EduTap

SUMMARY SHEET

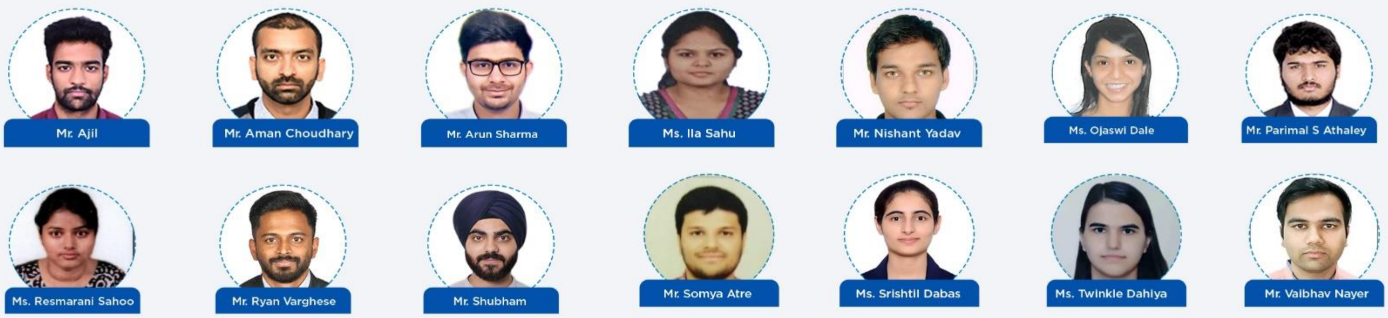
Alternate Sources of Finance

EduTap

EduTap Hall of Fame

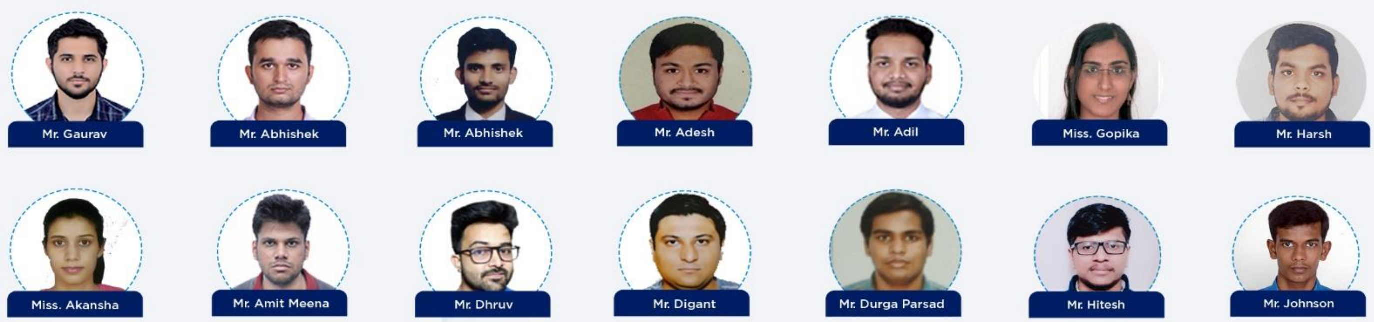
RBI Grade B 2020 - 21

198 Selections Out of 257



SEBI Grade A 2020

63 Selections Out of 80



NABARD Grade A 2020

65 Selections Out of 69

Important Points

1. This Summary Sheet shall only be used for Quick Revision after you have read the Complete Notes
2. For Building Concepts along with examples/concept checks you should rely only on Complete Notes
3. It would be useful to go through this Summary sheet just before the exam or before any Mock Test
4. Questions in the exam are concept based and reading only summary sheets shall not be sufficient to answer all the questions

1 Summary Points

- **Leasing (Asset based Lenders) -** It is an agreement between two parties – the user (lessee) and the owner (lessor). The lessor grants the lessee right to use the property of the lessor for a defined period. The lessee just has the rights to use but does not have the ownership rights. In return Lessee agrees to pay series of fixed payments to the lessor. Lessor is also called Asset based lender in this case

