FINANCIAL MARKETS AND SERVICES

Objective: To enlighten the students with the Concepts and Practical dynamics of Financial Markets and Financial Services

UNIT 1 Structure of Financial System: Role of Financial System in Economic Development – Financial Markets and Financial Instruments – Capital Markets – Money Markets – Primary Market Operations – Role of SEBI – Secondary Market Operations – Regulation – Functions of Stock Exchanges – Listing – Formalities – Financial Services Sector Problems and Reforms.

UNIT 2 Financial Services: Concept, Nature and Scope of Financial Services – Regulatory Frame Work of Financial Services – Growth of Financial Services in India – Merchant Banking – Meaning-Types – Responsibilities of Merchant Bankers – Role of Merchant Bankers in Issue Management – Regulation of Merchant Banking in India.

UNIT 3 Venture Capital: Growth of Venture Capital in India – Financing Pattern under Venture Capital – Legal Aspects and Guidelines for Venture Capital, Leasing – types of Leases – Microfinance models: Generic models viz. SHG, Grameen, and Co- operative, variants SHG NABARD model, SIDBI model, SGSY model, Grameen Bangladesh model, credit unions.

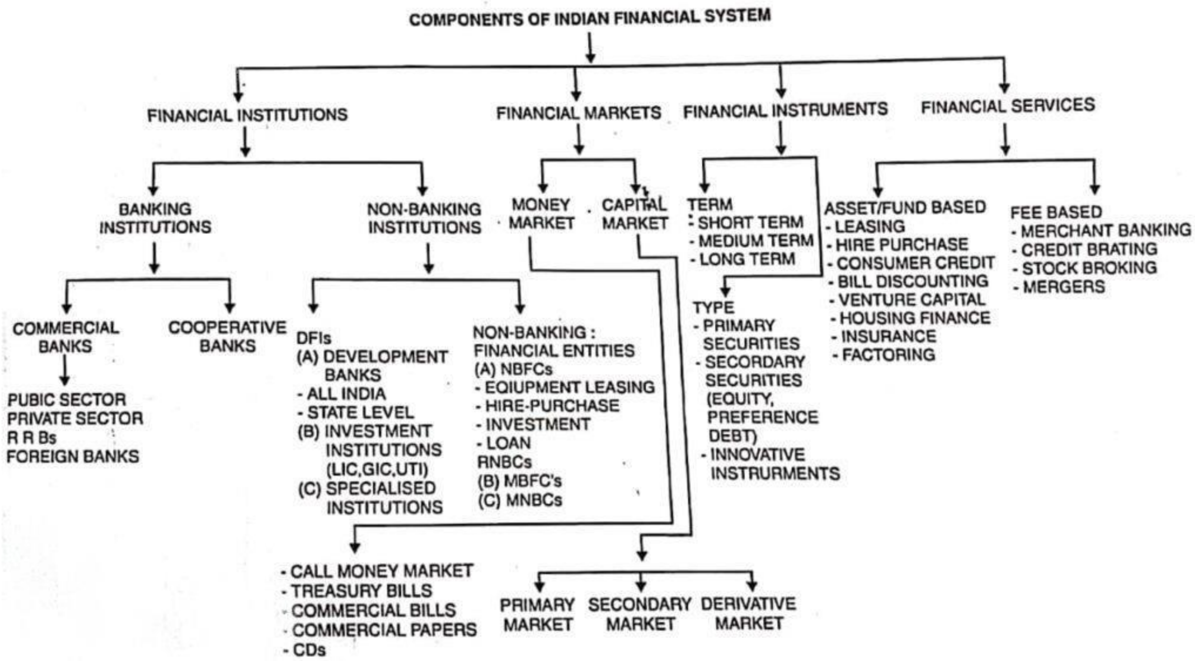
UNIT 4 Credit Rating: Meaning, Functions – Debt Rating System of CRISIL, ICRA and CARE. Factoring, Forfeiting and Bill Discounting – Types of Factoring Arrangements – Factoring in the Indian Context;

UNIT 5 Mutual Funds: Concept and Objectives, Functions and Portfolio Classification, Organization and Management, Guidelines for Mutual Funds, Working of Public and Private Mutual Funds in India. Debt Securitization – Concept and Application – De-mat Services-need and Operations- role of NSDL and CSDL..

UNIT – I : Structure of Financial System –

The financial system is the main part of running the economy smoothly. Financial system provides the flow of finance in the economy. Which leads to the development of the country financial system show the strength of the country.

Indian Financial System is a combination of financial institutions, financial markets, financial instruments and financial services to facilitate the transfer of funds. Financial system provides a payment mechanism for the exchange of goods and services. It is a link between saver and investor.



Structure of Indian Financial System

Structure of Indian Financial System

The following are the four major components that comprise the **Indian Financial System:**

- **Financial Institutions**
- **Financial Markets**
- **Financial Instruments/Assets/Securities**
- **Financial Services.**

Financial Institutions

Financial institutions are the **intermediaries** who facilitate the smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Structure of Indian Financial System also provides services to entities (individual, business, government) seeking advice on various issues ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere. The financial Institutions is very important for the function of a financial system

Types of Financial Institutions

Financial institutions can be classified into two categories

- **Banking Institutions**
- **Non-Banking Financial Institutions**

Financial Markets

Financial markets may be broadly classified as negotiated loan markets and open The negotiated **loan market** is a market in which the lender and the borrower personally negotiate the terms of the loan agreement, e.g. a businessman borrowing from a bank or from a small loan company. On the other hand, the open market is an impersonal market in which standardized securities are treated in large volumes. The stock market is an example of an open market. The financial markets, in a nutshell, the credit markets catering to the various credit needs Of the individuals, links and institutions. Credit is supplied both on a short as well as a long

On the basis of the credit requirement for short-term and long term purposes, financial markets are divided into two categories

Types of the **financial market**

- **Money Market**
- **Capital Market**

Financial Instruments/ Assets/ Securities

This is an important component of the financial system. Financial instruments are monetary **contracts between parties**. The products which are traded in a financial market are financial assets, securities or other types of financial instruments. There is a wide range of securities in the markets since the needs of investors and credit seekers are different. Financial instruments can be real or virtual documents representing a legal agreement involving any kind of monetary value. Equity-based financial instruments represent ownership of an asset. Debt-based financial instruments represent a loan made by an investor to the owner of the asset.

Types of Financial Instruments

- **Cash Instruments**
- **Derivative Instrument**

Financial Services

It consists of services provided by **Asset Management and Liability Management** Companies. They help to get the required funds and also make sure that they are efficiently invested. They assist to determine the financing combination and extend their professional services up to the stage of servicing of lenders

Role of financial system in economic development

The following are the **roles of financial system** in the economic development of a country.

Savings-investment relationship

To attain economic development, a country needs more investment and production. This can happen only when there is a facility for savings. As, such savings are channelized to productive resources in the form of investment. Here, the role of financial institutions is important, since they induce the public to save by offering attractive interest rates. These savings are channelized by lending to various business concerns which are involved in production and distribution.

Financial systems help in growth of capital market

Any business requires two types of capital namely, fixed capital and working capital. Fixed capital is used for investment in fixed assets, like plant and machinery. While working capital is used for the day-to-day running of business. It is also used for purchase of raw materials and converting them into finished products.

- **Fixed capital** is raised through capital market by the issue of debentures and shares. Public and other financial institutions invest in them in order to get a good return with minimized risks.
- For **working capital**, we have money market, where short-term loans could be raised by the businessmen through the issue of various credit instruments such as bills, promissory notes, etc.

Foreign exchange market enables exporters and importers to receive and raise funds for settling transactions. It also enables banks to borrow from and lend to different types of customers in various foreign currencies. The market also provides opportunities for the banks to invest their short term idle funds to earn profits. Even governments are benefited as they can meet their foreign exchange requirements through this market.

Government Securities market

Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions. The budgetary gap is filled only with the help of government securities market. Thus, the capital market, money market along with foreign exchange market and government securities market enable businessmen, industrialists as well as governments to meet their credit requirements. In this way, the development of the economy is ensured by the financial system.

Financial system helps in Infrastructure and Growth

Economic development of any country depends on the infrastructure facility available in the country. In the absence of key industries like coal, power and oil, development of other industries will be hampered. It is here that the financial services play a crucial role by providing funds for the growth of infrastructure industries. Private sector will find it difficult to raise the huge capital needed for setting up infrastructure industries. For a long time, infrastructure industries were started only by the government in India. But now, with the policy of economic liberalization, more private sector industries have come forward to start infrastructure industry. The Development Banks and the Merchant banks help in raising capital for these industries.

Financial system helps in development of Trade

The financial system helps in the promotion of both domestic and foreign trade. The financial institutions finance traders and the financial market helps in discounting financial instruments such as bills. Foreign trade is promoted due to per-shipment and post-shipment finance by commercial banks. They also issue Letter of Credit in favor of the importer. Thus, the precious foreign exchange is earned by the country because of the presence of financial system. The best part of the financial system is that the seller or the buyer do not meet each other and the documents are negotiated through the bank. In this manner, the financial system not only helps the traders but also various financial institutions. Some of the capital goods are sold through hire purchase and installment system, both in the domestic and foreign trade. As a result of all these, the growth of the country is speeded up.

Employment Growth is boosted by financial system

The presence of financial system will generate more employment opportunities in the country. The money market which is a part of financial system, provides working capital to the businessmen and manufacturers due to which production increases, resulting in generating more employment opportunities. With competition picking up in various sectors, the service sector such as sales, marketing, advertisement, etc., also pick up, leading to more employment opportunities. Various financial services such as leasing, factoring, merchant banking, etc., will also generate more employment. The growth of trade in the country also induces employment opportunities. Financing by Venture capital provides additional opportunities for techno-based industries and employment.

Venture Capital

There are various reasons for lack of growth of venture capital companies in India. The economic development of a country will be rapid when more ventures are promoted which require modern technology and venture capital. Venture capital cannot be provided by individual companies as it involves more risks. It is only through financial system, more financial institutions will contribute a part of their investable funds for the promotion of new ventures. Thus, financial system enables the creation of venture capital.

Financial system ensures Balanced growth

Economic development requires a balanced growth which means growth in all the sectors simultaneously. Primary sector, secondary sector and tertiary sector require adequate funds for their growth. The financial system in the country will be geared up by the authorities in such a way that the available funds will be distributed to all the sectors in such a manner, that there will be a balanced growth in industries, agriculture and service sectors.

Financial system helps in fiscal discipline and control of economy
It is through the financial system, that the government can create a congenial business atmosphere so that neither too much of inflation nor depression is experienced. The industries should be given suitable protection through the financial system so that their credit requirements will be met even during the difficult period. The government on its part, can raise adequate resources to meet its financial commitments so that economic development is not hampered. The government can also regulate the financial system through suitable legislation so that unwanted or speculative transactions could be avoided. The growth of black money could also be minimized.

Financial system's role in Balanced regional development
Through the financial system, backward areas could be developed by providing various concessions or sops. This ensures a balanced development throughout the country and this will mitigate political or any other kind of disturbances in the country. It will also check migration of rural population towards towns and cities.

Role of financial system in attracting foreign capital
Financial system promotes capital market. A dynamic capital market is capable of attracting funds both from domestic and abroad. With more capital, investment will expand and this will speed up the economic development of a country.
Financial system's role in Economic Integration
Financial systems of different countries are capable of promoting economic integration. This means that in all those countries, there will be common economic policies, such as common investment, trade, commerce, commercial law, employment legislation, old age pension, transport co-ordination, etc. We have a standing example of European Common Market which has gone to the extent of creating a common currency, representing several countries in Western Europe.

Role of financial system in Political stability
The political conditions in all the countries with a developed financial system will be stable. Unstable political environment will not only affect their financial system but also their economic development.

Financial system helps in Uniform interest rates
The financial system is capable of bringing an uniform interest rate throughout the country by which there will be balanced movement of funds between centres which will ensure availability of capital for all kinds of industries.

Financial system role in Electronic development:
Due to the development of technology and the introduction of computers in the financial system, the transactions have increased manifold bringing in changes for the all round development of the country. The promotion of World Trade Organization (WTO) has further improved international trade and the financial system in all its member countries.

Financial Markets

Definition: Financial Market refers to a marketplace, where **creation and trading of financial assets**, such as shares, debentures, bonds, derivatives, currencies, etc. take place. It plays a crucial role in allocating limited resources, in the country's economy. It **acts as an intermediary between the savers and investors** by mobilising funds between them.

The financial market provides a platform to the buyers and sellers, to meet, for trading assets at a price determined by the demand and supply forces.

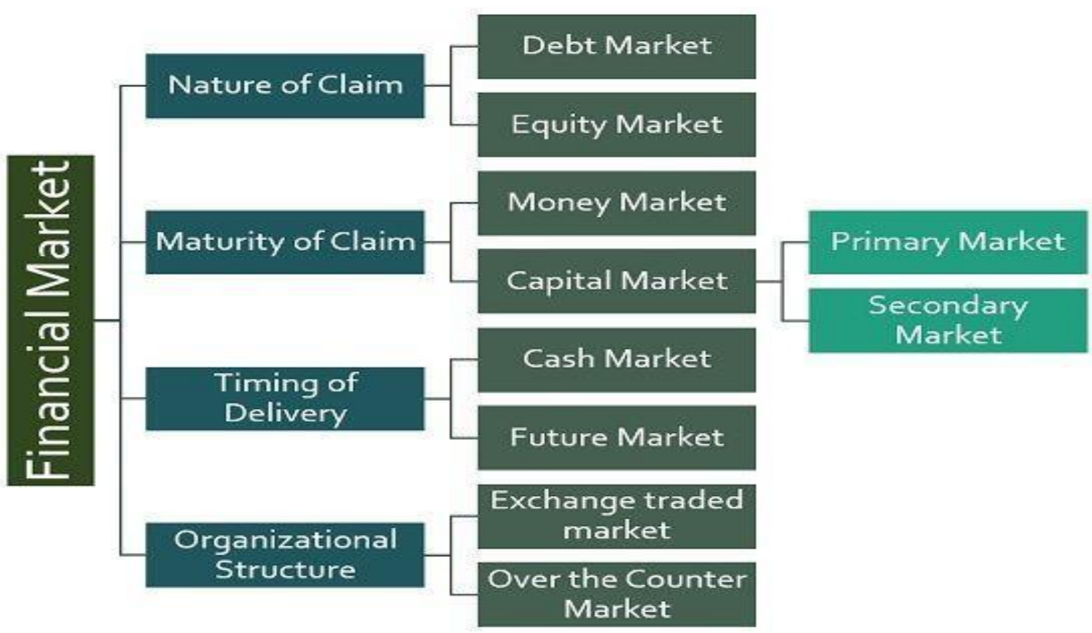
Functions of Financial Market

The functions of the financial market are explained with the help of points below:

- It facilitates **mobilisation of savings** and puts it to the most productive uses.
- It helps in **determining the price of the securities**. The frequent interaction between investors helps in fixing the price of securities, on the basis of their demand and supply in the market.
- It provides **liquidity to tradable assets**, by facilitating the exchange, as the investors can readily sell their securities and convert assets into cash.
- It **saves the time, money and efforts of the parties**, as they don't have to waste resources to find probable buyers or sellers of securities. Further, it reduces cost by providing valuable information, regarding the securities traded in the financial market.

The financial market **may or may not have a physical location**, i.e. the exchange of asset between the parties can also take place over the internet or phone also.

Classification of Financial Market



1. **By Nature of Claim**
   - **Debt Market**: The market where fixed claims or debt instruments, such as debentures or bonds are bought and sold between investors.
   - **Equity Market**: Equity market is a market wherein the investors deal in equity instruments. It is the market for residual claims.
2. **By Maturity of Claim**

- **Money Market**: The market where monetary assets such as commercial paper, certificate of deposits, treasury bills, etc. which mature within a year, are traded is called money market. It is the market for short-term funds. No such market exist physically; the transactions are performed over a virtual network, i.e. fax, internet or phone.
- **Capital Market**: The market where medium and long term financial assets are traded in the capital market. It is divided into two types:
  - **Primary Market**: A financial market, wherein the company listed on an exchange, for the first time, issues new security or already listed company brings the fresh issue.
  - **Secondary Market**: Alternately known as the Stock market, a secondary market is an organised marketplace, wherein already issued securities are traded between investors, such as individuals, merchant bankers, stockbrokers and mutual funds.

3. **By Timing of Delivery**
   - **Cash Market**: The market where the transaction between buyers and sellers are settled in real-time.
   - **Futures Market**: Futures market is one where the delivery or settlement of commodities takes place at a future specified date.
4. **By Organizational Structure**
   - **Exchange-Traded Market**: A financial market, which has a centralised organisation with the standardised procedure.
   - **Over-the-Counter Market:** An OTC is characterised by a decentralised organisation, having customised procedures.

Importance of Financial Markets

There are many things that financial markets make possible, including the following:

- Financial markets provide a place where participants like investors and debtors, regardless of their size, will receive fair and proper treatment.
- They provide individuals, companies, and government organizations with access to capital.
- Financial markets help lower the unemployment rate because of the many job opportunities it offers

Financial Instruments

A **financial instrument** is a monetary contract between parties. We can create, trade, or modify them. We can also settle them. A financial instrument may be evidence of ownership of part of something, as in stocks and shares. Bonds, which are contractual rights to receive cash, are financial instruments.

Checks (UK: cheques), futures, options contracts, and bills of exchange are also financial instruments.

Securities, i.e., contracts that we give a value to and then trade, are financial instruments.

Put simply; a financial instrument is an asset or package of capital that we can trade.

The *Association of Chartered Certified Accountants (ACCA)* has the following definition or a financial instrument:

“A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.”

“The definition is wide and includes cash, deposits in other entities, trade receivables, loans to other entities. investments in debt instruments, investments in shares and other equity instruments.”

A

financial instrument can represent ownership of something, a loan that an investor made to the asset’s owner, or a foreign currency.

Financial instrument – cash or derivative

There are two main types of financial instruments, derivative or cash instruments.

Derivative instruments

Derivative instruments are instruments whose worth we derive from the value and characteristics of at least one underlying entity. Assets, interest rates, or indexes, for example, are underlying entities.

We also call them ‘derivatives.’ They are contracts whose values come from the performance of an underlying entity.

Derivative instruments are securities that we link to other securities such as stocks or bonds. ‘Stocks,’ in this context, means the same as ‘shares.’ Derivative instruments can also be linked to Forex and Cryptocurrencies.

According to *TradingOnlineGuide.com*, the term FOREX stands for the Foreign Exchange Market.

Cash instruments

Cash instruments are instruments that the markets value directly. Securities, which are readily transferable, for example, are cash instruments. Deposits and loans, where both lender and borrower must agree on a transfer, are also cash instruments.

Financial instrument by asset class

We can also categorize financial instruments by asset class, depending on whether they are debt or equity based.

Debt-based financial instruments reflect a loan the investor made to the issuing entity.

Equity-based financial instruments, on the other hand, reflect ownership of the issuing entity.

Regarding these types of financial instruments, *Wikipedia* writes:

“If the instrument is debt, it can be further categorized into short-term (less than one year) or long-term.”

“Foreign exchange instruments and transactions are neither debt- nor equity-based and belong in their own category.”

Capital Markets –

Definition: Capital Market, is used to mean the market for long term investments, that have explicit or implicit claims to capital. Long term investments refers to those investments whose lock-in period is greater than one year.

In the capital market, both equity and debt instruments, such as equity shares, preference shares, debentures, zero-coupon bonds, secured premium notes and the like are bought and sold, as well as it covers all forms of lending and borrowing.

Capital Market is composed of those institutions and mechanisms with the help of which medium and long term funds are combined and made available to individuals, businesses and government. Both private placement sources and organized market like securities exchange are included in it.

Functions of Capital Market

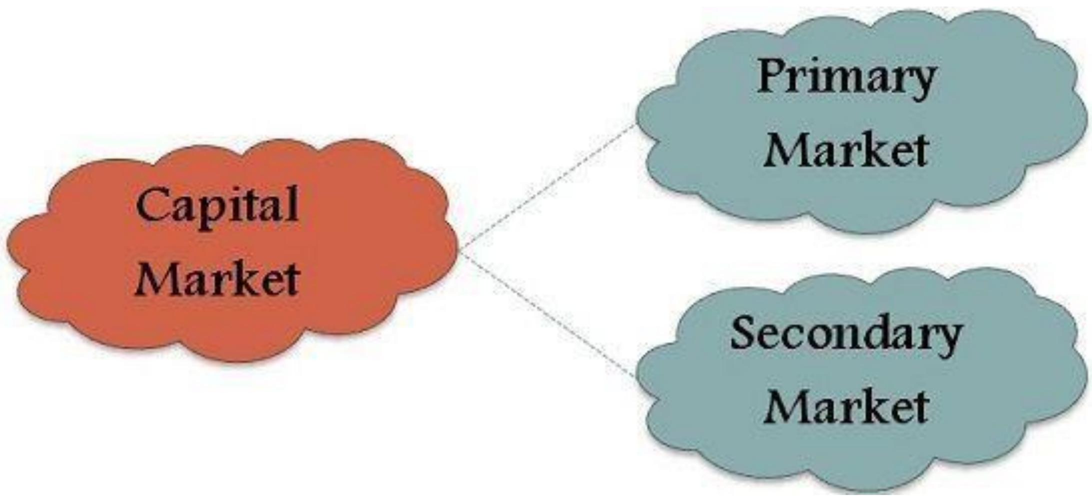
- Mobilization of savings to finance long term investments.
- Facilitates trading of securities.
- Minimization of transaction and information cost.
- Encourage wide range of ownership of productive assets.
- Quick valuation of financial instruments like shares and debentures.
- Facilitates transaction settlement, as per the definite time schedules.

- Offering insurance against market or price risk, through derivative trading.
- Improvement in the effectiveness of capital allocation, with the help of competitive price mechanism.

Capital market is a measure of inherent strength of the economy. It is one of the best source of finance, for the companies, and offers a spectrum of investment avenues to the investors, which in turn encourages capital creation in the economy.

Types of Capital Market

The capital market is bifurcated in two segments, primary market and secondary market:



1. **Primary Market**: Otherwise called as New Issues Market, it is the market for the trading of new securities, for the first time. It embraces both initial public offering and further public offering. In the primary market, the mobilisation of funds takes place through prospectus, right issue and private placement of securities.
2. **Secondary Market**: Secondary Market can be described as the market for old securities, in the sense that securities which are previously issued in the primary market are traded here. The trading takes place between investors, that follows the original issue in the primary market. It covers both stock exchange and over-the-counter market.

Capital market improves the quality of information available to the investor regarding the investment. Add to that, it plays a crucial role in encouraging the adoption of rules of corporate governance, which backs the trading environment. It includes all the processes that help in the transfer of already existing securities.

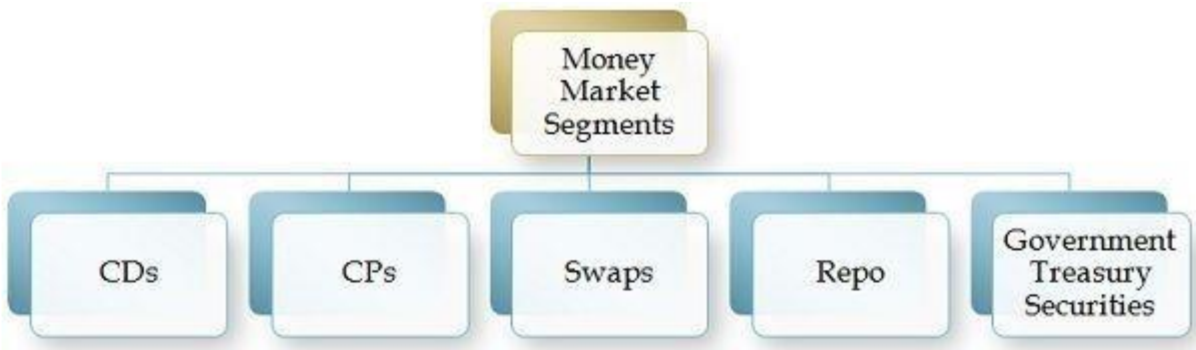
Money Markets –

Definition: Money Market can be understood as the market for short term funds, wherein lending and borrowing of funds varies from overnight to a year. It is an important part of the financial system that helps in fulfilling the short term and very short term requirements of the companies, banks, financial institution, government agencies and so forth.

Salient Features of Money Market

- It is a wholesale market, as the transaction volume is large.
- Trading takes place over the telephone, after which written confirmation is done by way of e-mails.
- Participants include banks, mutual funds, investment institutions and Central Banks.
- There is an impersonal relationship between the participants in the money market, and so, pure competition exists.
- Money market operations focus on a particular area, which serves a region or an area. On the basis of the market size and needs, the area may differ.

There are five major segments of money market which are Certificate of Deposits (CD), Commercial Paper, Swaps, Repo and Government treasury securities.



Money Market Instruments

In this market, only those financial instruments are traded which are immediate substitutes for money, which includes:

1. **Call/Notice Money**: When the money raised or borrowed on demand for a very short term which ranges from one day to 14 days, then it may be called as notice money, and when it exceeds 14 days it is termed as call money.
2. **Treasury Bills**: These are short term, negotiable financial assets issued by the central bank, on behalf of the government, for overcoming liquidity shortfalls.
3. **Commercial Bills**: A commercial bill is a negotiable, self-liquidating instrument that is less risky in nature. When goods are bought on credit, these bills improve the liability to make payment at the specified date.
4. **Commercial Paper**: It alludes to an unsecured promissory note, issued by large and creditworthy companies, at a discount on its face value and redeemable at its face value.
5. **Certificate of Deposit**: It is an unsecured, negotiable financial instrument which a bank and financial institution issues to individuals, corporation, trust, funds etc. at a discount on its face value and its maturity vary from 15 days to one year.

The financial assets dealt in the money market possess high liquidity, low transaction cost, less risky and no loss in value. And so, it acts as a whole sale debt market for such instruments.

Functions of Money Market

The three basic functions of money market are:

- It provides a balancing tool for equating the demand for and supply of short term funds.
- It provides a centre for the intervention of central bank, for controlling liquidity and general interest rate level.
- It provides a proper reach to the suppliers and users of the short term funds, to fulfil their requirements, at a reasonable market clearing price.

Money market plays a vital role in equating the short term liquidity imbalances within the country. Indeed, with the help of this market, the central bank controls liquidity and interest rates level in the country.

Primary Market Operations
Primary Market

In a **primary market**, securities are created for the first time for investors to purchase. New securities are issued in this market through a stock exchange, enabling the government as well as companies to raise capital.

For a transaction taking place in this market, there are three entities involved. It would include a company, investors, and an underwriter. A company issues security in a primary market as an initial public offering (IPO), and the sale price of such new issue is determined by a concerned underwriter, which may or may not be a financial institution. An underwriter also facilitates and monitors the new issue offering. Investors purchase the newly issued securities in the primary market. Such a market is regulated by the Securities and Exchange Board of India (SEBI).

The entity which issues securities may be looking to expand its operations, fund other business targets or increase its physical presence among others. **Primary market example** of securities issued includes notes, bills, government bonds or corporate bonds as well as stocks of companies.

Functions of Primary Market

The functions of such a market are manifold –

- **New issue offer**

The primary market organises offer of a new issue which had not been traded on any other exchange earlier. Due to this reason, it is also called a New Issue Market. Organising new issue offers involves a detailed assessment of project viability, among other factors. The financial arrangements for the purpose include considerations of promoters' equity, liquidity ratio, debt-equity ratio and requirement of foreign exchange.

- **Underwriting services**

Underwriting is an essential aspect while offering a new issue. An underwriter's role in a primary marketplace includes purchasing unsold shares if it cannot manage to sell the required number of shares to the public. A financial institution may act as an underwriter, earning a commission on underwriting.

Investors rely on underwriters for determining whether undertaking the risk would be worth its returns. It may so thus happen that an underwriter ends up buying all the IPO issue, and subsequently selling it to investors.

- **Distribution of new issue**

A new issue is also distributed in a **primary marketing** sphere. Such distribution is initiated with a new prospectus issue. It invites the public at large to buy a new issue and provides detailed information on the company, issue, and involved underwriters.

