpitude or any economic offense and is a fit and proper person to act as director or principal officer or employee of the company
iii. it is a fit and proper person.

B. If the application is made by a trust

a. The instrument of trust (Trust Deed) is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908.
b. The main object of the trust is to carry on the activity of a venture capital fund
c. None of its trustees or directors of the trustee company, if any, is involved in any litigation connected with the securities market which may have an adverse bearing in the business of the venture capital fund.
d. The directors of its trustee company or the trustees have not at anytime being convicted of an offense involving moral turpitude or any economic offense.
e. the applicant is a fit and proper person

C. if the application is made by a body corporate

a. it is set up or established under the laws of the Central or State Legislature.
b. the applicant is permitted to carry on the activities of a venture capital fund.
c. the applicant is a fit and proper person.
d. the directors or the trustees, as the case may be, of such body corporate have not been convicted of any offence involving moral turpitude or of any economic offense.
e. the directors or the trustees, as the case may be, of such body corporate, if any, is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant.

Procedure for Grant of Certificate: If SEBI is satisfied that the applicant is eligible for grant of certificate, it shall send intimation to the applicant of its eligibility. On receipt of intimation, the applicant must pay to SEBI, registration fee of Rs 500,000 and on the receipt of such fees, SEBI shall grant a certificate of registration in Form B

Conditions for the Grant of Certificate

a. The venture capital fund shall abide by the provisions of the SEBI Act and these regulations.
b. The venture capital fund shall not carry on any other activity other than that of a venture capital fund.
c. The venture capital fund shall inform SEBI in writing of any information or details previously submitted to SEBI which have changed after grant of the certificate.
d. If the information or details submitted are found to be false or are misleading in any particular manner, suitable penal action can be taken

Raising Finance

A venture capital fund may raise money from any source, whether Indian, foreign or non resident Indian by way of issue of units. No venture capital fund shall accept any investment from any investor less than Rs500,000. However this condition is not applicable to :-

a. employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust
b. the employees of the fund manager or asset management company
c. Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least Rupees five crores before the start of operations by the venture capital fund.

Investments Conditions & Restrictions

All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely:-

a. venture capital fund shall disclose the investment strategy at the time of application for registration;
b. venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;
c. shall not invest in the associated companies; and
d. venture capital fund shall make investment as enumerated below: -
    i. at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking .
    ii. Not more than 33.33% of the investible funds may be invested by way of:
        a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed ;
        b. debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity
        c. preferential allotment of equity shares of a listed company subject to lock in period of one year.
        d. the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

        Explanation 1 - For the purpose of these regulations, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its networth as at the beginning of the previous financial year.

        e. Special Purpose Vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations

        Explanation - The investment conditions and restrictions stipulated in clause (d) of regulation 12 shall be achieved by the venture capital fund by the end of its life cycle."

e. venture capital fund shall disclose the duration of life cycle of the fund."

Prohibition on Listing

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

General Obligations and Responsibilities

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

Private placement

A venture capital fund may raise money only through private placement of its securities or units. The venture capital fund before issuing any securities or units must file with SEBI a placement memorandum.

Placement Memorandum or Subscription Agreement: The venture capital fund must :-

a. issue a placement memorandum which shall contain details of the terms and conditions subject to which monies are proposed to be raised from investors; or
b. enter into contribution or subscription agreement with the investors which shall specify the terms and conditions subject to which monies are proposed to be raised.

The Venture Capital Fund must file with the Board for information, the copy of the placement memorandum or the copy of the contribution or subscription agreement entered with the investors along with a report of money actually collected from the investor

The placement memorandum and /or subscription agreement must give the following details:

1. Details of the trustee or the trustee company and the directors or chief executives of the venture capital fund.
2. the proposed corpus of the fund and the minimum amount to be raised for the fund to be operational.
3. the minimum amount to be raised for each scheme and the provision for refund of monies to investor in the event of non receipt of minimum amount
4. details of entitlements units of venture capital fund for which subscription is being sought
5. Tax implications that are likely to apply to the investors.
6. Manner of subscription to the units or securities of the Venture Capital Fund
7. Period of maturity of the Fund.
8. Manner in which the fund is to be wound up.
9. Manner in which the benefits accruing to the investors in the units of the trust are to be distributed.
10. Details of the fund manager or asset management company if any, and the fees to be paid to such manager
11. The details about performance of the fund, if any, managed by the Fund Manager
12. investment strategy of the fund.
13. any other information specified by the Board.

Maintenance of Books and Records: Every venture capital fund must maintain for a period of 8 years books of accounts, records and documents which must give a true and fair picture of state of affairs of the venture capital fund.

Power to Call for Information: SEBI may at anytime call for any information from the venture capital fund in respect to any matter relating to its activity as a venture capital fund. Such information must be submitted within the time specified by days to SEBI.

Submission of reports to SEBI: SEBI may at anytime call upon the venture capital fund to file such report as it deems fit with regards to the activity carried out by venture capital fund.

Winding -up: A scheme of venture capital fund setup as a trust shall be wound up:

i. When the period of the scheme as mentioned in the placement memorandum is over ; or
ii. If, in the opinion of the trustees or the trustee company, it is in the interest of the investors that be wound-up ; or
iii. If 75 % of the investors in the scheme pass a resolution at a meeting of unit holders of the scheme that the scheme be wound up ; or
iv. If SEBI so directs, in the interest of investors.

The venture capital fund setup as a company shall be wound up according to provision of the Companies Act, 1956.

A venture capital fund set up as a body corporate shall be wound up in accordance with the provisions of the statute under which it is constituted.

The trustees or trustee company of the venture capital fund set up as a trust or the Board of Directors in the case of the venture capital fund is set up as a company (including body corporate) shall intimate the Board and investors of the circumstances leading to the winding up of the Fund or Scheme.

Effect of winding up

1. On and from the date of intimation of the winding up, no further investments shall be made on behalf of the scheme to be wound up.
2. Within three months from the date of intimation, the assets of the scheme shall be liquidated and the proceeds accruing to the investors in the scheme distributed to them after satisfying all liabilities.

Notwithstanding anything contained in sub-regulation (2) and subject to the conditions, if any, contained in the placement memorandum or contribution agreement or subscription agreement, as the case may be, in-specie distribution of assets of the scheme, shall be made by the venture capital fund at any time, including on winding up of the scheme, as per the preference of investors, after obtaining approval of at least 75% of the investors of the scheme.

Powers of SEBI for Inspection & Investigation: Details covered under Chapter -V of the Regulations

Procedure for Action in Case of Default - Offences & Penalties: Details covered under Chapter -VI of the Regulations

Venture capital funds which desire to claim exemption from income tax are required to follow rules given hereunder:

- Registration with SEBI
- Claiming Income tax exemption in respect of dividend and capital gains income.
- Not more than 40 percent of equity in a venture
- 80 percent of monies raised for investment are required to be invested in equity shares of domestic companies whose shares are not listed on recognized stock exchange
- Shares of investee companies are required to be held for a period of at least 3 years. However, these shares can be sold either if they are listed on recognized stock exchange in India

UNIT -5

MERCHANT BANKING

Origin of Merchant Banking:

The origin of merchant banking can be traced back to 13th century when a few family owned and managed firms engaged in sale and purchase of commodities were also found to be engaged in banking activity. These firms not only acted as bankers to the kings of European States, financed coastal trade but also borne exchange risk.

In order to earn profits, they invested their funds where they expected higher returns despite high degree of risk involved. They charged very high rates of interest for financing highly risky projects. In turn, they suffered heavy losses and had to close down. Some of them restarted the same activity after gaining financial strength. Thus merchant Banking survived and continued during the 13th century.