  Types of Leasing – Financial Lease, Operating Lease, Sale and Lease Back, Direct Lease, Single Investor Lease, Leveraged Lease, Domestic Lease, International Lease
  - **Operating lease** is one of the short-term and cancelable leases. It is also called as service lease. The asset is returned to the lessor after the lease period comes to an end
  - **Financial lease**: It is also called as full payout lease. It is long term lease period. For example, lease for 100 years. During the lease period the ownership remains with the lessor but the ownership is transferred to the lessee after the lease period
  - **Direct lease:** When the lease belongs to the owner of the assets and users of the assets with direct relationship it is called as direct lease
  - **Sale and lease back:** It is a lease under which the owner sells an asset for cash to a prospective leaser and then leases back the same asset, making fixed periodic payments for its use

- **Single investor lease:** When the lease belongs to only two parties namely leaser and lessee it is called as single investor lease
- **Leveraged lease:** This type of lease is used to acquire the high level capital cost of assets and equipment's. Under this lease, there are three parties involved; the leaser, the lender and the lessee. Under the leverage lease, the leaser acts as equity participant supplying a fraction of the total cost of the assets while the lender supplies the major part.
- **Domestic lease:** In the lease transaction, if both the parties belong to the domicile of the same country it is called as domestic leasing

➢ **Franchising:** Under this model the Company (Franchisor) which does not have capital to expand, give the franchise rights (right to run a local business under the brand name of the franchisor) to an individual or a company(Franchisee)

Types of Franchise – Product Franchise, Management Franchise and Business Format Franchise

➢ **Factoring**: Through this process, a service provider will give you the money on invoices that have been billed out, which you then pay back once the customer has settled the bill.

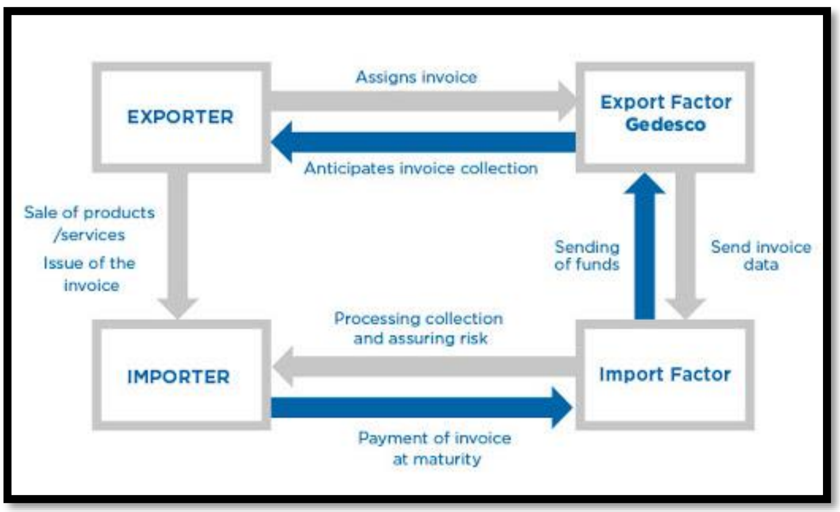
- There are three parties directly involved: **the *factor*** who **purchases the receivable**, **the one who sells the receivable, and the debtor who has a financial liability that requires him or her to make a payment to the owner of the invoice**
- The ***sale* of the receivable transfers ownership of the receivable to the factor**, indicating the factor obtains all of the rights associated with the receivables
- Notified Factoring is one in which the debtor is informed about change in Ownership of the receivables where as in non-notified factoring the debtor is not informed on the same
- If the factoring transfers the receivable "**without recourse**", the factor (purchaser of the receivable) must bear the loss if the account debtor where as in **with recourse** factoring the seller is responsible for any nonpayment by debtor
- There are four principal parts to the factoring transaction
  - "**Fee**" paid to the factor
  - The **Interest Expense** paid to the factor
  - The "**bad debt expense**" for nonpayment by debtor
  - The "**factor's holdback receivable**" amount to cover merchandise returns

- The Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 to examine the feasibility and mechanics of starting factoring organizations in India

- The government of India enacted the Factoring Regulations Act, 2011 to bring in the much-needed legal framework for the factoring business. The Act also specifies that any entity conducting the factoring business would need to be registered with the RBI as NBFCs

➢ **Domestic and International Factoring**: Under domestic factoring, the receivables arising out of only domestic trade shall be considered for factoring. Usually, the factor makes 80% of the payment upfront and the rest is issued after the factor obtains the amount from debtor. The max debt period normally permitted under factoring is 150 days inclusive of max grace period of 60 days

Under International Factoring, the receivables arising out of only international trade are considered for Financing. In International factoring there are normally 2 factors – Factor in the import country and factor in the export country.