Investing in stocks is now super simple

Types of Primary Market Issuance

After the issuance of securities, investors can purchase such securities in various ways. There are 5 **types of primary market** issues.

- **Public issue**

Public issue is the most common method of issuing securities of a company to the public at large. It is mainly done via Initial Public Offering (IPO) resulting in companies raising funds from the capital market. These securities are listed in the stock exchanges for trading.

A privately held company converts into a publicly-traded company when its shares are offered to the public initially through IPO. Such public offer allows a company to raise funds for expansion of business, improving infrastructure, and repay its debts, among others. Trading in an open market also increases a company's liquidity and provides a scope for issuance of more shares in raising further capital for business.

The Securities and Exchange Board of India is the regulatory body that monitors IPO. As per its guidelines, a requisite due enquiry is conducted for a company's authenticity, and the company is required to mention its necessary details in the prospectus for a public issue.

- **Private placement**

When a company offers its securities to a small group of investors, it is called private placement. Such securities may be bonds, stocks or other securities, and the investors can be both individual and institutional.

Private placements are easier to issue than initial public offerings as the regulatory stipulations are significantly less. It also incurs reduced cost and time, and the company can remain private. Such issuance is suitable for start-ups or companies which are in their early stages. The company may place this issuance to an investment bank or a hedge fund or place before ultra-high net worth individuals (HNIs) to raise capital.

- **Preferential issue**

A preferential issue is one of the quickest methods available to companies for raising capital. Both listed and unlisted companies can issue shares or convertible securities to a select group of investors. However, the preferential issue is neither a public issue nor a rights issue. The shareholders in possession of preference shares stand to receive the dividend before the ordinary shareholders are paid.

- **Qualified institutional placement**

Qualified institutional placement is another kind of private placement where a listed company issues securities in the form of equity shares or partly or wholly convertible debentures apart from such warrants convertible to equity shares and purchased by a Qualified Institutional Buyer (QIB).

QIBs are primarily such investors who have the requisite financial knowledge and expertise to invest in the capital market. Some QIBs are –

- Foreign Institutional Investors registered with the Securities and Exchange Board of India.
- Foreign Venture Capital Investors.
- Alternate Investment Funds.
- Mutual Funds.
- Public Financial Institutions.
- Insurers.
- Scheduled Commercial Banks.
- Pension Funds.

Issuance of qualified institutional placement is simpler than preferential allotment as the former does not attract standard procedural regulations like submitting pre-issue filings to SEBI. The process thus becomes much easier and less time-consuming.

- **Rights and bonus issues**

Another issuance in the primary market is rights and bonus issue, in which the company issues securities to existing investors by offering them to purchase more securities at a predetermined price (in case of rights issue) or avail allotment of additional free shares (in case of bonus issue).

For rights issues, investors retain the choice of buying stocks at discounted prices within a stipulated period. Rights issue enhances control of existing shareholders of the company, and also there are no costs involved in the issuance of these kinds of shares. For bonus issues, stocks are issued by a company as a gift to its existing shareholders. However, the issuance of bonus shares does not infuse fresh capital.

Examples of Primary Stock Market Selling

Company	**Details**
Facebook	One of the remarkable IPOs that were undertaken includes the Facebook initial public offering. The offer initiated in 2012 is to date the largest IPO in the

	technology sector. The company successfully raised $16 billion through its initial public offering. As an effect, its turnover increased by close to 100%. Also, there was a high demand for the stock in the primary market, which led to the pricing of Facebook's stock to be fixed at $38 for each share as determined by the underwriters. The valuation of the stock eventually amounted to $104 billion, highest for a newly formed public company.
Coal India	The biggest IPO undertaken in India was by Coal India in 2010, which raised Rs. 15,200 Crore. The shares were listed at Rs. 287.75 and eventually increased to Rs.340. The company offered a 5% discount on the final IPO price to retail investors, along with the subsidiaries and employees of the company.

Furthermore, the Union Budget 2020-2021 also proposed the sale of a part of the government's stake in Life Insurance Corporation. Even a 10% stake sale may fetch Rs. 80,000 crore to the government. Listing of the insurer will thus make it the biggest initial public offer in India surpassing Coal India IPO.

Advantages of Primary Market

- Companies can raise capital at relatively low cost, and the securities so issued in the primary market provide high liquidity as the same can be sold in the secondary market almost immediately.
- The primary market is an important source for mobilisation of savings in an economy. Funds are mobilised from commoners for investing in other channels. It leads to monetary resources being put into investment options.
- Chances of price manipulation in the primary market are considerably less when compared to the secondary market. Such manipulation usually occurs by deflating or inflating a security price, thereby deliberately interfering with fair and free operations of the market.

- The primary market acts as a potential avenue for diversification to cut down on risk. It enables an investor to allocate his/her investment across different categories involving multiple financial instruments and industries.
- It is not subject to any market fluctuations. The prices of stocks are determined before an initial public offering, and investors know the actual amount they will have to invest.

Disadvantages of Primary Market

- There may be limited information for an investor to access before investment in an IPO since unlisted companies do not fall under the purview of regulatory and disclosure requirements of the Securities and Exchange Board of India.
- Each stock is exposed to varying degrees of risk, but there is no historical trading data in a primary market for analysing IPO shares because the company is offering its shares to the public for the first time through an initial public offering.
- In some cases, it may not be favourable for small investors. If a share is oversubscribed, small investors may not receive share allocation.

With this information regarding the primary market, individuals can make a well-thought-out decision regarding investment in the market. It also makes way for the creation of an investment portfolio with diversified risk.

Role of SEBI

Securities and Exchange Board Of India [SEBI] is a regulator of securities market in India. Initially, it was formed for the purpose of observing the activities afterward in May 1992, Government of India granted legal status to SEBI. What is the function of Primary Market under SEBI? What is the role of SEBI? What is the process of issuance of securities? Role of SEBI in eliminating insider trading?

Functions of Primary Market Under SEBI

- Primary Market facilitates capital growth by encouraging individuals to convert savings into investments.
- Primary Market being the part of Capital market also issues new securities.

- Government or Public sector institutions and companies can obtain funds in exchange of a new stock or bond issues via an investment Bank or financial Syndicate of securities dealers.
- It encourages Initial Public Offerings [IPO]

Role of SEBI

Protecting the interest of investors

- SEBI ensures that the investors do not get befooled by misleading and false advertisements. In return, SEBI issued guidelines so as to protect investors and also ensured that the advertisement is fair and concise.
- Regulation of price rigging: Price rigging refers to manipulation of prices by way of fluctuating the prices with the object of inflating and depressing the market price of securities.
- SEBI make efforts to educate investors so that they are able to make choices between the offerings of different companies and choose the most profitable securities.
- SEBI has issued guidelines to investigate cases of fraud and insider trading. Adding to this the provisions for fine and Imprisonment.

To ensure Development activities in Stock Exchange

- E-Trading: Concept of E-trading have been introduced few years back by SEBI to eliminate the discomfort. It simplifies the process of buying and selling of securities.
- The initial public offering of Primary Market (which is a part of Capital market) permits through stock exchange.
- SEBI promotes training of intermediaries of securities market with the object of smooth functioning.

Regulate the business of stock exchange and activities of stock exchange

SEBI introduced proper Code Of Conduct applicable to everyone who is a part of the process of buying and selling of securities, stock exchange, etc. Following are the areas of concern:

- Rules and Regulations to regulate intermediaries such as Broker, underwriters, etc.

- Registers and Regulates the working of merchant Bankers, sub-brokers, stock-brokers, share transfer agent, trustees, etc.
- Registers the working of mutual Funds.
- SEBI regulates turnover of the companies.
- It also conducts inquiry and audits.

To Regulate Insider Trading

Insider Trading have been a problem since the introduction of the Market dealing with buying and selling of securities, stock exchange, etc. An Insider is a person or a group of people having first- hand knowledge about the internal issues and Ups and downs of a company. The moment insider gets to know about the loss which is going to occur, the shares under insider's name are sold immediately. Hence, company suffers a huge amount of loss.

Secondary Market Operations –

Secondary market is the platform where the existing securities are dealt with. Here, the new investors can invest into the securities and the existing investors can disinvest or invest more, as they wish. It is very helpful in economic growth and development as it channelizes the funds to the most productive use through the activity of investment, reinvestment and disinvestment. Here the main role is played by the stock exchanges or stock markets. With the advanced technology, it has become easier to buy and sell the securities as per the comfort from anywhere at any time. National stock exchange, Bombay stock exchange are some examples of the same.

Secondary market is thus the place where the existing securities are bought as well as sold. It has a geographical location and thus a physical existence. In secondary markets there is not a fixed price for the securities but it fluctuates based on the demand and supply of the securities in the market. It is quick so that the investors can get the funds they invested quickly back in the form of cash

1. Economic Barometer:

A stock exchange is a reliable barometer to measure the economic condition of a country.

Every major change in country and economy is reflected in the prices of shares. The rise or fall in the share prices indicates the boom or recession cycle of the economy. Stock exchange is also known as a pulse of economy or economic mirror which reflects the economic conditions of a country.

2. Pricing of Securities:

The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

3. Safety of Transactions:

In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company. The companies which are listed they also have to operate within the strict rules and regulations. This ensures safety of dealing through stock exchange.

4. Contributes to Economic Growth:

In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

5. Spreading of Equity Cult:

Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment.

6. Providing Scope for Speculation:

To ensure liquidity and demand of supply of securities the stock exchange permits healthy speculation of securities.

Regulation –

Secondary Market Regulations

Secondary market regulations protect investors by curbing insider trading and through regulations governing the buyback of shares by the company.

Insider trading: An insider is any person, who is or deemed to be or was connected with the company and who is reasonably expected to have access, by virtue of such a connection, to unpublished, price sensitive information about the securities of the company. Unpublished, price-sensitive information pertains to any information which is of direct or indirect concern to the company and is not generally known or published, but which, if published or known, might materially affect the price of the securities of that company in the market. The following information is deemed to be price sensitive:

a. Periodical financial results;
b. intended declaration of interim/final dividends;
c. Issue of securities/buy back;
d. Major expansion/new projects;
e. amalgamation/takeovers;
f. Disposal of whole/substantial part of the undertaking; and
g. Any significant change in policies, plans, or operations of the company.

The insiders of a company (directors/promoters/officers/designated employees, and others) are prohibited from trading in shares/ securities of the company based on unpublished, price-sensitive information.

SEBI has given a model code of internal procedure and conduct for implementation and compliance by companies and others associated with the securities market. As per the code:

- The compliance officer of the company (a senior level employee) is made responsible for the preservation of price-sensitive information and pre-clearing of trading in securities of designated employees and their dependents. The compliance Officer maintains a record of designated employees who will include officers of the top three tiers of the management and all employees of the finance department. Specific employees may also be designated by the company for this purpose.
- The unpublished, price-sensitive information should be disclosed by the company only to those within the company who need the information for the discharge of their duties and in whose possession the information will not give rise to a conflict of interest or misuse.
- The company has to specify a trading period (trading window) during which trading of securities can be done by the directors/ officers/designated employees. They cannot trade in the company's securities during the period when the trading window is closed.
- The trading window will be closed, among others, at the time of declaration of financial results/dividends (interim/final), decisions are taken using price sensitive information. The trading window for the insider will be opened 24 hours after the above information is made public. The trading window can be closed during other periods also, at the discretion of the company.
- All directors/officers/designated employees should get a preclearance of the transactions in securities that they intend to deal. The company is permitted to fix a minimum threshold limit above which such pre-clearance would be required. An application has to be made by such a person, giving prescribed particulars to the compliance officer. Once the compliance officer gives his approval, the person concerned has to execute the order within a week. Moreover, if securities are acquired, the same has to be held for a minimum period of 30 days.
- The compliance officer has to place before MD/CEO/a committee all the details of the dealings in securities by employees/ directors/officers. This is to be done on a monthly basis.
- The company has to ensure that adequate and timely disclosure of price-sensitive information is given on continuous and immediate basis to the stock exchanges. The compliance officer has to approve and oversee the disclosures. The company has to lay down the procedure for responding to any queries/ requests for verification of market rumours by stock exchanges.

The compliance officer is also responsible for deciding whether a public announcement is necessary for verifying/denying rumours and then make the disclosure. The disclosure has to be done through various media/company web site. Information sent to stock exchanges may be put on the website. While dealing with institutions, only public information has to be provided. At least two company representatives should be present at meetings with institutions and discussions should preferably be recorded.

Buyback of shares:

The Companies (Amendment) Ordinance promulgated on October 3 1, 1998 has empowered companies to purchase their own shares or other specified securities (referred to as “buy-back”). As the Companies (Amendment) Bill, 1998 introduced in the House of the People has not been passed, the ordinance was repromulgated on January 7, 1999 .Thee permission for buy back is subject to the conditions specified by the Ordinance, including the stipulation that it should be in accordance with regulations framed by SEBI. The SEBI regulations on buy-back apply only to listed securities and as such unlisted securities issued through private placement or otherwise fall

outsidethepurviewofSEBIregulations

A company, authorized by a resolution passed by the board of directors at its meeting to buy back its securities, may buy back its securities subject to the following conditions:

- It should be authorized by the articles of association of the company.
- A special resolution has been passed at the general meeting of the company authorizing the buy back.
- If the buy back is or less than 10 percent of the total paid up equity share capital, a resolution at the general meeting is not needed to be passed rather a simple board resolution is enough.
- Provided that no offer of buy back shall be made within three sixty five days reckoned from the date of proceeding offer of buy back.
- The buy back is or less than 25 percent of the total paid up equity share capital and free reserves
- The ratio of debt owned by the company is not more than twice the capital and its free reserves after such buy back.
- All the shares or other specified securities for buy back are fully paid up.
- The buyback of shares or other specified securities listed on any recognized stock exchange is in accordance with the regulations made by the securities and exchange board of India in this behalf:
- The buy back in respect of shares and other specified securities other than those specified in the aforesaid clause is in accordance with the guidelines specified.

Buyback through tender offer/buyback of odd lot specified securities

A company may buy back its specified securities from its existing securities holders on a proportionate basis. The offer for buyback remains open to the members for a period not less than 15 days and not exceeding 30 days. The date of the opening of the offer cannot be earlier than seven days or later than thirty days after the specified date. The letter of offer has to be sent to the securities holders so as to reach them before the opening of the offer. In case the number of specified securities offered by the securities holders is more than the total number of specified securities to be bought back by the company, the acceptances per securities holder will be on a proportionate basis. The company has to open an escrow account on or before the opening of the buyback offer. The escrow account consists of cash deposited with a scheduled commercial bank, bank guarantee in favor of the merchant banker, or deposit of acceptable securities with the merchant banker, or a combination of above. The escrow account balance will be at the rate of 25 per cent of the consideration payable if the total consideration payable does not exceed Rs. 100 crores. If the consideration payable exceeds Rs. 100 crores, then beyond the base level of 25 per cent, for every additional Rs. 100 crores a 10 per cent additional balance is required.

Buyback from open market

1. A company intending to buy-back its shares from the open market shall do so in accordance with the provisions of this Chapter.
2. The buy-back of shares from the open market may be in any one of the following methods:
    a. through stock exchange
    b. Book Building process.

Buyback through stock exchange

company shall buy-back its shares through the stock exchange as provided here under:

a. The special resolution referred to in regulation 5 shall specify the maximum price at which the buy-back shall be made;
b. The buy-back of the shares shall not be made from the promoters or persons in control of the company;
c. The company shall appoint a merchant banker and make a public announcement as referred to in regulation 8;
d. The public announcement shall be made at least seven days prior to the commencement of buy-back;
e. A copy of the public announcement shall be filed with the Board within two days of such announcement along with the fees as specified in schedule IV;
f. The public announcement shall also contain disclosures regarding details of the brokers and stock exchanges through which the buy-back of shares would be made;
g. The buy-back shall be made only on stock exchanges with electronic trading facility;
h. The buy-back of shares shall be made only through the order matching mechanism except 'all or none' order matching system;
i. The company and the merchant banker shall give the information to the stock exchange on a daily basis regarding the shares purchased for buy-back and the same shall be published in a national daily;
j. The identity of the company as a purchaser shall appear on the electronic screen when the order is placed.

Functions of Stock Exchanges –

1. Continuous market for securities

The Investors are able to invest in good securities and in case of any risk, it enables people to switch over from one security to another. So stock markets provides a ready and continuous opportunities for securities.

2. Evaluation of securities
It the stock exchange, the prices of securities clearly indicate the performance of the companies. It integrates the demand and supply of securities in an effective manner. It also clearly indicates the stability of companies. Thus, investors are in a better position to take stock of the position and invest according to their requirements.

3. Mobilizes savings
The savings of the public are mobilized through mutual funds, investments trusts and by various other securities. Even those who cannot afford to invest in huge amount of securities are provided opportunities by mutual funds and investment trusts.

4. Healthy speculation
The stock exchange encourages healthy speculation and provides opportunities to shrewd businessmen to speculate and reap rich profits from fluctuations in security prices. The price of security is based on supply and demand position. It creates a healthy trend in the market. Any artificial scarcity is prevented due to the rules and regulations of the market.
5. Mobility of funds
The stock exchange enables both the investors and the companies to sell or buy securities and thereby enable the availability of funds. By this, the money market also is strengthened as even short-term funds are available. The banks also provide funds for dealing in the stock exchanges.
6. Stock exchange Protect investors
As only genuine companies are listed and the activities of the stock exchange are controlled, the funds of the investors are very much protected.

7. Stock exchange helps Capital formation
Stock exchange plays an active role in the capital formation in the country. Companies are able to raise funds either by issuing more shares through rights shares or bonus shares. But when a company wants to go in for diversification, they can issue the shares and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.
Stock exchanges also creates the habit of saving, investing and risk bearing amongst the investing public.

8. Liquidity in Stock Exchange
Institutions like banks can invest their idle funds in the stock exchange and earn profit even within a short period. When necessity arises , these securities can be immediately sold for raising funds. Thus, it is the stock exchange which provides opportunities for converting securities into cash within a short notice.

9. Economic barometer
The most important function of a stock exchange is that it acts as an economic indicator of conditions prevailing in the country. A politically and economically strong government will have an upward trend in the stock market. Whereas an unstable government with heavy borrowings from other countries will have a downward trend in the stock market. So, every government will adopt policies in such a manner that the stock exchange remains dynamic.

10. Control on companies

One of the major function of stock exchange is that it has control on companies. The companies listing their securities in the stock exchange has to submit their annual report and audited balance sheet to the stock exchange. Thus, only genuine companies can function and have the shares transacted. If not, such companies will be black listed and they will find it difficult to raise their capital.

11. Attracts foreign capital

Due to its dynamism and higher return on capital, the stock exchange is capable of attracting more foreign funds. Due to this, the exchange rate of the currency will improve when there is more trade undertaken by the government.

12. Monetary and fiscal policies

The monetary policy and the fiscal policy of the government have to be favorable to businessmen and producers. If they are not so, then through the stock exchange the government may indicate and accordingly suitable steps can be taken.

13. Safety of Capital and Fair Dealing

The stock exchange transactions are made publicly under well defined rules and regulations and bye-laws. This factor ensures a great measure of safety and fair dealings to the average investors.

14. Proper Canalization of Capital

Stock exchange directs the flow of savings into the most productive and profitable channels.

15. Regulation of Company management

The companies, which want to get their securities listed in the stock exchange, should have to follow certain rules and fulfill certain conditions. Thus stock exchanges safeguards the interest of the investing public and also regulates company management.

Listing –

Listing means the admission of securities of a company to trading on a stock exchange. Listing is not compulsory under the Companies Act 2013/1956. It becomes necessary when a **Public Limited Company** wants to issue shares or debentures to the public. When securities are listed on a stock exchange, the company has to comply with the requirements of the exchange.

The listing provides an exclusive privilege to securities on the stock exchange. Only listed shares are quoted on the stock exchange. Stock exchange provides transparency in transactions of listed securities and equality and competitive conditions. Listing is beneficial for the company, to the investor, and to the public at large.

Objectives of Listing

- To provide liquidity to securities
- To provide a mechanism for effective control and supervision of trading
- To mobilize savings for economic development
- To provide free negotiability to stocks.
- Ability to raise further capital

Eligibility Criteria

1. Applicant Company, desirous of getting listed should comply with the required Eligibility criteria as prescribed by the stock exchange. Minimum Listing Requirements for New Companies-

- The minimum post-issue paid-up capital of the company shall be INR. 10 Crore for IPOs and INR.3 crore for FPOs, and
- The minimum issue size shall be INR. 10 crore, and
- The minimum market capitalization of the Company shall be INR. 25 crore ;
- Default in compliance with the listing agreement shall not be done by applicant, promoters and /or group companies
- In addition to the above eligibility criteria, certain conditions prescribed under SEBI ICDR (Issue of Capital & Disclosure Requirements) Regulations, 2009.
- The issuer shall comply with all the applicable guidance, regulations interlaid from
- Securities Contracts (Regulations) Act 1956
- Securities Contracts (Regulation) Rules 1957
- Securities and Exchange Board of India Act 1992
- And any other circular, clarifications, guidelines issued by the appropriate authority.
- Companies Act 2013/1956

2. Permission to Use the Name of BSE Listing Process in Issuer Company's Prospectus

Companies have to take prior approval from BSE to use the name of BSE in their prospectus or offer for sale documents before filing the same with the concerned office of the Registrar of Companies

3. Submission of Letter of Application

A Letter of Application need to be submitted to all the stock exchanges where they want to get it listed before filing to the Concerned ROC

4. Allotment of Securities

As per the Listing Agreement, a company is required to complete the allotment of securities within 30 days of the date of closure of the subscription list to the public

5. Trading Permission

After the completion of allotment, within 7 working days, the issuer Company has to complete the formalities for trading at all the stock exchanges, where the securities are to be listed.

6. The requirement of 1% Security

Companies have to deposit 1% of the issue amount with the designated stock exchange before the issue opens.

7. Listing Fees

All listed companies are required to pay to BSE, an Annual Listing Fees by 30th April of every financial year

8. Compliance with the Listing Agreement

When companies get listed at stock exchanges, whether it is BSE/NSE Listing Process they are required to enter into an agreement which is called the listing Agreement under which they are required to file certain compliances and disclosures which are given by listing Agreement, failing which the company may face some disciplinary action, including suspension/delisting of securities. Under listing agreements, all the terms and conditions are written on the basis of which the company has to perform like

- provide facilities for direct transfer, registration, sub-division, and consolidation of securities;
- send proper notices of the closure of transfer books and record dates, forward 6 copies of Annual Reports, Balance Sheets and Profit and Loss Accounts to BSE
- to file shareholding patterns and financial results on a quarterly basis;
- to intimate Exchange the happenings which are likely to materially affect the financial performance of the Company and its stock prices,
- to comply with the conditions of Corporate Governance, etc.

Financial Services Sector Problems and Reforms

In India, a decade old on-going financial reforms have transformed the operating environment of the finance sector from an administrative regime to a competitive market base system. Since mid-1991, a number of reforms have been introduced in the financial sector in India. Rangarajan once noted that domestic financial liberalization has brought about the deregulation of interest rates, dismantling of directed credit, reforming the banking system, improving the functioning of the capital market, including the government securities market. The main emphasis on the financial sector reform has been on the banking system so as to improve the performance of public sector banks. The Narasimhan Committee constituted in 1991 laid the foundation for the revamping of the financial sector in India. The Committee had submitted two reports– in 1992 and 1998 which gave immense importance on enhancing the efficiency and viability of this sector.

Taking a cue from the developments in the finance sector taking place globally, India undertook structural changes by way of these reforms and successfully relaxed the external constraints in its operation i.e. reduction in Cash Reserve Ratio and Statutory Liquidity Ratio, capital adequacy reforms, restructuring and recapitulation of banks and enhancement in the competitive element in the market through the entry of new banks. Banks in India had to give a go-by to their traditional operational methods of directed credit, fixed interest rates and directed investments, all of which, had the effect of deteriorating the quality of loan portfolios and inadequacy of capital and erosion of profitability. Another prominent consequence of the reforms was the sprouting up of a number of banks due to the entry of new private and foreign banks, increased transparency in the banking system through the introduction of prudential norms and increase in the role of the market forces due to the deregulated interest rates. All these measures lead to major changes in the operational environment of the finance sector.

Objectives of Financial Sector Reforms in India

The primary objective of financial sector reforms in the 1990s was to create an efficient, competitive and stable that could contribute in greater measure to stimulate growth. Economic reform process took place amidst two serious crises involving the financial sector:

1. The crisis involving the balance of payments that had threatened the international credibility of the country and dragged it towards the brink of default.
2. The crisis involving the grave threat of insolvency threatening the banking system which had concealed its problems for years with the aid of defective accounting policies.

Apart from the above two dilemmas, there were many deeply rooted problems of the Indian economy in the early 1990s which were strongly related to the finance sector. Prevalent among these were:

- Till the early 1990s, the Indian financial sector could be described as an example of financial repression. The sector was characterized by administered interest rates fixed at unrealistically low levels, large pre-emption of resources by authorities and micro regulations which direct the major flow of funds back and forth from the financial intermediaries.
- The act of the government involving large scale pre-emption of resources from the banking system to finance its fiscal deficit.
- More than necessary structural and micro-regulation that inhibited financial innovation and increased transaction costs.
- Relatively inadequate level of prudential regulation in the financial sector.
- Inadequately developed debt and money markets.
- Obsolete and out-dated technological and institutional structures that lead to the consequent inefficiency of the capital markets and the rest of the financial system.
- Till the early 1990s, the Indian financial system was characterized by extensive regulations viz. administered interest rates, weak banking structure, directed credit programmes, lack of proper accounting, risk management systems and lack of transparency in operations of major financial market participants. Furthermore, this period was characterized by the restrictive entry of foreign banks since after the nationalization of banks in 1969 and 1980, almost 90 per cent of the banking assets were under the control of government owned banks and financial institutions. The financial reforms initiated in this era attempted to overcome these weaknesses with the view of enhancing efficient allocation of resources in the Indian economy.

The Reserve Bank of India had been making efforts since 1986 to develop efficient and healthy financial markets which were accelerated after 1991. RBI focused on the development of financial markets especially the money market, government securities market and the forex markets. Financial markets also benefited from close coordination between the Central Government and the RBI as also between the other regulators.

Major Contours of the Financial Sector Reforms in India

On a general understanding, there are three groups of reform measures that are used to handle the problems faced by the financial sector. These are that of removal of financial repression, rehabilitation of the banking system and lastly, deepening and development of capital markets.

The focal issues addressed by financial sector reforms in India have primarily aimed to include the following:

1. Removal of the problem of financial repression.
2. Creation of an efficient, profitable and healthy financial sector.
3. Enabling the process of price discovery by market determination of interest rates which leads to an improvement in the efficiency in the allocation of resources.
4. Providing institutions with greater operational and functional autonomy.
5. Prepping up the financial system for international exposure and competition.
6. Introduction of private equity in public sector banks and their listing.
7. Opening up of the external sector in a regulated manner.
8. Promoting financial stability in the back-drop of domestic and external shocks.

The Two Phases of Financial Sector Reforms in India

To overcome the economic crisis that plagued the Indian economy in May 1991, the government undertook extensive economic reform policies that brought along with them an era of privatization, deregulation, globalization and most importantly, liberalization.

The financial reforms since the 1990s can be classified into two phases. The first phase, also known as the first generation reforms, was aimed at the creation of an efficient, productive, profitable and healthy financial sector which would function in an environment of functional autonomy and operational flexibility. The first phase was initiated in 1992 based on the recommendations of the Committee on Financial System. While the early phase of reforms was being implemented, the global economy was also witnessing prominent changes coinciding with the movement towards global integration of financial services. Narasimhan Committee I noted that the objective of Financial Sector Reforms in India should not focus on correcting the present financial weaknesses but should strive to eliminate the roots of the cause of the present challenges being faced by the Indian market economy.

The second generation reforms or the second phase commenced in the mid-1990s and laid greater emphasis on strengthening the financial system and on the introduction of structural improvements. Narasimhan Committee II was to look into the extent of the effectiveness of the implementation of reforms suggested by Narasimhan Committee I and was entrusted with the responsibility to lay down a course of future reforms for the growth and integration of the Indian banking sector with international standards.