Later, merchant Bankers were known as "commission agents" who handled the coastal trade on commission basis and provided finance to the owners or supplier of goods. They made investments in goods manufactured by sellers and made huge profits. They also financed continental wars. The sole objective of these merchant bankers was profit maximisation by making investments in risky projects.

Then came the industrial revolution in England. The scope of international trade widened to include North America and other continents. Many people were attracted to take up merchant banking activities to transfer the machine made goods from European nations to other nations and colonies and bringing raw material from other nations and colonies to Europe and to finance such trade.

During the early nineteenth century, merchants indulged in overseas trade and earned good reputation. They accepted bills of the lesser reputed traders by guaranteeing the holder to receive full payment on due date. This practice of accepting bills has grown over the years with expansion in trade and has become part of the merchant banking activity.

Meaning of merchant Banking:

Dictionary meaning of merchant banking points at merchant bank as an organization that underwrites securities for corporations advises such clients on mergers and is involved in the ownership of commercial ventures.

The term 'merchant banking' has been used differently in different parts of the world. While in UK, a merchant banking refers to the 'accepting and issuing houses', in USA it is known as 'investment banking'.

The word merchant banking has been so widely used that sometimes, it is applied to banks who are not merchants, sometimes to merchants who are not banks and sometimes to those intermediaries who are neither merchants nor banks.

In UK, the term merchant banking originated from merchants in London who started financing of foreign trade through acceptance of bills. After sometimes, the merchants began to help governments of underdeveloped countries in raising long-term funds through floating of bonds in the London Money Market.

In 1914, these merchants formed an association which is now called 'Merchant Banking and Securities House Association'.

The merchant banks then extended their activity to the domestic business of loan syndication both for short-term as well as long-term purposes.

Today, these banks provide a variety of services, such as issue management, portfolio management, asset management, underwriting of new issues, act as registrars, share transfer agents, trustees, and provide leasing, project consultation, advice on mergers and amalgamations, Euro credits, etc.

In India, merchant banking services were started only in 1967 by National Grind lays Bank followed by Citi Bank in 1970. The State Bank of India was the first Indian commercial bank having set up a separate merchant banking Division in 1972. Since then, a number of other banks, financial institutions and other organizations are also engaged in providing merchant banking services.

But merchant banks in India have been primarily operating as issue houses than full-fledged merchant banks as in other countries.

In view of the above, we can define merchant bank as an institution or an organisation which provides a number of services including management of securities issues, portfolio services, underwriting of capital issues, insurance, credit syndication, financial advices and project counseling, etc.

It would also be necessary to make a distinction between merchant banking and commercial banking for a better understanding of the nature of merchant-banking. The merchant banks mainly offer financial services for a fee, while commercial banks accept deposits and grant loans.

The merchants do not act as repositories for savings of the individuals. Even when merchant banks engage themselves in fund-based activities and act as commercial banks, they function only as whole-sale bankers for a few selected industrial houses and not as retail banks for the general public.

The merchant banks are also different from the dealers, traders and brokers of securities. The merchant banks mainly deal in new issues while the dealers, traders and brokers deal mainly in secondary market.

Evolution of Merchant Banking:

‘Hundi’ was the main instrument of credit used by indigenous bankers before the coming of western merchants in India. It was in 1813, when merchants came from European countries to trade with India. Agency houses were set up by merchant bankers based at London.

These agency houses raised deposits at cheaper rates of interest viz. 4% to 5% from their home and made advances to native merchants at 10% to 12% and in addition they charged high commissions on every kind of service provided to the clients.

Easy availability of money at the spot from the agency houses had completely eliminated the role of acceptance house or the merchant banking in India. It was only with the entrance of East India Company that restrictions were put on operation of agency houses.

During 19th century, foreign merchant bankers operated in India through 'East India House'. East India House members moved into real estate business viz. tea and rubber plantation, cotton mills etc. They faced tough competition from Persian finance houses who were willing to grant credit to the trade with India.

It was in 1860 when the merchant's interest in joint stock banking started growing and with their own investments they floated joint stock banks. Some new banks were founded which included Orient Bank in 1845, Chartered Bank of India and Asia in 1853, Chartered Merchantile Bank of India, London & China in 1857 and so on.

These banks financed the trade transactions. The control and management of these banks lied with managing agents.

The managing agency system enabled a single firm to look after a number of firms in complementary industries. With the result, the banking industry flourished in India on the support of London based merchant bankers and the merchants who had full control on the Board. Telegraphic transfers improved banking links and the business.

The managing agents acted as merchants banks and performed functions of promoting financing and marketing of securities. They developed strong roots in depth of India's economic, commercial and industrial structure. They served the industry, trade and commerce as the merchant bankers were doing in UK and European countries or the investment bankers were doing in USA.

Managing agents acquired large share of investible capital initially and later on dispose off the shares once the company gets established. In other words, Managing Agency Houses acted as issue house for securities. It was found that 600 industrial establishments were managed under the managing agency system in 1951.

Few Indian managing agency houses were also established in the pre-World War II who started as family business later on, converted into partnership and public limited companies.

Examples of prominent managing agency houses included:

1. Tata's,

2. Birla's,

3. Dalmias,

4. Singhanias,

5. Thapars,

6. Narangs etc.

These managing houses had necessary skills and expertise which helped in the development of projects. Functions performed include:

(i) Investing funds as venture capital in promoting the enterprise.

(ii) Assist the enterprises in procuring finance by guaranteeing the bank loans and advances.

(iii) Raising public deposits.

(iv) Enter into negotiation with foreign capitalists.

Thus, they acted as intermediaries of investment by holding the shares of new companies, motivating people to invest and keep deposits for investment.

In Post-World War II, Amendments in the Companies Act, 1956 led to the streamlining of the procedure for capital issues and facilitated the growth of capital market in India.

In order to speed up the pace of economic development, efforts were made to channelize the household savings into investment in industry and trade. Significant amendments were made in Companies Act, Capital Issues (Control) Act, Banking Companies Act to regulate the growth of business enterprises.

In 1948, Industrial Finance Corporation of India (IFCI) was set up to provide long and medium term finance to industrial enterprises and underwrite new securities. At state level, State Financial Corporations were also established in 1951 to provide financial assistance to industry.

In 1955, the Industrial Credit and Investment Corporation of India (ICICI) were set up to provide developmental finance to industrial concerns. ICICI makes investment in equity by way of direct subscription and also underwrites shares and debentures.

Many more financial and investment institutions emerged at national and state levels e.g. LIC, RCI (Refinance Corporation for Industry), Industrial Development Bank of India (IDBI), Unit Trust of India (UTI), State Industrial Development Corporation (SIDC) etc. over the years.

The basic objectives of setting up all these institutions was to boost industrial sector, improve capital market, make finance easily available and support the investment climate in the country. These institutions also underwrite the capital issues besides lending support of broking houses.

The need for merchant banking services was widely felt. It was during this period that National & Grind lays Bank (now Grind lays Bank) took a lead by taking up merchant banking activities and announced inauguration of its "Merchant Banking Division" in January, 1969.

Functions of Merchant Banking

The functions of merchant banking are listed as follows:

1. Raising Finance for Clients : Merchant Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc. It helps its clients to raise finance from the domestic and international market. This finance is used for starting a new business or project or for modernization or expansion of the business.