1. The exporter sells the goods to the importer
2. The importer issues invoice to the exporter
3. The exporter produces the invoice to the export factor
4. The export factor disburses amount to the exporter
5. The export factor send invoice to the import factor who is in foreign country
6. The import factor on due date will collect the payment from the importer
7. The importer will send the funds to the export factor in domestic country

➢ **Forfeiting:** Forfeiting is similar to factoring which allows exporters to obtain cash by selling their receivables from the foreign country at some discount.

Forfeiters only work with exporters unlike in factoring where transaction can take place with any entity

Forfeiting is always without recourse whereas Factoring can be with or without recourse.

In forfeiting, 100% of payment is made by the factor upfront to the exporter after deducting commission and exporter does not have any risk since it is always without recourse.

- **<u>Peer To Peer Platform:</u>** Online P2P sites seek to connect interested lenders with borrowers, thereby eliminating intermediaries and costs.

  Borrowers can raise the money mostly without the need for collaterals and at much lower rates compared to banks, while investors that are sitting on idle cash have the option to get returns that are very lucrative.

  The Platform provides a credit rating to the individual who wants to borrow money. The platforms provide services such as details of credit history of a borrower or collecting interest payments from the borrower.

  For this the platforms charges a fee from both the lender and borrower

  <u>RBI's Regulation of Peer to Peer Platforms</u>
  RBI Now Regulates Peer to Peer Platforms and they are categorized P2P NBFCs

- **<u>Crowd Funding</u>**: These platforms allow businesses to pool small investments from a number of investors instead of having to look for a single investment

  Since investments are made from large number of people and hence the name crowd funding

  Two Main types of Crowdfunding – Reward and Equity Crowdfunding

  - **Rewards crowdfunding**: entrepreneurs presell a product or service to launch a business concept without incurring debt or sacrificing equity/shares
  - **Equity crowdfunding: Equity crowdfunding** is the online offering of private company securities to a group of people for investment and therefore it is a part of the capital markets.

- **Debt Based Crowdfunding**: The concept discussed in Peer to Peer lending is called Debt based Crowdfunding
- **Litigation Funding**: This is done basically to fund a litigation for a common cause
- **Charity donation-based crowdfunding** is the collective effort of individuals to help charitable causes.

- **Angel Investors:** group of individuals or an individual itself who invest their own money in the early (concept) Stages of the company and in return take a share in the company

  They invest typically less money than the Venture Capitalists and they are They are not involved much in the functioning of the company.

- **Venture Capitalists:** They are professional managing money of corporates , pension funds and individuals which is invested into the companies requiring funding and are high potential.

  They are not much into funding at early stages of the business though if the concept is really good they might invest in early stage also. They invest huge amounts of money, much larger than Angel Investors.

  When they invest, they also designate people on the board of the company (they are fully involved in the functioning of company) and people who have the industry knowledge to work on a daily basis in the operations of the company.

1.8.1 Difference between VC and Angel Investor

Angel Investor	VC
Amount Invested is less	Amount Invested is high
Invest in Start Ups	Invest in little established business
Not Involved Much in day to day functioning	Involved fully in the board and daily operations of the company
Decide quickly on the investment decision	Takes huge amount of time to take decision on investing

- **Public Equity:** In this process the equity (Share in business) is offered to general public (Individual People or Corporates like pension funds, mutual funds) through Initial Public Offering (IPO).

It's only possible for companies with established business model looking for capital for further growth

- **Advantages and Disadvantages of Leasing**

Advantages

(i) **No Large Outlay:** Leasing could provide 100% financing as the lessor buys the equipment and leases to the lessee. The lessee need not make large cash payments for the purchase of the needed equipment.

(ii) **Tax Advantages:** Lease rentals are considered as an operating cost, which means that it is possible to deduct them from taxable profits (as a trading expense).

(iii) **Budgeting:** As a lease agreement is almost always a fixed contract, it is relatively easy to budget and forecast with.

(iv) **Hedge Against Risk of Obsolescence**: In an operating lease, the obsolescence risk is borne by the lessor. Likewise, the lessee is saved of the trouble of having to dispose of the asset that he is not using—by simply terminating the contract or returning it to the lessor.

(v) Inflation-friendly: Leasing is fixed-rate financing; Even though the costs go up over the years, the lessee pays the same agreed rate and the equal monthly-lease rentals.