Principles of Financial Sector Reforms in India

Former RBI Governor, Dr. Y.V. Reddy has stated that the financial sector reforms in India are based on Punch-sutra or five principles which are explained as follows:

1. Introduction of various measures by cautious and gradual phasing thus giving time to various agents to carry out the necessary norms. For instance, the gradual introduction of prudential norms.
2. Mutually reinforcing measures, that would serve as enabling reforms which would not in anyway disrupt the confidence in the system. E.g. Improvement in the profitability of banks by the combined reduction in refinance and Cash Reserve Ratio.

3. Complementary nature of the reforms in the banking sector with other commensurate changes in fiscal, external and monetary policies.
4. Development of the financial infrastructure in terms of technology, changing legal framework, setting up of a supervisory body, and laying down of audit standards.
5. Introducing initiatives to nurture, integrate and develop money, Forex and debt market so as to give an equal opportunity to all major banks to develop skills and to participate.

Policy Reforms in the Financial Sector

Indian financial reforms can be explained by way of a four-pronged approach viz. (a) banking reforms, (b) debt market, (c) Forex market reforms, and (d) reforms in other segments of the financial sector. These are explained in detail.

1. Banking Reforms

Despite the general approach of the financial sector reform process, many of the regulatory and supervisory norms were started out first for commercial banks and thereafter were expanded to other financial intermediaries. Banking reforms consisted of a two-fold process. Firstly, the process involved recapitalization of banks from government resources to bring them at par with appropriate capitalization standards. On a second level, an approach was adopted replacing privatization. Under this, increase in capitalization has been brought about through diversification of ownership to private investors up to a cap of 49 per cent and thus keeping majority ownership and control with the government.

The main idea was to increase the competition in the banking system by a gradual process and unlike other countries, banking reform in India, did not involve large-scale privatization. Due to such widening of ownership, majority of these banks have been publicly listed which in turn has brought about greater transparency through enhanced disclosure norms. The phased introduction of new banks in the private sector and expansion in the number of foreign banks provided for a new level of competition. Furthermore, increasingly tight capital adequacy norms, prudential and supervision norms were to apply equally across all banks, regardless of their ownership.

2. Government Debt Market Reforms

A myriad of reforms have been introduced in the government securities debt market. Only in the 1990s a proper G-Sec debt market had been initiated which had progress from strategy of pre-emption of resources from banks at administered rates of interest to a system that is more market oriented. The main instrument of pre-emption of bank resources in the pre-reform period was through the prescription of a Statutory Liquidity Ratio i.e. the ratio at which banks are required to invest in approved securities. It was initially introduced as a prudential measure. The high SLR reserve requirements lead to the creation of a captive market for government securities which were issued at low administered interest rates. After the introduction of reforms, the SLR ratio has been brought down to a statutory minimum level of 25 per cent. Numerous measure have been taken to broaden the G-Sec market and to increase the transparency. Automatic monetization of the government's deficit has been given a go-by. At present, the market borrowings of the central government are undertaken through a system of auctions at market-related rates.

3. Forex Market Reforms

The foreign exchange market in India had been characterized by heavy control since the 1950s commensurate with increasing trade controls designed to foster import substitution. As a result of these practices, the current and capital accounts were shut and Forex was made available through a complex licensing system undertaken by the RBI. Thus, the major task before the government was to move away from a system of total control to a market-based exchange rate system. This transformation in 1993 and the subsequent adoption of current account convertibility were the highlights of the Forex reforms introduced in the Indian market. Under these reforms, authorized dealers of foreign exchange as well as banks have been given greater autonomy to carry out a wide range of activities and operations. Furthermore, the entry of new players has been allowed in the market. The capital account has become effectively convertible for non-residents but still has some reservations fore residents.

4. Reforms in Other Segments of the Finance Sector

Several measures have been introduced for non-banking financial intermediaries as well. Non-banking financial companies (NBFCs) including those involved in public deposit taking activities, have been brought under the supervision of the RBI. As for development finance institutions (DFIs), NBFCs, urban cooperative banks, specialized term-lending institutions and primary dealers- all of these have been brought under the regulation of the Board for Financial Supervision. Reforms were introduced in phases for this segment as well.

Till the 1990s, insurance business was under the public ownership. After the passage of the Insurance Regulation and Development Act in 1999, many changes have been introduced. The most prominent amongst these was the setting up of the Insurance Regulatory and Development Agency as well as the setting up of joint ventures to handle insurance business on a risk sharing or commission basis.

Another important step has been the setting of the Securities and Exchange Board of India as a regulator for equity markets and to improve market efficiency and integration of national markets and to prevent unfair practices regarding trading. The reform measures in the equity market since 1992 have laid emphasis mainly on regulatory effectiveness, enhancement of competitive conditions, reduction of information asymmetries, development of modern technological infrastructure, mitigation of transaction costs and lastly, controlling of speculation in the securities market. Furthermore, the reform process had the effect of putting an end to the monopoly of the United Trust of India by opening up of mutual funds to the private sector in 1992. Mutual funds have been permitted to open offshore funds for the purpose of investing in equities in other jurisdictions. Another development which took place in 1992 was the opening up of the Indian capital market for foreign institutional investors. The Indian corporate sector has been granted permission to tap international capital markets through American Depository Receipts, Foreign Currency Convertible Bonds, Global Depository Receipts and External Commercial Borrowings. Moreover, now Overseas Corporate Bodies and non-resident are allowed to invest in Indian companies.

UNIT – II :

Financial Services:

Meaning of financial services

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:

Importance of Financial Services

- 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.
- Forfaiting.
- 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 forfaiting 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.

Nature and Scope of Financial Services

Financial services refer to economic services provided by various financial institutions that deal with the management of money. It is an intangible product of financial markets like loans, insurance, stocks, credit card, etc. Financial services are products of institutions such as banking firms, insurance companies, investment funds, credit unions, brokerage firms, and consumer finance companies.

Nature of Financial Services

Nature of Financial Services

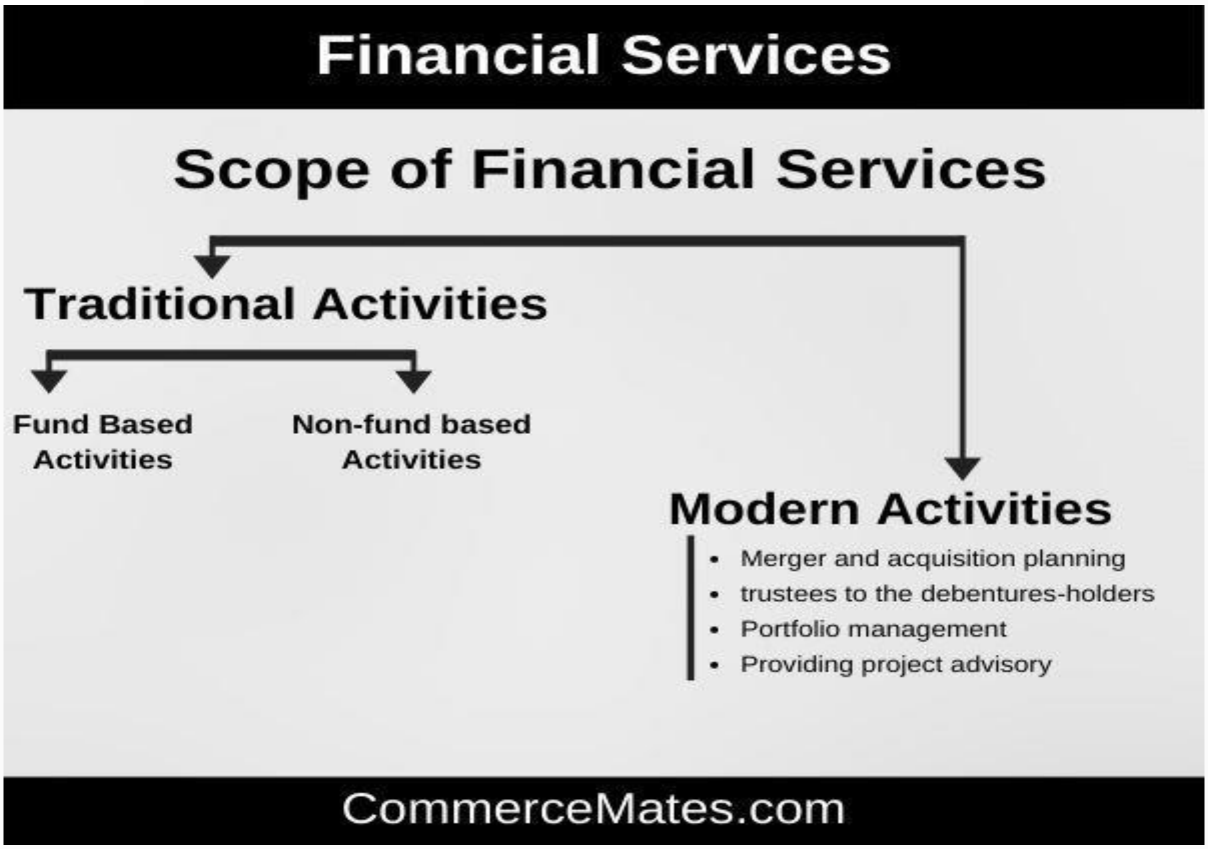
1. **Customer Oriented:** Financial services are customer-focused services that are offered as per the requirements of customers. Financial institutions properly study customer needs before designing and offering such services. They are meant to fulfill the specific needs of a customer which differs from person to person.
2. **Intangibility**: These services are intangible which makes their marketing a challenging task for financial institutions. Such institutions need to focus on building their brand image by providing innovative and quality products to customers. Firms enjoying better credibility in market are easily able to sell off their products.
3. **Inseparable:** Financial services are produced and delivered at the same time simultaneously. These services are inseparable and can't be stored in advance. Here production and supply function both occurs at the same time.
4. **Manages Fund:** Financial services are specialized at managing funds of people. These services enable peoples in allocating their idle lying funds into useful means for earning revenues. Financial services provide various means to people for converting their savings into investment.
5. **Financial Intermediation:** These services does the work of financial intermediation as it brings together the lender and borrower. Financial services mobilize the funds of people who are having enough of it and made it available to the one who are in need of it.
6. **Market Based:** Financial services are market based which changes as per the changing conditions. It is a dynamic activity which varies as per the variations in socio-economic environment and varying needs of customers.

7. **Distributes Risk:** Risk distribution is the key feature offered by financial services. These services transfer the risk of an individual not willing to take among different persons who all are willing to bear it. Financial institutions diversify the risk and secure people against damages by providing them various insurance policies.

Scope of Financial Services

Financial services consist of wide range of activities which are broadly classified into 2: –

1. **Traditional Activities.**
2. **Modern Activities.**



Scope of Financial Services

Traditional Activities

Financial intermediaries have been offering a large range of services traditionally

Related to capital and money market activities. These services are classified into 2 groups: – *Fund based activities and Non-fund based activities*.

Fund Based Activities.

Fund based activities comprises of activities which are concerned with acquiring funds and assets for clients. Different services covered under fund based activities are: Primary and secondary market activities, dealing in money market instruments, foreign exchange market activities and involving in hire purchase, venture capital, equipment leasing etc.

Non-fund based Activities.

These services are provided by financial intermediaries on non-fund basis and are called *fees-based* services. Non-fund bases activities are specialized services offered by financial institutions to customers in exchange for fees, commission, dividend and brokerage. This comprises of services such as Portfolio management, issue management, stock broking, merchant banking, credit rating, debt and capital reconstructing, bank guarantee etc.

Modern Activities
Financial intermediaries beside the traditional services offers a wide range of financial services at present. These activities are mostly in the category of non-fund based activities.

Few of the modern activities are listed below: –

- Merger and acquisition planning and helping with their smooth carry out.
- Providing guidance in capital reconstructing to corporate customers.
- Assisting in rehabilitation and reconstruction of sick companies.
- Portfolio management of large public sector corporations.
- Providing recommendations in management style and structure for attaining better results.
- Acting as trustees to the debentures-holders.
- Providing project advisory services ranging from project preparation to capital raising.

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Regulatory Frame Work of Financial Services

The Financial and Corporate Service Providers Act 2000 provides for the licensing and regulation of certain financial and corporate services in The Bahamas.

Regulated Activities

The act regulates the following activities:

- the conduct or the carrying on of financial services in or from The Bahamas, including online financial services;
- the registration or management and administration of international business companies incorporated or existing under the International Business Companies Act 2000;
- the provision of registered agent services and registered office services for Bahamian international business companies (IBCs);
- the provision of directors or officers for Bahamian IBCs;
- the provision of nominee shareholders for Bahamian IBCs;
- the provision of partners for partnerships registered and existing under the Exempted Limited Partnership Act 1995; and
- the provision of registered agent services and registered office services for partnerships registered and existing under the Exempted Limited Partnership Act 1995.

Authorized Persons

The following persons only are authorized to provide the regulated services: (i) banks and trust companies licensed under the Banks and Trust Companies Regulation Act 2000, and (ii) persons licensed as financial and corporate service providers under the Financial and Corporate Service Providers Act.

Individuals or organizations conducting the business of financial and corporate services, including registered agent services, immediately prior to the commencement of the Financial and Corporate Service Providers Act are required to submit an application for a licence to the inspector within three months of the commencement date of the act (December 29 2000).

Criteria for Obtaining a License

In granting a license, the inspector will consider the following:

- whether the applicant is a fit and proper person;
- whether the applicant is qualified to carry out the business of a financial and corporate service provider;
- the professional reputation and experience of the applicant;
- whether each officer, director or manager of the applicant is a fit and proper person to act as such;
- in the case of an application by a partnership, whether each partner is a fit and proper person to act as such; and
- whether the applicant, if an individual, is resident in The Bahamas or, if a company, is registered under the Companies Act.

In the event that the inspector refuses to grant a licence, the applicant may appeal to the court against the decision.

A licence is valid for one year, until December 31 of each year, and renewable annually thereafter as of January 1, subject to the payment of a renewal fee. The criteria for renewing a licence are identical to those items considered upon submission of an application for a licence.

Register of Licensees

The inspector will maintain a register of licensees, which will be opened to the public. The name, address and location of the registered office of each licensee, and the date on which the licence was issued, will be stated therein.

Functions of the Inspector

The inspector's role is to maintain a general review of financial and corporate services in The Bahamas. On an annual basis and when required by the minister of finance, the inspector also conducts on-site and off-site examinations of the licensee's business, at the expense of the licensee, in order to ensure that the licensee is in compliance with the provisions of the Financial and Corporate Service Providers Act, the Financial Transaction Reporting Act 2000, the International Business Companies Act 2000 and any other laws. In such cases, where the inspector is unable to conduct such examination, he may appoint an auditor, at the expense of the licensee, to conduct such examination and to report thereon.

Powers of the Inspector

With respect to the performance of his duties under the act, the inspector has the power to require a licensee to (i) produce for examination its books, records and other documents that it is required to maintain pursuant to the provisions of the Financial and Corporate Service Providers Act, and (ii) supply such information or explanation as the inspector may reasonably require for the purpose of enabling him to perform his functions under the act.

Duties of a Licensee

A licensee has the following duties under the act:

- to maintain a high standard of professional conduct in the performance of its duties and refrain from engaging itself or any of its employees in any illegal or improper conduct. This includes engaging in any activity, in or outside of The Bahamas, which may reflect negatively on other service providers or on the reputation of the country as an international financial centre;

- to verify the identity of each client upon receipt of instructions; and

- to maintain a record of each client for a period of at least six years from the date of termination of such relationship.

Suspension or Revocation of Licences

Where the inspector is of the opinion that a licensee is in contravention of any provision under the Financial and Corporate Service Providers Act or any other law, he may require the licensee immediately to take such steps as may be necessary to rectify the contravention, and suspend the licensee's licence for a maximum period of 30 days. A suspension for a longer period requires a court order and in such instance may only be for a maximum period of 60 days.

The inspector may revoke the licence of a licensee if:

- the inspector is of the opinion that the licensee is carrying on its business in a manner that is detrimental to the public interest, the interest of the companies managed by him or the reputation of The Bahamas;

- the licensee has ceased to carry on financial and corporate services; or

- the licensee becomes bankrupt or goes into liquidation, or is wound up or otherwise dissolved.

A licensee may appeal to the court a decision by the inspector to suspend or revoke its licence.

Offences under the Act

The offences under the act are as follows:

- Any person who engages in or carries on the business of financial corporate services in or from within The Bahamas without a licence commits an offence and is liable upon summary conviction to a fine of $75,000. Where the offence continues subsequent to conviction that person is liable to a fine of $1,000 for each day that the offence continues.

- A person who, with intent to deceive, contravenes any provision or requirement of the act by any action or omission commits an offence and is liable upon summary conviction to a fine of $100,000.

- Any licensee who invites, either directly or indirectly by advertisement, other parties to commit breaches of the law of the country in which such advertisement appears, or to which such advertisement is directed, commits an offence and is liable upon summary conviction to a fine of $50,000. Such liability is imputed to every director and officer concerned with the management of a company convicted for this offence, unless such director or officer satisfies the court that the offence was committed without his knowledge or consent, or that he took all reasonable steps to prevent commission of the offence.

- Any person who, with intent to deceive, for any purposes of the act makes any representation that he knows to be false or does not believe to be true commits an offence and is liable upon summary conviction to a fine of $100,000.

- Any person who assaults or obstructs the inspector or his appointee in the performance of his functions, or contravenes any provision of the act for which no punishment is specially provided, commits an offence and is liable upon summary conviction to a fine of $10,000.

- Any licensee who fails to comply with the record-keeping requirement of the act commits an offence and is liable upon summary conviction to a fine of $50,000.

Growth of Financial Services in India

The present growth rate of financial sector in India is about 8.5% p.a. An increase in growth rate is equivalent to growth of our economy.Over the past few years,there have been reforms in monetary policies,economicpolicies,opening up of financial markets,development of other financial sectors e.t.c.In present times,a wide variety of financial products and services are offerred to consumers to keep them satisfied.The Reserve Bank of India has also played a major role to help in growth of financial sector of India.

The diversified financial sector of India comprises of banks,mutualfunds,insurancecompanies,pension funds e.t.c.Do you know that the banking sector in India holds more than 60% of the total financial asstes of the country?At present ,India is without any doubts one of the world's most vibrant capital market.Let's take a look at growth of some of the financial sectors of India one by one-

Growth of the banking sector

Being one of the most extensive,the entire Indian banking system has a total asset value of approximately US$ 270 billion with total deposits being around US$ 220 billion.The banking system in India is continuously advancing and tranformingitself.The current development of Core banking,Internet banking e.t.c. has made banking operations easy and customer friendly.

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Growth of the Capital Market in India

The capital markets in India have also witnessed changes.Some of them are-

- Stock exchanges facing privatisation.
- Removal of ill-used forward trading mechanism
- In order to serve different investors in different locations,the introduction of infotech systems in National Stock Exchange.
- The increase in the ratio of transaction with deposit system and share ratio.

Growth in the Insurance sector in India

- The market potential in India is immense.But it is untapped.So now in order to utilise this opportunity,both foreign and Indian private players are providing tailor made products with opening of the market.

- Because of huge competiton and entry of new players,the insurance sector has also witnessed innovations like innovative insurance based products,services and value ass-onse.t.c.
- Many foreign companies like New York Life,Aviva,Standard Life have also entered this sector.
- Now a days,the insurance companies are engaged in aggressive marketing,selling and distribution techniques because of the extreme competition that they face from each other..
- The credit for the development of this sector also goes to the active part of the regulatory body –Insurance Regulatory and Development Authority.

Growth of the Venture Capital market in India

- Inspite of the hindrances by the external setup,the venture capital sector in India is a very active financial sector.
- In India,currently,there are around 2 international and 34 national venture capital funds registered by SEBI.

Merchant Banking

Every corporation whether it is emerging or establish, require funds at some stage during its operation and raise capital from the financial market is the most popular and convenient mode of arranging finance. Hence, the business corporates raise from the market by issuing financial securities and on the other hand individuals or institutional investors purchase these securities to invest their money to earn a profit.

Thus the role of merchant banks emerges in such circumstances. In this topic, we will learn the concept of **Merchant Banking** in brief.

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Merchant Banking:

"**Merchant Banking** refers to the financial intermediary services provided by specialised banks called Merchant Bank (other than commercial banks) for business corporates and individual with high net worth."

Merchant banks act as an intermediary/ middleman between business corporates and investors. In other words, merchant banking is financial intermediation between the business entities which require funds and the investors who possess ready capital and seeking an opportunity for investment so that they can make a return.

Thus, we can say that Merchant banking matches the gap between the issuer of capital (Corporates) and purchaser of capital (Investors). Hence, it is the function that facilitates the flow of capital in the financial system.

Role of Merchant Banking:

- Merchant Banking facilitates in channelising the financial surplus of the general public into productive investment avenues.
- It coordinates the activities of various intermediaries to share issue.
- It ensures compliance with rules and regulations governing the securities market.

- Merchant banking is said to be the centre of capital market operations and their activities are primarily non-fund based.
- Their basic requirement is a high professional with skills and worldwide contact.

Merchant Banking- Origin:

The concept of merchant banking is originated in the 13th century from Italy and the first-ever merchant banks were Riccardi of Luca, Medici, Fugger etc. Initially, there was no distinction between the functions of commercial banking and merchant banking until 1932.

The merchant banks are also known as “Accepting and Issuing Houses” in the United Kingdom and they are known as Investment Banks in the United States as well.

Merchant Banking in India:

Merchant Banking Service in India was originated in 1969 when the merchant banking division of Grindlays Bank was initiated for undertaking and management of the public issue and financial consultancy. Further, State Bank of India stated merchant banking service in 1973 and ICICI Bank Ltd became the first development financial institution to initiate merchant banking services in 1974.

During mid-seventies, India witnessed a boom in the growth of merchant banking organisations which were sponsored by the banks, NBFCs, Brokers etc. This led to the diversification into the scope of the following activities.

- Loan Syndication
- Portfolio Management
- Corporate Counselling
- Project Counselling
- Debenture Trusteeship
- Mergers and Acquisitions

However, the scope of such services was neither defined nor any rules and regulation were set up to govern such activities. Then in 1992, the formation of SEBI (Securities of Exchange Board of India) was taken place. This became a landmark in the evolution of merchant banking as a professional service in the country.

Merchant Banker Functions:

Although merchant banks provide numerous services to their client these days, some of the most significant functions of merchant banks are explained below.

1) Underwriting of Debt and Equity:

Underwriting/ management of debt securities such as debentures and share capital is one of the most important functions of a merchant banker. The merchant banks act as middlemen between the issuer of debt securities and individual or institutional investor and assists the companies in raising funds from the market. Merchant banks evaluate the value of the business and the number of shares or debentures is to be issued.

2) Placement and Distribution:

The merchant bankers facilitate in distributing various securities like equity shares, debt instruments, mutual funds, fixed deposits, insurance policies, commercial papers and distribution network of the merchant banker can be classified as institutional and retail.

3) Corporate Advisory Services:

Merchant bankers offer customised solutions to their clients' financial problems and financial structuring includes determining the right debt-equity ratio and gearing ratio for the client and appropriate capital structure theory is framed as well.

Merchant banker explores the refinancing alternatives for the client and evaluates cheaper sources of funds. It also provides Rehabilitation, Turnaround and Risk management services such as designing a revival package in coordination with banks and financial institutions for sick industrial units, appropriate hedging strategies to reduce the risk associated.

4) Project Advisory Services:

Merchant bankers help their clients in various stages of the project undertaken by the clients:

1. They assist them in conceptualising the project idea in the initial stage
2. Once the idea is formed, they conduct feasibility studies to examine the viability of the proposed project
3. They also assist the client in preparing different documents like a detailed project report

5) Loan/ Credit Syndication:

Merchant bankers arrange tie-up loans for their clients. This takes place in a series of steps. Firstly they analyse the pattern of the client's cash flows, based on which the terms of borrowings can be defined. Then the merchant banker prepares a detailed loan memorandum, which is circulated to various banks and financial institutions and they are invited to participate in the syndicate. The banks then negotiate the terms of lending based on which the final allocation is done.

6) Provide Venture Capital and Mezzanine Financing:

Merchant bankers help companies in obtaining venture capital financing for financing their new and innovative strategies. They also help small organisations and entrepreneurs to obtain initial funding, other business ideas and opportunities, Government policies and incentives.

In addition, merchant bankers also provide various other services as well.

7) Portfolio Management Services:

Merchant banks offer portfolio management service to their clients. They guide their clients regarding profitable, easy liquid and less risky investment avenue. They also update their clients with important and crucial news and updates regarding investment opportunities and market fluctuations.

8) Interest/ Dividend Management:

Merchant bankers also facilitate their client on computing, declaration and allocation of interest on debt securities such as debentures and dividend of shares/stocks.

9) Brokerage Services:

Merchant banks also act as a broker in the stock exchange. They purchase or sell the shares on behalf of their clients and also provide guidance on which or when to buy or sell shares.

10) Manage Money Market Instruments:

Merchant bankers also manage money market instruments like Government bonds, Treasury bills, commercial papers, certificate of deposits for the Government entities as well as large companies and financial institutions.

Registration of Merchant Bankers:

To function as a merchant banker, a business firm or company needs to register with SEBI and comply with the following terms and conditions:

- The applicant should be a body corporate and should have a minimum net worth of Rs.5 crores.
- The applicant should not carry on any business other than those connected with the securities market
- The applicant should have the necessary infrastructure like office space, equipment, manpower etc
- The applicant must have at least two employees with prior experience in merchant banking
- Any associate company, group company, subsidiary or the interconnected company of the applicant should not have been a registered merchant banker.
- The applicant should not have been involved in any securities scam or proved guilt for any offer.

Types

Types of Merchant Banks in India

The Securities and Exchange Board of India (SEBI), which is a regulatory body, has classified *'Merchant Bankers'* under the following four categories –

Category I Merchant Bankers:

This category contains the Merchant Bankers who can act as Issue Managers, Consultants, Advisors, Portfolio Managers and Underwriters.

Category II ***Merchant Bankers:***

These Merchant Bankers can act as Advisors, Consultants, Portfolio Managers and Underwriters. But they cannot act as issue managers on their own but as Co-Managers.

Category III ***Merchant Bankers:***

This category of Bankers is allowed to act as Advisors, Consultants and Underwriters only. They can neither act as Issue Managers on their own nor as Co-Managers. Also, they cannot undertake portfolio management activities.

Category IV ***Merchant Bankers:***

This category of Merchant Bankers can only act as Advisors or Consultants regarding an issue of capital.

Responsibilities of Merchant Bankers

Merchant banker's role in Public Issue

1. **Furnishing Information**:
   - Number of issues for which the merchant banker is engaged as banker to issue.
   - Number of applications received and details of application money received
   - Dates on which applications from investors were forwarded to issuing company.
   - Details of amount as refund to investors.

2. **<u>Books to be Maintained</u>**:
   - Books of accounts for a minimum period of 3 years
   - Records regarding the company
   - Documents such as company applications, names of investors, etc.

3. **<u>Agreement with issuing company</u>**

Agreement with the issuing company by the merchant banker should contain

   - Number of collection centres
   - Application money received
   - Daily statement by each branch which is a collecting centre.

4. **<u>Action by RBI</u>:** Any action by RBI on merchant banker should be informed to SEBI by the merchant banker concerned.

5. **<u>Code of Conduct</u>**
   - Having high integration in dealing with clients.
   - Disclosure of all details to the authorities concerned. Avoiding making exaggerated statements.
   - Disclosing all the facts to its customers.
   - Not disclosing any confidential matter of the clients to third parties.

A rights issue is the offer of shares of a company to the existing shareholders. A merchant banker has the **following responsibilities in Rights issue**.

Responsibilities of merchant bankers in Rights Issue

1. The merchant banker will **ensure that when Rights issues are taken up by a company**, the merchant banker who is responsible for the Rights issue, shall see that an advertisement regarding the same is published in an English national daily, in an Hindi national daily and in a regional daily.
These newspapers should be in circulation in the city / town where the registered office of the company is located.