2. Broker in Stock Exchange : Merchant bankers act as brokers in the stock exchange. They buy and sell shares on behalf of their clients. They conduct research on equity shares. They also advise their clients about which shares to buy, when to buy, how much to buy and when to sell. Large brokers, Mutual Funds, Venture capital companies and Investment Banks offer merchant banking services.
3. Project Management : Merchant bankers help their clients in the many ways. For e.g. Advising about location of a project, preparing a project report, conducting feasibility studies, making a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the government.
4. Advice on Expansion and Modernization : Merchant bankers give advice for expansion and modernization of the business units. They give expert advice on mergers and amalgamations, acquisition and takeovers, diversification of business, foreign collaborations and joint-ventures, technology up-gradation, etc.
5. Managing Public Issue of Companies : Merchant bank advice and manage the public issue of companies. They provide following services:
   i. Advise on the timing of the public issue.
   ii. Advise on the size and price of the issue.
   iii. Acting as manager to the issue, and helping in accepting applications and allotment of securities.
   iv. Help in appointing underwriters and brokers to the issue.
   v. Listing of shares on the stock exchange, etc.
6. Handling Government Consent for Industrial Projects : A businessman has to get government permission for starting of the project. Similarly, a company requires permission for expansion or modernization activities. For this, many formalities have to be completed. Merchant banks do all this work for their clients.
7. Special Assistance to Small Companies and Entrepreneurs : Merchant banks advise small companies about business opportunities, government policies, incentives and concessions available. It also helps them to take advantage of these opportunities, concessions, etc.
8. Services to Public Sector Units : Merchant banks offer many services to public sector units and public utilities. They help in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance from term lending institutions.
9. Revival of Sick Industrial Units : Merchant banks help to revive (cure) sick industrial units. It negotiates with different agencies like banks, term lending institutions, and BIFR (Board for Industrial and Financial Reconstruction). It also plans and executes the full revival package.
10. Portfolio Management : A merchant bank manages the portfolios (investments) of its clients. This makes investments safe, liquid and profitable for the client. It offers expert guidance to its clients for taking investment decisions.
11. Corporate Restructuring : It includes mergers or acquisitions of existing business units, sale of existing unit or disinvestment. This requires proper negotiations, preparation of documents and completion of legal formalities. Merchant bankers offer all these services to their clients.
12. Money Market Operation : Merchant bankers deal with and underwrite short-term money market instruments, such as:
   i. Government Bonds.
   ii. Certificate of deposit issued by banks and financial institutions.
   iii. Commercial paper issued by large corporate firms.

iv. Treasury bills issued by the Government (Here in India by RBI).

13. Leasing Services : Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee called rentals.
14. Management of Interest and Dividend : Merchant bankers help their clients in the management of interest on debentures / loans, and dividend on shares. They also advise their client about the timing (interim / yearly) and rate of 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**
  During 1996-97, 179 merchant bankers were granted registration. The certificates of registration granted to 14 merchant bankers were cancelled due to non payment of fees.

  Merchant bankers are registered in 4 categories. For each category, there are different eligibility criteria, which have been set keeping in view the different activities which Merchant Bankers are authorized to do. The category wise details of the registration of merchant bankers are given in Table 26.

- **Registrars to an issue and share transfer agents**
  Registrars to an Issue (RTI) and Share Transfer Agents (STA) are registered and regulated under SEBI (Registrar to an Issue and Share Transfer Agent) Rules and Regulations, 1993. Under these regulations, registration commenced in 1993-94 and is granted under two categories: Category I to act as both registrar to an issue and share transfer agent and Category II to act as either registrar to an issue or share transfer agent. Table 27 gives details of registration of registrars to an issue and share transfer agents. SEBI issued instructions to all registered RTIs and/or STAs to appoint compliance officers who would ensure that all rules, regulations, guidelines and directions issues by SEBI, the government and other regulatory authorities are complied with, and any deviations therefrom were to be reported to SEBI.

- **Bankers to an issue**
  Scheduled banks acting as bankers to an issue are required to be registered with SEBI in terms of SEBI (Bankers to an Issue) Rules and Regulations, 1994. Under these regulations, registration commenced in 1994-95 and bankers to an issue are required to comply with the guidelines issued and submit quarterly reports of their activities. At the end of March 1997, 80 bankers to an issue were registered with SEBI.

- **Debenture trustees**
  Debenture trustees are registered under and regulated by the SEBI (Debenture Trustees) Rules and

Regulations, 1993. Under these regulations, registration commenced in 1993-94 and at the end of March 1997, 27 debenture trustees were registered with SEBI.

- **Underwriters**
  The number of underwriters registered with SEBI in terms of the SEBI (Underwriters) Rules and Regulations, 1993, which was 40 at the end of 1995-96, fell to 34 at the end of 1996-97.

- **Portfolio managers**
  During the year 1996-97, 3 portfolio managers were granted registration. Thus the number of portfolio managers rose from 13 at the end of 1995-96 to 16 at the end of 1996-97. It may be mentioned here that Category I and II merchant bankers are also authorised to undertake the activities of portfolio managers.

Secondary Market Intermediaries

- **Stock brokers**
  All stock brokers are registered with SEBI in terms of the SEBI (Stock Brokers and Sub Brokers) Regulations, 1992. During 1996-97, 391 brokers were registered with SEBI making the total number of stock brokers registered with SEBI to 8,867 as on March 31, 1997. Exchange wise details of stock brokers registered with SEBI are given in the Table 28 below. Figure 12 below illustrates the number of stock brokers and the level of corporatisation of membership of stock exchanges.

  From the table, the trend towards corporatisation can be seen. Corporate membership has gone up from 1,917 (23% of the total membership) as on March 31, 1996 to 2,360 (27% of total membership) as on March 31, 1997. The trend towards corporatisation of membership is expected to continue further in 1997-98 considering the one time exemption from capital gains tax proposed in the Budget for 1997-98. As of March 31, 1997, the majority of members of the NSEI and the OTCEI were corporate bodies. Other exchanges which are large in terms of number of members, such as Mumbai, Calcutta, Jaipur and Uttar Pradesh, had comparatively lower rates of corporatisation of members.

- **Sub-brokers**
  Individual investors invariably transact securities through sub-brokers. It is therefore absolutely imperative to regulate this class of intermediaries. SEBI's efforts in registering and regulating them have not been very successful so far. As on March 31, 1997 only 1,798 sub brokers are registered with SEBI

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.

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.

6. Lead managers are responsible for allotment of securities, refunds, etc.

7. Merchant banker will submit to SEBI all returns and send reports regarding the issue of shares.

8. A code of conduct for merchant bankers will be given by SEBI, which has to be followed by them.

9. Any violation by the merchant banker will lead to the revocation of authorization by SEBI.

Lead Manager

The commercial or investment bank which has primary responsibility for organizing 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 market 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.

It is necessary for a lead manager who is Category I merchant banker, to accept a minimum underwriting obligation of 5 percent of the total underwriting commitment or Rs 25 lakh, whichever is less. If he is unable to do so, he has to make arrangements for underwriting of an equal amount by a merchant banker associated with that issue under intimation to the SEBI.

Due Diligence Certificate: The lead manager is responsible for the verification of the contents of a prospectus/letter of offer in respect of an issue and the reasonableness of the views expressed in them. He has to submit to the SEBI, at least two weeks before the opening of the issue for subscription, a due diligence certificate to the effect that (1) they are in conformity with the documents/materials and papers relevant to the issue., (2) all legal requirements connected with the issue have fully complied with, and (3) the disclosures are true, fair and adequate to enable the investors to make a well-formed decision as to the investment in the proposed issue.

Submission of Documents: The lead managers to an issue have to submit to the SEBI, at least two weeks before the date of filing with the registrar of companies/regional stock exchanges or both, particulars of the issue, draft prospectus/letter of offer, other literature to be circulated to the investors/ share holders and so on to the SEBI. They have to ensure that the modifications/suggestions made by it with respect to the information to be given to the investors are duly incorporated. They have to continue to be associated with the issues till the subscribers have received the share/debenture certificates or the refund of excess application money.

Acquisition of Shares: A merchant banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment either from the client or otherwise. He has to submit to the SEBI complete particulars of any acquisition of securities of a company whose issue is being managed by him within 15 days from the date of the transaction.