Disadvantages of Leasing

(i) **No Ownership:** the main disadvantage of leasing is that business will never own the asset. It remains the property of the leasing company during and after the lease.

(ii) **Long-term Expense:** As lease cannot be terminated before the original term is completed, it can pose a major financial problem for the lessee when the business experiences a downturn.

(iii) **Cost of Maintenance**: In leasing, the lessee is responsible for maintaining the equipment, as specified by the terms of the lease, and failure to do so can prove costly to him.

(iv) **Restrictions on Use of Equipment:** Sometimes, the lease agreement may pose some restrictions on the use of the equipment, thereby making it uneconomical for the lessee.

- **Advantages and Disadvantages of Franchising**

Advantages of Franchising

1. **Rapid expansion**: In traditional business models, the promoters would require large amounts of capital or bank loan to expand their business. However, in a franchise model, the franchisee provides the capital and the franchisor provide the

brand and technical know-how to quickly expand with the minimum capital requirement.

2. **Local business knowledge**: India is a diverse country having different cultures, languages, and market. Therefore, most businesses do not have enough business, legal, or real estate knowledge and experience to invest across States and cities in India. However, in franchising, the franchisors have the ability to work with the franchisees to become aware of the knowledge about local market conditions.
3. **Branding**: The franchise business is typically better advertised and branded when compared to traditional business. Also, in the case of a franchise business, since advertising or branding cost is shared by all the franchisees, the overall cost of branding is lower in a franchise model.
4. **Minimal risk for franchisee**: Since the franchisor puts all the effort in promoting the brand, the franchisee is exposed to minimal risk. Further, in a franchise model, since the business model is also proved, the business risk for a franchisee is minimized.
5. **Training and technical know-how**: In a franchising business, the franchisor provides the franchisee with training and technical know-how by the franchisor. Therefore, it prevents the chances of costly mistakes due to lack of training on the part of the franchisee.

Disadvantages of Franchising

1. **Non-Independence of franchisee**: In a franchise model, though the franchisee is an owner of a business, the franchisee cannot act independently. The franchisor regulates the franchisees, and it is necessary to submit various reports to the franchisor.
2. **Commitment or lock-in period**: Typically, franchisees are made to commit to the franchisor a lock-in period until which they would be mandatorily expected to operate the business irrespective of profits or loss. During the lock-in period, the franchisee will not be allowed to change the business model or change franchisor.
3. **Negative publicity**: In case the franchising business gets negative publicity due to the actions of the franchisor or another franchisee, the entire brand would suffer. This could lead to loss of sales or customers for a franchisee that was not involved in that act as well.

- **Advantages and Disadvantages of Factoring**

Advantages of Factoring:

1) Immediate Cash Inflow: This type of finance shortens the cash collection cycle. It provides swift realization of cash by selling the receivables to a factor.

2) Attention towards Business Operations and Growth: By selling off invoices, business managers can feel stress-free of the task of collection from the customers. Resources employed in the receivables department can be directed towards business operations, financial planning, and future growth.

3) Evasion of Bad Debts: Factoring is of two types – with recourse and without recourse. Under without recourse factoring, in case of bad debts, the loss is borne by the factor. Hence, the seller is under no obligation to the factor once it sells off its receivables.

4) No Requirement of Collateral: The advances are extended on the basis of the strength of accounts receivables and their credit healthiness. Unlike cash credit & overdraft, factors do not require any collateral security to be pledged/hypothecated. New businesses, startups can easily avail the advances provided they have strong receivables.

Disadvantages of Factoring

1) Reduction of Profit: The factor deducts a certain discount from the value of accounts receivable as fees for the services offered. Consequently, profit of an entity is reduced by a significant margin.

2) Reliability of Customer's Credit: The factor assesses and evaluates credit wellness of the party who owes bills receivables. This is a critical factor which is outside the control of the seller. A factor may refuse to extend advances due to poor credit ratings of the concerned party.

3) Presence of Contingent Liability: The liability of the seller is not completely waived in case of with recourse factoring. If a party fails to pay its debts to the factor, the factor is legally entitled to recover it from the seller.

4) Higher Finance Charges: Factors usually deduct 2% to 4% of the total amount involved as their fees for the duration of 45-60 days. Computing it annually, the cost of finance turns out to be around 18% to 24% p.a. which is very higher than other sources of finance.