2. It is the duty of the merchant banker to **ensure that the application forms for Rights issue should be made available to the shareholder**s and if they are not available, a duplicate composite application form is made available to them within a reasonable time.
3. If the shareholders are not able to obtain neither the original nor the duplicate application for Rights shares, they can apply on a plain paper through the merchant banker.

4. The details that should be furnished in the plain paper, while applying for Rights shares should be provided by the merchant hanker.

5. The merchant banker should mention in the advertisement, the company official to whom the shareholders should apply for Rights shares.

6. The merchant banker should also inform that no individual can apply twice, in standard form as well as in plain paper.

Regulation of Merchant Banking in India

Regulations by SEBI 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.

UNIT – III : Venture Capital

'Venture Capital' is an important source of finance for those small and medium- sized firms, which have very few avenues for raising funds. Although such a business firm may possess a huge potential for earning large profits in the future and establish itself into a larger enterprise. But the common investors are generally unwilling to invest their funds in them due to risk involved in these types of investments. In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. In a way, venture capital is a commitment of capital, or shareholdings, for the formation and setting-up of small scale enterprises at the early stages of their lifecycle.

The term venture capital comprises of two words, namely, 'venture' and 'capital'. The term venture literally means a course or proceeding, the outcome of which is uncertain but which is uncertain but which is attended by the risk of danger of 'loss'. On the other hand, the term capital refers to the resources to start the enterprise. However, the term venture capital can be understood in two ways.

According to narrow sense, the capital which is available for financing the new business ventures is called venture capital. Generally, it involves lending finance to the growing companies.

In the broad sense, venture capital is the investment of long-term equity finance where the venture capitalist earns his returns primarily in the form of capital gain. It is under the assumption that the entrepreneur and thee venture capital would act as partners. It is a commitment of capital for the formation and setting up of small scale enterprises specializing in new ideas or new technologies. Venture capital does not deal in financing the enterprise which is engaged intrading, broking, investment or financial services and agency or liaison work. It is generally considered as a high risk capital. Venture capital is not an injection of funds into new firm but also an input of the skills need to set up thee firm, design its marketing strategy, organize and then manage it.

A venture capitalist (also known as a VC) is a person or investment firm that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (often an LP or LLC) that primarily invests the financial capital of third- party investors in enterprises that are too risky for the standard capital markets or bank loans.

Venture capital is also associated with job creation, the knowledge economy and used as a proxy measure of innovation within an economic sector or geography. The term Venture Capital fund is usually used to denote Mutual funds or Institutional investors. They provide equity finance or risk capital to little known, unregistered, highly risky, young and small private business, specially in technology oriented and knowledge intensive business.

Venture Capital termed as long-term funds in equity or semi- equity from to finance hi-tech investment in novel technology based projects with display potential for significant growth and financial return."

According to JameKoloskiMorries, " Venture capital is defined as providing seed, startup, and first stage financing and also funding expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit-oriented institutional funding sources, Venture Capital also provides management in leveraged buy out financing".

Features of Venture Capital

1) For New Entrant: Venture Capital investment is generally made in new enterprises that use new technology to produce new products, in expectation of high gains or sometimes, spectacular returns.

2) Continuous Involvement: Venture capitalists continuously involve themselves with the client's investments, either by providing loans or managerial skills or any other support.

3) Mode of Investment: Venture capital is basically an equity financing method, the investment being made in relatively new companies when it is too early to go to the capital market to raise funds. In addition, financing also takes the form of loan finance/ convertible debt to ensure a running yield on the portfolio of the venture capitalists.

4) Long-term Capital: The basic objective of a venture capitalist is to make a capital gain on equity investment at the time of exit, and regular return on debt financing. It is a long-term investment in growth- oriented small/medium firms. It is a long-term capital that is an injected to enable the business to grow at a rapid pace, mostly from the start-up stage.

5) Hands-On Approach: Venture capital institution take active part in providing value – added services such as providing business skills, etc., to investee firms. Thy do not interfere in the management of the firms nor do they acquire a majority / controlling interest in the investee firms. The rationale for the extension of hands- on management is that venture capital investments tend to be highly non- liquid.

6) High risk- return Ventures: Venture capitalists finance high risk-return ventures. Some of the ventures yield very high return in order to compensate for the heavy risks related to the ventures. Venture capitalists usually make hug capital gains at the time of exit.

7) Source of Finance: Venture capitalists usually finance small and medium- sized firms during the early stages of their development, until they are established and are able to raise finance from the conventional industrial finance market. Many of these firms are new, high technology- oriented companies.

8) Liquidity: Liquidity of venture capital investment depends on the success or otherwise of the new venture or product. Accordingly, there will be higher liquidity where the new ventures are highly successful.

Venture Capital Funding Process

Obtaining capital for a project through this rout is very difficult. It involves many steps, which a prospective entrepreneur has to adopt when he approaches an investor. They are:

1) Making a Deal (Deal Origination): A continuous flow of deals is essential for the venture capital business. Deals may originate in various ways. Referral system is an important source of deals. Deals

may be referred to the VCs through their parent organizations, trade partners, industry associations, friends, etc. The venture capital industry in India has become quit proactive in its approach to generating the dal flow by encouraging individuals to come up with their business plans.

VCFs carry out initial screening of all projects on the basis of some broad criteria. For example the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, or Product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

2) Evaluation or Due Diligence: Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. Hence a sophisticated, formal evaluation is neither possible nor desirable. The Vcs thus rely on a subjective but comprehensive evaluation. VCFs evaluate the quality of the entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and expected return on the venture.

3) Investment Valuation: The investment valuation process is aimed at ascertaining an acceptable price for the deal. The valuation process goes through the following steps.
i) Projections on future revenue and profitability.
ii) Expected market capitalization.
iii) Deciding on the ownership stake based on the return expected on the proposed investment.
iv) The pricing thus calculated is rationalized after taking into consideration various economic scenarios, demand and supply of capital, founders/ management team's track record, innovation/unique Selling Propositions (USPs), the product/ Service size of the potential market, etc.

4) Deal Structuring: Once the venture has been evaluated as viable, the venture capitalist and the investment company negotiate the terms of the deal, i.e., the amount, form and price of the investment. This process is termed as dal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalists' right to control the invest company and to change its management if needed, buy back arrangements, acquisition, making Initial Public Offerings (IPOs), etc. Earn- out arrangements specify the entrepreneur's equity share and the objectives to be achieved. Venture capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for a return commensurate with the risk, influence over the firm through board membership, minimizing taxes, assuring investment liquidity and the right to replace management in case of consistent poor managerial performance.

5) Post-Investment Activities and Exit: Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also involves in shaping of the direction of the venture. This may be done via a formal representation on the board of director, or informal influence in improving the quality of marketing, finance and other managerial functions. The degree of the venture capitalists involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene and even install a new management team. Venture capitalists typically aim at making medium- to long- term capital gains. They generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture capitalist can exit in four ways.

i) Initial Public Offerings (IPOs): When the company is making good profits and the market condition is conductive, the venture capitalists offer their shareholding to the public, the advantage of this exit rout is that the shares can be priced at premium in time with the market trend and will bring them good fortune. However, there are some disadvantages like high cost of issue, lower demand, etc.

ii) Acquisition by Another Company: Another strategy is to sell their holdings to another company who are interested to expand their business in this line. The advantage of this strategy is that they can negotiate the deal and results into transfer of controlling interest, the existing promoters may play defensive strategies for fear of loss of control. Sometimes the negative reputation of the acquiring company may bring down the business of the acquired company also.

iii) Repurchase of the Venture Capitalist's Share by the Investee Company: If the promoters have enough cash at their disposal, thy can buy- back the shares from the venture capitalists so that they can retain their control over the company. However, if the company is enjoying good reputation in the market, the venture capitalists may demand a hefty amount as compensation for their exit.

iv) Purchase of VCs Share by a Third Party: Venture capitalists can sell their holdings through private placements to one or more third parties. Here also there is a chance of loss of control to the existing promoters, who may play some defensive strategies. However, compared to the public offer, this will be a cheaper route for exit.

Growth of Venture Capital in India

The venture capital in India is still an emerging concept and is still at an introductory state. For Venture Capital firms to flourish in India, there should be a proper promotion of innovation, enterprise, commercial execution of innovative ideas, entrepreneurial culture etc. India has already entered the era of Information technology and this sector has seen tremendous growth over the years. The "Make in India" campaign has attracted many individuals and companies from all over to invest and build in India.

A development in the Venture Capital environment will fill the gap between the capital requirement of tech-based and knowledge based startups and traditional financing systems. The traditional Indian Venture Capital environment can be dated back to 150 years when agencies provided both finance and skills to projects.

Phases of Venture Capital

The growth and development of venture capital in India has taken in different phases. The need for the venture capital was first noticed by the Bhatt **Committee** in 1972 under the chairmanship of R.S. Bhatt. This committee identified the problems of new entrepreneurs and technologists in setting up industries.

- In 1975, venture capital financing was introduced in India by all-india financial institutions with the establishment of Risk Capital Foundation (RCF) supported by Industrial Finance Corporation (IFCI).
- In 1976, seed capital scheme was introduced by Industrial Development Bank of India (IDBI).
- In 1984, Industrial Credit and Investment Corporation of India (ICICI) decided to allocate funds for providing assistance to venture capital firms.

- In 1985, the government announced the creation of a Venture Capital Fund and presented it in parliament. The fund created equity capital for pilot projects with potential businesses.

The First Phase 1986-1995

- April 1, 1986, Venture Capital Fund established by the government was operational and administered by IDBI Bank.
- In 1986, ICICI launched a venture capital scheme to encourage new technocrats in the private sector in the emerging field of high-risk technology.
- In August, 1986, ICICI Bank undertook administration of **Programme for Advancement of Commercial Technology (PACT)**
- In 1987, IDBI started a venture capital fund scheme
- In 1987-1988, Technology Development Fund (TDF) changed the course of Venture Capital in India.Government of India and World Bank joined together for economic liberalisation in India. November 25, 1988, government announced guidelines for the establishment and functioning of venture capital activities.
- In 1993, Indian Venture Capital Association (IVCA) was established headquartered in Bangalore.
- First phase of Venture Capital in india was a developing experience and policy making with some regulatory framework

The Second Phase 1995-1999

Capital Under Management in India increased after 1995. Non-resident Indians (NRIs) invested in Venture Capital Funds. Suggestion from Shri Vishnu Varshney in 1998, resulted in tax privileges , progressive liberalisation in IPO guidelines and institutions.

In 1999, 80% of total venture capital investment were derived overseas firms.Such overseas firms were registered in Mauritius and operated in India to avoid the regulation by Indian government. IVCA refined its terms and framework to facilitate the Venture Capital ecosystem

The Third Phase 2000 and above

- In 1999, various regulations were adjusted and the horizon of investment in venture capital for other financial institutions was broadened. All the banks with permission were allowed to invest 5% of their new fund in venture capital annually.
- Venture capital industry faced liquidity, legal, political, economical and operational problems during the course of action. K.B. Chandrasekhar committee addressed all these issues and submitted a report to SEBI.
- In 2012 A.D., $3.1 B capital was deployed in India and by the end of 2018, this capital investment amounted to $6.4 billion. By the end of 2019, this amount will reach $ 10 billion.
- Similarly, In 2012, the number of Venture Capitalists investment was 458 and by the end of 2019, the number of investments was more than 750.

Legal Aspects and Guidelines for Venture Capital

Venture Capital in India governs by the SEBI[8] Act, 1992 and SEBI (Venture Capital Fund) Regulations, 1996. According to which, any company or trust proposing to carry on activity of a

Venture Capital Fund[9] shall get a grant of certificate from SEBI[10]. However, registration of Foreign Venture Capital Investors (FVCI) is not obligatory under the FVCI regulations[11]. Venture Capital funds and Foreign Venture Capital Investors are also covered by Securities Contract (Regulation) Act, 1956, SEBI (Substantial Acquisition of Shares & Takeover) Regulations, 1997, SEBI (Disclosure of Investor Protection) Guidelines, 2000.

Constitution of Venture Capital Funds

There are three layers of structured or institutional venture capital funds i.e. venture capital funds set up by high net worth individual investors, venture capital subsidiaries of corporations and private venture capital firms/ funds. Venture funds in India can be divided on the basis of the type of promoters.

1. Venture Capital Funds promoted by the Central government controlled development financial institutions such as TDICI, by ICICI, Risk capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.

2. It is promoted by the state government-controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC) and Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC)

3. Also, promoted by Public Sector banks such as Canfina and SBI-Cap.

4. Venture Capital Funds promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund and Grindlay's India Development Fund[12].

Eligibility and Investment Criteria for Venture Capital Funds

For Venture Capital Funds it is required that Memorandum of Association or Trust Deed must have main objective to carry on action of Venture Capital Fund including prohibition by Memorandum of Association & Article of Association for making an invitation to the public to subscribe to its securities. Further, it is required that Director or Principal Officer or Employee or Trustee is not caught up in any litigation connected with the securities market and has not at any time been convicted of any offence involving moral turpitude or any economic offence. Also, in case of, body corporate, it must have been set up under Central or State legislations and applicant has not been refused certificate by SEBI[13].

A Venture Capital Funds may generate investment from any investor (Indian, Foreign or Non-resident Indian) by means of issue of units and no Venture Capital Fund shall admit any investment from any investor which is less than five Lakhs. Employees or principal officer or directors or trustee of the VCF or the employees of the fund manager or Asset Management Company (AMC) are only exempted. It is also mandatory that VCF shall have firm commitment of at least five Crores from the Investors before the start of functions by the VCF. Disclosure of investment strategy to SEBI before registration, no investment in associated companies and duration of the life cycle of the fund is compulsorily being done. It shall not invest more than twenty five percent of the funds in one Venture Capital Undertaking. Also, minimum 66.67% of the investible funds shall be utilized in unlisted equity shares or equity linked instruments of Venture Capital Undertaking.

It is also mandatory that not more than 33.33% of the investible funds may be invested by way of following as stated below:-

1. Subscription to IPO[14] of a Venture Capital Undertaking (VCU)
2. Debt or debt instrument of a VCU in which VCF has already made an investment by way of equity
3. Preferential allotment of equity shares of a listed company subject to lock in period of one year

4. The equity shares or equity linked instruments of a monetarily weak company or a sick industrial company whose shares are listed.
5. SPV (special purpose vehicles) which are created by VCF for the purpose of making possible investment.

RBI and Investment Criteria
A foreign venture capital investor proposing to carry on venture capital activity in India may register with the Securities and Exchange Board of India ("SEBI"), subject to fulfilling the eligibility criteria and other requirements contained in the SEBI Foreign Venture Capital Investor Regulations. The SEBI Foreign Venture Capital Investor Regulations prescribe the following investment guidelines, which can impact overall financing plans of foreign venture capital funds.

a) The foreign venture capital investor must disclose its investment strategy and life cycle to SEBI, and it must achieve the investment conditions by the end of its life cycle.

b) At least 66.67 per cent of the investible funds must be invested in unlisted equity shares or equity linked instruments.

c) Not more than 33.33 per cent of the investible funds may be invested by way of:
· Subscription to initial public offer of a venture capital undertaking, whose shares are proposed to be listed.
· Debt or debt instrument of a venture capital undertaking in which the foreign venture capital investor has already made an investment, by way of equity.
· Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year.
· The equity shares or equity linked instruments of a financially weak or a sick industrial company (as explained in the SEBI FVCI Regulations) whose shares are listed.

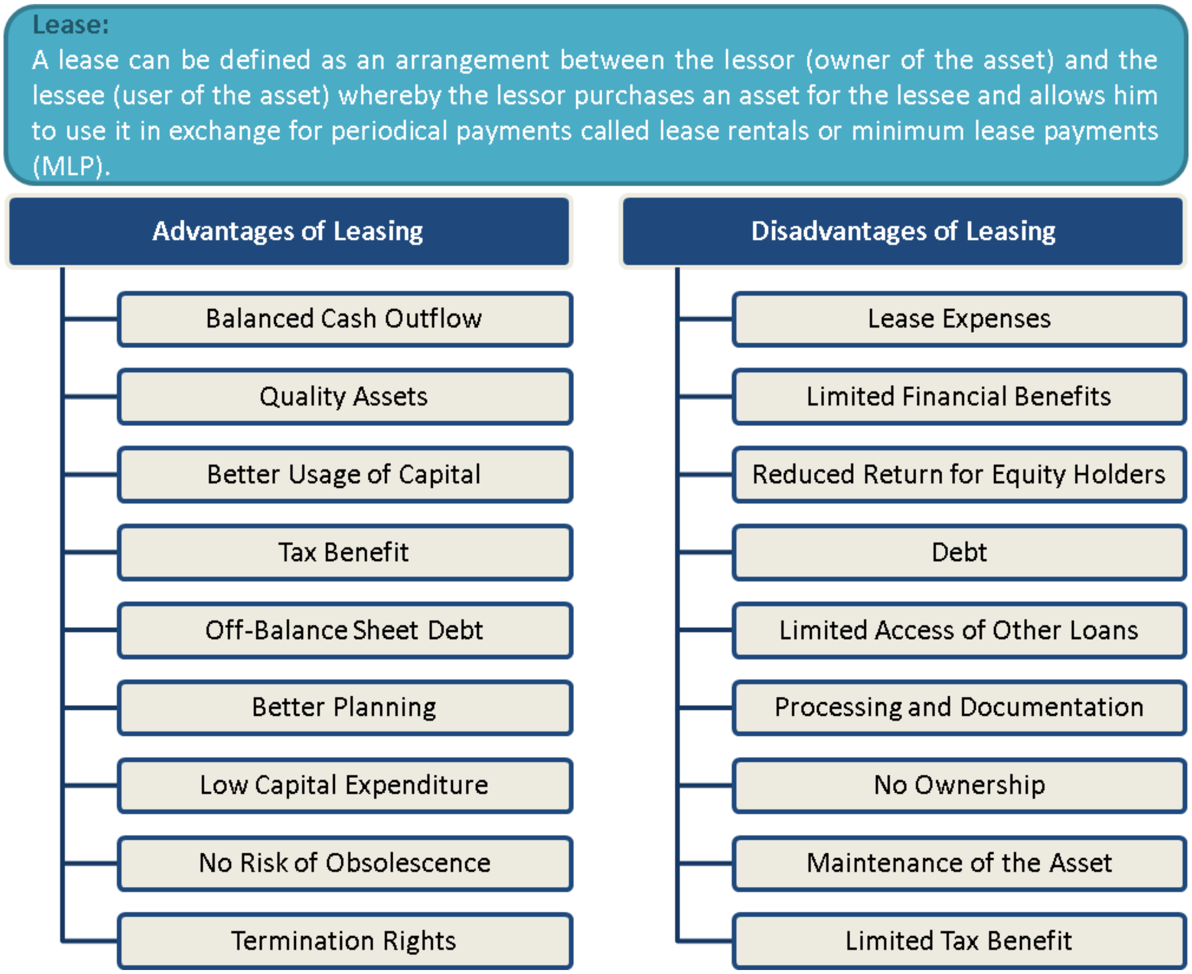
A foreign venture capital investor may invest its total corpus into one venture capital fund[15].

Tax Matters related to Venture Capital Funds
Indian Venture Capital Funds are allowed to tax payback under Section 10(23FB) of the Income Tax Act, 1961. Any income earned by an SEBI registered Venture Capital Fund (established either in the form of a trust or a company) set up to raise funds for investment in a Venture Capital Undertaking is exempt from tax[16]. It will also be extensive to domestic VCFs and VCCs which draw overseas venture capital investments provided these VCFs/VCCs be conventional to the guidelines pertinent for domestic VCFs/VCCs. On the other hand, if the Venture Capital Fund is prepared to forego the tax exemptions available under Section 10(23F) of the Income Tax Act, it would be within its rights to invest in any sector[17].

Leasing
WHAT IS A LEASE OR LEASING?
A famous quote by Donald B. Grant says, "*Why own a cow when the milk is so cheap? All you really need is milk and not the cow.*" The concept of Lease is influenced by this quote. We can compare 'milk' with the 'rights to use an asset' and 'cow' with the 'asset' itself. Ultimately, a person who wants to manufacture a product using machinery can get to use that machinery under a leasing arrangement without owning it.
A lease can be defined as an arrangement between the lessor (owner of the asset) and the lessee (user of the asset) whereby the lessor purchases an asset for the lessee and allows him to use it in exchange for periodical payments called lease rentals or minimum lease payments (MLP). Leasing is beneficial to both the parties for availing tax benefits or doing tax planning.
At the conclusion of the lease period, the asset goes back to the lessor (the owner) in an absence of any

other provision in the contract regarding compulsory buying of the asset by the lessee (the user). There are four different things possible post-termination of the lease agreement.

- The lease is renewed by the lessee perpetually or for a definite period of time.
- The asset goes back to the lessor.
- The asset comes back to the lessor and he sells it off to a third party.
- Lessor sells to the lessee.



PURPOSE OF LEASING

The purpose of choosing a lease can be many. Generally, a lease is structured for the following reasons.

BENEFITS OF TAXES

The tax benefit is availed to both the parties, i.e. Lessor and Lessee. Lessor, being the owner of the asset, can claim depreciation as an expense in his books and therefore get the tax benefit. On the other hand, the lessee can claim the MLPs i.e. lease rentals as an expense and achieve tax benefit in a similar way.

AVOID OWNERSHIP AND THEREBY AVOIDING RISKS OF OWNERSHIP

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

ADVANTAGES OF LEASING

BALANCED CASH OUTFLOW

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

QUALITY ASSETS

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

BETTER USAGE OF CAPITAL

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

TAX BENEFIT

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

OFF-BALANCE SHEET DEBT

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

BETTER PLANNING

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

LOW CAPITAL EXPENDITURE

Leasing is an ideal option for a newly set-up business given that it means lower initial cost and lower CapEx requirements.

NO RISK OF OBSOLESCENCE

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

TERMINATION RIGHTS

At the end of the leasing period, the lessee holds the right to buy the property and terminate the leasing contract, thus providing flexibility to business.

DISADVANTAGES OF LEASING

LEASE EXPENSES

Lease payments are treated as expenses rather than as equity payments towards an asset.

LIMITED FINANCIAL BENEFITS

If paying lease payments towards a land, the business cannot benefit from any appreciation in the value of the land. The long-term lease agreement also remains a burden on the business as the agreement is locked and the expenses for several years are fixed. In a case when the use of asset does not serve the requirement after some years, lease payments become a burden.

REDUCED RETURN FOR EQUITY HOLDERS

Given that lease expenses reduce the net income without any appreciation in value, it means limited returns or reduced returns for an equity shareholder. In such a case, the objective of wealth maximization for shareholders is not achieved.

DEBT

Although lease doesn’t appear on the balance sheet of a company, investors still consider long-term lease as debt and adjust their valuation of a business to include leases.

LIMITED ACCESS TO OTHER LOANS

Given that investors treat long-term leases as debt, it might become difficult for a business to tap capital markets and raise further loans or other forms of debt from the market.

PROCESSING AND DOCUMENTATION

Overall, to enter into a lease agreement is a complex process and requires thorough documentation and proper examination of an asset being leased.

NO OWNERSHIP

At the end of the leasing period, the lessee doesn’t end up becoming the owner of the asset though quite a good sum of payment is being done over the years towards the asset.

MAINTENANCE OF THE ASSET

The lessee remains responsible for the maintenance and proper operation of the asset being leased.

LIMITED TAX BENEFIT

For a new start-up, the tax expense is likely to be minimal. In these circumstances, there is no added tax advantage that can be derived from leasing expenses.

types of Leases

Types of leases:

Different types of Leasing

1. Financial Lease

Financial leasing is a contract involving payment over a longer period. It is a long-term lease and the lessee will be paying much more than the cost of the property or equipment to the lessor in the form of lease charges. It is irrevocable. In this type of leasing the lessee has to bear all costs and the lessor does not render any service.

2. Operating Lease

In an operating lease, the lessee uses the asset for a specific period. The lessor bears the risk of obsolescence and incidental risks. There is an option to either party to terminate the lease after giving notice. In this type of leasing

- lessor bears all expenses
- lessor will not be able to realize the full cost of the asset

- specialized services are provided by the lessor.

This kind of lease is preferred where the equipment is likely to suffer obsolescence.

3. Leveraged and non-leveraged leases

In leveraged and non-leveraged leases, the value of the asset leased may be of a huge amount which may not be possible for the lessor to finance. So, the lessor involves one more financier who will have charge over the leased asset.

4. Conveyance type lease

In Conveyance type lease, the lease will be for a long-period with a clear intention of conveying the ownership of title on the lessee.

5. Sale and leaseback

In a sale and leaseback, a company owning the asset sells it to the lessor. The lessor pays immediately for the asset but leases the asset to the seller. Thus, the seller of the asset becomes the lessee. The asset remains with the seller who is a lessee but the ownership is with the lessor who is the buyer. This arrangement is done so that the selling company obtains finance for running the business along with with the asset.

6. Full and non-pay-out lease

A full pay-out lease is one in which the lessor recovers the full value of the leased asset by way of leasing. In case of a non pay-out lease, the lessor leases out the same asset over and over again.

7. Specialized service lease

The lessor or the owner of the asset is a specialist of the asset which he is leasing out. He not only leases out but also gives specialized personal service to the lessee. Examples are electronic goods, automobiles, air-conditioners, etc.

8. Net and non-net lease

In non-net lease, the lessor is in charge of maintenance insurance and other incidental expenses. In a net lease, the lessor is not concerned with the above maintenance expenditure. The lessor confines only to financial service.

9. Sales aid lease

In case, the lessor enters into any tie up arrangement with manufacturer for the marketing, it is called sales aid lease.

10. Cross border lease

Lease across national frontiers are called cross border lease, Shipping, air service, etc., will come under this category.

11. Tax oriented lease

Where the lease is not a loan on security but qualifies as a lease, it will be considered a tax-oriented lease.

12. Import Lease

In an Import lease, the company providing equipment for lease may be located in a foreign country but the lessor and the lessee may belong to the same country. The equipment is more or less imported.

13. International lease

Here, the parties to the lease transactions may belong to different countries which is almost similar to cross border lease.

Evaluation of Leasing Option Vs. Borrowing

Evaluation of Lease Decision: 3 Methods (with formula)

The methods used in evaluation of lease decision are as follows: - 1. Present Value Method 2. Cost of Capital Method 3. Bower-Herringer-Williamson Method.

1. Present Value Method:

Under this method the present value of lease rentals are compared with the present value of the cost of an asset acquired on outright purchase by availing a loan. In leasing, the tax advantage in payment of lease rentals will reduce the cash outflow.

In case an asset is purchased by borrowing a loan, the repayment of principal and interest charges on loan is considered as cash outflow and it is reduced by tax advantage of depreciation claim and interest charge. The present value of the net cash outflows over the period of lease is considered to ascertain the present value over the lease/loan period. The alternative with low total present value of cash outflow will be selected.

2. Cost of Capital Method:

Under this method, the rate of cost of capital is calculated for the payments of installments and then it is compared with the cost of capital of the other available sources of finance such as fresh issue of equity capital, retained earnings, debentures, term loans etc. The lease option is chosen if the rate is lower than the cost of equity capital etc. This method does not require the prior selection of any discounting rate.

3. Bower-Herringer-Williamson Method:

Under this method, the financial and tax aspects of lease financing are considered separately.

The following steps are involved in evaluation of lease decision:

Step 1:

Make a comparison of the present value of cost of debt with the discounted value of gross amount of lease rentals. The rate of discount applicable is being the gross cost of debt capital. Then, obtain the total present value of a financial advantage/disadvantage of leasing.

Step 2:

Again compute the comparative tax benefit during the lease period and discount it at an appropriate cost of capital. The total present value is the operating advantage/ disadvantage of leasing. Step 3 – When the present value of operating advantage of lease is more than its financial disadvantage, then select the leasing. When the present value of financial advantage is more than operating disadvantages, then select the leasing.

Illustration:

Vindhya Papers Ltd. planning to install a captive generator set at its plant. Its Finance Manager is asked to evaluate the alternatives either to purchase or acquire generator on lease basis.

Buying	*Initial cost Rs.*5,00,000	*Residual Value Rs.*1,60,000
Leasing for 5 *years*	*Annual lease rental Rs.*1,50,000 *to lessee in* 5 *years time*	*Residual value Rs.*90,000 *returned*

Depreciation @ 20% p.a. on written down value. Corporate tax rate 40%. After tax cost of debt is 14%.