Disclosure to SEBI: As and when required, a merchant banker has to disclose to the SEBI: (1) his responsibilities with regard to the management of the issue, (2) any change in the information/particulars previously furnished which have a bearing on the certificate of registration granted to it, (3) the names of the companies whose issues he has managed or has been associated with (4) the particulars relating to the breach of capital adequacy requirements, and (5) information relating to his activities as manager, underwriter, consultant or advisor to an issue.

Procedure for Inspection:

The SEBI can undertake inspection of the books of accounts, records, and documents of a merchant banker to ensure that the books are maintained in the manner required, the provision of the SEBI Act, rules, regulations are being complied with, and to investigate complaints from investors/other merchant bankers/any other person or any matter having a bearing on his activities as a merchant banker and to investigate suo moto in the interest of securities business/investors into the affairs of the merchant banker.

The merchant banker has an obligation to furnish all information called for, allow a reasonable access to the premises, extend reasonable facility for examination of books/records/ documents/computer data and provide copies of the same and give all assistance to the inspecting authority in connection with the inspection.

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.

Another important intermediary in the new issue/ primary market is the underwriters to issue of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organization is an important element of primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers / merchant bankers to the issues.

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 than by 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.

General Obligations and Responsibilities

Furnish Information : When required, a banker to an issue has to furnish to the SEBI the following information : (a) the number of issues for which he was engaged as banker to an issue (b) the number of applications / details of the applications money received (c) the dates on which applications from investors were forwarded to the issuing company / registrar to an issue (d) the dates / amount of refund to the investors.

Books of account/record / documents : A banker to an issue is required maintain books of accounts/ records/ documents for a minimum period of three years in respect of, inter alia, the number of applications received, the names of the investors, the time within which the applications received were forwarded to the issuing company / registrar to the issue and dates and amounts of refund money to investors.

Agreement with issuing companies : Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centers at which application/ application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the baker stating the number of applications and the amount of money received from the investor.

Code of Conduct : Every banker to an issue has to abide by a code of conduct. He should observe high standards of integrity and fairness in all his dealings with clients/ investors/ other members of the profession. He should exercise due diligence. A banker to an issue should always endeavor to render the best possible advice to his clients and ensure that all professional dealings are effected in a prompt, efficient and cost-effective manner.

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

The registrars to an issue, as an intermediary in the primary market, carry on activities such as collecting applications from the investors, keeping a proper record of applications and money received from the investors or paid to the sellers of securities and assisting companies in determining the basis of allotment of securities in consultation with the stock exchanges,
Finalizing the allotment of securities and processing / dispatching allotment letters, refund orders, certificates and other related documents in respect of the issue of capital.

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
.
Code of Conduct: The registrars to an issue and the share transfer agents have to maintain high standards of integrity and fairness in all dealings with their clients and other registrars to
The issue and share transfer agents in the conduct of the business. They should endeavor to ensure that (a) enquiries from investors are adequately dealt with, and (b) adequate steps are taken for proper allotment of securities and refund of application money without delay and as per law. Also, they should not generally and particularly in respect of any dealings in securities to be a party to (a) creation of false market, (b) price rigging or manipulation (c) passing of unpublished price sensitive information to brokers, members of stock exchanges and other intermediaries in the securities market or take any other action which is not in the interest of the investors and (d) no registrar to an issue, share transfer agent or any of its directors, partners or managers managing all the affairs of the business is either on their respective accounts, or though their respective accounts, or through their associates or family members, relatives or friends indulges in any insider trading

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. The certificate of registration for portfolio management services is granted to eligible applicants on payment of Rs.5 lakh as registration fee. Renewal may be granted by SEBI on payment of Rs. 2.5 lakh as renewal fee (every three years).

Contract with clients : Every portfolio manager is required, before taking up an assignment of management of portfolio on behalf of the a client, is enter into an agreement with such clients clearly defining the inter se relationship, and setting out their mutual rights, liabilities and obligations relating to the management of the portfolio of the client. The contract should, inter alia, contains :

i. The investment objectives and the services to be provided.

ii. Areas of investment and restrictions, if any, imposed by the client with regards to investment in a particular company or industry.

iii. Attendant risks involved in the management of portfolio.

iv. Period of the contract and provisions of early termination, if any.

v. Amount to be invested.

vi. Procedure of setting the clients' account including the form of repayment on maturity or early termination of contract.

vii. Fee payable to the portfolio managers

viii. Custody of securities.

The funds of all clients must be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank. He can charge an agreed fee from the clients for rendering portfolio management services without guaranteeing or assuring, either directly or indirectly, any return and such fee should be independent of the returns to the client and should not be on a return sharing basis.

Investment of Clients money: The portfolio manager should not accept money or securities from his clients for less than one year. Any renewal of portfolio fund on the maturity of the initial period is deemed as a fresh placement for a minimum period of one year. The portfolio funds and be withdrawn or taken back by the portfolio clients at his risk before the maturity date of the contract under the following circumstances :

a. Voluntary or compulsory termination of portfolio management services by the portfolio Manager.

b. Suspension or termination of registration of portfolio manager by the SEBI.

c. Bankruptcy or liquidation in case the portfolio manager is a body corporate.

d. Permanent disability, lunacy or insolvency in case the portfolio manager is an individual.

The portfolio manager can invest funds of his clients in money market instruments or as specified in the contract, but not in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies. While dealing with client's money he should not indulge in speculative transactions.

Reports to be furnished to the Clients: The portfolio manager should furnish periodically a report to the client, agreed in the contract, but not exceeding a period of six months Containing the following details :

a. The composition and the value of the portfolio, description of security, number of securities, value of each security held in portfolio, cash balances aggregate value of the portfolio as on the date of report.

b. Transactions undertaken during the period of report including the date of transaction and details of purchases and sales.

c. Beneficial interest received during that period in respect of interest, dividend, bonus shares, rights shares and debentures,

d. Expenses incurred in managing the portfolio of the client and details of risk relating to the securities recommended by the portfolio manager for investment or disinvestments.

So, we discussed so far the intermediaries in security market. Next task of yours would be to submit in writing the latest regulations of SEBI in the regards to various intermediaries.

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

By using this Issue Management Process, you'll also be able to:

- Assign actions to staff to resolve issues
- Monitor the outcome of the actions taken
- Assign roles and responsibilities for managing issues
- Report on the status of issues to management

Your ability to identify and resolve issues as quickly as possible will directly affect the success of your team. This Issue Management Process will help you achieve this, by describing the steps taken to resolve issues swiftly and efficiently.

STAGES INVOLVED PRICING OF PUBLIC ISSUES

To initiate the process the Company to pass a Board Resolution and proceed to appoint a Merchant Banker, with whom an MOU may be entered into. Subsequent sequential steps are as under:

a. Prepare Draft Prospectus. This is to be approved by the Board.
b. A Resolution at a meeting of Shareholder's in terms of Section 81(1A) of the Companies Act, 1956. is also necessary
c. Form 23 to be filed with ROC for passing special resolution for issuing shares as above
d. Appointment of intermediaries and entering into MOU with them (underwriters, Bankers to the Issue, Registrars, brokers to the issue for marketing the same
e. Filing of prospectus with the SEBI/Registrar of Companies: The draft prospectus along with the copies of the agreements entered into with the Lead Manager, Underwriters, Bankers, registrars and Brokers to the issue is filed with SEBI and the Registrar of Companies of the state where the registered office of the company is located along with the fees & other prescribed requirements, (with due diligence by merchant banker)

f. Vetting of prospectus by SEBI as per suggestions, if any, received from SEBI
g. Obtaining in-principle approval from stock exchange
h. File final prospectus with SEBI / stock exchanges / ROC
i. Printing and dispatch of Application forms: The prospectus and application forms are printed and dispatched to all the merchant bankers, underwriters, brokers to the issue.
j. Filing of the initial listing application: A letter is sent to the Stock exchanges where the issue is proposed to be listed giving the details and stating the intent; of getting the shares listed on the Exchange. The initial listing application has to be sent with a fee of Rs. 7,500/-.
k. Statutory announcement: An abridged version of the prospectus and; the Issue start and close dates are published in major English; dailies and vernacular newspapers.
l. Submission of 1% Security Deposit with the Regional Stock Exchange.
m. Depositing Promoter's Contribution in the issue in a separate bank account.