- **Advantages and Disadvantages of Forfeiting**

Advantages of Forfaiting

- Forfaiting ensures immediate cash to the exporter who is protected from the risk of non-payment by the importer, as well as it eliminates collection cost.
- It is a way of earning for the commercial bank, which purchases the instrument yielding high return, can earn a good amount when the currency is appreciated.
- As the banks of both exporter and importer are involved, the risk becomes exceptionally low.
- Forfaiting makes the transaction easy by converting the credit sale into cash sale.
- It is flexible in nature, in the sense that the forfeiter can customize the offering according to the requirement of the seller of the capital goods. As well as it can be changed to a number of international transactions.

Disadvantages of Forfaiting

- Only major selected currencies are taken for forfaiting, as they possess international liquidity.
- Forfaiting reduces the risk for exporters; however, it is more expensive as compared to the basic financing provided by the banks or financial institutions, which results in higher export cost.
- The higher export cost is borne by the importer, which is included in the standard pricing.
- Not all the transactions can avail the forfaiting facility. Meaning that transactions more than equal to a definite sum are eligible for forfaiting.

➢ **Advantages and Disadvantages of Peer-to-Peer Lending**

Advantages of P2P lending:

1. **Accessibility**: Surveys of P2P borrowers reveal that the convenience of using a web-base to get credit is the highest ranked benefit of P2P-lending.
2. **High Returns to lenders**: In P2P lending, Returns are high, in double digits. This is much higher than bank deposits or debt mutual funds.
3. **Lower administration cost and enhanced efficiency**: The advantages are seen mainly as lower transaction costs in the loan application process and a much shorter time span, when compared to bank loans, from first contact until the loan pay-out is received. Lower transaction costs are a result of 24/7 accessibility of the platform, reduced bureaucracy and documentation requirements, and a simple and transparent application process.
4. **No mandatory collateral**: Corporate borrowers could obtain P2P loans without providing collateral.

5. **Cheaper credit**: Due to low administration cost, P2P can provide cheaper credit than banks.
6. **Extra flexibility that P2P offers over banks**: Most platforms allow borrowers to cancel loan contracts prematurely without paying a prepayment penalty.

Disadvantage of P2P lending:

1. **Lack of legal disclosure of risks for lenders**: There are no legally defined disclosure standards to ensure that lenders have a clear and accurate understanding of the risks associated with using a specific P2P platform.
2. **No uniform standards to calculate profit returns**: The methods used for calculating the risk-adjusted net returns differ considerably from platform to platform because national laws and regulators have yet to define a common standard for measuring the performance of P2P-loan investments.
3. **Lack of disclosure about platforms and borrowers**: There are no disclosure standards for information about borrowers or platforms' credit assessment methods. This makes it impossible for investors to assess and compare the quality of platforms and so make a careful selection of the "right" platform.
4. **Lack of transparency regarding credit assessment**: There is lack of transparency about how platforms assess credit. Borrowers may not know what kind of data their platforms are using and how credit ratings are calculated.

- **Advantages and Disadvantages of Crowdfunding**

Advantages of Crowdfunding:

1. **Reduced financial risks**: Crowdfunding enables small businesses to test the viability of their business ideas before making huge investments. With crowdfunding, you can test the market and get some feedback before spending heavily.
2. **Validates business idea**: A successful campaign provides social proof for your business idea. It eliminates any doubts by proving that there is a demand for your products and services.
3. **Raises a lot of money**: Crowdfunding can raise enough capital to kick start your venture.
4. **More than financial support**: Sharing your idea attracts not only funding but also expert guidance and feedback on how to better your ideas.
5. **Brand promotion**: Investors will continually track the progress of your business, unconsciously promoting your brand in their networks.

Disadvantage of Crowdfunding:

1. **Takes a lot of time and effort**: Successful campaigns require a lot of personal devotion, in terms of time, effort, and money. You will spend a lot of time and money creating prototypes, convincing videos, and persuasive content to sell your idea.
2. **Possibility of failure**: The sad reality is that only a fraction of crowdfunding campaigns meets their desired goals. If you fail, you may have to deal with bad publicity and embarrassment.
3. **Theft of idea**: Unless your crowdfunding idea is patented and you have all the copyrights and trademarks in place, someone could steal it. Some individuals could steal your idea and build a better version (or just market it more successfully).
4. **Lack of regulatory Framework:** Without a proper legal framework, the likelihood of scam, fraud or an abuse of fund is high.