The time gap between the claiming of the tax allowance and receiving the benefit is one year.

Evaluate the lease or buy decision based on the above information.

Solution:

Alternative (1) : Buying

Year	Cost or W.D.V.	Depreciation @ 20%	Corporate tax @40%
1	5,00,000	1,00,000	40,000
2	4,00,000	80,000	32,000
3	3,20,000	64,000	25,600
4	2,56,000	51,200	20,480
5	2,04,800	-	-
Less: Residual value	1,60,000	-	-
	44,800	44,800	17,920

Calculation of Net Present Value

Year	Cost (Rs.)	Tax relief (Rs.)	Net cashflow (Rs.)	P.V. factor @ 14%	P.V. (Rs.)
0	(5,00,000)	-	(5,00,000)	-	(5,00,000)
1	-	-	-	0.8772	-
2	-	40,000	40,000	0.7695	30,780
3	-	32,000	32,000	0.6750	21,600
4	-	25,600	25,600	0.5921	15,158
5	1,60,000	20,480	1,80,480	0.5194	93,741
6	-	17,920	17,920	0.4556	8,164
				N P V =	(3,30,557)

Alternative (2) : Leasing

Year	Lease rentals (Rs.)	Tax relief (Rs.)	Net cashflow (Rs.)	P.V. @ 14%	P.V. (Rs.)
0	(1,50,000)	-	(1,50,000)	-	(1,50,000)
1	(1,50,000)	-	(1,50,000)	0.8772	(1,31,580)
2	(1,50,000)	60,000	(90,000)	0.7695	(69,255)
3	(1,50,000)	60,000	(90,000)	0.6750	(60,750)
4	(1,50,000)	60,000	(90,000)	0.5921	(53,289)
5	90,000	60,000	1,50,000	0.5194	77,910
6	(Share residual value)	60,000	24,000	0.4556	10,934
	Tax on residual value	(36,000)			
				NPV =	(3,76,030)

Analysis:

From the above analysis, by applying the discounted cashflow technique, we can observe that the net present value of cash outflow is higher in case of leasing decision i.e., Rs. 3,76,030 as compared to buying decision it is only Rs. 3,30,557. The company may go for purchase of the generator instead of acquiring on lease basis.

Financial Evaluation of Leasing: Way # 1.
Lessee's Point of View:
(Lease or Buy/Lease or Borrow Decisions):

Once a firm has evaluated the economic viability of an asset as an investment and accepted/selected the proposal, it has to consider alternate methods of financing the investment. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

Thus, the firm may consider leasing of the asset rather than buying it. In comparing leasing with buying, the cost of leasing the asset should be compared with the cost of financing the asset through normal sources of financing, i.e., debt and equity.

Since, payment of lease rentals is similar to payment of interest on borrowings and lease financing is equivalent to debt financing, financial analysts argue that the only appropriate comparison is to compare the cost of leasing with that of cost of borrowing. Hence, lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing.

The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:
(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

We have illustrated the above analysis in the following illustrations.

Illustration 1:
A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:
(i) To borrow the amount at 18% p.a. repayable in 5 equal installments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

Note:
(1) The present value of Re. 1 at 18% discount factor is:

1st year – .847

2nd year – .718

3rd year – .609

4th year – .516

5th year – .437

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

Solution:

(i) **Calculation of loan instalment**

$$\text{Loan Instalment} = \frac{\text{Amount of Loan}}{\text{P.V. Factor of Annuity}}$$

$$= \frac{5{,}00{,}000}{3.127}$$

$= ₹\ 1{,}59{,}898$ appx.

(ii) **Schedule of Loan Payment**

Year	Loan Balance at beginning of the year	Loan Instalment	Interest Payment	Principal Payment	Loan Balance at the end of the year
	(₹)	(₹)	(₹)	(₹)	(₹)
1.	5,00,000	1,59,898	90,000	69,898	4,30,102
2.	4,30,102	1,59, 898	77,418	82,480	3,47,622
3.	3,47,622	1,59,898	62,572	97,326	2,50,296
4.	2,50,296	1,59,898	45,053	1,14, 845	1,35,451
5.	1,35,451	1,59,832*	24,381	1,35,451	Nil

* The amount of loan instalment in the last year is different from the equal payments because of compensation for rounding error.

(iii) **Calculation of Present Value of After-Tax Cash Outflows under Borrowing/Buying Option**

Year end	Loan Instalment (₹)	Tax Saving on			Net cash Outflow (₹)	P.V. factor at 18%	P.V. of after tax Net cash Outflow (₹)
		Interest (₹)	Dep. (after-tax) (₹)	Total (₹)			
Col. 1	2			3	4 = 2–3	5	6
1.	1,59,898	45,000	50,000	95,000	64,898	.847	54,969
2.	1,59,898	38,709	40,000	78,709	81,189	.718	58,294
3.	1,59,898	31,286	32,000	63,286	96,612	.609	58,837
4.	1,59,898	22,527	25,600	48,127	1,11,771	.516	57,674
5.	1,59,832	12,190	20,480	32,670	1,27,162	.437	55,570
							Total : 2,85,344
			Less : P.V. of salvage at the end of 5th year (1,80,000 × .437)				78,660
							2,06,684

(iv) **Calculation of Present Value of After-Tax Cash Outflows under Lease Option**

Year end	Lease Rental	Tax Savings on Lease Rent	After-Tax Cash Outflow	P.V. Annuity Factor at 18%	Total P.V. of Cash Outflows
	(₹)	(₹)	(₹)	(₹)	(₹)
1–5	1,20,000	60,000	60,000	3.127	1,87,620

(v) Evaluation:

As the present value of after-tax cash outflows under the leasing option is lesser than the present value of after-tax cash outflows of the buying option, it is advisable to take the asset on lease.

(vi) Decision if Investment Allowance is allowed:

In case Investment Allowance is allowed on purchase of asset the total of present value of net cash outflows will decrease by the present value of tax savings on investment allowance as below:

	₹
Investment Allowance :	
(allowed at the end of 1st year) $5{,}00{,}000 \times \frac{25}{100}$	1,25,000
Tax Savings (50%)	62,500
P.V. Factor at the end of year 1	.847
P.V. of Tax Savings on Investment Allowance	52,938
Hence, P.V. of Cash Outflows in Buying Option shall be = ₹ 2,06,684-52,938	1,53,746

In that case, the P.V. of cash outflows under buying option shall be lesser than the P.V. of cash outflows under leasing option and the company should buy the asset.

Financial Evaluation of Leasing: Way # 2.

Lessor's Point of View:

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:

This method involves the following steps:

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

	₹
Lease Rental (say)	1,00,000
Less : Depreciation (say)	20,000
Earnings Before Tax (EBT)	80,000
Less : Tax (say 50%)	40,000
Earnings After Tax (EAT)	40,000
Add : Depreciation	20,000
Cash Inflows After Tax (CFAT)	60,000

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

The above technique has been explained with the help of the following example.

Illustration 2:

From the information given below, you are required to advise about leasing out of the asset:

Cost of Equipment	₹ 4,00,000	
Average Cost of Capital to the lessor	12%	
Depreciation (Allowable)	20%	on original cost
Expected Life of Asset	5	years
Salvage Value	Nil	
Lease Rent payable at the end of each of 5 years	₹ 1,50,000	
Corporate Tax (applicable to lessor)	50%	
P.V. of an annuity of Re. 1 for 5 years at 12% is ₹ 3.605		

Solution:

(i)	**Calculation of Cash Outflow**			(₹)
	Cost of Equipment			4,00,000
	Less : Tax Advantage, if any			Nil
	Cash Outflow			4,00,000
(ii)	**Calculation of After-Tax Cash Inflows**			(₹)
	Lease Rental			1,50,000
	Less : Depreciation			80,000
	Earnings Before Tax (EBT)			70,000
	Less : Tax at 50%			35,000
	Earnings After Tax (EAT)			35,000
	Add : Depreciation			80,000
	Cash Inflows After Tax (CFAT)			1,15,000
(iii)	**Calculation of Present Value (P.V.) of Cash Outflows**			
***Year* (₹)**	***Cash Outflow* (₹)**	***P.V. Discount Factor at 12%***		***P.V. of Cash Outflow* (₹)**
0	4,00,000	1.00		4,00,000
(iv)	**Calculation of P.V. of Cash Inflows**			
Year	***Cashflow After Tax (CFAT)* ₹**	***P.V. Annuity Discount Factor at 12%***		***P.V. of Cash Inflows* ₹**
1-5	1,15,000	3.605		4,14,575
(iv)	**Calculation of Net Present Value**			₹
	Present value of Cash Inflows			4,14,575
	Less : P.V. of Cash Outflows			4,00,000
	Net Present value of Cash flows			14,575

Since the present value of cash inflows is more than the present value of cash outflows or says N.P.V. is positive, it is desirable to lease out the asset.

(b) Internal Rate of Return Method:

The internal rate of return can be defined as that rate of discount at which the present value of cash-inflows is equal to the present value of cash outflows.

It can be determined with the help of the following mathematical formula:

$C = A_1/(1+r) + A_2/(1+r)^2 + A_3/(1+r)^3 + \dots\dots\dots\dots + A_n/(1+r)^n$

where, C = Initial Outlay at time Zero.

$A_1, A_2, \dots\dots A_n$ = Future net cash flows at different periods.

2,3 ...., = Numbers of years

r = Rate of discount of internal rate of return.

The Internal rate of return can also be determined with the help of present value tables.

The following steps are required to practice the internal rate of return method:

(1) Determine the future net cash flows for the period of the lease. The net cash inflows are estimated future net cash flows for the period of the lease. The net cash inflows are estimated future earnings, from leasing out the asset, before depreciation but after taxes.

(2) Determine the rate of discount at which the present value of cash inflows is equal to the present value of cash outflows. This may be determined as follows:

(a) When the annual net cash flows are equal over the life of the asset:

Firstly, find out Present Value Factor by dividing initial outlay (cost of the investment) by annual cash flow, i.e., Present Value Factor = Initial Outlay/Annual Cash Flow. Then, consult present value annuity tables with the number of year equal to the life of the asset and find out the rate at which the calculated present value factor is equal to the present value given in the table.

Illustration 3:

Initial Outlay	₹ 50,000
Life of the Asset	5 years
Estimated Annual Cash-flow	₹ 12,500
Calculate the Internal Rate of Return.	

Solution:

$$\text{Present Value Factor} = \frac{\text{Initial Outlay}}{\text{Annual Cash Flow}}$$

$$= \frac{50{,}000}{12{,}500} = 4.$$

Consulting Present Value Annuity Tables for 5 years periods at Present Value Factor of 4. (For Present Value Tables see Appendix A and B given at the end of the book)

Internal Rate of Return =8% approx.

(as seen from the table that at 8% for 5 year period, the present value is 3.9927 which is nearly equal to 4.)

(b) When the annual cash flows are unequal over the life of the asset:

In case annual cash flows are unequal over the life of the asset, the internal rate of return cannot be determined according to the technique suggested above. In such cases, the internal rate of return is calculated by hit and trial and that is why this method is also known as hit and trial yield method.

We may start with any assumed discount rate and find out the total present value of all the cash flows by consulting present value tables.

The so calculated total present value of cash inflows as compared with the present value of cash outflows which is equal to the cost of the initial investment where total investment is to be made in the beginning. The rate, at which the total present value of all cash inflows equals the initial outlay, is the internal rate of return. Several discount rates may have to be tried until the appropriate rate is found. The calculation process may be summed up as follows.

(i) Prepare the cash flow table using an arbitrary assumed discount rate to discount the net cash flow to the present value.

(ii) Find out the Net Present Value by deducting from the present value of total cash flows calculated in (i) above the initial cost of the investment.

(iii) If the Net Present Value (NPV) is positive, apply higher rate of discount.

(iv) If the higher discount rate still gives a positive net present value, increase the discount rate further until the NPV becomes negative.

(v) If the NPV is negative at this higher rate, the internal rate of return must be between these two rates:

(3) Accept the proposal if the internal rate of return is higher than or equal to the minimum required rate of return, i.e. the cost of capital or cut off rate.

(4) In case of alternative proposals select the proposal with the highest rate of return as long as the rates are higher than the cost of capital or cut-off rate.

Illustration 4:

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

Estimated Net Annual Cash Flows:

	₹
1st Year	15,000
2nd Year	20,000
3rd Year	30,000
4th Year	20,000

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

Note:

Present Value Factor at various rates of discount.

P.V. Cash Flows Table at Various Assumed Discount Rates of 10%, 12%, 14% & 15%

Year	Annual Cash Flow ₹	Discount rate 10% P.V.F.	10% P.V. ₹	12% P.V.F.	12% P.V. ₹	14% P.V.F.	14% P.V. ₹	15% P.V.F.	15% P.V. ₹
1	15,000	.909	13,635	.892	13,380	.877	13,155	.869	13,035
2	20,000	.826	16,520	.797	15,940	.769	15,380	.756	15,120
3	30,000	.751	22,530	.711	21,330	.674	20,220	.657	19,710
4	20,000	.683	13,660	.635	12,700	.592	11,840	.571	11,420
			66,345		63,350		60,595		59,285

(1) The present value of cash flows at 14% rate of discount is Rs. 60,595 and at 15% rate of discount it is t 59,285. So the initial cost of investment which is Rs. 60,000 falls in between these two discount rates. At 14% the NPV is+ 595 but at 15% the NPV is – 715, we may say that IRR = 14.5% (approx).

(2) As the IRR is less than the minimum required rate of return, the lessor should not lease out the asset.

Got it 👇. Let's go step by step with a **detailed explanation of Microfinance models**, focusing on the two most popular ones: **Self-Help Group (SHG) model** and the **Grameen model**.

Microfinance Models: Detailed Explanation

Microfinance refers to the provision of small loans and other financial services to low-income households who lack access to traditional banking. Over time, different models have evolved, but the **SHG model** (India-centric) and the **Grameen model** (Bangladesh-origin) are the most widely discussed.

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1. Self-Help Group (SHG) Model

Origin: Popularized in India by NABARD (National Bank for Agriculture and Rural Development) in the 1990s.
Target group: Poor women, especially in rural areas.

Features:

- A **group of 10–20 women** voluntarily come together.
- Members **save small amounts regularly** (weekly/monthly).
- Savings are pooled into a **common fund**.
- The group provides **loans to members** from this pooled fund at mutually agreed interest rates.
- After a track record of savings and repayment is established, the group can **link with banks** (SHG-Bank linkage programme).

Steps in SHG Functioning:

1. **Formation:** Women form groups, usually with homogeneity (similar socio-economic background).
2. **Savings Mobilization:** Each member contributes fixed small savings.
3. **Internal Lending:** Members borrow from group funds for consumption, health, education, or small businesses.
4. **Bank Linkage:** SHGs maintain savings accounts in banks and, after credibility is established, access larger bank loans.
5. **Repayment & Sustainability:** Loans are repaid with interest, and the cycle continues.

Advantages of SHG Model:

- Encourages **savings habit** among the poor.
- **Empowers women** socially and financially.

- Promotes **collective decision-making** and mutual trust.
- Improves access to **formal banking**.
- Reduces dependence on **moneylenders**.

Challenges:

- Sometimes plagued by **poor record-keeping**.
- **Unequal participation** (few members dominate).
- Banks may hesitate to provide loans due to **default risks**.
- Capacity-building and continuous training are required.

---

2. Grameen Model

Origin: Developed by Prof. Muhammad Yunus in Bangladesh (Grameen Bank, 1976).
Target group: Rural poor households (both men and women, but women preferred).

Features:

- **Borrowers are organized into small groups of 5 members**.
- No collateral is required.
- Loans are given to **individuals**, but the group ensures repayment (social collateral).
- Initially, 2 members receive loans → repayment discipline → then others qualify.
- Weekly meetings at village centers ensure discipline, repayment, and social development.

Steps in Grameen Model Functioning:

1. **Formation of Groups:** Groups of 5 people are created, then clustered into a "Center" (6–8 groups).
2. **Loan Disbursement:** Loans given for income-generating activities (small trade, agriculture, livestock).
3. **Repayment Schedule:** Weekly repayment with small installments.
4. **Social Development Programmes:** Borrowers also take "Sixteen Decisions" (rules related to health, education, family planning, etc.).
5. **Sustainability:** Over time, successful repayment improves creditworthiness.

Advantages of Grameen Model:

- Ensures **high repayment rates** due to peer pressure & group accountability.
- Provides **credit without collateral**.
- Encourages **entrepreneurship** and income-generating activities.
- Incorporates **social development goals** beyond finance.

Challenges:

- Weekly repayment schedules may create **stress for borrowers**.
- Sometimes used for **consumption loans** rather than income generation.
- Over-indebtedness possible if multiple loans taken from different sources.
- Requires strong **institutional support** and monitoring.

Comparison: SHG vs. Grameen Model

Aspect	SHG Model	Grameen Model
Origin	India (NABARD, 1990s)	Bangladesh (Muhammad Yunus, 1976)
Group Size	10–20 women	5 members per group (clustered into centers)
Savings Requirement	Compulsory before loan access	Savings encouraged, but not compulsory pre-loan
Loan Type	Group savings + bank linkage	Individual loan under group guarantee
Repayment	Flexible, depends on SHG	Weekly, small installments
Focus	Empowerment + access to banks	Income generation + social development
Collateral	None	None (social collateral ensures repayment)

Perfect 👍 You want a **long, detailed answer** on the **Co-operative Model of Microfinance** and the **SHG–Bank Linkage Programme (NABARD model and its variants)**. I'll write it in a structured way, like you'd use in an exam or assignment.

Microfinance Models: Co-operative and SHG (NABARD) Models

---

1. Co-operative Model of Microfinance

Introduction

The Co-operative model is one of the oldest forms of microfinance, much before formal microfinance institutions (MFIs) and banks entered rural credit. It is based on the principles of **mutual help, collective ownership, and democratic management**.

In this model, members form a **co-operative society** where they pool their resources (savings), which are then used to provide credit and financial

Aspect	SHG Model	Grameen Model

services to members at affordable rates.

Features of Co-operative Model

1. **Membership-based:** Open to people of common interest (farmers, artisans, workers).
2. **Democratic functioning:** One member = one vote (irrespective of share capital).
3. **Savings mobilization:** Members contribute regularly to a common fund.
4. **Credit provision:** Loans are provided to members from pooled funds at low interest.
5. **No collateral:** Loans are usually unsecured, based on mutual trust.
6. **Support services:** Apart from credit, many co-operatives also provide marketing, input supply, and training support.

Types of Co-operatives in Microfinance

1. **Primary Agricultural Credit Societies (PACS):** Village-level credit societies in India.
2. **Credit Unions:** Member-owned institutions providing small loans (popular worldwide).
3. **Urban Co-operative Banks:** Provide loans to small entrepreneurs, traders, and low-income households.
4. **Women's Co-operatives (Mahila Co-operatives):** Focused on women empowerment and small-scale business promotion.

Advantages of Co-operative Model

- Promotes **collective ownership** and **social cohesion**.
- Encourages **savings habit** among members.
- Provides **low-interest loans** compared to moneylenders.
- Helps in **capacity-building and empowerment** of marginalized groups.
- Can also offer **marketing and input services** (not just finance).

Limitations

- Often plagued by **political interference** and poor governance.
- Suffer from **high default rates** due to weak monitoring.
- Lack of professional management → inefficiency.
- Limited to local members → small resource base.
- In some regions, co-operatives became **dependent on government subsidies**, reducing sustainability.

Aspect	SHG Model	Grameen Model

✅ **Summary:**
The Co-operative model is rooted in **self-help and mutual aid**, but its success depends on **transparent governance, professional management, and strong member participation**.

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2. SHG–Bank Linkage Programme (NABARD Model)

Introduction

The **Self-Help Group (SHG) model** was formalized and promoted by **NABARD (National Bank for Agriculture and Rural Development)** in the early 1990s in India.

This programme became the **largest microfinance initiative in the world**, linking informal SHGs of poor people (mainly women) with the formal banking system.

Basic Concept of SHG

- A Self-Help Group is a **small group of 10–20 people**, usually women, from similar socio-economic backgrounds.
- Members pool savings into a **common fund**.
- The fund is used for **internal lending** among members.
- Once the group develops a track record of savings and repayment, banks provide **loans to the SHG as a whole**, instead of to individuals.

NABARD's SHG–Bank Linkage Programme (SBLP)

Launched in **1992**, NABARD's initiative had three main objectives:

1. To **link the unbanked poor** with formal banking institutions.
2. To **promote savings** and credit discipline.
3. To encourage **women empowerment** and poverty reduction.

Variants of SHG–Bank Linkage Model (Three Approaches)

1. **Model I: SHGs formed and financed by banks**
   - Banks themselves take the initiative in **forming, nurturing, and financing SHGs**.
   - Direct relationship between bank and SHG.
   - Advantage: Closer monitoring and quick linkage.
   - Limitation: Higher workload for banks; not very common.
2. **Model II: SHGs formed by NGOs/government agencies, financed by banks**

Aspect	SHG Model	Grameen Model

- NGOs, MFIs, or government departments **mobilize, train, and promote SHGs**.
- Once the group is mature, it is linked to a bank for credit.
- This is the **most popular model in India** (accounts for majority of SHGs).
- NGOs act as facilitators, while banks provide the finance.

3. **Model III: SHGs financed by banks through MFIs/NGOs as intermediaries**
   - In this model, **NGOs/MFIs act as both facilitators and financial intermediaries**.
   - Banks lend to the NGO/MFI, which in turn lends to SHGs.
   - Advantage: Useful in remote areas where banks have no presence.
   - Limitation: Higher cost of funds due to intermediaries.

Advantages of SHG–Bank Linkage (NABARD Model)

- Promotes **financial inclusion** of rural poor.
- Helps build **creditworthiness** of women and marginalized groups.
- Creates a platform for **collective empowerment** (social + financial).
- Reduces exploitation by moneylenders.
- Ensures **bank penetration** in rural areas.

Limitations

- Quality of SHGs varies: some are strong, others weak and inactive.
- Problems in **record-keeping and accounting**.
- Many SHGs depend heavily on NGOs → weak sustainability if NGO support ends.
- Banks sometimes hesitate due to **repayment concerns**.

✅ **Summary:**
The **SHG–Bank Linkage model of NABARD** has been a **game-changer** in Indian microfinance, reaching **millions of rural households**. Its **variants** (Model I, II, III) provide flexibility in implementation. However, **capacity-building, financial literacy, and sustainability** remain key challenges.

Final Conclusion

- The **Co-operative model** and the **SHG–Bank Linkage model** are two pillars of microfinance.
- The **Co-operative model** emphasizes **mutual aid and collective ownership**.
- The **SHG–Bank Linkage model (NABARD)** focuses on **linking**

Aspect	SHG Model	Grameen Model

poor women's groups with banks for **savings-led microfinance**.

- Together, they have contributed significantly to **poverty reduction, women empowerment, and financial inclusion** in India and other developing countries.

☞ Do you want me to also prepare a **diagram/flowchart** (e.g., SHG-Bank linkage process, Co-operative structure) so you can use it directly in an exam answer or presentation?

Alright 👍 You want **long notes** on **SIDBI model, SGSY model, Grameen Bangladesh model, and Credit Unions**. I'll prepare them in a structured, exam-ready way with introduction, features, advantages, and limitations for each.

Microfinance Models – Long Notes

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1. SIDBI Model of Microfinance

Introduction

- **SIDBI** (Small Industries Development Bank of India) is the apex financial institution in India for promoting and financing **micro, small, and medium enterprises (MSMEs)**.
- In the 1990s, SIDBI introduced the **SIDBI Foundation for Micro Credit (SFMC)** to expand microfinance through **indirect lending** to Microfinance Institutions (MFIs), who in turn lend to the poor.

Features of SIDBI Model

1. **Indirect approach:** SIDBI does not lend directly to individuals but to **NGOs, MFIs, and SHGs**.
2. **Whole-sale lending:** Provides **bulk loans** to MFIs, who then distribute among their clients.
3. **Capacity building:** Provides training, technology support, and skill development to MFIs.
4. **Sustainability focus:** Encourages MFIs to adopt **financial viability and self-sufficiency**.
5. **Target group:** Poor women, artisans, small entrepreneurs, rural households.

Advantages

- Strengthens the **institutional base** of microfinance.
- Promotes **scalability**, as SIDBI can reach millions through partner MFIs.

Aspect	SHG Model	Grameen Model

- Provides **long-term refinance support** and training to MFIs.
- Encourages **entrepreneurship development** among the poor.

Limitations

- Relies heavily on the efficiency of **intermediary MFIs**.
- Risk of **high interest rates** by MFIs to cover costs.
- Benefits may not reach the poorest directly (sometimes "missing middle" problem).

✅ **Summary:** The **SIDBI model** works as a **wholesale lending approach**, strengthening MFIs who then provide microfinance services to the poor. It is more institutional in nature compared to SHG/Grameen models.

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2. SGSY Model (Swarnjayanti Gram Swarozgar Yojana)

Introduction

- **Launched in 1999** by the Government of India.
- A **poverty alleviation programme** that adopted the **SHG approach** for providing sustainable income to rural poor.
- Later replaced by **NRLM (National Rural Livelihoods Mission)** in 2011.

Features of SGSY Model

1. **Focus on SHGs:** Formation and nurturing of SHGs as the core strategy.
2. **Subsidy + Credit:** Provided **bank loans with government subsidy** for income-generating activities.
3. **Capacity building:** Training and skill development for SHG members.
4. **Activity clusters:** Promoted activities like dairy, poultry, handicrafts, weaving, etc.
5. **Target group:** Families below poverty line (BPL).

Advantages

- Combined **credit with subsidy**, reducing risk for poor households.
- Promoted **self-employment** and sustainable income.
- Strengthened **SHG movement** in India.
- Created linkages with banks, NGOs, and government departments.

Aspect	SHG Model	Grameen Model

Limitations

- Subsidy-led model often led to **dependency and misuse**.
- Quality of SHGs varied → some became inactive.
- Insufficient training and **weak monitoring**.
- Many loans were used for consumption instead of productive use.

✅ **Summary:** The **SGSY model** was a government-driven microfinance-cum-poverty alleviation programme, relying on SHGs. However, it was later restructured into **NRLM** due to operational weaknesses.

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3. Grameen Model (Bangladesh)

Introduction

- Originated in **Bangladesh** in 1976 by **Prof. Muhammad Yunus** (Grameen Bank).
- Won the **Nobel Peace Prize (2006)** for innovative microfinance.
- Based on the idea of providing **collateral-free credit** to poor households for self-employment and poverty reduction.

Features of Grameen Model

1. **Group-based lending:** 5 members form a group; several groups form a "center."
2. **Social collateral:** Loans are given to individuals, but **group guarantees repayment**.
3. **Credit first:** Loans provided first, then repayment discipline is established.
4. **Weekly repayment meetings:** Small installments, fostering financial discipline.
5. **Sixteen Decisions:** Borrowers commit to health, education, family planning, and social development rules.

Advantages

- Very high **repayment rates** due to peer pressure.
- Provides **credit to the poorest** without collateral.
- Encourages **income generation** (small business, agriculture, handicrafts).
- Integrates **social development goals** with financial services.

Limitations

Aspect	SHG Model	Grameen Model

- Weekly repayment schedules can cause **stress**.
- Over-borrowing and **multiple loans** from different MFIs led to indebtedness.
- Works better in homogeneous rural communities, less effective in urban areas.
- Some critics argue it does not significantly **reduce long-term poverty**.

✅ **Summary:** The **Grameen Bangladesh Model** pioneered **group-based, collateral-free lending**, becoming a global inspiration for microfinance programmes.

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4. Credit Unions

Introduction

- **Credit unions** are **member-owned, co-operative financial institutions** that provide savings and credit services to their members.
- They originated in Europe in the 19th century (Germany, Ireland), and spread worldwide.
- In microfinance, credit unions serve as **community-based alternatives to banks**.

Features of Credit Unions

1. **Member-owned:** Operated by and for members (not-for-profit).
2. **Democratic control:** Each member has **one vote**, regardless of deposits.
3. **Savings-led approach:** Members contribute savings, which form the base for loans.
4. **Affordable loans:** Provide loans at lower rates compared to moneylenders.
5. **Community focus:** Work in small, local communities with mutual trust.

