Financial Services

Definition

- They cater to the needs of financial institutions, financial markets and financial instruments which are geared to serve individual and institutional investors.
- The functioning of financial system greatly depends on the range of financial services extended by the financial institutions, as well as their efficiency and effectiveness.
- Financial services sector is regulated by SEBI through a plethora of legislations

Fund based services

- The firm raises funds through equity, debt, and deposits
- They invest these funds in securities or lend to those who are in need of capital
- The fund based services are as follows:
    - Leasing
        - Leasing is a contract where the owner of a particular asset allows another party to use the asset in return for some rent
        - The cost of the asset is recovered by periodic rental and the final sale of the asset
        - The lessor is the person owning the asset
        - The lessee is the person renting the asset
        - The lessee is responsible for the maintenance of the asset
    - Hire purchase
        - Hire purchase is hybrid instrument and an alternative to bank financing the purchase of a particular asset
        - The hirer (purchaser) will pay the amount of the asset in equal periodic instalments over a period of time
        - Usually used for financing consumer durables
    - Housing finance
        - Housing is the basic need of society and plays a vital role in socio-economic development of country
        - In today's time, the costs of the houses are so high that a person's savings are not adequate to buy a house
        - To take advantage of this situation, lending institutions (house loan institutions) compete with each other for market share by offering attractive schemes to customers
        - These attractive schemes include lower interest rates, longer payment period, liberal requirements etc.
    - Credit cards
        - Credit cards are plastic money, and aid purchase of products without having to render cash immediately
        - The convenience and safety adds values to these credit cards
        - It is a document that can be used to purchase all kinds of goods and services in the world without having to pay cash; the owner of the card is identified, he needs to present the card at the cash counter and sign some forms
        - The card issuer issues credit cards depending on the credibility of the customer
        - The card issuer also ties up with merchant establishments which are engaged in various fields of business activities
        - The issuer for safety sets a credit limit for the credit card owner; also sets floor limit for its merchant establishment partners
        - Basically credit cards can be used as a great substitute for cash and cheque

- Venture capital
  - Venture capital is long term investment in high risk projects with high return expectations
  - The investment can be at any stage – start up or commencement of commercial production
  - Defined as organised financing of relatively new and young enterprises to achieve substantial capital gains.
- Factoring (done in very detail)
  - It is an arrangement between financial institutions or banks (factor) and business concern (suppliers) which provides goods and services to its customers on credit, wherein the factor buys out client (suppliers) book debts.
  - **Factoring mechanism (domestic arrangement)** is explained below:
    - ✓ Customer places an order for good / service with the client on **credit**
    - ✓ The client delivers the good / service and sends invoice to customer (stating that the amount of the good / service must be paid to the factor with whom he has made an arrangement)
    - ✓ The client also sends invoice to factor
    - ✓ The factor makes prepayment up to 80% of the amount of the good / service and sends periodic statements to the customer
    - ✓ Customer makes payment to the factor
    - ✓ Factor makes balance 20% of the payment to the client
  - There is always a difficulty of foreign languages, fear of distance, stringent customs and laws, ocean barriers which inhibit entrepreneurs to venture into export business (which also affects country's exports)
  - Factoring is a service that relieves exporters from the fear of credit losses enabling them to offer their products to overseas customers
  - **Factoring mechanism (international arrangement)** is explained below:
    - ✓ The exporter receives an order from importer and is able to estimate financing requirement
    - ✓ The exporter provides export factor with contact details of importer (customer) along with estimates of credit limit
    - ✓ The export factor forwards these details to the correspondent import factor in the relevant country
    - ✓ On approval of exporter's credit limits, the exporter enters into factoring agreement with the export factor
    - ✓ The exporter ships the goods / services to the importer
    - ✓ The exporter submits invoice, airway bill, customs tax invoice, etc. to the export factor
    - ✓ The export factor scrutinises the documents and makes prepayment as agreed upon to the exporter
    - ✓ The export factor sends these documents to the corresponding import factor in the relevant country
    - ✓ The import factor contacts the customer (importer) and collects payment from them
    - ✓ The import factor sends this amount to the export factor
    - ✓ On this collection, the export factor makes the balance payment to the exporter
  - **Benefits** of factoring:
    - ✓ Exporter deals with only one factor even if his exports are spread across different countries
    - ✓ Exporter can also obtain experience and advise from export factor in terms of legal laws and business practices
    - ✓ The exporter's risk and debts can be reduced
    - ✓ Exporter can expand business into new markets