Post-Issue Obligations

a. Processing of applications: After the close of the Public Issue all the application forms are collected, at the Registrars to the issue and scrutinized, tabulated in consultation with the merchant banker.
b. Establishing the liability of the underwriter: In case the Issue is not fully subscribed to, then the liability for the subscription falls on the underwriters who have to subscribe to the shortfall, incase they have not procured the amount committed by them as per the Underwriting agreement.
c. Allotment of shares: after the issue is subscribed to the minimum level. Basis of allotment in consultation with the regional stock exchange. Refer detailed allotment procedure as prescribed by SEBI.
d. Release Post Issue Advertisement
e. Despatch of share certificates / refund orders
f. Listing of the Issue: The shares after having been allotted have to be listed compulsorily in the regional stock exchange and optionally at the other stock exchanges. For this purpose enter into an listing agreement with stock exchange(s). Also obtain permission from Stock Exchanges for listing & trading of securities for Commencement of trading of securities
g. File Form No. 2 for Return of Allotment with ROC
h. Attend to Redressal of Investors Grievances received
i. 78-day post issue monitoring report to be submitted by merchant banker with SEBI.

Guidelines for Allotment

1. Allotment has to be made within 30 days of the closure of the Public Issue and 42 days in case of a Rights issue.
2. Net Offer to the General Public has to be at least 25% of the Total Issue Size for listing on a Stock exchange
3. For listing an IPO on the NSE Paid up capital should be Rs. 20 Crores, secondly the issuer or the promoting company should have a track record of profitability and thirdly the project should be appraised by a financial Institution, banks or Category I merchant bank. For knowledge based companies like IT the paid up capital should be Rs. 5 Crores, but the market capitalization should be at least Rs. 50 Crores.

4. It is mandatory for a company to get its shares listed at the regional stock exchange where the registered office of the issuer is located.
5. In an issue of more than Rs. 100 crores the issuer is allowed to place the whole issue by book building.
6. Minimum of 50% of the Net offer to the Public has to be reserved for Investors applying for less than 1000 shares.
7. All the listing formalities for a public Issue has to be completed within 70 days from the date of closure of the subscription list.
8. There should be at-least 5 investors for every 1 lakh of equity offered.
9. Quoting of permanent Account number or GIR No. in application for allotment of securities is compulsory where monetary value of Investment is Rs.50,000/- or above.
10. Firm Allotment to permanent and regular employees of the issuer is subject to a ceiling of 10% of the issue amount.
11. Indian development financial institutions ad Mutual Fund can be allotted securities upto 75% of the Issue Amount.
12. Allotment to categories of FIIs and NRIs/OCBs is up to Maximum of 24% which can be further extended to 30% by an application to the RBI - supported by a resolution passed in the General Meeting.
13. 10% individual ceiling for each category a) Permanent employees' b) Shareholding of the promoting companies.
14. Securities issued to the promoter, his group companies by way of firm allotment and reservation have a lock-in period of 3 years. However shares allotted to FII's and certain Indian and multilateral development financial institutions and Indian Mutual Funds are not subject to Lock-in periods
15. The minimum period for which a public issue has to be kept open is 10 working days. The minimum period for a rights issue is 15 working days and the maximum 60 working days.
16. A public issue is effected if the issue is able to procure 90% of the Total issue size within 60 days from the date of earliest closure of the Public Issue. In case of over - subscription the company may have the right to retain the excess application money and allot shares more than the proposed issue which is referred to as the 'green-shoe' option.

Difference between Book Building and Public Issue

"Book Building": means a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document. In Book Building securities are offered at prices above or equal to the floor prices, whereas securities are offered at a fixed price in case of a public issue. In case of Book Building, the demand can be known everyday as the book is built. But in case of the public issue the demand is known at the close of the issue

Instances Where Companies are permitted to Make Public Issues only through
Book Building Process

1. An unlisted company can make a public issue of equity shares or any security convertible into equity shares at a later date, only through the book-building process if, it does not comply with the conditions of the Regulation with regards to Net Worth and Track record.

2. its proposed issue size exceeds five times its pre-issue net-worth as per the last available audited accounts either at the time of filing draft offer document with the Board or at the time of opening of the issue
3. Provided that sixty percent (60%) of the issue size shall be allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded.
4. A listed company which does not fulfil the condition given in the proviso to clause 2.3.1 of the Regulation (Net worth & Past Track Record) above, shall be eligible to make a public issue only through the book building process. Provided that sixty percent (60%) of the issue size shall be allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded.
5. A company, whose equity shares or any security convertible at later date into equity shares are offered through an offer for sale, shall comply with the eligibility provisions relating to net worth & past track record Offer for sale can also be made only through the book-building process

Rights Issue

The rights issue involves selling of securities to the existing shareholders in proportion to their current holding. When a company issues additional equity capital it has to be offered in the first instance to the existing shareholders on a pro-rata basis as per Section 81 of the Companies Act, 1956. The shareholders may by a special resolution forfeit this right, partially or fully by a special resolution to enable the company to issue additional capital to the public or alternatively by passing a simple resolution and taking the permission of the Central Government.

Private Placement

A private placement results from the sale of securities by the company to one or few investors. The distinctive features of private placement is that there is no need for a formal prospectus as well as underwriting arrangement. The terms of the issue are negotiated between the company and the investors. The issuers are normally the listed public limited companies or closely held public or private limited companies which cannot access the primary market. The securities are placed normally with the Institutional investors, Mutual funds or other Financial Institutional

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. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. This is the preferred method which is recommended by all major stock exchanges and as a result is followed in all major developed countries in the world.

Book Building Process

The detailed process of book building is as follows:

1. **Appointment of Investment Banker:** The first step starts with appointing the lead investment banker. The lead investment banker conducts due diligence. They propose the size of the capital issue that must be conducted by the company. Then they also propose a price band for the shares to be sold. If the management agrees with the propositions of the investment banker, the prospectus is issued with the price range as suggested by the investment banker. The lower end of the price range is known as the floor price whereas the higher end is known as the ceiling price. The final price at which securities are indeed offered for sale after the entire book building process is called the cut-off price.
2. **Collecting Bids:** Investors in the market are requested to bid to buy the shares. They are requested to bid the number of shares that they are willing to buy at varying price levels. These bids along with the application money are supposed to be submitted to the investment bankers. It must be noted that it is not a single investment banker who is engaged in the collection of bids. Rather, the lead investment banker can appoint sub-agents to tap into their network especially for receiving the bids from a larger group of individuals.
3. **Price Discovery:** Once all the bids have been aggregated by the lead investment banker, they begin the process of price discovery. The final price chosen in simply the weighted average of all the bids that have been received by the investment banker. This price is declared as the cut-off price. For any issue which has received substantial publicity and which is being anticipated by the public, the ceiling price is usually the cut-off price.
4. **Publicizing:** In the interest of transparency, stock exchanges all over the world require that companies make public the details of the bids that were received by them. It is the lead investment banker's duty to run advertisements containing the details of the bids received for the purchase of shares for a given period of time (let's say a week). The regulators in many markets are also entitled to physically verify the bid applications if they wish to.
5. **Settlement:** Lastly, the application amount received from the various bidders has to be adjusted and shares have to be allotted. For instance, if a bidder has bid a lower price than the cut-off price then a call letter has to be sent asking for the balance money to be paid. On the other hand, if a bidder has bid a higher price than the cut-off, a refund cheque needs to be processed for them. The settlement process ensures that only the cut-off amount is collected from the investors in lieu of the shares sold to them.