Advantages

- Encourages **savings and thrift** among low-income people.
- Provides **affordable credit** without exploitation.
- Strengthens **community solidarity and trust**.
- Profits are ploughed back into the union for members’ benefit.

Limitations

Aspect	SHG Model	Grameen Model

- Limited by **small resource base** (dependent on members' savings).
- Vulnerable to **mismanagement and fraud** if governance is weak.
- May not reach the **very poorest**, as they may not have initial savings.
- Sometimes lack modern financial technology and professional expertise.

✅ **Summary:** Credit unions are **grassroots, community-owned financial institutions** that promote savings and provide loans. They combine the co-operative model with microfinance principles, but their effectiveness depends on governance and scale.

Final Conclusion

- The **SIDBI model** strengthens **MFIs through wholesale lending and capacity building**.
- The **SGSY model** was a **government subsidy-credit scheme** through SHGs for poverty alleviation (later NRLM).
- The **Grameen Bangladesh model** is the **pioneering group-based, collateral-free lending approach**, globally recognized.
- **Credit unions** are **member-owned co-operatives**, promoting savings and affordable loans at the community level.

Together, these models showcase the diversity of **microfinance approaches**, ranging from **government-led**, **institutional**, **co-operative**, and **community-based** initiatives.

☞ Do you want me to also prepare a **comparative table** of all these models (SIDBI, SGSY, Grameen, Credit Unions, SHG, Co-operative) so you can quickly revise before exams?

UNIT – IV: Credit Rating

CREDIT RATING: CONCEPT, TYPES AND FUNCTIONS

Many a times, it has happened that investors in debentures or fixed deposits were shown rosy pictures of companies and offered very high rates of interests by bogus companies and in the end the investor neither got his money back nor the promised interest. Actually, it is very difficult for an individual investor to gather details about creditworthiness of a company, neither he has the time nor the skills to undertake risk evaluation.

Every investor wants to ensure safety of his investment. Credit rating agencies investigate the financial position of the company issuing various kinds of instruments and assess risks involved in investing money in them. In the system of credit rating, the credit rating agency rate the risks involved in investment in instruments of a particular company, they may rank it from very safeto very risky. At present credit rating is done only for debt-instruments and rarely for preference or equityshares.

DEFINITION

Creditratingsystemcanbedefinedasanactofassigningvaluestocreditinstrumentsbyassessing the solvency i.e., the ability of the borrower to repay debt, and expressing them through pre-determinedsymbols.

Investopedia defines Credit Rating as “An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation”. A credit rating can be assigned to any entity that seeks to borrow money – an individual, corporation, state or provincial authority, or sovereign government.

CHARACTERISTICS OF CREDIT RATING

1. **Assessment of issuer's capacity to repay**. It assesses issuer's capacity to meet its financial obligations i.e., its capacity to pay interest and repay the principal amountborrowed.
2. **Basedondata.**Acredit ratingagencyassessesfinancialstrengthoftheborroweronthefinancial data.
3. **Expressedinsymbols**.Ratingsareexpressedinsymbolse.g.AAA,BBBwhichcanbeunderstood by a laymantoo.
4. **Done by expert.** Credit rating is done by expert of reputed, accreditedinstitutions.
5. **Guidance about investment-not recommendation.** Credit rating is only a guidance to investors and not recommendation to invest in any particularinstrument.

WHAT CREDIT RATING IS NOT

1. **Notforcompanyasawhole.**Creditratingisdoneforaparticularinstrumenti.e.,foraparticular class of debentures and not for the company as a whole, it is quite possible that two instruments issued by the same company may carry differentrating.
2. **Does not create a fiduciary relationship.** Credit rating does not create a fiduciary relationship (relationship of trust) between the credit rating agency and theinvestor.
3. **Not attestation of truthfulness of information provided by rated. company.** Rating does not imply that the credit rating agency attests the truthfulness of information provided by the rated company.
4. **Ratingnotforever.**Creditratingisnotaone-timeevaluationofrisk.whichremainsvalidforthe entire life of a security. It can change from time totime.

COMPULSORY CREDIT RATING

Obtaining credit rating is compulsory in the following cases

1. **For debt securities.** The Reserve Bank of India and SEBI have made credit rating compulsoryin respect of all non-government debt securities where the maturities exceed 18months
2. **Public deposits.** Rating of deposits in companies has also been madecompulsory.
3. **For commercial papers (CPs).** Credit rating has also been made compulsory for commercial papers. As per Reserve Bank of India guidelines rating of P2 by CRISIL or A2 by ICRA or PP2 by CARE is necessary for commercialpapers.
4. **Forfixeddepositswithnon-bankingfinancialinstitutions(NBFCs).**UndertheCompaniesAct, credit rating has been made compulsory for fixed deposits withNBFs.

FACTORS CONSIDERED IN CREDIT RATING

1. **Issuers ability to service its debt.** For this credit rating agenciescalculate
   a) Issuer company's past and future cashflows.
   b) Assesshowmuchmoneythecompanywillhavetopayasinterestonborrowedfundsandhow much will be itsearnings.
   c) How much are the outstandingdebts?
   d) Company's short term solvency through calculation of currentratio.
   e) Value of assets pledged as collateral security by thecompany.
   f) availability and quality of raw material used, favorable location, costadvantage.
   g) Track record of promoters, directors and expertise of thestaff.
2. **Market positon of the company.** What is the market share of various products of the company, whetheritwillbestable,doesthecompanypossesscompetitiveadvantageduetodistributionnet- work, customer base research and development facilitiesetc.
3. **Quality of management.** Credit rating agency will also take into consideration track record, strategies, competency and philosophy of seniormanagement.
4. **Legal position of the instrument.** It means whether the issued instrument is legally valid, what are the terms and conditions of issue and redemption; how much the instrument is protected from frauds, what are the terms of debenture trust deedetc.
5. **Industry risks.** Industry risks are studied in relation to position of demand and supply for the productsofthatindustry(e.g.carsorelectronics)howmuchistheinternationalcompetition,what are the future prospects of that industry, is it going to die orexpand?
6. **Regulatory environment.** Whether that industry is being regulated by government (like liquor industry), Whether there is a price control on it, whether there is government support for it, can it take advantage of tax concessionsetc.
7. **Otherfactors.**Inadditiontotheabove,theotherfactorstobenotedforcreditratingofacompany are its cost structure, insurance cover undertaken, accounting quality, market reputation, working capital management, human resource quality, funding policy, leverage, flexibility, exchange rate risksetc.

CREDIT RATING PROCESS

In India credit rating is done mostly at the request of the borrowers or issuer companies. The borrower or issuer company requests the credit rating agency for assigning a ranking to the proposed instrument. The process followed by most of the credit rating agencies is as follows:

1. **Agreement.** An agreement is entered into between the rating agency and the issuer company. It covers details about terms and conditions for doing therating.
2. **Appointment of analytical team.** The rating agency assigns the job to a team of experts.The team usually comprises of two analysts who have expert knowledge in the relevant business area and is responsible for carrying outrating.
3. **Obtaining information.** The analytical team obtains the required information from the client companyandstudiescompany'sfinancialposition,cashflows,natureandbasisofcompetition, marketshare,operatingefficiencyarrangements,managementstrackcoststructure,sellingand distribution record, power (electricity) and labour situation etc.
4. **Meeting the officials.** To obtain clarifications and understanding the client's business the analytical team visits and interacts with the executives of theclient.
5. **Discussion about findings.** After completion of study of facts and their analysis by the analytical team the matter is placed before the internal committee (which comprises of senior analysts) an opinion about the rating istaken.
6. **Meeting of the rating committee.** The findings of internal committee are referred to the “rating committee" which generally comprises of a few directors and is the final authority for assigningratings.
7. **Communication of decision.** The rating decided by the rating committee is communicatedto the requestingcompany.
8. **Information to the public.** The rating company publishes the rating through reports and the press.
9. **Revision of the rating.** Once the issuer company has accepted the rating, the rating agency is under an obligation to monitor the assigned rating. The rating agency monitors all ratings during the life of theinstrument.

TYPES OF CREDIT RATING

1. **Rating of bonds and debentures.** Rating is popular in certain cases for bonds and debentures. Practically, all credit rating agencies are doing rating for debentures andbonds.
2. **Ratingofequityshares.**RatingofequitysharesisnotmandatoryinIndiabutcreditratingagency ICRA has formulated a system for equity rating. Even SEBI has no immediate plans for compulsory credit rating of initial public offerings(IPOs).
3. **Rating of preference shares.** In India preference shares are not being rated, however Moody's Investor Service has been rating preference shares since 1973 and ICRA has provision forit.
4. **Rating of medium term loans (Public deposits, CDs etc.).** Fixed deposits taken by companies are rated on regular scale inIndia.
5. **Rating of short-term instruments [Commercial Papers (CPs)**. Credit rating of short term instrumentslikecommercialpapershasbeenstartedfrom1990.CreditratingforCPsismandatory which is being done by CRISIL, ICRA andCARE.

6. **Rating of borrowers.** Rating of borrowers, may be an individual or a company is known as borrower'srating.
7. **Rating of real estate builders and developers.** A lot of private colonisers and flat builders are operatinginbigcities.Ratingaboutthemisdonetoensurethattheywillproperlydevelopacolony or build flats. CRISIL has started rating of builders anddevelopers.
8. **Ratingofchitfunds.**Chitfundscollectmonthlycontributionsfromsaversandgiveloanstothose participants who offer highest rate of interest. Chit funds are rated on the basis of their ability to make timely payment of prize money to subscribers. CRISIL does credit rating of chitfunds.
9. **Ratings of insurance companies.** With the entry of private sector insurance companies, credit rating of insurance companies is also gaining ground. Insurance companies are rated on the basis of their claim paying ability (whether it has high, adequate, moderate or weak claim-paying capacity). ICRA is doing the work of rating insurancecompanies.
10. **Rating of collective investment schemes.** When funds of a large number of investors are collectively invested in schemes, these are called collective investment schemes. Credit rating about them means (assessing) whether the scheme will be successful or not. ICRA is doing credit rating of suchschemes.
11. **Ratingofbanks.**PrivateandcooperativebankshavebeenfailingquiteregularlyinIndia.People like to deposit money in banks which are financially sound and capable of repaying back the deposits. CRISIL and ICRA are now doing rating ofbanks.
12. **Rating of states.** States in India are now being also rated whether they are fit for investment or not. States with good credit ratings are able to attract investors from within the country and from abroad.
13. **Ratingofcountries**.Foreigninvestorsandlendersareinterestedinknowingtherepayingcapacity and willingness of the country to repay loans taken by it. They want to make sure that investment in that country is profitable or not. While rating a country the factors considered are its industrial and agricultural production, gross domestic product, government policies, rate of inflation, extent of deficit financing etc. Moody's, and Morgan Stanley are doing rating ofcountries.

FUNCTIONS/IMPORTANCE OF CREDIT RATING

1. **It provides unbiased opinion to investors.** Opinion of good credit rating agency is unbiased because it has no vested interest in the ratedcompany.
2. **Provide quality and dependable information.** Credit rating agencies employ highly qualified, trainedandexperiencedstafftoassessrisksandtheyhaveaccesstovitalandimportantinformation andthereforecanprovideaccurateinformationaboutcreditworthinessoftheborrowingcompany.
3. **Provideinformationineasytounderstandlanguage.**Creditratingagenciesgatherinformation, analyseandinterpretitandpresenttheirfindingsineasytounderstandlanguagethatisinsymbols like AAA, BB, C and not in technical language or in the form of lengthyreports.
4. **Provideinformationfreeofcostoratnominalcost.** Creditratingsofinstrumentsarepublished in financial newspapers and advertisements of the rated companies. The public has not to pay for them. Even otherwise, anybody can get them from credit rating agency on payment of nominal fee. It is beyond the capacity of individual investors to gather such information at their owncost.
5. **Helps investors in taking investment decisions.** Credit ratings help investors in assessing risks and taking investmentdecision.
6. **Disciplines corporate borrowers.** When a borrower gets higher credit rating, it increases its goodwillandothercompaniesalsodonotwanttolagbehindinratingsandinculcatefinancial

discipline in their working and follow ethical practice to become eligible for good ratings, this tendency promotes healthy discipline among companies.

7. **Formationofpublicpolicyoninvestment.** Whenthedebtinstrumentshavebeenratedbycredit rating agencies, policies can be laid down by regulatory authorities (SEBI, RBI) about eligibility of securities in which funds can be invested by various institutions like mutual funds, provident fundstrustetc.Forexample,itcanbeprescribedthatamutualfund cannotinvestindebenturesof a company unless it has got the rating ofAAA.

BENEFITS OF CREDIT RATING

Credit rating offers many advantages which can be classified into

A. Benefits toinvestors.
B. Benefits to the rated company.
C. Benefits tointermediaries.
D. Benefits to the businessworld.

BENEFITS TO INVESTORS

1. **Assessment of risk.** The investor through credit rating can assess risk involved in an investment. A small individual investor does not have the skills, time and resources to undertake detailed risk evaluation himself. Credit rating agencies who have expert knowledge, skills and manpower to study these matters can do this job for him. Moreover, the ratings which are expressed insymbols like AAA, BB etc. can be understood easily byinvestors.
2. **Information at low cost.** Credit ratings are published in financial newspapers and are available fromratingagenciesatnominalfees.Thiswaytheinvestorsgetcreditinformationaboutborrowers at no or littlecost.
3. **Advantage of continuous monitoring.** Credit rating agencies do not normally undertake rating of securities only once. They continuously monitor them and upgrade and downgrade the ratings depending upon changedcircumstances.
4. **Provides the investors a choice of Investment.** Credit ratings agencies helps the investors to gather information about creditworthiness of different companies. So, investors have a choice to invest in one company or theother.
5. **Ratings by credit rating agencies is dependable.** A rating agency has no vested interest in a security to be rated and has no business links with the management of the issuer company. Hence ratings by them are unbiased andcredible.

BENEFITS TO THE RATED COMPANY

1. **Ease in borrowings.** If a company gets high credit rating for its securities, it can raise funds with more ease in the capitalmarket.
2. **Borrowingatcheaperrates.**Afavourablyratedcompanyenjoystheconfidenceofinvestorsand therefore, could borrow at lower rate ofinterest.
3. **Facilitates growth.** Encouraged by favourable rating, promoters are motivated to go in for plans of expansion, diversification and growth. Moreover, highly rated companies find it easy to raise funds from public through issue of ownership or credit securities in future. They find it easy to borrow frombanks.
4. **Recognitionoflesserknowncompanies.**Favourablecreditratingofinstrumentsoflesserknown or unknown companies provides them credibility and recognition in the eyes of the investing public.
5. **Addstothegoodwilloftheratedcompany.**Ifacompanyisratedhighbyratingagenciesitwill automatically increase its goodwill in themarket.
6. **Imposes financial discipline on borrowers.** Borrowing companies know that they will get high creditratingonlywhentheymanagetheirfinancesinadisciplinedmanneri.e.,theymaintaingood operating efficiency, appropriate liquidity, good quality assets etc. This develops a sense of financial discipline among companies who want toborrow.
7. **Greaterinformationdisclosure.**Togetcreditratingfromanaccreditedagency,companieshave to disclose a lot of information about their operations to them. It encourages greater information disclosures, better accounting standards and improved financial information which in turn help in the protection of theinvestors.

BENEFITS TO INTERMEDIARIES

1. **Merchant bankers' and brokers' job made easy.** In the absence of credit rating, merchant bankers or brokers have to convince the investors about financial position of the borrowing company. If a borrowing company's credit rating is done by a reputed credit agency, the task of merchant bankers and brokers becomes much easy.

BENEFITS TO THE BUSINESS WORLD

1. **Increaseininvestorpopulation.**Ifinvestorsgetgoodguidanceaboutinvestingthemoneyindebt instrumentsthroughcreditratings,moreandmorepeopleareencouragedtoinvesttheirsavingsin corporatedebts.
2. **Guidance to foreign investors.** Foreign collaborators or foreign financial institutions will invest in those companies only whose credit rating is high. Credit rating will enable them to instantly identify the position of thecompany.

CREDIT RATING AGENCIES IN INDIA

There are 6 credit rating agencies which are registered with SEBI. These are CRISIL, ICRA, CARE, Fitch India, Brickwork Ratings, and SMERA.

1. Credit Rating and Information Services of India Limited(CRISIL)
    - It is India's first credit rating agency which was incorporated and promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions in1987.
    - After 1 year, i.e. in 1988 it commenced itsoperations
    - It has its head office in Mumbai.
    - ItisIndia'sforemostproviderofratings,dataandresearch,analyticsandsolutions, with a strong track record of growth andinnovation.
    - It delivers independent opinions and efficientsolutions.
    - CRISIL's businesses operate from 8 countries including USA, Argentina, Poland, UK, India, China, Hong Kong andSingapore.
    - CRISIL's majority shareholder is Standard &Poor's.
    - It also works with governments and policy-makers in India and other emerging markets in the infrastructuredomain.
2. Investment Information and Credit rating agency(ICRA)
    - The second credit rating agency incorporated in India was ICRA in1991.
    - It was set up by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit RatingAgency.
    - It is a public limitedcompany.
    - It has its head office in NewDelhi.
    - ICRA's majority shareholder isMoody's.
3. Credit Analysis & Research Ltd.(CARE)
    - The next credit rating agency to be set up was CARE in1993.
    - It is the second-largest credit rating agency inIndia.
    - It has its head office in Mumbai.
    - CARERatingsisoneofthe5partnersofaninternationalratingagencycalledARC Ratings.
4. ONICRA
    - It is a private sector agency set up by OnidaFinance.
    - It has its head office inGurgaon.
    - Itprovidesratings,riskassessmentandanalyticalsolutionstoIndividuals,MSMEs andCorporates.
    - It is one of only 7 agencies licensed by NSIC (National Small Industries Corporation) to rateSMEs.
    - They have Pan India Presence with offices over 125locations.

Factoring, Forfeiting

Factoring also known as **account receivables factoring** or debtor financing , is a method in which **a company (client)** sell its account receivables (debt) to a **bank or financial institution (called factor)** at a certain discount.

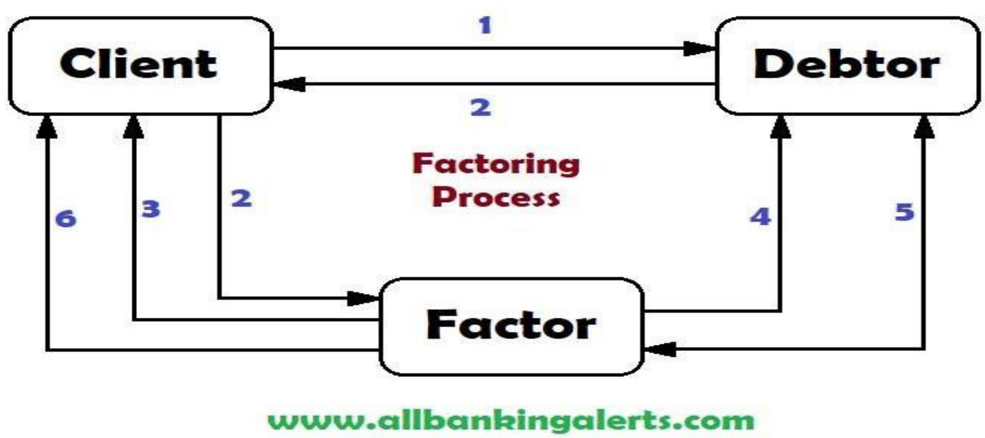
There are three parties involved in factoring contract –

1. ***Debtor (Buyer of Goods)*** **–** One who has purchase goods or services on credit and has to pay for same once the credit period gets over.
2. ***Client (Seller of Goods)*** **–** who has supplied goods or services to the customer on credit terms.
3. ***Factor (Financier)*** – who purchase the account receivables from client (seller of goods) and collect the money from debtor of his clients.

In other words, Factoring is a mechanism in which an **exporter (seller)** transfer his rights to receive payment against goods exported or services rendered to the **importer**, in exchange for instant cash payment from a forfaiter.

Factoring is prevalent in business in various ways. For example, Credit Card. Factoring is often more short term than forfaiting and is applicable where receivables are due within around 90 days.

Factoring Process



Factoring Process

1 – Client concludes a credit sale with the customer

2 – Client sells the account receivable to the factor (financier) and notify the same to customer

3 – Factor makes a part payment (advance) against the account receivable purchased after adjusting the discount or commission and interest on advance.

4 – Factor maintains the customer's account and follows up the payment

5 – Debtor makes the payment due to the factor

6 – Factor makes the final payment to the client when the account receivable is collected or on a guaranteed **payment date.**

Factoring may **be recourse** or **non recourse.**

In **recourse factoring**, Factor buys the account receivable from client with an agreement that the client will buy them back if they remain uncollected from debtor.

Whereas in **Non Recourse factoring**, Client sells the account receivables to Factor without any obligation of buying them back if they remain unpaid by the debtor. As Factors have to bear any losses arising on account of irrecoverable debts, factor charges higher commission in this type of factoring.

Forfaiting

In Forfaiting, Exporter sell their medium and long term account receivables at a discount and obtain cash from the forfaiter on **non recourse basis**. In Forfaiting, there is no risk for exporter of importer becoming insolvent as there is **100 percent finance** of contract value. Forfaiting is generally evidenced by a legally enforceable and transferable payment obligation such as bills of exchange, promissory note, a letter of credit.

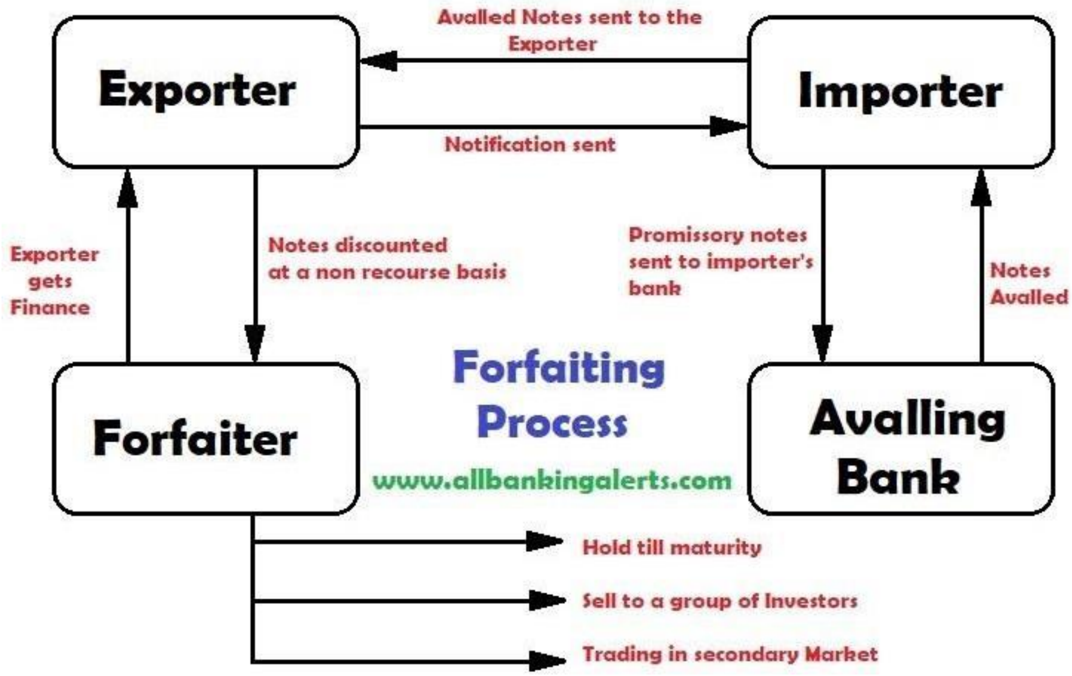
Forfaiting is a specialized form of factoring which is undertaken on export transactions on a non recourse basis.

The major parties involved in a transaction of Forfaiting are : An exporter, an importer, a domestic bank, a foreign bank and a primary forfaiter.

Forfaiting Process

Exporter sells the goods to importer on deffered payment basis. Importer issues series of promissory notes undertaking to pay the exporter in installments with interest.

Importer approaches its banker (Avalling Bank) for adding the bank gurantee on the promissory note that the payment will be made on each maturity date. The promissory notes are now avallised and sent to exporter.



Forfaiting Process

Availed notes are sold to forfaiter (usually exporter's bank) as a discount at a non recourse basis and exporter obtain finance from forfaiter.

Forfaiter hold till maturity date and obtain payment from importer's bank / availing bank or sell it in the secondary market or sell it to a group of investors.

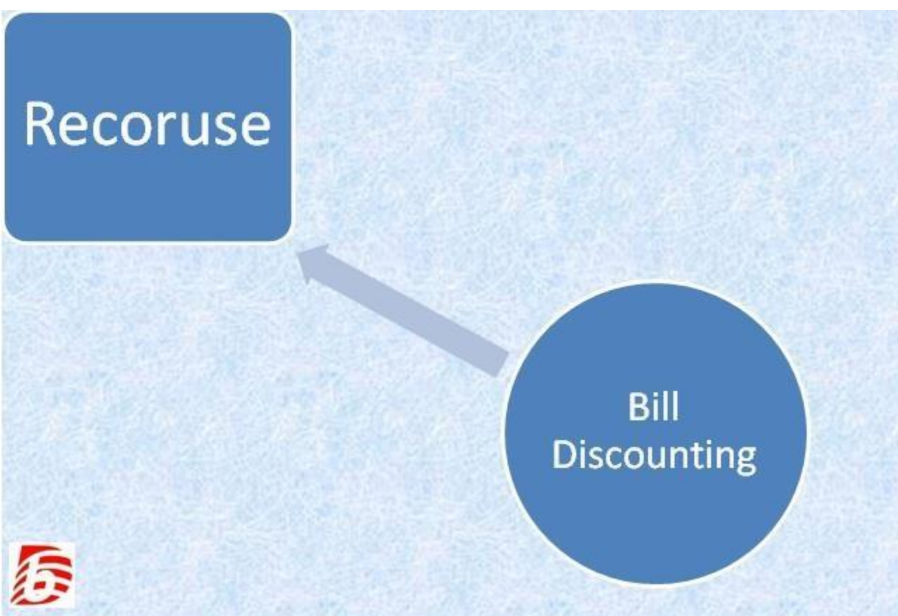
Key Differences between Factoring and Forfaiting

Basis for difference	**Factoring**	**Forfaiting**
Definition / Meaning	Factoring is the process in which you receive advance against account receivables / debt from the factor (bank or financial institution) without waiting for payment in future.	In Forfaiting, Exporter sell their medium and long term account receivables and obtain cash from the forfaiter.
Maturity of Receivables	It involves account receivables of short term maturities	It involves account receivables of medium and long term maturities.
Extent of Finance	Usually 80-90 percent of the value of invoice.	100 percent of value of invoice.
Type	Recourse Factoring and Non Recourse Factoring	Non Recourse

Credit Worthiness	Factor does the credit rating in case of no recourse factoring transaction.	Forfaiting Bank relies on the creditability of the Avalling Bank.
Cost	Factoring Cost is borne by the Client (seller).	Cost of forfaiting borne by the overseas buyer
Services Provided	Day to Day administration of sales and other allied services are provided	No Services are provided
Negoatiable Instruments	No dealing with Negotiable Instruments	Forfaiting is evidenced by bills of exchange, promissory note, a letter of credit.

Bill Discounting –
What is Bill Discounting?

In bill discounting, the seller of goods draws up a bill of exchange on the buyer of the goods and then discounts the said bill of exchange with a bank or financial company. The seller is able to get immediate finance minus the fee charged by the finance firm. Bill discounting lets the seller recover their receivables faster thereby improving cash flow. Before purchasing the bill, the bank or financial institution has to consider a number of factors including the risk of non-payment associated with the bill and the amount of time remaining for the bill to become due. A bill with lower risk and shorter duration of becoming due is preferred. Once the buyer of the goods makes the payment to the bank the transaction is settled.



What is the difference between Factoring and Bill Discounting?