➢ **<u>Comparison between different types of Funding</u>**

Funding Type	**Benefit**	**Drawback**	**Suitable for**
Leasing	Property Is not sold but still finance is arranged	Not any as such	Person needing finance and having idle lying property
Franchising	Growth without much investment	Franchisee eats into the profits	Established brands looking for growth in local area without investment
Factoring	Credit for payments due in future	Fees may be charged from lender	Companies having poor cash flows and problems with working capital
Forfeiting	Credit for payments due in future in foreign countries and thus eliminating the risk	Fees may be charged from lender which can be high	Companies having poor cash flows or wants to eliminate the risk of payment from foreign country
Peer to peer	Gets best interest rate after comparison	Risk for the investor that he does not know the risk involved in the business	Small business which are deemed to be risky
Crowd Funding	Flexible funding timelines and not much pressure to perform	Not much guidance from the funders	Where angel Investors and VC's do not agree for funding or funding is required for social cause

Angel Investors	Some coaching and contacts	Some meddling by investors and regular results reporting	Early in the company concept stage
VC's	Don't have to pay the money back. VCs can also bring advice and partners	VCs involvement in the company may challenge management	Early stage typically before you want to make big but have a proven model
Public Equity	Access to Large amount of Capital Public Investors do not interfere in day to day activities	Lot of money and effort spent on accounting and reporting Effort spent on managing/Informing the stock exchanges	Companies which are profitable and has sustained business model Large Amount of Money

Private and Social Cost Benefit

- **Private Costs:** Private costs are the costs borne by those who are directly involved in the decision to produce a product. In the case of a XYZ company, private costs will include, for example, the cost of transporting the wood and the cost of labor

- **Private Benefits**: Private benefits are the benefits received by those directly involved in the consumption and production of a product. The private benefit for XYZ Company would be revenue earned from selling the wood

  Company XYZ might only consider private costs and benefits and as long as the private benefits exceeds the cost, the company will keep on cutting the trees

- **External Costs**: The negative effects on third parties, due to the consumption and production activities of others, are known as external costs. In case of company XYZ, external costs due to cutting of trees may include damage to wildlife habitats, loss of plant species that could be used to develop medicines, global warming and interference with the lifestyle of local tribes

- **External Benefits**: The positive effects on third parties, due to the consumption and production activities of others, are known as external benefits. In Case of company XYZ, external benefits may include reduced transport costs and reduced transport time for tourist firms in the area due to construction of roads by company XYZ

- **Social costs** are the total costs of an economic activity to society. The social cost of cutting down trees in the wild life forest, will consist of both external and private costs. When social costs exceed private costs, there are external costs involved

Social Costs = Private Costs + External Costs

Social Benefit = Private Benefit + External Benefit

- **Social benefits** are the total benefits to the society, arising from an economic activity. They include both private and external benefits. Again, where social benefits are greater than private benefits, external benefits exist

The level of output which will cause maximum benefit to the society and not only individual will occur when the social benefit of the last unit produced is equal to the social cost of that unit. If the social cost exceeds the social benefit, it implies that too many resources are being devoted to the production of the product

<u>Peer to Peer Lending Regulation</u>

RBI issued directions related operating as Peer-to-Peer lending companies. So, Peer to Peer lending companies is now regulated by RBI and they are designated as NBFCs- P2P. The regulations passed by RBI related to this are called Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017.

- **Eligibility Criteria**
  1. No non-banking institution other than a company shall undertake the business of Peer-to-Peer Lending Platform
  2. No NBFC-P2P shall commence or carry on the business of a Peer-to-Peer Lending Platform without obtaining a Certificate of Registration
  3. **Net owned fund of not less than rupees twenty million** or such higher amount as the Bank may specify
  4. **The company is incorporated in India**