Partial Book Building

Partial book building is another variation of the book building process. In this process, instead of inviting bids from the general population, investment bankers invite bids from certain leading institutions. Based on their bids, a weighted average of the prices is created and cut-off price is decided. This cut-off price is then offered to the retail investors as a fixed price. Therefore, the bidding only happens at an institutional level and not at a retail level.

This is also an efficient mechanism to discover prices. Also the cost and complications involved in conducting a partial book building are substantially low.

How is Book Building Better Than the Fixed Price Mechanism?

First of all, the book building process brings flexibility to the pricing of IPO's. Prior to the introduction of book building, a lot of IPO's were either underpriced or overpriced. This created problems because if the issue was underpriced, the company was losing possible capital. On the other hand, if the issue was overpriced it would not be fully subscribed. In fact, if it was subscribed below a given percentage, the issue of securities had to be cancelled and the substantial costs incurred over the issue would simply have to be written off. With the introduction of book building process, such events no longer happen and the primary market functions more efficiently.

GREEN SHOE OPTION INITIAL PUBLIC OFFERING PROMOTERS CONTRIBUTION

Green shoe option allows companies to intervene in the market to stabilise share prices during the 30-day stabilisation 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.

Before investing in an IPO, we go through the offer document of the company to know more about it. A listed company is legally bound to abide by commitments made in the document. Besides providing information about the company's competitive strengths, industry regulation, corporate structure, main objects, subsidiary details, risk factors, etc, the offer document also mentions a technical word called "Green shoe option".

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.
- Green shoe option is a clause contained in the underwriting agreement of an IPO. The green shoe option is also often referred to as an over-allotment provision. It allows the underwriting syndicate to buy up to an additional 15% of the shares at the offering price if public demand for the shares exceeds expectations and the stock trades above its offering price.
- From an investor's perspective, an issue with green shoe option provides more probability of getting shares and also that post listing price may show relatively more stability as compared to market.

Origin of the Green shoe

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.

Green shoe option in India

Green shoe options or over-allotment options were introduced by the Securities and Exchange Board of India (SEBI) in 2003 to stabilize the aftermarket price of shares issued in IPOs.

Guidelines for exercising green shoe option

- The guidelines require the promoter to lend his shares (not more than 15% of issue size) which is to be used for price stabilization to be carried out by a stabilizing agent (normally merchant banker or book runner) on behalf of the company.
- The stabilization period can be up to 30 days from the date of allotment of shares to bring stability in post listing pricing of shares.
- After making the decision to go public, the company appoints underwriters to find the buyers for their issue. Sometimes, these underwriters also help the corporate in determining the issue price and the kind of equity dilution i.e. how many shares will be made available for the public.
- But with the turbulent times prevailing in the market place, it is however quite possible that the IPO undersubscribed and trades below its issue price.
- This is where these underwriters invoke the green shoe option to stabilize the issue.

How green shoe option works

- As said earlier, the entire process of a green shoe option works on over-allotment of shares. For instance, a company plans to issue 1 lakh shares, but to use the green shoe option; it actually issues 1.15 lakh shares, in which case the over-allotment would be 15,000 shares. Please note, the company does not issue any new shares for the over-allotment.
- The 15,000 shares used for the over-allotment are actually borrowed from the promoters with whom the stabilizing agent signs a separate agreement. For the subscribers of a public issue, it makes no difference whether the company is allotting shares out of the freshly issued 1 lakh shares or from the 15,000 shares borrowed from the promoters.
- Once allotted, a share is just a share for an investor. For the company, however, the situation is totally different. The money received from the over-allotment is required to be kept in a separate bank account (i.e. escrow account)

Role of the stabilizing agent

- The stabilizing agent starts its process only after trading in the share starts at the stock exchanges.
- In case the shares are trading at a price lower than the offer price, the stabilizing agent starts buying the shares by using the money lying in the separate bank account. In this manner, by buying the shares when others are selling, the stabilizing agent tries to put the brakes on falling prices. The shares so bought from the market are handed over to the promoters from whom they were borrowed.
- In case the newly listed shares start trading at a price higher than the offer price, the stabilizing agent does not buy any shares.

Green shoe option in action

- It is very common for companies to offer the green shoe option in their underwriting agreement. In 2009, most realty companies in India, who were planning to raise funds from the primary market, had opted for green shoe option in their IPOs to stem volatility in share prices following their listing on the exchanges.
- Companies such as Sahara Prime City, DB Realty, Lodha Developers and Ambience had opted for the green shoe option, which helped them stabilize share prices in the event of extreme volatility or prices moving below offer price.

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.

12. Declaration by secretary or director of the company.

SEBI Guidelines for first issue by new companies in Primary Market:

1. A new company which has not completed 12 months of commercial operations will not be allowed to issue shares at a premium.

2. If an existing company with a 5-year track record of consistent profitability, is promoting a new company, then it is allowed to price its issue.

3. A draft of the prospectus has to be given to the SEBI before public issue.

4. The shares of the new companies have to be listed either with OTCEI or any other stock exchange.

SEBI guidelines for Secondary market

1. All the companies entering the capital market should give a statement regarding fund utilization of previous issue.

2. Brokers are to satisfy capital adequacy norms so that the member firms maintain adequate capital in relation to outstanding positions.

3. The stock exchange authorities have to alter their bye-laws with regard to capital adequacy norms.

4. All the brokers should submit with SEBI their audited accounts.

5. The brokers must also disclose clearly the transaction price of securities and the commission earned by them. This will bring transparency and accountability for the brokers.

6. The brokers should issue within 24 hours of the transaction contract notes to the clients.

7. The brokers must clearly mention their accounts details of funds belonging to clients and that of their own.

8. Margin money on certain securities has to be paid by claims so that speculative investments are prevented.

9. Market makers are introduced for certain scrips by which brokers become responsible for the supply and demand of the securities and the price of the securities is maintained.

10. A broker cannot underwrite more than 5% of the public issue.

11. All transactions in the market must be reported within 24 hours to SEBI.

12. The brokers of Bombay and Calcutta must have a capital adequacy of Rs. 5 lakhs and for Delhi and Ahmadabad it is Rs. 2 lakhs.

13. Members who are brokers have to pay security deposit and this is fixed by SEBI.

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.

1 CREDIT RATING OF INDIVIDUALS, COMPANIES AND COUNTRIES

Credit rating is resorted to: a) Companies b) Individuals c) Countries

a) Rating of Individuals: Individuals go for credit rating when they want to borrow from recognized institutions. In India, we have Onida Individual Credit Rating Agency (ONICRA) which gives credit rating for individuals.

b) Rating of Companies: As per the guidelines of SEBI and RBI, companies have to resort to credit rating when they : (i) accept public deposits (ii) issue credit instruments in domestic market (iii) issue credit instruments in overseas market.

c) Rating of Countries: Credit rating is resorted to by countries for borrowing in international market or for attracting foreign investments or for raising funds from the international institutions like IMF and IBRD.