Factoring and bill discounting are both sources of short term finance which offer traders and sellers an avenue to obtain payment for receivables in a fast and convenient manner. Both forms of short term financing help improve cash flow and working capital management. Despite their similarities, there are a few differences between factoring and bill discounting. Bill discounting is always recourse, whereas factoring may be recourse or non-recourse. Factoring also maintains sales ledgers and collect debt, while bill discounting only involves the purchase of the bill and no sales ledger maintenance is carried out by the finance company. It is possible for a bill to be discounted a number of times before maturity. However, this is not the case for factoring. Factoring is a facility that can be extended over a number of invoices, whereas in bill discounting each bill is assessed individually before being discounted.

Factoring vs Bill Discounting

• Factoring and bill discounting are both sources of short term finance which are offered by banks and financial institutions.

• In factoring receivables, the trader sells their unpaid invoices to factoring companies such as banks and financial institutions at a discounted rate.

• In the process of factoring receivables, factoring companies are also responsible for maintaining all credit control activities including management of the sales ledger and collecting debts directly by contacting customers.

• In bill discounting, the seller of goods draws up a bill of exchange on the buyer of the goods and then discounts the said bill of exchange with a bank or financial company.

• Before purchasing the bill, the bank or financial institution has to consider a number of factors including the risk of nonpayment associated with the bill and the amount of time remaining for the bill to become due.

• Factoring is a facility that can be extended over a number of invoices, whereas in bill discounting each bill is assessed individually before being discounted.

Types of Factoring Arrangements

Factoring – different types of factoring arrangements : Factoring has its recent origin in India after RBI constituted a high powered committee to examine the score for offering factoring services in the country in 1988. Committee submitted its recommendation to set up factoring subsidiaries in 1989. Following the announcement of the guidelines, the State Bank of India and Canara Bank have set-up their factoring subsidiaries – SBI Factors & Commercial Services Limited and Canbank Factors Limited. We recommend you to read our previous article on what is Factoring and its process. After reading this article you will be able to understand about **different types of factoring** arrangements between the client and factor.

Different Types of Factoring Arrangements

1. ***Recourse Factoring***

2. ***Non Recourse Factoring***
3. ***Maturity Factoring***
4. ***Advance Factoring***
5. ***Invoice Discounting***
6. ***Full Factoring***
7. ***Bank Participation Factoring***
8. ***Domestic and Cross border Factoring***

Recourse Factoring :

In this type of factoring, the factor has recourse to the client (seller of goods) if importer(buyer of goods) become insolvent. In other words, risk of account receivables purchased from client becoming bad is borne by client himself.

Non RecourseFactoring :

In this type of factoring, factor has no recourse to the client if the debt / account receivables purchased turns out be bad or irrecoverable. Factor can not claim the amount from the client. As factor bear the risk of non payment, commission charged for the services is higher than recourse type of factoring.

The additional commission charged by the factor for bearing the risk of insolvency / bad debts is called **del credere commission.**

Maturity Factoring :

No advance payment is made by the factor to client. Factor pay the client only after collection of account receivables/ debt or on a guaranteed payment date. The guaranteed payment date is usually fixed taking into account the previous ledger experience of the client and a period for slow collection after the due date of the invoice.

Advance Factoring :

Factor pay the advance varying between 75-85 percent of the value of receivables or invoice factored. The balance is paid upon collection or on the guaranteed payment date.

Invoice Discounting :

Under Invoice Factoring arrangement, factor makes prepayment to the client against the purchase of book debts and charges interest for the period spanning the date of pre payment to the date of collection. The sales ledger administration and collection are carried out by the client. The client provides the factor with periodical reports on the value of unpaid invoices and the ageing schedule of debts. This facility is usually kept confidential i.e., the customers (whose debts have been purchased by the factor) are not informed of the arrangement. Therefore, this arrangement is also referred as **'Confidential Factoring' or undisclosed factoring**.

Full Factoring :

Also known as **Conventional Factoring**, it combines the features of both non recourse and advance factoring arrangement. Full factoring provides the entire spectrum of services – collection, credit protection, sales-ledger administration and short-term finance.

Bank participation factoring :

Under this arrangement, **a bank participate** in factoring by providing an advance to the client against the reserves maintained by the factor. For example, assume that a factor has advanced 80 percent of the value of factored receivables and the commercial bank provides an advance limited to 50 percent of the factor reserves. The client is required to fund only 10 percent of the investment in receivables, the balance 90 percent being provided by the factor and the commercial bank.

Domestic and Cross Border Factoring :

The basic difference in domestic and cross border factoring is on account of number of parties involved in factoring process.

In domestic factoring, three parties are involved – **seller (client), Factor, Buyer**

While in cross border or export factoring, four parties are involved in transaction – **Exporter (Seller/client), Importer (buyer), Export Factor, Import Factor.**

It is also known as **Two Factor system of Factoring** as there are two factors involved in the transaction.

UNIT 5

Mutual Funds –

Introduction

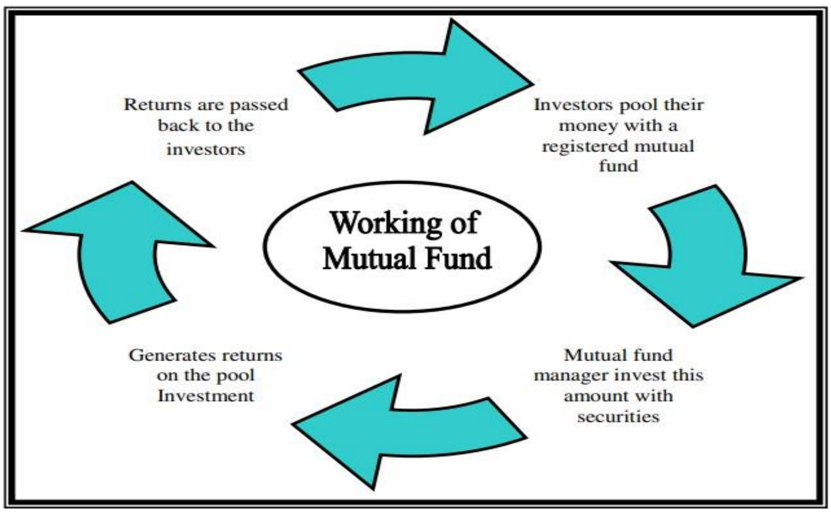
There are many investment avenues available in the financial market for an investor. Investors can invest in bank deposits, corporate debentures and bonds, post office saving schemes etc. where, there is low risk together with low return. They may invest in stock of companies where the risk is high and sometimes the returns are also proportionately high. For retail investors, who do not have the time and expertise to analyze and invest in stock, Mutual Funds is a viable investment alternative. This is because Mutual Funds provide the benefit of cheap access to expensive stocks. A Mutual Fund is a collective investment vehicle formed with the specific objective of raising money from a large number of individuals and investing it according to a pre-specified objective, with the benefits accrued to be shared among the investors on a pro-rata basis in proportion to their investment. According to Encyclopedia Americana, "Mutual funds are open end investment companies that invest shareholders' money in portfolio or securities. They are open ended in that they normally offer new shares to the public on a continuing basis and promise to redeem outstanding shares on any business day." According to Securities and Exchange Board of India Regulations, 1996 a mutual fund means "a fund established in the form of trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments".

Concept of Mutual Fund

A Mutual Fund is a trust registered with the Securities and Exchange Board of India (SEBI) which pools up the money from individual/corporate investors and invests the same on behalf of the investors/units holders, in equity shares, government securities, bonds, call money market etc. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. This pooled income is professionally managed on behalf the unit-holders, and each investor holds a proportion of the portfolio.

Operational flow of Mutual Fund

The following diagram depicts the operational flow of Mutual Fund



Parties to Mutual fund

The following diagram illustrates various entities involve in organizational structure of mutual fund:

Objectives of Mutual Funds

Most people have neither the time nor interest to research and select individual stocks and bonds for their investment portfolios, and that's where mutual funds come in. Mutual funds can invest in a variety of stocks, bonds and other assets, giving you diversification, which means a decline in value in any one stock or bond won't significantly hurt your overall return. A handful of well-chosen mutual funds or index funds can offer a diversified portfolio that allows the individual investor to spend his or her time on other pursuits. Thousands of mutual funds are available that can satisfy the objectives of different types of investors.

Tips

- A mutual fund acts as a diversified, relatively stable investment vehicle that allows casual investors to profit from market action without requiring constant oversight and management on their part.

Diversification of Assets

Investors are often advised that they shouldn't "put all their eggs in one basket." Investors who have too high of a percentage of their assets in one or two stocks can be severely affected if one of the companies goes belly-up. Most financial experts say investors should have at least 15 stocks in their portfolios. It takes a lot of time and effort to keep up with that many companies. Conversely, mutual funds hold a number of stocks, which gives investors instant diversification and protects them from a sharp decline in any one holding.

Exploring Growth Funds

Some mutual fund investors are looking for rapid growth in the value of their funds. Stocks have historically offered the best long-term returns of any asset class, though it can be an up-and-down ride. Stock funds that are labeled "growth" typically invest in companies with bright prospects, while "value" funds target stocks that seem inexpensive compared with the company's earnings.

When discussing mutual fund investments, it is important to note the distinction between closed-end and open-end funds. Whereas there is no limit to the number of open-end fund shares that can be purchased or distributed, closed-end funds feature a limited number of shares. Open-end funds are also not traded on the open market, whereas closed-end funds are traded through standard markets.

Evaluating the Benefits of ETFs

Exchange-traded funds, or ETFs, have become attractive investment opportunities for many individuals due to the numerous benefits they offer. Thanks to a highly diverse grouping of assets, ETFs are considered a relatively stable form of investment, and are linked to every major index today. Compared to mutual funds, ETFs typically feature a lower expense ratio, making them more affordable for investors.

Identifying Steady Income Opportunities

Other fund investors care more about receiving income from their investments. Numerous stock funds invest in companies with high dividend payouts. Bond funds also can provide steady income, as can funds that invest in real estate investment trusts, or REITs. All these income-focused funds pass the yields along to their investors, usually on a monthly or quarterly basis. Yields of 3 percent to 7 percent are often available with income-oriented mutual funds.

Gaining International Exposure

Some large international firms offer their shares on U.S. markets, but others don't. For example, individual investors can have a hard time getting access to shares in the fast-growing Chinese market. But international-focused mutual funds have an easier time investing in these shares. Exposure to overseas stocks and mutual funds may add much-needed diversification and open the door to additional lucrative opportunities.

Benefitting From Low Fees

Stock picking can be expensive thanks to broker commissions, but many "no-load" mutual funds are available that don't charge investors anything. Many other funds charge investors less than 1 percent a year for operational fees.
Investors looking for especially inexpensive funds might consider index funds, which charge fees as low as 0.1 percent per year. In 2018, Fidelity even introduced zero-fee index funds. These funds usually hold every stock or bond in a given asset class, which offers tremendous diversification at a low cost.

Mutual Fund Functions
The personalized sales approach of the modern investment industry has helped fuel recent growth in mutual funds, but investors mainly flock to them because of their versatility. Mutual funds pool assets and let you invest in different industries and different types of stocks and bonds with the help of investment professionals. These funds have multiple functions, such as saving you time and money, as well precisely tailoring your portfolio to reach your financial objectives. Pooling your funds with other investors can also grant you access to blue-chip stocks and expensive investments you couldn't afford on your own.

Exploring Fund Management

When you invest in a mutual fund, you benefit from **professional money managers and their research team.** Spectacular returns aren't guaranteed just because professionals run the fund, but you do know your funds lie in the hands of an experienced crew who understand the financial markets. This means you don't have to spend a lot of time researching stocks yourself, as you would if you were investing in individual stocks.
Instead, mutual fund managers track the financial markets and the day-to-day fluctuation of different industries for you and then act accordingly.

Understanding Fund Diversification

When you buy into a mutual fund you have the opportunity to buy multiple stocks, bonds or other assets, depending on the type of fund it is. This diversified approach minimizes the effect of price fluctuations in a single asset. The more assets you own, **the less overall effect each individual asset has on your portfolio.**
Invest in a single mutual fund and you are already more diversified than if you purchased a single stock. Buying multiple funds, including bond, stock and money-market funds, provides a diversification level nearly impossible to achieve by purchasing stocks and bonds one at a time.

Evaluating Cost-Effectiveness

When you buy a fund, you will have to pay a commission as well as a yearly management fee. Ranging from **1 percent of your total investment to several percentage points**, this fee compensates the fund controllers for managing your money. Don't let these fees deter you from investing. Remember that mutual funds hold multiple assets. Purchasing all those assets individually to attain a similar diversification level on your own could result in an **even more expensive commission bill and higher brokerage fees.**

Assessing Your Precise Investment Goals

Mutual funds let you tailor your portfolio to meet investment objectives by purchasing different fund types. Mutual funds range from conservative and low-risk to exotic and high-risk. Bonds and money-market funds are typically low-risk, providing stable but relatively small returns. Funds invested in domestic and foreign stock are riskier than bond funds, but over the long haul usually provide a higher return.

Organization and Management

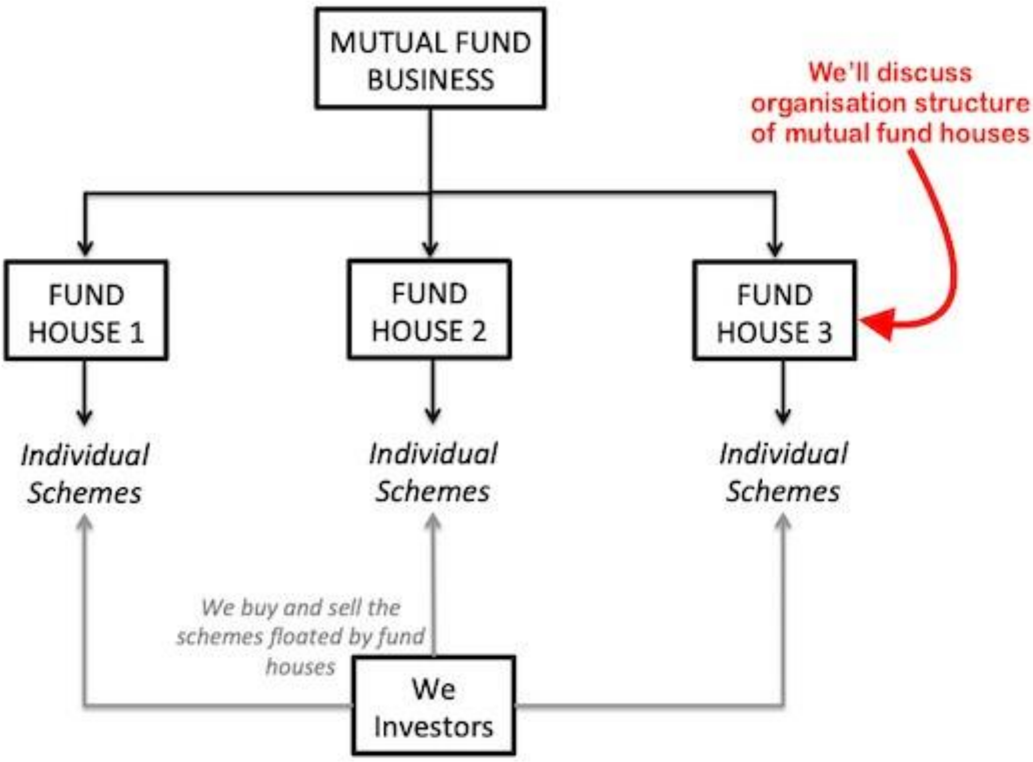
Organisation Structure of Mutual Funds in India

Introduction

What we often phrase as "**Mutual Fund**" is actually a *type of business*. Within this line of business, there are approximately 35-40 nos **fund houses**.

These fund house are actually the companies, whom SEBI has allowed to operate mutual fund schemes. It is these **schemes** which we common people buy and sell as *investment products.*

I am sure you already know this, but allow me to present this information in a more graphical form for clearer understanding.



India's Top 5 Fund Houses in term of the size of the Asset Under Management (AUM) – *as on Dec'18*, are listed below:

SL	Mutual Fund Houses	AUM (Rs.Crore)
1	HDFC Mutual Fund	3,34,964
2	ICICI Prudential Mutual Fund	3,07,735
3	SBI Mutual Fund	2,64,353
4	Aditya Birla Sun Life Mutual Fund	2,42,344
5	Reliance Mutual Fund	2,36,256

The most visible person of a mutual fund is the "Fund Manager". But do you know, there is a Chairman, CEO, CFO of a fund house?

Example: Aditya Birla Sun Life Mutual Fund.

- Chairman: Kumar Mangalam Birla.
- CEO: A. Balasubramanian.

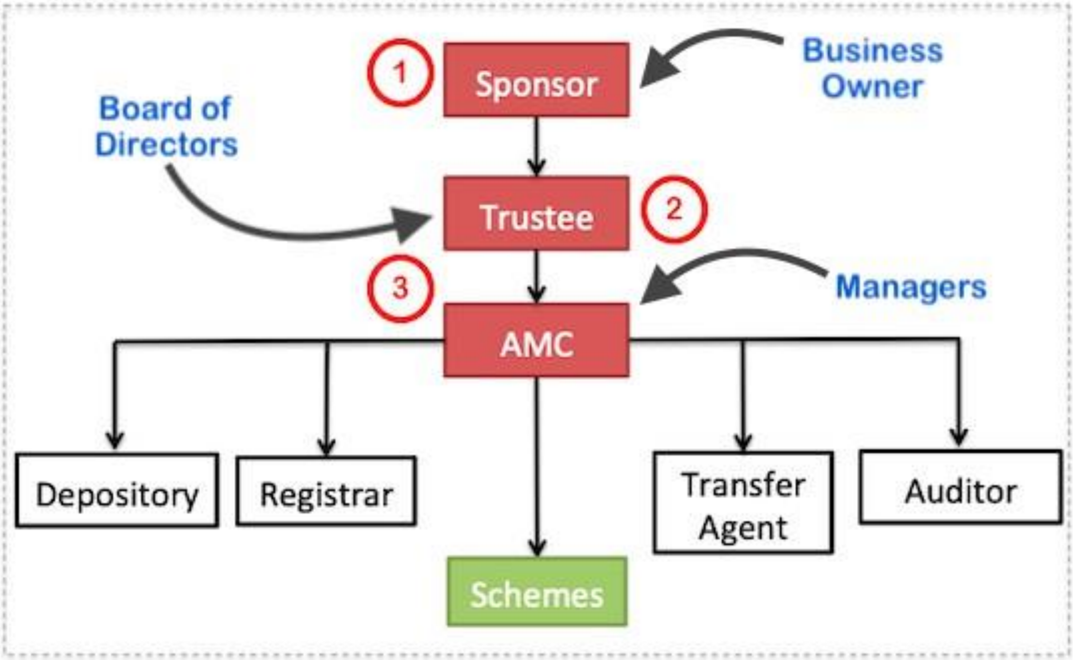
To have more clarity about how a mutual fund operates, we will have to know the organisation structure of a typical mutual fund house in India.

THREE TIER STRUCTURE OF FUND HOUSE

The three tier structure of a mutual fund house consist of the following heads:

1. Sponsor.
2. Trustee.
3. AMC.

A Typical Mutual Fund House - regulated by SEBI



It is **SEBI** who has prepared the framework of the above 3-tier structure of mutual funds. All mutual funds operates in India under SEBI guidelines.

It is the **SPONSORS** (also called promoters) who first conceptualise the idea of starting a mutual fund business. Before they can act further, they must approach SEBI for *registration* of the business.

If the sponsors has the necessary credentials, SEBI will issue the "Certificate of Registration" to the sponsors. Which are the credentials required?

- The sponsor must have experience of 5 years in financial services.
- They must be a profit making company (3 out of 5 years).
- Last 5 years net worth of the company must be positive.

Once the certification is received, further steps can be taken to start a mutual fund activity. Which are the next steps?

1. Formation of Trust.
2. Appointment of AMC.
3. Appointment of Depository (Custodian), Registrar, Transfer Agent, and Auditor.

#1. Trustee – Father Figure

The sponsors of mutual fund forms a Trust. This Trust must have a "Board of Trustees" (like board of directors).

Who shall be in the Board of Trustee (BOT)? There is a stipulation of SEBI which must be followed in the BOT.

The minimum strength of the board must be four (4) members.

Out of the whole board members, two-third members must be "Independent Directors". Who are independent directors? Those people who have no relation with the sponsors in any way.

The idea of the formation of a Trust is to have a management in place. The priority of this management will be like this:

"Protect the interest of the unit-holders and their invested money"

It is also the responsibility of the Trustee to ensure that, mutual fund operates as per the regulations of SEBI.

As per SEBI guidelines, at all times, out of the total net worth of the AMC, a minimum amount must be contributed by the sponsors.

There is another reason why SEBI has stipulated such strict norms related to the Board of Trustees. What is the reason? Generally corporate houses are the sponsors of mutual fund schemes. Example: Tata Group, ICICI bank, Mahindra and Mahindra Group, HDFC bank etc.

SEBI has stipulated such rules to ensure that the investors pooled money is not used by the sponsors in their group companies.

BOT members may not engaged in the day to day operations of the mutual fund.

Daily operations of the mutual fund is managed by the appointed "Managers (AMC)" and other team members.

#2. AMC – Manager of Mutual Fund

After Trustees, the most important entity in the mutual fund is its AMC (The Asset Management Company).

AMC of a mutual fund is formed as per the "Companies Act 1956". The AMC must also be registered with the Government of India accordingly.

After an AMC is registered, it will start functioning as a full fledged company. This is one reason why we see the following three types of AMC's in India:

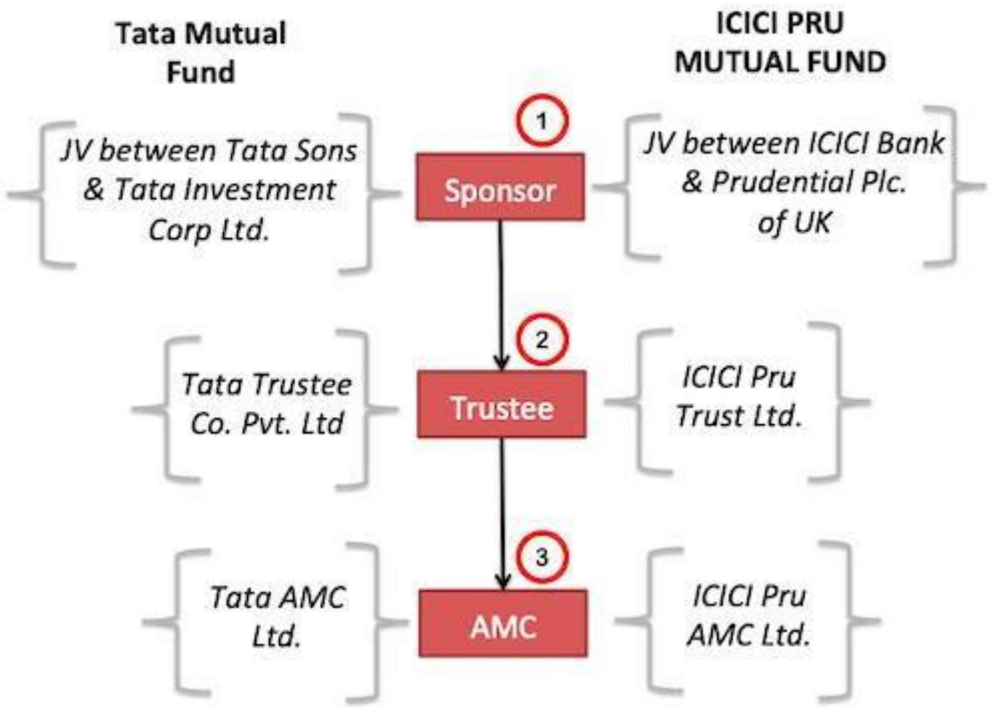
1. Private Limited Company.
2. Wholly Owned Subsidiary of an already Public Limited Co.
3. Joint Venture (Indian or Overseas Companies).

When the trustees are forming the AMC, it is also their job to appoint the following managers who will in turn run the AMC:

- CEO
    - Chief Investment Officer.
        - Fund Manager

      Chief Marketing Officer (CMO)Chief Operations Officer (COO)Compliance Officer.Etc.
    - Chief Marketing Officer (CMO)Chief Operations Officer (COO)Compliance Officer.Etc.

Example of Three Tier Structure:



#3. What is the role of the Custodian (Depository)?

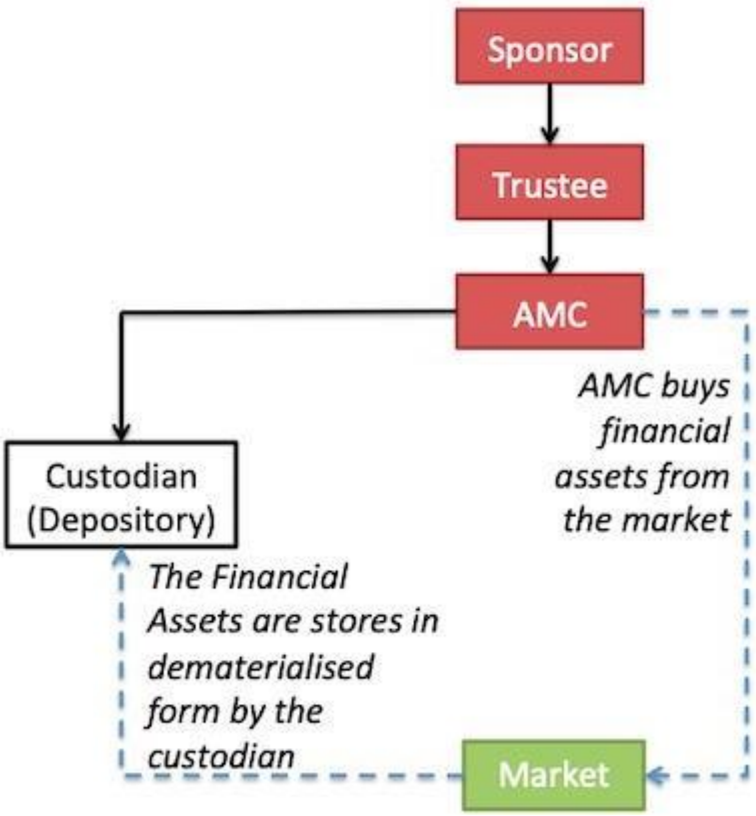
A mutual fund scheme purchases various types of financial assets. Some of these assets can be like this:

1. Stocks of companies.
2. Government bonds.
3. Company deposits.
4. Cash etc.

It is the responsibility of the depository (custodian) to hold all financial assets safely in its custody.

A good analogy of a 'depository' is our bank's locker. In the locker we can keep important documents, jewellery etc.

Example: HDFC Bank provides custodian service to ICICI Pru Mutual Fund.

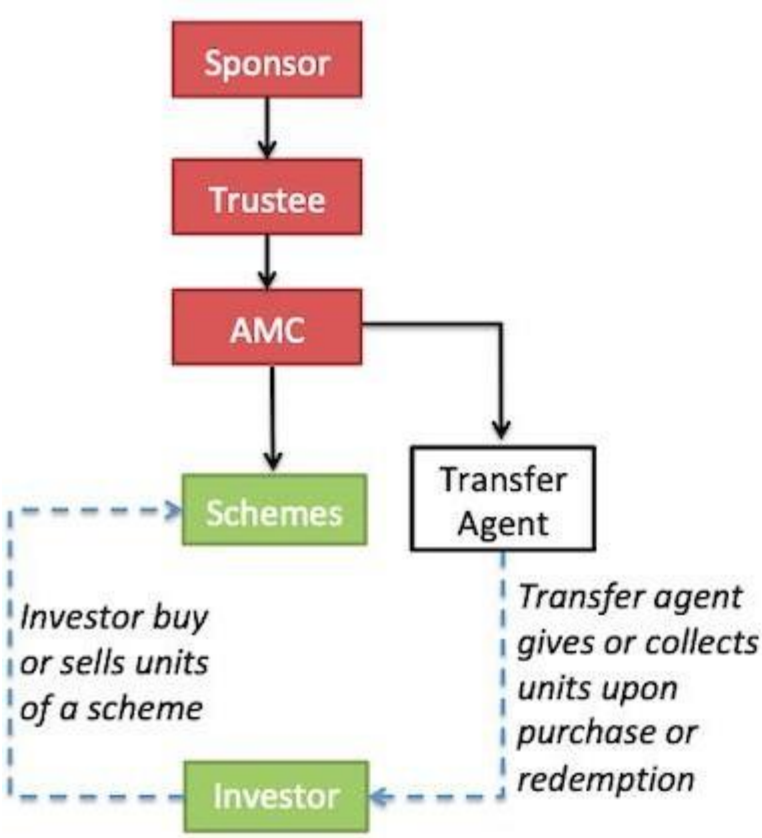


#4. What a Transfer Agent does?