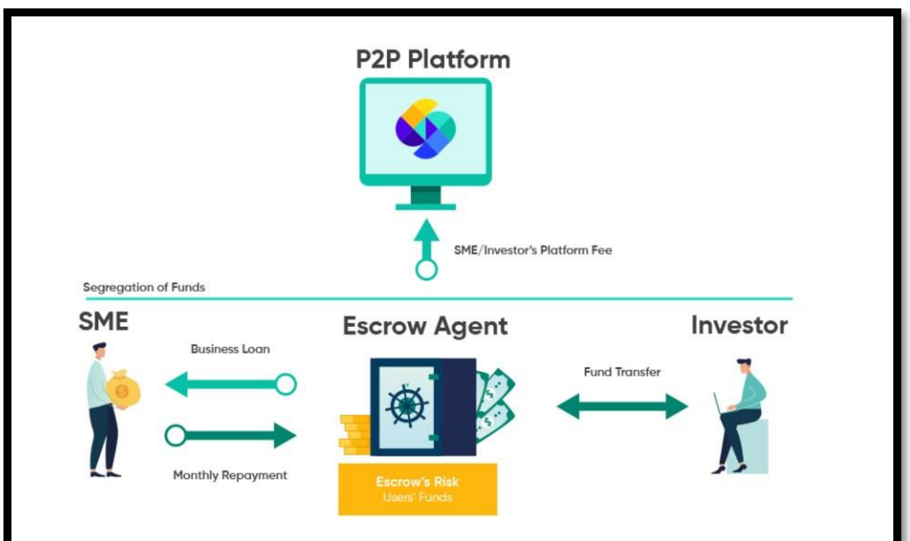
- **Restrictions on NBFCs P2Ps**
  1. It cannot raise Deposits
  2. Cannot Lend Own its Own. They can just facilitate one party lending to another party

3. Cannot Provide any Guarantee to the Lender
4. Funds received from lenders or borrowers are not shown as assets or liabilities in its balance sheet
5. Cannot Sell Any Other Product except for Loan Insurance Products
6. International flow of funds is not permitted

- **Scope of Activities**
  1. undertake credit assessment and risk profiling of the borrowers and disclose the same to their prospective lenders
  2. undertake documentation of loan agreements and other related documents
  3. help in disbursement and repayments of loan amount
  4. render services for recovery of loans originated on the platform

- **Prudential Requirements**
  1. NBFC-P2P shall maintain a Leverage Ratio **not exceeding 2**
  2. Aggregate exposure of a lender to all borrowers at any point of time should **not exceed 50,00000**
  3. The lender investing more than **₹10,00,000 across P2P platforms** shall produce a certificate to P2P platforms from a practicing Chartered Accountant certifying **minimum net-worth of ₹50,00,000**
  4. The exposure of single lender to single borrower at any point of time **should not exceed 50,000**
  5. The **aggregate loans taken by a borrower** at any point of time, across all P2Ps, shall be subject to a **cap of ₹ 10,00,000/-.**
  6. The maturity of the loans shall **not exceed 36 months**

- **Fund Transfer mechanism**



I. P2P lending Company will not be involved in transaction such as taking money from lender in its own account and giving the same to the borrower

II. As per the guidelines, the transfer of funds under P2P lending happens through an escrow account mechanism, which is operated by a bank promoted trustee. It requires at least two escrow accounts, one for funds received from lenders and pending disbursal, and the other for collections from borrowers, be maintained

III. Escrow is the use of a third party capable of holding assets on behalf of two parties who are in the process of completing a transaction. The asset could be money, funds, stocks etc. The third-party holds these, often called the **escrow agent**, until instructions regarding disbursement are received, or as per predefined timeline. Thus, an escrow account is the third-party account which holds the asset until the conclusion of a specific event or time. In a transaction where escrow account is used, the following activities take place,

- The buyer and the seller agree on the terms and conditions
- The buyer pays the amount into the escrow account
- The seller performs the service/ships the goods
- The buyer receives the same
- The escrow releases the amount in favor of the buyer

➢ **Requirement to obtain prior approval of the RBI for allotment of shares, acquisition, or transfer of control of NBFC-P2P**

I. If anybody acquires shares in NBFC-P2P such that the **aggregate holding becomes 26 percent or more, then the same should be done after approval from the RBI. There is an exception:** Prior Approval may not be required if the aggregate holding becomes 26% due to buyback of shares

II. Any change in control of NBFC-P2P irrespective of change in management**, then the same should be done after approval from the RBI**

III. Any change in the management of the NBFC-P2P which would result in change in more than 30 per cent of the Directors, excluding independent Directors **then the same should be done after approval from the RBI**

IV. Any change in shareholding that will give the acquirer a right to nominate a director, **then the same should be done after approval from the RBI**

V. **The NBFC-P2P shall submit the following on quarterly basis, the number and amount of loans**

   a. disbursed during the quarter
   b. closed during the quarter and
   c. outstanding at the beginning and at the end of the quarter, including the number of lenders and borrowers outstanding as at the end of the quarter

VI. Number of complaints outstanding at beginning and at end of quarter, and disposed of during the quarter bifurcated as received from Lender and Borrower.