2 Basis of Credit Rating Various aspects are taken into account by a credit rating agency when a borrowing company applies for rating. They are :

a. Business Analysis

b. Evaluation of industrial risks

c. Market position of the company within the industry

d. Operating efficiency of the company

e. Legal position in terms of prospectus

f. Financial analysis based on accounting quality

g. Statement of profits

h. Earnings protection

i. Cash flow and their adequacy

j. Financial flexibility

k. Track record of management

l. Capacity to overcome adverse situations

m. Goals philosophy and strategy

n. Labour turnover

o. Regulatory and competitive environment

p. Asset quality

q. Financial position-interest/tax sensitivity

3 Credit Rating Companies in India

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. In 993, Credit Analysis and Research Ltd. (CARE) was started. 8. The suffix of ―+ (plus) or ―- (minus) signs are used with the rating symbols to indicate the comparative position of the instrument within the group covered by the symbol.

4 Types of Credit Rating We have seen the various rating symbols for different categories of the debt instruments. We can also classify credit rating as *types of credit rating* which are based on different securities. These are: 1. Equity rating 2. Bond rating 3. Promissory note rating

1. Equity Rating

When different companies are issuing shares, equity rating will enable the investor to choose proper equity share on the basis of the credit rating. While judging the equity rating, the past performance of the company, the earning per share and the turn-over of the company will be taken into account. If a loss making company turns into a profit making one, after wiping off its losses, its equity rating will go up. At the same time, if there is a decline in the dividend rate of an existing concern, compared to its previous years, its rating will get a beating.

2. Bond Rating Bonds are issued both by Government as well as by private sector companies. In the international market, rating of bonds will depends on the rate of interest offered and the value of the currency it represents. If the bond is issued in terms of U.S. Dollar or Pound Sterling, its value will be high and the rating will naturally be on the positive side. But the bonds of under developed countries will have lesser credit rating due to high fluctuations in their currency value. Bonds are also issued in the domestic market by both State and Central governments. Even the local governments, such as Corporation, such as Corporations and Boards also issue bonds for raising long-term finance in India; government bonds are preferred to private bonds as there is a guarantee for repayment of the principal and interest amount.

3. Promissory Note Rating In order to raise short-term loans, promissory note are issued by different commercial companies and depending upon their resources, these promissory notes will have credit rating.

But, the issue of promissory notes will have no backing and the person advancing the resources against the promissory notes will undertake greater risks. Depending upon the credit rating, ranging from P1 to P6, promissory notes are preferred as a short-dated instrument. The unutilized resources lying with commercial banks may be invested in promissory notes of a better credit rating so obtained on idle funds.

4. Commercial Papers These are instruments issued by leading non-banking financial companies which can be obtained by companies for raising short-term loans from commercial banks. On due date, commercial banks will present these papers to the NBFC which has issued the commercial paper and funds will be obtained along with interest. Later on, the NBFC will collect the amount from the company which has utilized its commercial paper for raising its short-term loans. In order to enable the commercial banks to discount commercial papers, credit rating is provided to the commercial papers which depends upon the standing of the non-banking financial company NBFC) which is issuing the commercial paper.

5. Sovereign Rating When countries are issuing credit instruments in the international market such as Treasury bills and Bonds, they will be rated according to the economic condition of the country. Generally, the countries in the world are grouped under three categories, viz.,

(a) Countries which are politically and economically well developed.

(b) Countries which are politically stable but economically week.

(c) Countries which are politically and economically unstable or weak. In the first category, we have all the developed countries like U.S.A., U.K., Japan, etc., and their bonds will have high credit rating. In the second category we have countries like India which have slightly lesser credit rating and in the third category we have some of the African countries such as Rwanda, Kenya, Zulu, etc. The credit rating of the third category of countries will certainly be lower. In India, State Bank of India issued in the international market different credit instruments such as *India Resurgent Bonds* and *Millennium Deposits* and they were oversubscribed owing to the reputation of SBI,. All the NRIs throughout the world, could subscribe to these bonds and SBI could raise a substantial amount in terms of foreign exchange.

The Objective and Importance of Credit Ratings

Anytime that you apply for credit, whether it be for a credit card, auto loan or home loan, a lender will review your credit report and determine your credit rating. The higher your rating, the more likely you are to qualify, as well as to nab higher loan amounts and lower interest rates. A high credit rating can offer you a degree of financial freedom that those with a low rating may never see.

Home Loans

Your credit rating will most likely determine whether or not you become a homeowner. Home loans, home equity loans and re-financing are only made available to those with a good credit rating.

Renting

Your credit rating may also impact your ability to rent. When a landlord conducts a background check, he often looks to your credit rating before determining whether or not to approve your application.

Credit Cards

Nowadays, having at least one credit card is almost a requirement. A good credit rating will not only ensure that you can get a credit card, but it may qualify you for instant credit with low interest rates. There are a number of credit card perks for those with a good credit rating.

Purchasing

Some businesses won't accept anything but credit cards. Without a high credit rating and the ability to get a credit card, you may be missing out. For example, many airline companies only accept credit cards on board the aircraft.

Saving Money

A high credit rating may save you thousands each year in interest and other fees.

Advantages of Credit Rating

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. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he decides about the investment. Highly rated issues gives an assurance to the investors of safety of Investments and minimizes his risk.
- Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.
- Freedom of investment decisions. Investors need not seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions on rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.
- Wider choice of investments. As it is mandatory to rate debt obligations for every issuer company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.
- Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable. Credibility of issuer and attracts investors. As rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors.
- In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.
- Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rated security of a
- company.
- Relief from botheration to know company. Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Credit

- rating by professional and specialised analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.
- Advantages of continuous monitoring. Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways.

- Easy to raise resources. A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.
- Reduced cost of borrowing. Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.
- Reduced cost of public issues. A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expenditure on press and publicity. Rating facilitates best pricing and timing of issues.
- Rating builds up image. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns,
- investors feel secured of their investments and creditors are assured of timely payments of interest and principal.
- Rating facilitates growth. Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or through credit from banks and FIs to finance their expansion activities.
- Recognition to unknown companies. Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on ‘name recognition’.

C. Benefits to Intermediaries

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.

Disadvantages of Credit Rating

Credit rating suffers from the following limitations

- **Non-disclosure of significant information**. Firm being rated may not provide significant or material information, which is likely to affect the investor’s decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of such significant information may put investors at a loss.
- **Static study**. Rating is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk inductiveness of rating.
- **Rating is no certificate of soundness**. Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

- **Rating may be biased**. Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.
- **Rating under unfavorable conditions**. Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hampers the company's interest.
- **Difference in rating grades**. Same instrument may be rated differently by the two rating agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

Credit Rating of Instruments

Credit rating is the process of assigning standard scores which summarize the probability of the issuer being able to meet its repayment obligations for a particular debt instrument in a timely manner. Credit rating is integral to debt markets as it helps market participants to arrive at quick estimates and opinions about various instruments. In this manner it facilitates trading in debt and money market instruments especially in instruments other than Government of India Securities.

Rating is usually assigned to a specific instrument rather than the company as a whole. In the Indian context, the rating is done at the instance of the issuer, which pays rating fees for this service. If it is unsatisfied with the rating assigned to its proposed instrument, it is at liberty not to disclose the rating given to it. There are 4 rating agencies in India. These are as follows:

CRISIL - The oldest rating agency was originally promoted by ICICI. Standard & Poor, the global leader in ratings, has recently taken a small 10% stake in CRISIL.
ICRA - Promoted by IFCI. Moody's, the other global rating major, has recently taken a small 11% stake in ICRA.
CARE - Promoted by IDBI.
Duff and Phelps - Co-promoted by Duff and Phelps, the world's 4th largest rating agency.
CRISIL is believed to have about 42% market share followed by ICRA with about 36%, CARE with 18% and Duff and Phelps with 4%.

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.

Credit rating is a dynamic concept and all the rating companies are constantly reviewing the companies rated by them with a view to changing (either upgrading or downgrading) the rating.
They also have a system whereby they keep ratings for particular companies on "rating watch" in case of major events, which may lead to change in rating in the near future. Ratings are made public through periodic newsletters issued by rating companies,which also elucidate briefly the rationale for particular ratings. In addition, they issue press releases to all major newspapers and wire services about rating events on a regular basis.