- Forfaiting (done in very detail)
  - It is non-recourse long-term financing of international trade
  - It converts the exporter's credit sale into cash sale
  - By transforming the exporter's credit into cash, it protects the exporter from all risks associated with selling overseas on credit
  - Trade receivables (TR) are bills of exchange, promissory notes, letters of credit etc.
  - The exports surrenders these TR to forfaiting agency which pays him in cash after deducting some charges
  - The forfaiting agency then collects the dues from the importer
  - Thus, forfaiting enables exporters to offer long-term financing to importers of capital goods from India
  - **Benefits** of forfaiting:
    - ✓ Exporter is absolved from all types of risks – commercial, political, transfer, interest and exchange
    - ✓ It improves liquidity of exporter as it converts credit sales to cash sales
    - ✓ Helps exporter undertake more exports
    - ✓ Increases volume of business and the exporter can expand into risky countries
    - ✓ Documentation procedure is simple so forfaiting is easy and efficient
    - ✓ Does not affect existing bank limits of the exporter
    - ✓ Forfaiting is transaction specific; so does not require the exporter to get into long-term agreement with the forfeiter
- **Difference between factoring and forfaiting:**

Basis of comparison	Factoring	Forfaiting
Meaning	Converts receivables into ready cash and don't need to wait for payment at a future date	Forfeiter purchases claims from exporter in return for cash payment
Maturity of receivables	Involves account receivables of short term maturities	Involves account receivables of medium to long term maturities
Goods	Trade receivables on ordinary goods	Trade receivables on capital goods
Finance up to	80-90%	100%
Type	Recourse or non – recourse	Non – recourse
Cost	Cost of factoring borne by the seller (client)	Cost of forfaiting borne by the overseas buyer
Secondary market	No	Yes
Negotiable instrument	Does not deal in negotiable instrument	Involves dealing with negotiable instrument

- Bill discounting
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Fee based services

- Financial institutions operate in specialised fields to earn substantial income by the way of fees, dividends, commission, discount or brokerage.
- The fee based services are as follows:
  - Issue management
    - Managing issues of corporate securities like equity shares, debentures or bonds
    - Issue managers are known as merchant managers / lead managers
    - Involves marketing of capital issues, right issues etc.
    - Provides assistance to corporate units on designing sound structure acceptable to financial institutions
    - Merchant managers also advise issuing company to go for fresh issue, bonus issue, additional issue, right issue or a combination of these

- Credit rating
  - Credit is trust in a person's ability and intention to pay
  - Rating means to estimate the worth or value of
  - In India, the scope of credit rating is limited to debentures, bonds, fixed deposits etc.
  - In some countries, equity shares are also included
  - Credit rating is thus an important device in the hands of investors to analyse the authenticity of issuers
- Mutual funds
  - Mutual fund is a trust that pools the savings of number of investors who have a common goal
  - The collected money is invested with the help of professional managers in shares, debentures, and other securities
  - It is usually long term with a certain level of risk
  - Mutual fund has an open ended feature where the investor gets money whenever he wants at short notice
- Asset securitisation
  - It is a process where loans and other receivables are packaged, underwritten and sold in the form of asset-backed securities
  - The assets which can be securitised are:
    - ✓ Credit card receivables
    - ✓ Trade related receivables
    - ✓ Receivables from govt.
    - ✓ Real estate loans
    - ✓ Housing loans
    - ✓ Automobile loans etc.
  - Securitisation is a synthetic technique to:
    - ✓ Convert asset into securities
    - ✓ Securities into liquidity
    - ✓ Liquidity into assets
    - ✓ And cycle goes on…
  - Such a system provides flexibility of yield, pricing pattern, size risks and marketability of instruments which are used to the advantage of both borrowers and lenders (investors)
- Corporate advisory services
  - These services are needed to ensure that corporate enterprise runs efficiently at its maximum potential through effective management of financial and other resources
  - Such services include:
    - ✓ Providing guidance in areas of business diversification
    - ✓ Appraising product lines
    - ✓ Analyse growth and profitability
    - ✓ Advice on capital structuring / restructuring
  - The scope of corporate advisory services is very vast ranging **from** managerial economics, investment and financial management **to** corporate laws and related legal aspects.