AMC appoints a transfer agent. The transfer agent handles the following:

- Communication with investors.
- Maintains investors data.
- Process all transactions of units (purchased or redeemed).

Example: For ICICI Pru Mutual Fund, the transfer agent is ICICI Infotech along with CAMS Ltd. For Tata AMC, the transfer agent if CAMS.



#5. What is the role of a Registrar?

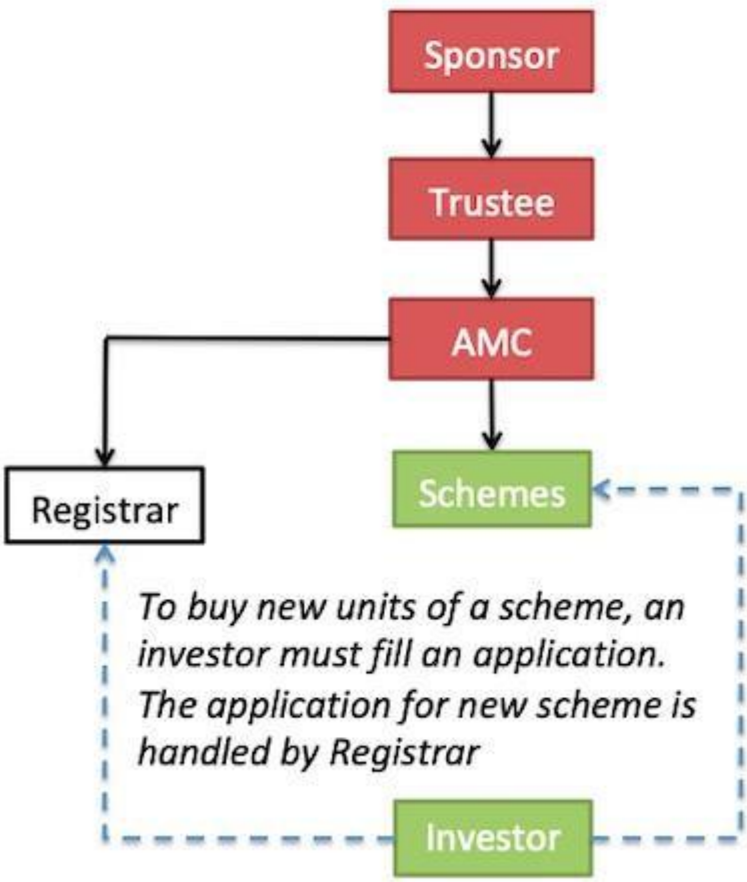
Again, it is the AMC who appoints the Registrar for its mutual funds.

These days generally the role of Transfer Agent and Registrar is performed by the same company.

In India the most common registrar utilised by mutual fund companies are CAMS and Karvy.

The main functions of Registrar are the following:

- Data Entry.
- Send Account Statements to Investors.
- Etc.



#6. Role of an Auditor…

As per companies act, all companies must get their book of accounts audited by an external financial auditor. These auditors are basically certified chartered accountants.

All financial transactions done by a mutual fund company must be presented to the auditors for scrutiny. At the end of the financial year, the auditors also checks and certifies the financial reports prepared by the mutual fund companies.

Guidelines for Mutual Funds

The regulator for markets in India, SEBI (Securities and Exchange Board of India), works for the protection of investors' interest in securities while regulating and promoting the securities' market. The organisation has created guidelines for investors to gain awareness regarding the manner in which mutual funds function by offering the required information. The regulator aims to simplify the wide variety of schemes that tend to confuse investors due to their complexity. The guidelines regarding the consolidation and merger of MF schemes are created in an effort to make it easier for investors to compare different schemes made available by mutual fund companies.

Guidelines Regarding Structure

The guidelines regarding the structure of schemes define a Guarantor as someone who introduces a mutual fund. The guarantor's role is to generate revenue through the launch of a mutual fund. The fund is then handed to a fund manager.

A sponsor, according to the guidelines, is defined as someone who sets up schemes in keeping with the regulations of the Indian Trust Act, 1882. Sponsors primarily have the role of listing the schemes with the Securities and Exchange Board of India.

The Securities and Exchange Board of India is responsible for making policies related to mutual funds. It also has the responsibility of regulating the industry and laying down the law so that investors' interest is safeguarded. So far as 'asset allocation' and 'investment strategy' are concerned, mutual funds can be very different from one another. The new guidelines have focused on uniformity so far as the functioning of schemes is concerned. Investors will, therefore, find it easier to make investment decisions. To make things standard and to introduce uniformity in schemes that are similar to one another, the following is the manner in which mutual funds are categorised:

- Equity funds
- Debt funds
- Balanced or hybrid funds
- Solution-oriented funds
- Other funds

Major Highlights of SEBI Regulations for Investment in Mutual Funds

The following are the major highlights of the regulator's guidelines regarding mutual funds:

- Mutual funds have been categorised into 5 groups – equity, debt, balanced, solution-oriented, and others.
- Definitions of small, mid, and large cap have been made clearer to facilitate uniformity.
- Solution-oriented funds come with a lock-in period.
- Only one scheme is permitted in each category, apart from ETFs or index funds, thematic or sectoral funds, and fund of funds.

Apart from laying down the law, the Securities and Exchange Board of India has also created guidelines for investors.

SEBI Guidelines for Investors

- Assessing personal finances: Mutual funds are highly diverse investment options. As a result, they carry some risk with them. Investors are urged to be clear when they assess their financial standing. They are also asked to be careful when assessing their ability to bear risk in case a scheme does not perform as expected. The risk appetite of investors must be considered individually in keeping with each scheme.
- Research information regarding schemes: Before making investments in mutual funds, it is essential for investors to attain detailed information regarding the scheme in which they wish to invest. Equipping yourself with all the details regarding your investment options will make it easy to make the right decision.
- Diversification of portfolios: Investors can spread their investments carefully by diversifying their portfolios. As a result, the potential to mitigate risks or maximise profits of potentially major losses increases. Diversification of portfolios is instrumental in gaining sustainable long-term financial results.

- Refrain from cluttering portfolios: Select the right funds to create a portfolio needs professional management of the schemes in addition to careful monitoring. Investors should ensure that their portfolio is not cluttered while choosing the number of schemes to add to their portfolio in order to ensure that the schemes can be well-managed individually as well as collectively.
- Assign time frames: Investors are advised to ensure that a time frame is assigned to each scheme in order to ensure that the plan grows. If there is stability in the maintenance of the schemes, market fluctuations and volatility can be curbed significantly.

Effects of New Categorisation on Investors

Investors will be affected by the new categorisation in the following ways:

- The number of schemes available may be lower, thus making it relatively easier for investors to make a selection.
- Some schemes may be merged with others.
- The expense ratio of investors could decline because of the higher Assets Under Management per scheme.

Experts suggest that the latest guidelines regarding the merger and consolidation of schemes will essentially simplify things for investors when it comes to comparing and investing in the numerous schemes made available by fund houses. The guidelines are also expected to reduce clutter while introducing uniformity, thereby making it easy for individuals across the country to invest in mutual funds.

Debt Securitization

Securitization is the method of converting the receivables of the financial institutions, i.e., loans and advances, into bonds which are then sold to the investors. In simple terms, it is the means of turning the illiquid assets into liquid assets to free up the blocked capital.

The receivables on debts against collateral assets like property, land, building and other real estate, become exchangeable financial instruments in this process of securitization.

Securitization Process

Securitization is a complex and lengthy process since it is the conversion of the receivables into bonds; it involves multiple parties.

The steps involved in the process of securitization are as follows:

Origination Function: The borrower approaches a bank or other financial institution (originator) for a loan. The respective financial institution allows a certain sum as debts in exchange for any collateral.

Pooling Function: The originator then sells off its receivables through pledge receipts to the special purpose vehicle.

Securitization: The SPV transforms these receivables into marketable securities, i.e., either Pay Through Certificate or PTC (Pass-Through Certificate). These instruments are then forwarded to the merchant banks for selling it to the investors. The investors buy these instruments to benefit in the long run.

Since the investors extend the loan, they are liable to receive a return on investment. The borrowers are unaware of this securitization and pay timely instalments.

The originator receives a lump sum amount, though at a discounted value from the SPV. The merchant bank charges fees for its services.

Types of Securitization

Asset-Backed Securities (ABS)

The bonds which are supported by underlying financial assets. The receivables which are converted into ABS include credit card debts, student loans, home-equity loans, auto loans, etc.

Residential Mortgage-Backed Securities (MBS)

These bonds comprise of various mortgages like of property, land, house, jewellery and other valuables.

Commercial Mortgage-Backed Securities (CMBS)

The bonds that are formed by bundling different commercial assets mortgage such as office building, industrial land, plant, factory, etc.

Collateralized Debt Obligations (CDO)

The CDOs are the bonds designed by re-bundling the personal debts, to be marketed in the secondary market for prospective investors.

Future Flow Securitization

The company issues these instruments over its debts receivable in a future period. The company meets the principal and interest through its routine business operations, though such obligations are secured against its future receivables.

Advantages of Securitization

In the securitization process, the multiple parties involved are borrowers, originator, special purpose vehicle, merchant bank and investors.

To the Originator

The originator derives maximum benefit from securitization since the purpose is to get the blocked funds released to take up other alluring opportunities. Let us discuss each one of these:

Unblocks Capital: Through securitization, the originator can recover the amount lent, much earlier than the prescribed period.

Provides Liquidity: The illiquid assets, such as the receivables on loans sanctioned by the bank, are converted into liquid assets.

Lowers Funding Cost: With the help of securitization, even the BB grade companies can benefit by availing AAA rates if it has an AAA-rated cash flow.

Risk Management: The financial institution lending the funds can transfer the risk of bad debts by securitizing its receivables.

Overcoming Profit Uncertainty: When the recovery of debts is uncertain, its profitability, in the long run, is equally doubtful. Thus, securitization of such obligations is a suitable option to avoid loss.

Reduces Need for Financial Leverage: Securitization releases the blocked capital to maintain liquidity; therefore, the originator need not seek to financial leverage in case of any immediate requirement.

To the Investor

The investor's aim is to accelerate the return on investment. Following are the different ways in which securitization is worth investing:

Quality Investment: The purchase of MBS and ABS are considered to be a wise investment option due to their feasibility and reliability.

Less Credit Risk: The securitized assets have higher creditworthiness since these are treated separately from their parent entity.

Better Returns: Securitization is a means of making a superior return on their investment; however, it depends more on the investor's risk-taking ability.

Diversified Portfolio: The investor can attain a well-diversified portfolio on including the securitized bonds; since these are very different from other instruments.

Benefit Small Investors: The investors having minimal capital for investment can also make a profit out of securitized bonds.

Disadvantages of Securitization

Securitization requires proper analysis and expertise; otherwise, it may prove to be quite unsound to the investors. Let us now discuss its various drawbacks:

- **Lack of Transparency**: The SPV may not disclose the complete information about the assets included in a securitized bond to the investors.
- **Complex to Handle**: The whole process of securitization is quite complicated involving multiple parties; also, the assets need to be blended wisely.
- **Quite Expensive**: When compared to share flotation, the cost of a securitized bond is usually high, including underwriting, legal, administration and rating charges.

- **Investor Bears Risk**: The non-repayment of debts by the borrower would ultimately end up as a loss to the investors. Therefore, the investor is the sole risk-bearer in the process.
- **Inaccurate Risk Assessment**: Sometimes, even the originator fails to identify the value of underlying assets or the associated credit risk.
- **Loss from Prepayment**: If the borrower pays off the sum earlier than the defined period, the investors will not make superior gains on their investment value.

De-mat Services-need and Operations

Before getting to know what is Demat account, let us first understand why holding documents in digital form is more beneficial than having them in physical form.
Today, we are more into digital wallets like Google Pay, Paytm, and all such. Because they are more secured and easily accessible.
Isn't it?
The same way, having a Demat account helps you keep all your financial assets in a single electronic form.
The main purpose of the Demat ac is to hold all the shares that you have bought or dematerialized (converted to electronic format physical shares) and to make trading easier for you.

What is the Meaning of a Demat Account?

Demat account is also known as a Dematerialized account. The primary use of Demat account is to hold shares and securities in an electronic format. It helps you in online trading like buying or selling shares, or converting physical shares into electronic form. All the shares, mutual funds, bonds, government securities, and other investments are saved in a dematerialized account. Also, through demat account investors can perform intraday trades.

What is Dematerialization?

Dematerialization is the term used to define the process of transferring physical certificates into electronic ones. Overall, it makes the documents available round the clock and accessible at your fingertip. The main motto of dematerialization is to avoid holding physical shares and help you with seamless tracking and monitoring. A demat account helps convert physical shares to electronic form.

What is the Use of Demat Account?

Below are the four major features of Demat account that make you understand the need of Demat account:

1. **Lower Costs**: Usually, investors need to spend on different unexpected expenses when transacting with physical share certificates such as handling cost, stamp duty and so on. You can eliminate the costs of holding shares in the form of physical share certificates by choosing a Demat account. You can also get to know the exact amount of the transaction beforehand.
2. **Less Paperwork:** Earlier, shares transactions used to happen through certificates or physical receipts which used to incur a lot of paperwork and used to slow down the trading activities. Nobody used to be able to do any transaction without presenting their certificates. A Demat account holds shares and securities in electronic form. Hence making it easy to transact.
3. **No-Risk:** Trading through physical securities was always risky with the threat of physical damage, loss, misplacement, or forgery. Demat accounts in india eliminate all these risks and give you peace of mind.

4. **Instant Transactions:** Delivering physical certificates used to take days even weeks sometimes due to the administrative system that needed to be fulfilled. With the help of Demat account, you are avoiding the waiting period as it offers instant transactions.

Benefits of Demat Account

Following are some of the benefits that a Demat account offers,

- Easy to use, convenient, and secured.
- Automatic credit of share in the event of a company merger, bonus, consolidation, and so on.
- All the Demat account information is accessible online just using a secure login.
- You do not need to keep visiting the stock market for transactions.
- Low transaction costs
- No stamp duty
- Unlike physical shares, here you can make transactions with odd numbers too.
- If you have a common Demat account, you do not need to update details from time to time. The companies will automatically receive your information from the Demat account.
- It offers a common banking solution.

How to use a Demat Account?

There is something important to note here before getting to know how to operate the online Demat account. A Demat account comes with a trading account linked to it, with unique login credentials. So, you will need to use the trading account for transacting and investing in stocks. Demant account holds all the purchased shares while trading account helps you sell and purchase the securities. Hence both demat and trading accounts are necessary for trading online.

So, whenever you are planning to buy or sell a share, you should log in to the trading account, which is also connected with your bank account. When you try to buy or sell a share, the request is sent to a trading account of a particular stock, with all other details. Then, your DP (Depository Participant) will forward all this to the stock exchanges immediately.

In case, if the request is to buy. The stock exchanges will find a seller who is selling a specific number of shares. And then forwards the order to clearinghouses to debit that quantity of shares the seller's demat account. The same is credited into your demat account.

If the request is to sell, it works the other way around. Finally, the buyer and the seller can hold the Demat account with Depository Participants of different depositories. You can buy any shares or securities through the Demat account. For instance, many have been struggling to understand how to buy mutual funds online, as mutual fund investments have been one of the best investment options lately. The good news is, you can do all this through an online demat account. Don't go anywhere else!

What is the Procedure for Opening a Demat Account?

Here is the account opening process for a Demat account

1. Firstly, decide where you want to open the demat account. Then choose a DP you want to open the Demat account with. You can find many financial institutions and brokerages offering this service.
2. Fill up the account opening form and submit it along with the copies of all the necessary documents and a passport size photo.
3. Have original documents handy for verification.
4. You will receive a copy of the terms and conditions agreement. Go through it.
5. A member of DP will get in touch with you and verify the details you have submitted.

6. If the application is processed, you will get a Demat account number along with a client ID which you can use for the account online.
7. You need to pay some account opening charges such as annual maintenance charge and the transaction fee (monthly basis). The fee differs from one to another Depository Participant. Some DPs charge a fat fee for each transaction while some charge a percentage to the total transaction value. DPs also charge for converting shares from physical forms to electronic ones, or vice-versa.
8. There is no limit on the minimum number of securities to keep your account active.

Documents required for opening a Demat account

While opening a Demat account online, you need to submit your ID proof, address proof and a passport size photo along with an opening form. You will need to submit the photocopies of the documents required. Also, you have to keep originals handy for verification. Here is the detailed list of documents required that are accepted as proofs for opening a Demat account online.

Proof of Identity

- Voter ID
- Pan Card
- Passport
- IT returns
- Bank Attestation
- Telephone Bill
- Electricity Bill
- Any other ID card which has your photo, issued by state or central government and other departments, regulatory or statutory authorities, scheduled commercial banks, PSUs (public sector undertakings), public financial institutions, or professional bodies like ICSI, ICAI, bar council, etc.

Proof of Address

- Passport
- Ration Card
- Driving License
- Voter ID
- Bank Statement
- Bank Passbook
- Electricity Bill
- Telephone Bill
- Agreement for Sale
- Self-Declaration by Supreme Court or High Court Judges
- Document or ID card issued by State or Central Government and its departments, regulatory or statutory authorities, scheduled commercial banks, PSUs (public sector undertakings), public financial institutions, or professional bodies like ICSI, ICAI, bar council, etc.

Demat Account Glossary

Following are some of the jargons associated with Demat ac that you need to know about:

Electronic Certificate

You need a bank account, Demat AC, and a trading account to deal with investments. Whenever you purchase equity shares, your ownership for those shares is marked through a certificate, which is available in electronic form. It is called an electronic certificate.

Central Depository

Central Depository or CD is a central agency that maintains all the information associated with Demat accounts opened with DPs around the country. India's CDs include NSDL (National Securities Depository Limited) and CDSL (Central Depository Services Limited).

NSDL (National Securities Depository Limited) is the largest and oldest depository in India. It is the first depository in India to offer trading and settlement of securities in dematerialized account format. CDSL (Central Depository Services Limited) is the second-largest depository in India. it facilitates account transfer.

Depository Participants DP

The depository participants DP are the fundamental intermediaries standing between the CDs and the Demat account holders. Several banks, financial institutes, and brokerage firms that offer Demat accounts in india to investors are all DPs.

Transaction Identification: To be able to buy or sell electronic security, you need to have a trading account as already discussed. It is as important as opening a Demat account. Every trading account comes with a unique ID that is used for all the investment transaction. It is called Transaction Identification.

Portfolio Holding

A Demat account keeps all your investment holdings such as exchange-traded funds, equity holdings, government securities, bonds, and mutual fund investments. All these together are referred to as portfolio holding. Also, you can access them all through your Demat account.

Consolidation

If you own different portfolios of any particular company and wish to consolidate them into a single portfolio, you can get it done by forwarding the physical certificates to the RSTA of that company along with a letter with your signature.

Account Freezing

You have the option of freezing your account or specific security for a given period.

Role of NSDL and CSDL

National Securities Depository Limited (NSDL) is a financial organization created to hold securities such as bonds, shares etc. in the form of physical or non-physical certificates i.e. in dematerialized format. These securities are held in depository accounts such as funds held in bank accounts. It facilitates prompt transfer of securities as ownership is transferred simply through book entries. This is usually done electronically thus eliminating the extra time that was taken in following the traditional practice where physical certificates had to be exchanged after a trade was completed.

The capital market of India, that is more than a century old, has always been very active. However, it had certain shortcomings like bad delivery, delayed execution of transfer, etc. due to paper based settlements. To curb these issues, The Depositories Act, 1996, was passed and it came into force on September 20, 1995. This act provided for creation of Security Depositories in India for managing securities.

Securities are financial assets that can be traded, i.e., they can be bought or sold in the financial market. They are financial instruments and include equity, fixed income instruments, equity warrants, common stocks, etc. They can be of 2 types – debt and equity. Debt instruments such as bank notes, bonds, debentures, etc. are like borrowed money and hence have to be repaid. Stocks and shares provide the buyers with partial ownership of the company.

Business Partners of NSDL

NSDL carries out its activities through various functionaries called "Business Partners" such as:

- Depository Participants (DPs),
- Issuing companies
- Registrars and Share Transfer Agents,
- Clearing corporations/Houses of the Stock Exchanges
- Investor
- Broker

These entities should get integrated into NSDL's depository system to provide key services to the clearing members and investors. The investor can obtain depository services through a depository participant of NSDL. It is similar to opening an account in bank. As a person opens a bank account to avail the services of a bank, an investor opens a depository account with a depository participant in order to avail depository facilities. Some salient features of NSDL's business partners are:

- A clearing member is allowed to open a special account with the depository system for settling trades carried through stock exchanges.
- The clearing account helps the clearing member in receiving securities from clients for the purpose of delivery to the Clearing House/Corporation as pay-in
- This account allows the clearing member to distribute the pay-out to clients received from the Clearing House/Clearing Corporation.
- The clearing corporations/houses of stock exchanges also have to be electronically linked to the depository
- Once linked, these corporations can electronically receive securities delivered by clearing members towards pay-in
- Clearing corporations can give out securities to clearing members towards pay-out.

- An issuer can allow its shareholders to dematerialize by signing an agreement with NSDL.
- After the issuer signs the agreement, an electronic link is established between NSDL, issuer or its R & T Agent.
- NSDL is electronically linked to each of these business partners.
- Specific processes are defined to make an application to NSDL for becoming a business partner.

The business partners of NSDL are as follows:

Depository Participants (DP)

NSDL provides services to the investors through Depository Participants. Bank, financial institution, custodian, broker or any entity eligible as per SEBI regulations can be appointed as a DP. Using the existing distribution channel helps NSDL reach large number of investors spread across wide geographical area. Investors are required to open a depository account with a DP to avail depository facilities. Appointment of DPs is a 2 step process:

- Evaluation and confirmation by SEBI
- Evaluation and approval by NSDL

Issuers

To become an issuer in NSDL, the entity must be able to offer dematerialization facilities to the shareholders. Security issuers, who have entered into an agreement with NSDL can dematerialize the security issued in NSDL depository. Issuers have to verify the certificates and maintain electronic connectivity. Following is the process for appointment of the issuer:

- An issuer needs to submit the prescribed documents including the letter of intent, audited financials for last 2 years, etc. to NSDL
- NSDL forwards blank Tripartite Agreement to R & T agent.
- The R&T Agent and the issuer signs the agreement
- This agreement is sent back to the NSDL

Registrar and Transfer (R&T) Agent

In NSDL depository system, the issuer can create and extinguish securities held in the demat form. Securities in demat can be created and extinguished in 2 ways. The ways in which securities can be created are:

- By converting the physical securities into demat form, i.e. dematerialization
- The issuer releases instructions to NSDL to credit eligible beneficial owners with securities as per their entitlements

The two ways in which securities can be extinguished are:

- Rematerialisation, i.e. converting demat form securities into physical certificate form
- The issuer releases instructions to NSDL to debit eligible beneficial owners with securities as per their entitlements

To effect these actions, the issuer may utilize the computer facility (named DPM-SHR) that is built in-house or borrowed from the said R&T Agent. Thus, the R&T Agent lends the required computer facility to confirm and execute these activities. Following is the process for appointment of R&T agent:

- Submit an introduction letter to NSDL
- Procurement and installation of required hardware and software
- Submission of the fee to procure DPM-SHR software
- Provision of training to the personnel who shall be managing the operations and equipment
- Pilot testing has to be done to check the working and response of the software system configured
- When NSDL activates the respective business partner as a share registrar, R&T Agent status is confirmed

Clearing Corporation/House

Any stock exchange that desires to facilitate settlement in demat shares should have a clearing corporation/house with a fully operational settlement guarantee mechanism. The settlement guarantee mechanism should be approved by SEBI. A clearing house is a mediator between the buyers and the sellers of financial instruments. It is responsible for settling trading accounts, clearing trades, collecting and maintaining margin money, regulating delivery, and reporting trading data.

- The corporation needs to have an operational structure that guarantees settlement
- The corporation also ensures that the payment against delivery is done flawlessly and in a timely manner
- NSDL has to be satisfied that the Clearing Corporation/House possesses the operational expertise to provide services related to the settlement of transactions with respect to securities that are in demat form
- The Clearing Corporation/House must have possession of necessary hardware and software systems that are crucial for interaction with the Depository without lags/timeouts.
- A clearing house has to ensure the redressal of grievances of clients and participants with respect to its operations in relation to the depository

- The procedure for joining NSDL, systems specification and investments and expenses to be incurred by a clearing corporation/house is same as that of Depository Participant.

Investor

An investor is a person or entity that invests in the financial instruments. An investor has to just open a beneficiary account with the DP along with the required documents.

Broker

Brokers are an important link between investors and the associated Clearing Corporation/House. They must have a clearing account with any DP. Such an account can be utilized only for the purpose of receiving and transferring the shares from and to the concerned Clearing Corporation/House. The broker does not have any ownership rights on the shares that move to and fro his account.

Clearing Member Accounts

The clearing member account has three parts:

- **Pool Account**: Shares are received from selling clients in the pool account. Transfer to buying clients is also done from the pool account.
- **Delivery Account**: Shares received from selling clients are moved from the pool account to the clearing corporation/house through the delivery account.
- **Receipt Account**: Shares are received in the pool account from the clearing corporation/house through the receipt account.

entral Depository Services Limited (CDSL) is a depository service that works for the Bombay Stock Exchange (BSE) and is promoted by the State Bank of India (SBI), Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Axis Bank and the Union Bank of India.

The primary function of this depository is to hold securities either in certificated or un-certificated (dematerialized) form, and it helps enable the book-entry transfer of securities up to 500 shares in physical form. However, most traders have now adapted to the electronic format for trading in securities. CDSL's primary focus is to provide safe, useful, reliable and secure depository services. CDSL began its operations from February 1999 onwards after obtaining prior clearance from market watchdog Securities and Exchange Board of India (SEBI).

A Depository Participant (DP) offers depository services to investors. According to SEBI-issued regulations, financial institutions, banks, custodians, and stockbrokers are eligible to act as DPs. The DP is a CDSL-authorized agent who serves as a link between the account holder or Beneficial Owner (BO), the issuing company, CDSL, the BO's broker and the Stock Exchange

Investors using depository services of the depository is known as the Beneficial Owner (BO), and they have to maintain a demat account to access the functions of the CDSL, including the facilities of dematerialization and transferring of securities. When the investor's purchases securities, they are automatically credited to the depository account, and when those securities are sold, they are automatically debited from the investor's depository account.

Benefits of holding demat securities in CDSL:

- As the share certificates are in an electronic format, the investor is safe from the risk of theft, loss or damage to the physical share certificates.
- The investor need not be skeptical about the genuineness of the securities purchased as the securities in the depository cannot be returned under objection for any reason, and it also eliminates the risk of bad delivery.
- The securities are immediately transferred to the investor's account as soon as the payment is transferred to the company's account. There is no need for the investor to wait for the registration process from the company or its Registrar.
- The stock exchanges follow the method of T+2 rolling settlement cycle, i.e. settlement of trades is done on the 2nd working day from the trade. This action is possible because dematerialized securities have paved the way for liquidity and swift transfer of securities.
- No stamp duty is applicable for investors when transferring securities in dematerialized format.
- Companies can directly credit their investors account in case of bonus issue or rights issue of shares.
- Any update or changes in the personal information or transmission of the BO can be directly updated with the CDSL. A single standing instruction to the CDSL would help the investor update their details with all companies in which they have a vested interest.
- The CDSL also sends the investor a statement that consolidates the position of all their holdings. This would enable investors to make informed decisions about their financial strategy.