Symbols of rating and grade

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.

[ICRA]AAA 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.

[ICRA]AA 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.

[ICRA]AA 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.

[ICRA]A Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

[ICRA]BBB Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

[ICRA]BB Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations

[ICRA]B Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

[ICRA]C Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.

[ICRA]D Instruments with this rating are in default or are expected to be in default soon.

ICRA's Medium-Term Rating Scale (only for Public Deposits)

Medium-Term Rating Scale All Public Deposit Programmes.

MAAA The highest-credit-quality rating assigned by ICRA. The rated deposits programme carries the lowest credit risk.

MAA The high-credit-quality rating assigned by ICRA. The rated deposits programme carries low credit risk.

MA The adequate-credit-quality rating assigned by ICRA. The rated deposits programme carries average credit risk.

MB The inadequate-credit-quality rating assigned by ICRA. The rated deposits programme carries high credit risk.

MC The risk-prone-credit-quality rating assigned by ICRA. The rated deposits programme carries very high credit risk.

MD The lowest-credit-quality rating assigned by ICRA. The rated instrument has very low prospects of recovery.

ICRA's Short-Term Rating Scale
Short-Term Rating Scale All instruments with original maturity within one year.

[ICRA]A1 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.

[ICRA]A2 Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.

[ICRA]A3 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.

[ICRA]A4 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.

[ICRA]D Instruments with this rating are in default or expected to be in default on maturity.

ICRA's Issuer Rating Scale - Long Term
for assessing the general creditworthiness of the rated entities relation to their senior unsecured obligations. ICRA's Issuer ratings are not specific to any particular debt instrument issued by the rated entities.

IrAAA The highest-credit-quality rating assigned by ICRA. The rated entity carries the lowest credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrAA The high-credit-quality rating assigned by ICRA. The rated entity carries low credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrA The adequate-credit-quality rating assigned by ICRA. The rated entity carries average credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrBBB The moderate-credit-quality rating assigned by ICRA. The rated entity carries higher than average credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrBB The inadequate-credit-quality rating assigned by ICRA. The rated entity carries high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrB The risk-prone-credit-quality rating assigned by ICRA. The rated entity carries very high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrC The lowest-credit-quality rating assigned by ICRA. The rated entity carries extremely high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

lrD The rated entity is in default or is expected to be in default soon. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

Note *For the Rating categories IrAA through to IrC the sign of + (plus) or – (minus) may be appended to the Rating symbols to indicate their relative position within the Rating categories concerned. Thus the Rating of IrAA+ is one notch higher than IrAA, while IrAA- is one notch lower than IrAA.*

ICRA's Issuer Rating Scale - Short Term
for assessing the general creditworthiness of the rated entities relation to their senior unsecured obligations. ICRA's Issuer ratings are not specific to any particular debt instrument issued by the rated entities.

lrA1 The very-strong-credit quality rating assigned by ICRA. The rated entity carries the lowest credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrA2 The strong-credit-quality rating assigned by ICRA. The rated entity carries low credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrA3 The moderate-credit-quality rating assigned by ICRA. The rated entity carries higher credit risk as compared to entities rated in the two higher categories. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrA4 The low-credit-quality rating assigned by ICRA. The rated entity carries very high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

lrD The rated entity is in default or is expected to be in default soon . The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

Note *For the Rating categories IrA1 through to IrA4 the sign of +(plus) may be appended to the Rating* *symbols to indicate their relative position within the Rating categories concerned. Thus the Rating of IrA1+ is one notch higher than IrA.*

Structured Finance Rating

Long term structured finance instruments. The instruments with original maturity exceeding one year

[ICRA]AAA(SO) 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.

[ICRA]AA(SO) 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.

[ICRA]A(SO) Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

[ICRA]BBB(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

[ICRA]BB(SO) Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

[ICRA]B(SO) Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

[ICRA]C(SO) Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

[ICRA]D(SO) Instruments with this rating are in default or are expected to be in default soon.

The Structured Finance ratings assigned by ICRA also factor in the estimate of the relative potential loss to the investor (taking into account credit enhancements, if any) over the tenure of the rated instrument.

Note *Modifiers{"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories [ICRA]AA(SO) to [ICRA]C(SO). The modifiers reflect the comparative standing within the category.*

Short term structured finance instruments. The instruments with original maturity of upto one year

[ICRA]A1(SO) Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such instruments carry lowest credit risk.

[ICRA]A2(SO) Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such instruments carry low credit risk.

[ICRA]A3(SO) Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

[ICRA]A4(SO) Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such instruments carry very high credit risk and are susceptible to default.

[ICRA]D(SO) Instruments with this rating are in default or expected to be in default on maturity.

The Structured Finance ratings assigned by ICRA also factor in the estimate of the relative potential loss to the investor (taking into account credit enhancements, if any) over the tenure of the rated instrument.

Note *Modifier {"+" (plus)} can be used with the rating symbols for the categories [ICRA]A1(SO) to [ICRA]A4(SO). The modifier reflects the comparative standing within the category.*

ICRA Mutual Fund Credit Risk Ratings Scale & Definitions
The Structured Finance ratings assigned by ICRA also factor in the estimate of the relative potential loss to the investor (taking into account credit enhancements, if any) over the tenure of the rated instrument.

ICRA’s Long-Term Debt Fund Credit Risk Rating Scale
This scale is used to rate the underlying credit risk of debt funds portfolio on the long term rating scale

[ICRA]AAA mfs 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.

[ICRA]AAmfs 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.

[ICRA]Amfs 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.

[ICRA]BBBmfs 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.

[ICRA]BBmfs Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.

[ICRA]Bmfs Schemes with this rating are considered to have high risk of default regarding timely receipt of payments from the investments that they have made.

[ICRA]Cmfs 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.

Note *Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories [ICRA]AAmfs to [ICRA]Cmfs. The modifiers reflect the comparative standing within the category.*

ICRA's Short-Term debt fund Credit Risk Rating Scale
This scale applies to debt funds with weighted average maturity up to one year. Such funds would generally include liquid funds and cash funds. Benchmark maturity for this scale is 12 months.

[ICRA]A1mfs 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.

[ICRA]A2mfs Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.

[ICRA]A3mfs Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.

[ICRA]A4mfs Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

Note *Modifiers {"+" (plus)} can be used with the rating symbols for the categories [ICRA]A1mfs to [ICRA]A4mfs. The modifier reflects the comparative standing within the category.*

Rating Scale for Claims paying ability of Insurance Companies

iAAA Highest claims paying ability. Indicates fundamentally strong position. Prospect of meeting policyholder obligations is the best.

iAA High claims paying ability. Risk factors are modest and may vary slightly. Prospect of meeting policyholder obligations is high and differs from iAAA only marginally.

iA Adequate claims paying ability. Prospect of meeting policyholder obligations is adequate. The risk factors are more variable and greater in periods of economic stress and any adverse changes in business/economic circumstances as may be visualised, may alter the fundamental strength.

iBBB Moderate claims paying ability. The protective factors are below average and adverse changes in business/ economic circumstances are likely to affect the prospect of meeting policyholder obligations.

iBB Inadequate claims paying ability. The protective factors fluctuate in case of changes in business/economic conditions and prospects of meeting policyholder obligations are more likely to be affected by such changes.

iB Weak claims paying ability. Risk factors indicate that policyholders obligations may not be met when due. Adverse changes in business/ economic conditions could result in inability/unwillingness to service policyholder obligations.

iC Lowest claims paying ability. Indicates fundamentally poor position. Such companies may often be in default on policyholder obligations and may be or are likely to be placed under supervision of insurance regulators.